Pecyn dogfennau cyhoeddus

Y Pwyllgor Cyllid

Lleoliad:
Ystafell Bwyllgora 2 – y Senedd

Dyddiad:
Dydd Mercher, 26 Mawrth 2014

Amser:
09.00

Cynulliad Cenedlaethol Cymru
National Assembly for Wales

I gael rhagor o wybodaeth, cysylltwch â:
Bethan Davies
Clerc y Pwyllgor
029 2089 8120
PwyllgorCyllid@cymru.gov.uk

Agenda

Cyfarfod preifat cyn y prif gyfarfod (09:00–09:30)

CYFARFOD CYHOEDDUS FFURFIOL (09:30)

1 Cyflwyniadau, ymddiheuriadau a dirprwyon (09:30)

2 Papurau i'w nodi (09:30) (Tudalennau 1 - 3)

Ymchwiliad i Cyllid Cymru: gwybodaeth ychwanegol gan Ffederasiwn y Busnesau Bach Cymru (Tudalennau 4 - 32)

3 Ymchwiliad i Cyllid Cymru: Sesiwn dystiolaeth 4 (09:35 - 11:00)

(Tudalennau 33 - 189)
FIN(4)-06-14 (papur 1)
FIN(4)-06-14 (papur 2)
FIN(4)-06-14 (papur 3)

Briff Ymchwil

Cyllid Cymru

Sian Lloyd Jones - Prif Weithredwr
Peter Wright - Cyfarwyddwr Buddsoddi Strategol
Ian Johnson - Cadeirydd Bwrdd Cyllid Cymru ccc
Chris Rowlands - Aelod o Fwrdd Cyllid Cymru a Chadeirydd y Pwyllgor Buddsoddi

4 Cynnig o dan Reol Sefydlog 17.42 i benderfynu gwahardd y cyhoedd o'r cyfarfod ar gyfer y canlynol: (11:00)

Eitemau 5 a 6

5 Ymchwiliad i Cyllid Cymru: Trafod y dystiolaeth (11:00-12:00)

6 Blaenraglen waith (12:00-12:30) (Tudalennau 190 - 191)

FIN(4)-06-14(papur 4)

Y Pwyllgor Cyllid

Lleoliad:	**Ystafell Bwyllgora 4 – Ty Hywel**
Dyddiad:	**Dydd Iau, 20 Mawrth 2014**
Amser:	**09.30 – 10.48**

Cynulliad Cenedlaethol Cymru
National Assembly for Wales

Gellir gwylio'r cyfarfod ar Senedd TV yn:
http://www.senedd.tv/archiveplayer.jsf?v=en_500000_20_03_2014&t=0&l=en

Cofnodion Cryno:

Aelodau'r Cynulliad:

Jocelyn Davies (Cadeirydd)
Peter Black
Christine Chapman
Paul Davies
Mike Hedges
Alun Ffred Jones
Ann Jones
Julie Morgan

Tystion:

Huw Vaughan Thomas, Archwilydd Cyffredinol Cymru, Swyddfa Archwilio Cymru
Isobel Garner, Wales Audit Officer
Ann Marie Harkin, Cyfarwyddwr Grŵp – Adnoddau, Swyddfa Archwilio Cymru
Terry Jones, Swyddfa Archwilio Cymru

Staff y Pwyllgor:

Bethan Davies (Clerc)
Meriel Singleton (Ail Clerc)
Claire Griffiths (Dirprwy Glerc)
Richard Bettley (Ymchwilydd)
Martin Jennings (Ymchwilydd)
Helen Jones (Ymchwilydd)

Joanest Jackson (Cynghorydd Cyfreithiol)

TRAWSGRIFIAD
Trawsgrifiad o’r cyfarfod.

1 Cyflwyniad, ymddiheuriadau, a dirprwyon
1.1 Croesawodd y Cadeirydd yr Aelodau i’r Pwyllgor

2 Papurau i’w nodi
2.1 Nodwyd y papurau

3 Swyddfa Archwilio Cymru – ystyried rhestr ffioedd 2014/15
3.1 Trafododd y Pwyllgor gynllun Swyddfa Archwilio Cymru i godi ffioedd ac fe’i cymeradwywyd ar yr amod bod rhai newidiadau technegol ar ôl 1 Ebrill 2014, pan ddaw’r Bwrdd i rym yn gyfreithiol.

3.2 Gofynnodd y Pwyllgor i Swyddfa Archwilio Cymru gyflwyno sesiwn i’r Pwyllgor i esbonio’i chyfrifon, ei hamcangyfrifon a’i chyfraddau.

4 Cyfarfodydd preifat – y Pwyllgor Cyllid
4.1 Derbyniwyd y cynnig.

5 Swyddfa Archwilio Cymru – Memorandwm Dealltwriaeth ar gyfer Swyddog Cyfrifyddu
5.1 Cytunwyd ar y Memorandwm Dealltwriaeth drafft a nododd y Pwyllgor y caiff ei gyhoeddi ar 1 Ebrill.

5.2 Cytunodd y Pwyllgor y dylai Archwilydd Cyffredinol Cymru weld copi drafft cyn y caiff ei ddefnyddio.

6 Ymchwiliad i arfer da o ran y gyllideb: ystyried y cylch gorchwyl
6.1 Trafododd yr Aelodau’r cylch gorchwyl arfaethedig gan gytuno y byddai’n well ganddynt gynnal yr ymchwiliad mewn dwy ran. Derbyniwyd y cylch gorchwyl a’r dull o gasglu tystiolaeth a bydd y Pwyllgor yn ystyried cyngor y cynghorydd arbenigol mewn cyfarfod arall.

7 Cyllido Addysg Uwch: ystyried y prif faterion

7.1 Trafododd y Pwyllgor y prif faterion. Bydd y clercod yn paratoi adroddiad drafft i'w drafod ar ôl toriad y Pasg.

Federation of Small Businesses
The UK's Leading Business Organisation

ALT+ Finance

Small firms and access to finance

Contents

ALT+ Foreword

Banks and small business loans are never far from the news. The Federation of Small Businesses (FSB) has been actively representing its membership to make sure viable small businesses can get access to the credit they need to invest, grow and create jobs.

Recent public policy changes and agreements have shown that Government does have an appetite for reforming the banking structure and to help consumers, mortgage seekers and small businesses. The Vickers' report, and the full acceptance by the Chancellor, showed that reform is important to protect the tax payer and help small businesses. The Project Merlin targets were less successful and from the start, the FSB stated that a target simply puts off the real discussion for 12 months.

The momentum however must not stop now. To bring true stability to the financial system, we need not just more competition between the high street banks but also viable channels and modes of non-bank finance providers. The FSB does not intend to 'bank bash' or go down the road of calling for all banks to be broken up, but we do need a discussion about Alt+ Finance.

Alt+ Finance shows how the Government can look at good policy measures in the US and a number of European countries that have installed principles in certain financial institutions, which take into consideration the social aspects as well as the commercial.

The FSB does not ask those systemically important banks (or even just the state funded banks), disregard profits, are broken up or forget about commercial activities. We do however ask why these countries small firms did not suffer to the same extent as their counterparts in the UK. When we start looking at these nations, key themes start to resonate: *transparency, diversity, and local rather than central*.

Moving away from traditional banks, we have also looked at what options there are for the Government in terms of realistic alternative finance providers. These are not blue-sky-thinking operations but realistic methods, which are lending to small businesses now, and which the Government should look at when finalising how credit easing will work.

Once again, the FSB suggests themes that the Treasury should look at: *scaling-up working models, looking at example from other nations and utilising public policy to foster non-bank channels*.

With this publication and the work of Tim Breedon at BIS through the non-bank finance taskforce, we hope that Government will come forward with creative and realistic options that will give small businesses the confidence to explore alternative routes of credit, but also the confidence to the non-bank providers to start investing and promoting themselves to a far larger extent with small businesses

As always, the FSB is here to represent members and the wider small business community, and are ready to help the Government where positive change is the objective.
I would also like to thank the New Economic Foundation (**nef**) for their valuable input and thoughts, which have contributed to the overall outcome and recommendations in this report.

Mike Cherry
FSB Policy Chairman

Executive Summary

This report has been born by the FSB's longstanding interest in finance, and the ability of our members and other small businesses to access finance on reasonable terms. With our shared interest in this area, this report has benefitted from the considerations and input from **nef** – the New Economics Foundation.

As has been well documented, since the credit crunch of 2008 small businesses have faced considerable challenges accessing finance through traditional high street banking routes. This raised questions about the structure of the UK banking sector, and the systemic risks it poses to the UK economy. It also highlighted that many small businesses felt that the relationship with the banks had been broken.

Many of these issues have been addressed by the Independent Commission on Banking's (ICB) report which put forward a range of recommendations that the FSB fully supported, especially the specific recommendations to increase competition among UK high street banks. While welcome, the FSB believes there is still a case for a more fundamental re-evaluation of the UK banking model, to see whether it really supports small businesses and their finance requirements both in times of economic growth and, perhaps more importantly, during economic contraction. The fact that the UK taxpayer owns a significant proportion of two high street banks may provide this opportunity.

The report therefore looks beyond the current banking structure, and examines alternative ways that small businesses might access finance from non-bank sources and ways to stimulate that market.

Lessons from Germany and the US

The report examines the contrasting banking models of the US and Germany, to see what lessons could be drawn. Though they take contrasting approaches, and there are difficulties in taking their experience and transplanting it wholesale into the UK context, it is striking how successful these countries have been in maintaining credit flow to small businesses.

"The report therefore looks beyond the current banking structure, and examines alternative ways that small businesses might access finance from non-bank sources and ways to stimulate that market"

For example, between 2007 and 2010, there was a 24 per cent fall in the number of successful loan applications made by small and medium-sized enterprises (SMEs) in the UK, compared to a nine per cent fall in Germany over the same time period.[1] Similarly, in the US, the Small Business Administration (SBA) increased its small business loans in 2010.

Signs such as these suggest other countries have a banking model far more effective in distributing credit to small firms than the UK. Some themes emerge in the report that explain why that might be the case, including:

- **The effects of competition.** As was recognised by the ICB report, the UK banking market is highly concentrated with high barriers to entry. In contrast, entry into the US retail banking sector is relatively straightforward, thereby increasing competition. Similarly, the more regulated German model has a much lower level of market concentration.

- **The benefits of a local banking network.** In both the US and especially Germany, where the Sparkassen market is geographically defined, banks have a strong local focus. Banks' performance is often linked directly to their local economy.

- **Transparency.** In the US, financial institutions are obliged to reveal the amount of money they keep in their local areas under the terms of the Community Reinvestment Act. Similarly, the boardroom structure of the German banks with stakeholder representation achieves similar results.

- **Investment approach.** In Germany, the dual focus of regional banks on both their financial position and their wider social role has meant lower rates of return on capital but delivered greater stability and long-term support for small businesses – attributes small firms value highly.

- **An active state role.** In the US, the SBA has used the wide network of local financial institutions to distribute quickly SBA loan programmes for small businesses as part of its recovery strategy. Similarly, the German Sparkassen has played a critical role in keeping credit flowing to small firms through the credit crisis.

- **A small business administration.** Alongside its banking structure, an important further element in the US model is the role of its SBA to develop and tailor Government backed loan products for small firms, and to orchestrate their distribution through the banking network.

Non-bank finance

This report shows that there is a suite of non-bank finance alternatives available to small businesses. Currently these provide a small level of finance for small businesses in the UK, but none yet have the scale to challenge seriously traditional banking sources of finance. Many are innovative, reflecting the wealth of financial expertise which the UK has in abundance. Given this position of strength, these alternatives should be expected to flourish as the financial services industry spots new opportunities. Alternative sources of finance examined by the report covers:

- Community development finance institutions
- Business-to-business credit
- Peer-to-peer lending
- Business angels and small business private equity
- Asset finance and leasing
- SME debt bonds

The FSB would like to see what additional measures can be made by the Government to increase the scale of non-banking channels. Combined with the ICB's reforms, these channels could provide additional competition to the banking sector once they have achieved sufficient scale. These models should also help introduce a dynamic element into the sector, as new entrants bring their innovative 'disruptive' business models into the market, giving greater choice and flexibility for the small business sector.

The report comes forward with a number of recommendations to boost these non-bank means of accessing finance, some of which require finance, others changes to regulation. It asks the Government to look closely at these and to bring forward clear and tangible measures to increase the presence of these models in the small business lending market place.

Recommendations

Banking

- Once the banks are on a firm financial footing, the Government should consider ways to develop a more local banking structure, building on and using the existing framework of the taxpayer-owned banks. The benefit of a local banking structure, with decision makers close to their customers, is a key strength of both the US and German banking models.

- The Government should also consider how it might help create ‘plain vanilla’ financial institutions not beholden to their shareholders and returns on capital but with a wider set of public obligations. Again, the German Sparkassen is a model that could be considered. Similar objectives could be reflected in the terms of a UK banking licence.

- In the short-term, the Government should introduce a UK Community Reinvestment Act to increase transparency in the sector, and help direct credit to where it is needed most. Consumers and businesses can then see the extent to which their banks are using deposits to serve the needs of local markets.

- A bolder step would be to consider the creation of the UK’s own Small Business Administration, similar to that of the United States. A UK institution would then be charged with developing loan products suited to the needs of small firms, and provide a distribution mechanism to help get finance to small businesses

Non-Bank Access To Finance

Community Development Finance Institutions (CDFIs)

- Responsibility for CDFIs is currently somewhat unclear and fragmented, with different government departments (BIS, DWP, OCS) responsible for different aspects. The Government should identify one department which co-ordinates community development finance. The FSB and the industry body, the Community Development Finance Association (CFDA), suggest it should be HM Treasury.

- CDFIs need to be brought into the mainstream. Currently there is an ad hoc referral scheme from local banks. If CDFIs are to grow and expand, a formal referral route, as outlined in the Project Merlin agreement, should be implemented.

- The Government should look to the US experience, and see how best to use public resources to help these institutions expand and lower the cost of capital for those starting-up and operating businesses in less advantaged areas.

- Further, the FSB recommends the Government to review and consult on a Community Reinvestment Act in the UK to see how that might support the development of the UK CDFI community.

- When affordable, well targeted tax incentives could help boost the sector. The FSB is pleased that the Government is looking at the Community Investments Tax Relief and hopes any reforms will go some way to change the behaviour of investors.

Peer-to-peer lending

- The Government and regulators must show the future importance of this funding model by fully engaging the p2p Finance Association along with the key players in this market. This should start by bringing these players into a fully recognised

“This report shows that there is a suite of non-bank finance alternatives available to small businesses”

regulatory environment that would help them attract a greater number of institutional investors to meet the demand from small businesses.

- Once within the regulatory environment, the Government should create investor accounts in the peer-to-peer firms that lend to small businesses and use this as an alternative route to the banks under the credit easing umbrella. This type of intervention would fit into the ICB recommendation of increasing competition within the SME credit market and also help increase the scale of this model.

Business Angels and small business private equity

- The FSB recommends that greater research is carried out into business angels as data is hard to compile, mainly due to the varied network of business angel networks and ad-hoc providers. Without such research, policy shifts will be hard to define.

- The new Seed Enterprise Investment Scheme is a beneficial move and the one year capital gains holiday should be made permanent if it proves successful at increasing deals, and the re-investment of profits in new deals which benefit small businesses.

- It is also important that businesses that have the potential to access and benefit from this type of finance should be targeted in terms of advice. This can be done through more work being done by provider networks, business groups and the Government. It is important that the benefits are shown, as well as the pre-application work (becoming 'investment ready') and the funding profile needed over a period of time.

Asset Backed Finance

- Asset backed finance needs a greater market penetration and awareness amongst businesses. The Government should look at bringing this finance route into the £1 billion Business Finance Partnership and other Government lending schemes (such as the Enterprise Finance Guarantee).

- More sensitivity is needed when changing the tax system. Changes to the capital allowance rate have had an adverse impact on investors, as has regular changes to the tax system. When relevant changes to the tax system take place, impact assessments should reflect this sensitivity.

SME Debt Bonds

- To evaluate the viability of an SME bond market, the Government should put in place a pilot scheme to see the demand and supply from small businesses and investors for an SME bond and its operational viability. This could be done quickly using existing FSA licensed Recognised Investment Exchanges (RIE).

- The Treasury should use credit easing to enhance the credit rating worthiness of singular debt bonds or of bundles of bonds issued by small firms.

- If the pilot is successful and the relationship between credit easing and the RIE works on a basis of full transparency, the same offering by the Government should be extended to the entire RIE network in the UK.

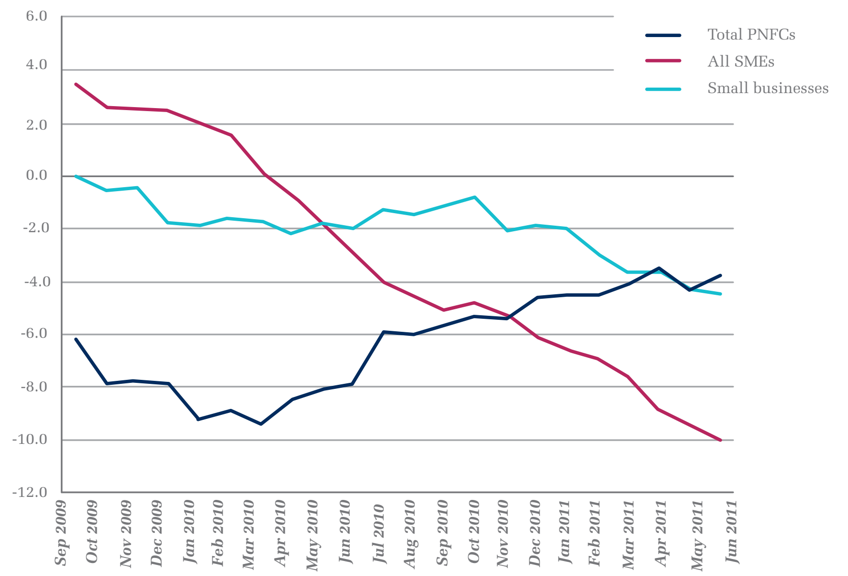
Business to business mutual credit schemes

- Though it has been in operation for some time, the Swiss invoice factoring model is little known in the UK. Nonetheless, the evidence shows it can offer benefits for small businesses. The Government should therefore examine what, if any, barriers there are to this form of finance in the UK and to consider if there is an opportunity for large institutions to support their foundation.

1. Introduction

The bank route of finance is the pre-eminent source of formal finance for small businesses in the UK. As is well-documented, following the banking crisis of 2008 credit conditions worsened for the small business community as wholesale banking markets seized up (Figure 1). But even before the crisis, concerns about the concentration of the UK retail banking sector and its effect on competition had been raised. Small firms had begun to raise concerns about their relationship with their high street banks, and the extent to which decisions were being made at the local level. The crisis emphasised some of the weaknesses of the model which the ICB has begun to address, setting out a wide-ranging series of reforms endorsed by the Government and warmly welcomed by the FSB.

Figure 1: Lending to UK SMEs by banks



PNFC – private non financial companies

Bank of England April 2011[2]

Though welcome, the ICB's reforms will bring benefits in the longer term and are necessarily focussed on the banks. Small firms face more immediate challenges accessing finance and continue to face challenges obtaining finance from banks on reasonable terms, with interest spreads over larger firms' loans increasing.[3] As a consequence, many small firms have missed their growth opportunity or, in the worst cases, been forced to close as lines of credit have dried up or new unfavourable terms been offered.

Current finance sources for small businesses

The 2011 FSB 'Voice of Small Business' Member Survey (of more than 11,000 FSB members) shows that bank overdrafts and loans

Figure 2: FSB 2011 Member Survey (multiple choices for major source of finance)

Q23a Which of the following sources, if any, have you used to finance your main business in the past 12 months? Base 11,367

still dominate the external finance portfolios of many small firms (Figure 2). Even when the totals are split by micro businesses (below 10 staff) and small businesses (above 10 and below 249), banks still dominate.

The split between micro and small is shown by the amount of businesses using factoring or other invoice products. Many of these are bought through the banks and can be labelled generically as 'accounts receivable finance' but are different to loans and overdrafts as they free up cash-flow and depend on the invoices a firm generates or are secured on them. The larger the business, the more likely it is to use account receivable products: 2.1 per cent of micro firms use these products against 7.2 per cent of small businesses.

Often there is a risk associated with Factoring or Invoice Discounting as they are not suitable for the majority of businesses being most appropriate for those with high growth. There are usually additional fees and charges associated with this form of financing.

Table 1: ONS credit success data (source: ONS 2011)[4]

Source	2007	2010	Change
Leasing	99.8	92.7	-7.0
Factoring	98.3	86.9	-11.4
Bank overdraft or credit line	94.3	83.0	-11.3
UK government subsidies	94.0	92.0	-2.0
Trade credits	87.9	86.5	-1.4
Advance payments	79.7	88.1	8.4
International trade facilities	100.0	99.4	-0.6
Mezzanine financing	24.1	79.3	55.2
Other finance sources	97.9	93.2	-4.7

Data from the Office for National Statistics (ONS), comparing data from 2007 and 2010, shows the application success rates of different finance products. Table 1 shows that only two forms of finance – advance payments and mezzanine financing – increased the success rates of applications over that period. All other forms of finance, including bank finance, saw a decrease the rate of successful applications, even though separate ONS data shows that applications as a bulk number increased.

The period between 2007 and 2012 was defined by the financial crisis, the prolonged technical recession and then subsequent flat growth patterns, which may have played a role in decreasing the generic credit rating of all businesses, and especially those in cash disposable sectors. However, this generic approach misses businesses that are innovative and creative and which might have had strong business plans. It also disregards local economic patterns.

To address these issues around access to credit and the terms on which is it offered, the FSB has been at the forefront of calling for reforms to the banking sector and promoting ways to create a more competitive, pluralistic credit market for small firms other than through the traditional banking system. Our approach has been based around three core principles:

1. **Increasing competition:** In keeping with the ICB report's recommendations, Government intervention should encourage competition in the market and

Box 1: Types of finance

Trade, factoring and leasing	The use of unpaid invoices to free up cash, selling commercial unresolved debt, pre-payment and use of supply chain or rental of assets from a provider in return of repayments and interest, and the possibility of purchase at closure of lease contract
Private equity	Investors or funds that purchase segments of businesses in return for equity within the business
Periphery finance	Peer-to-peer finance, crowd funding, personal (including family and friends)
Micro finance	Friend and family finance, saved personal finance, redundancy finance, etc.

aim to address the market dominance of a few large players. As this paper sets out, policy should also aim to stimulate the non-bank methods of accessing credit and thereby increase competition in this market segment via those channels. One risk of current credit easing proposals is that for the sake of speed of implementation, it unavoidably uses these banking channels thereby reinforcing the existing market structure.

2. **Increasing access to credit for start-ups and the smallest companies:** To encourage business start-ups and to ensure young, small companies have every chance of thriving, a key objective should be to improve the supply and price of credit to the lower end of the market, where start-up firms have had particular problems raising finance through traditional retail banking routes.

3. **Community development:** Where possible, Government intervention should aim to improve access to credit in areas of the economy such as rural areas, areas that have experienced industrial decline, and inner city areas.

This paper aims to build on the FSB's three principles. Chapter two first looks at the options to reform the banking sector, notably lessons that can be learnt from a regional retail banking system that is focused on nurturing the wellbeing of their local economies rather than shareholder returns. By moving to a more local level, this restructuring will go some way to reconnecting banks to the communities they operate in.[5] In that light, the chapter highlights the positive effect the Community Reinvestment Act (CRA) has had on banking institutions in the US in increasing access to finance for previously harder to reach sectors of the economy, and suggests the Government looks at enacting something similar in the UK.

Chapter three then goes on to look at a range of alternative non-banking routes plus periphery channels and products that already exist on the market. Currently these represent a small share of the market, but if the right conditions are in place, have the potential to offer other routes for small firms to access finance and start to put competitive pressure on retail banks in that market segment.

Small businesses have different approaches to identifying and categorising finance types and need requirements. Within this paper, the FSB will use four non-bank categories of finance (Box 1).

Many of these finance types can be subdivided into additional products and the size of businesses or scale of finance needed. The key difference that will inform borrowers is what the finance is needed for. For example, does the business owner need finance for short-term purposes and cash-flow flexibility or is it for mid to long-term needs? Questions will help point the potential borrower to different types of alternative finance products and providers.

Chapter four concludes by setting out areas for reform and policy actions for the Government to take forward, based on the evidence, and looks at good practice from other nations.

2. Banking

The ICB's final report made good recommendations on the future of retail banking and the structure of those organisations that provide finance to small businesses. The majority of the organisations that provide small business banking in the UK are systemically important banks and as such, the FSB welcomed the ICB's loose ring-fence proposal along with the recommendations on increasing competition.

The FSB was therefore fully supportive of the Chancellor, who accepted the ICB final recommentations in full. The reforms should remove the systemic risks posed by the UK banking sector. On the specific area of improving competition in the sector, the FSB strongly supported the following recommendations:

- Encouraging a **'challenger bank'** to enter the market and increase competition.
- Easier **switching accounts between banks**, with a free seven-day switching service – with automatic transfers or direct debits and lasting 13 months – which should encourage competition.
- The creation of a **Financial Conduct Authority (FCA)**, with a key role in promoting effective competition in financial services markets. The FSB welcomed this proposal, which should mean that at the highest levels within the Bank of England, competition will be a key policy driver and lever, instead of ad-hoc reviews and papers. The FCA should start by looking at a regional level, and then product ranges.

Though these reforms are welcomed, and should be implemented as soon as is feasible, the FSB believes they are predicated on the status quo of a high street banking system dominated by a few large players. It is unlikely that the new challenger bank will operate a significantly different business model, thereby forcing a change in the incumbent banks. In themselves, these reforms do not address underlying concerns that high street banks have become increasingly detached from the communities they serve, and whether alternative models could better serve those needs.

The following analysis looks at other banking models from Europe and the US, which provide some useful insights into how – if policy makers are bold enough – the UK banking sector could be reformed.

International experience

While the FSB has welcomed the Government's resolve to tackle structural weaknesses in the banking sector, and to remove the systemic risks it poses to the UK economy, it believes that lessons can be learnt from other banking models and potentially be applied in the context of the UK, to improve credit flows to small businesses.

The following analysis will look in detail at alternative banking models used in other developed countries, drawing on evidence from the US and Germany and also Swiss community banks. These can provide some insights into how the UK banking system might be remodelled so it is more responsive to the needs of small firms and the communities in which they operate.

Competition

To put the competition issue that the ICB grappled with in some perspective, and in sharp contrast to the UK's banking landscape where five banks dominate the sector, there are more than 15,000 financial institutions competing in the US market – around 7,700 banks and 7,600 Credit Unions. Barriers to entry into the sector are relatively low – banks can be set up using off-the-shelf packages – and there is good evidence that the high level of competition in the US market has stimulated lending. The majority of banks are independent, locally owned and operated institutions with assets ranging from less than $10 million to multi-billion dollar institutions.

Another model with a distinctly local aspect is the German Sparkassen network comprising 431 locally controlled banks with public interest criteria in their governing constitutions.[6] In the UK, more than 80 per cent of mortgages are in the hands of the top five banks, as is more than 90 per cent of SME accounts. In comparison, 70 per cent of the German banking sector is in small or community banks (Sparkassen), serving a tightly defined geographic market. Similarly, in Switzerland there are 24 Cantonal banks which explicitly recognise both social and economic responsibility towards their customers, employees and sponsoring cantons.

Germany

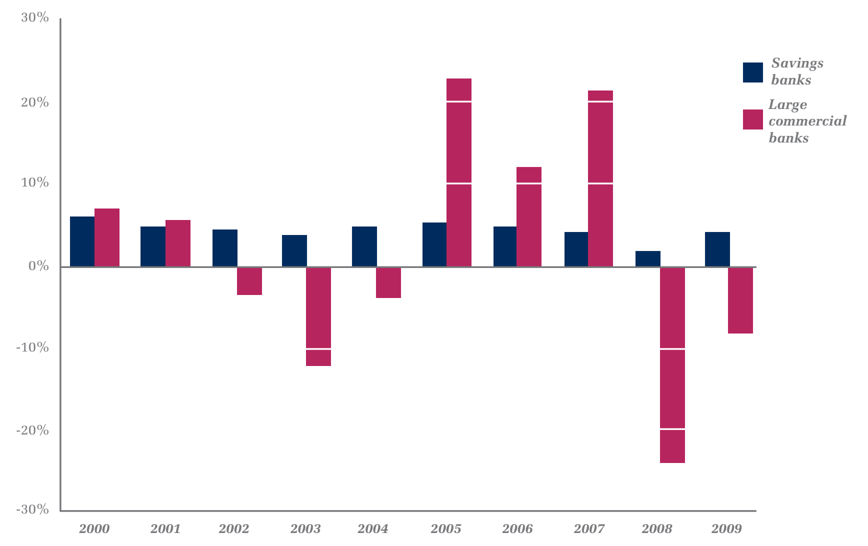
In Germany, Sparkassen, are regulated by a set of federal and regional government rules around local and regional banks that obliges them to invest primarily in local businesses. They answer the issue of scale economies and accessing finance at a competitive rate by acting as a group, providing mutual insurance and pooling certain financial services, such as leasing and factoring. Their combined balance sheet is over €1 trillion, and they have more than 15,600 branches and 248,000 employees.

A 'dual' bottom line orientation means they give regard to their financial position and their public legal obligations, and they do not invest in high-risk investment activities or proprietary trading: the emphasis is on 'plain vanilla' banking, offering a simple range of savings and loan products.

The tight geographical role of the Sparkassen is critical to the German model as most lending to German SMEs comes from these sources. Devolved decision making coupled with a high degree of autonomy allows the branches the freedom to use their expert local knowledge to make their lending decisions.

While in the past Sparkassen have been criticised for the low rates of returns on investments, this turned out to be its strength when economic conditions declined. Both German and Swiss local banks remained profitable and continued lending throughout the financial crisis, while large banks made losses and contracted lending. Figures 4, 5 and 6 provide evidence of the benefits of this kind of bank and from the graphs we show the return on capital and credit provision in German and Swiss banks over the period of the banking crisis.[7] They reflect the over-riding feature of the Sparkassen: that they are a prudently managed public interest institution, offering a range of 'plain vanilla' financial products with explicit social as well as economic objectives.

Figure 3: German Banks – Return on Capital: Profit after tax as a percentage of the average capital shown on the balance sheet



Tudalen 15

Figure 4: German Banks – Credit Provision: Change in annual lending compared with the year to June 2008

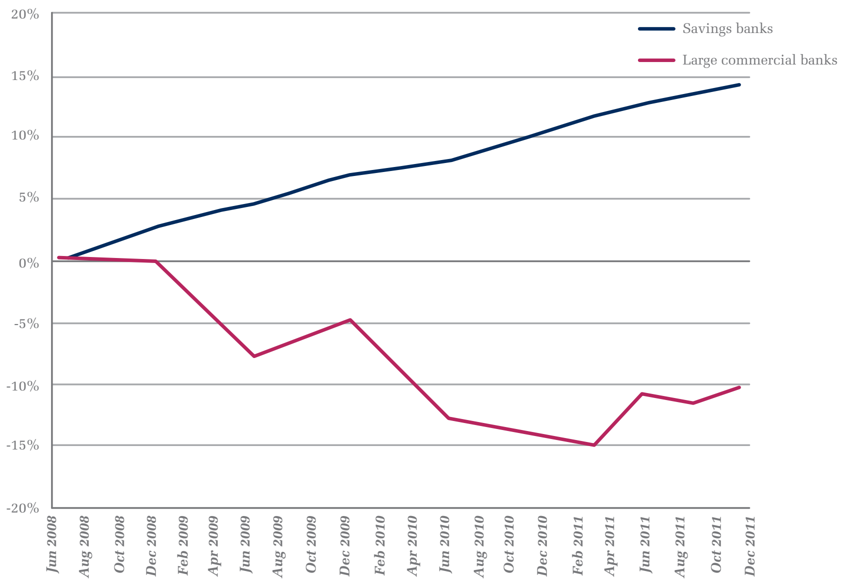
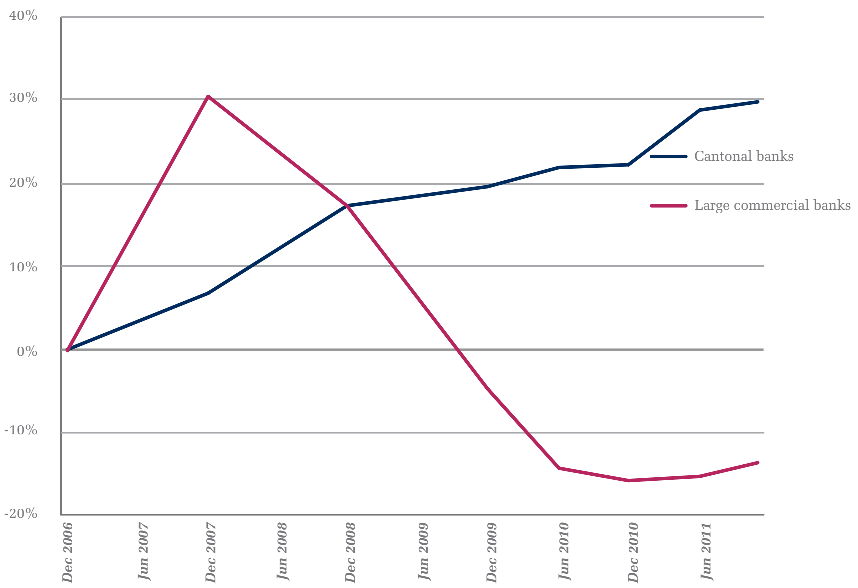


Figure 5: Swiss Banks – Credit Provision



Source: **nef** graphs based on Civitas report "German savings banks and Swiss cantonal banks, lessons for the UK" by Stephen L. Clarke, 2010

In both these examples, there is a stable line throughout the period that is represented by small banks. In contrast, the large international commercial banks such as Deutsche Bank and Credit Suisse demonstrate volatile returns on capital, and rapid credit expansion followed by equally rapid credit withdrawal from the economy. The key point about these graphs is that the performance of the large international German and Swiss banks are analogous to the performance of the UK's big banks, and is largely driven by the search for high returns, achieved in part through wholesale banking activities and the attendant risks that involves but also their approach to lending to business.

Crucially, the UK entirely lacks a sector can that produce the stable lines of steady but moderate profitability, and careful and gradual credit expansion provided by these local banking sectors. It is this feature of the German banking model that is attractive. By eschewing riskier forms of investment, the investment decisions and overall business mission of these local banks has sheltered small businesses (and individuals) from the worst effects of the global financial storms.

A further key feature is that the Sparkassen are resolutely focussed on serving the local area; lending decisions are made at the local level. The branch manager has the authority to back his or her judgement – the absence of which is a common complaint of small businesses in the UK. By being linked to the fortunes of the local economy it provides a clear incentive to back and nurture new business ventures and stay with customers for the long-term, even if times are tough. If the local economy prospers, so does the bank, and the local economy's strength is reflected in the wide range of sizes of banks from the Hamburger Sparkasse with total assets of nearly €38 billion and 5,500 employees in 2009 to the smallest one, Stadtsparkasse Bad Sachsa, with around €130 million of assets and 45 employees.

It is true that the German banking system is not without its problems. The seven regional banks, or Landesbanken, did get into trouble during the last decade after the European Commission forced the withdrawal of state guarantees from the sector in 2005. Chasing increased short-term profit to offset this withdrawal, some invested heavily in structured credit products (ironically originating from the US) which went toxic in 2008. It would also be surprising if the prudent Sparkassen were to escape completely unscathed from the global economic situation faced by its personal and business customers. However, they still represent a stability and usefulness to the real economy that is almost entirely lacking in the UK.

The United States of America

The US provides a contrasting model which nonetheless offers some further insights into how the UK banking market could be reformed. An overview of the sector once again makes the contrast clear with the highly concentrated UK market:

- Nearly half the deposits in the USA are lodged in small banks, which control approximately $1.4 trillion assets.
- The 6,700 local banks have loans worth $257 billion invested in small businesses and farms.
- The four biggest US banks have $5.4 trillion in assets (40% of the US total) but only $85 billion in small business loans[8] – evidence which suggests that big banks are not as well adapted to meeting the needs of the small business sector.

These assets are likely to grow given the way that small banks are rising up the political agenda at state level. New Mexico passed legislation in 2010 requiring the state to shift public assets into banks based in the state, in order to make that money available for lending to local businesses. Similar proposals have emerged in places like Oregon and Los Angeles.[9]

The reason for this political interest is that it is increasingly clear that smaller banks are more effective at creating jobs. They are also a vital conduit through which the SBA distributes its various Government backed loan products that have played an important role in ensuring small firms have been able to access to finance and play their part in restoring economic growth (see Box 2).

Transparency and the Community Reinvestment Act

A key feature of the US banking market is transparency and the disclosure of how much money stays in a local bank, and how much leaves to be deployed elsewhere in

Box 2: The SBA and access to finance

The network of local banks provides a conduit for the American (SBA) to administer its loans. The SBA guarantees against default, certain portions of business loans made by banks and other lenders that conform to its guidelines. Credit facilities are made on more generous terms than those normally offered by banks, meaning some businesses are able to borrow more than they otherwise would. Financial institutions do however need to act prudently: loans are not generally available for firms with bad credit history.

Accredited financial intermediaries (and not just banks) help dispense the two main forms of Government-backed finance. There is a further element for micro loans, generally valued between $35,000 and $50,000.

The 7(a) Loan Guarantee Program helps businesses to start up or expand their businesses, and is made available through bank and non-bank lending institutions.

The 504 Fixed Asset Financing Program is administered through non-profit Certified Development Companies throughout the country. This program provides funding for the purchase or construction of real estate and/or the purchase of business equipment/machinery. Of the total project costs, a lender must provide 50 per cent of the financing. A Certified Development Company provides up to 40 per cent of the financing through a 100 per cent SBA-guaranteed debenture, and the applicant provides approximately 10 per cent of the financing.

Box 3: How the CRA works

The CRA monitors the level of lending, investments, and services in low and moderate income communities excluded or under-served by the mainstream financial sector. The legislation requires regular examination and grading of a lending institution's activities in poorer communities. It has penalty mechanisms in place, including barring merger activity if a lender is neglecting its community by extracting deposits without reinvesting through loans and branch presence.

Evidence suggests that the CRA has driven the growth of CDFIs in the US, and that a vibrant CDFI sector can effectively complete the jigsaw of private sector finance in areas where both small businesses and individuals are underserved.

Arguments that the CRA helped to cause the sub-prime crisis in the US are refuted by evidence which in fact enhances the case for the CRA, revealing it as part of the solution to responsible and sustainable lending practices rather than part of the problem.

By entrenching principles of transparency and fairness in the banking system and tackling financial exclusion for individuals and small enterprises, the CRA can thereby ensure fuller participation in economic life and enhanced opportunities for disadvantaged communities and so simultaneously promote social justice and economic efficiency.

the banking group. Though this transparency is achieved by different means in Germany, the results are the same: customers have a clear idea how their money is being used by the financial institution. Box 3 examines evidence from the US about the impact of disclosure by looking at the impact of the Community Reinvestment Act (CRA).

In the UK, it is not possible to assess the performance of the UK banking sector in serving geographical markets, or the different types of customer within those markets, though some banks have taken the laudable step of publishing some useful data, such as Barclays in its *Corporate and Social Responsibility Report*, but in general the information is not available.

If a customer in Newcastle were to ask the question, *"In which bank can I put my savings and be sure that they will most benefit my local economy?"* it would be impossible to find the answer.

This is unsatisfactory for two reasons. First, one of the core principles of an efficient and effective free market is transparency and information. This puts power in the hands of the customer (and indeed the voter). Second, the retail banking sector is unique in its importance to the health of local economies. It can act as a siphon, draining capital out of already marginalised communities, or it can act as a pump primer, invigorating a local economy with investment and basic financial infrastructure. If we can see which is happening then there is a possibility of change for the better.

State banks

There has also been increasing interest in the idea of state banks, like the Bank of North Dakota.[10] The Bank of North Dakota was set up in 1919 – the same year that Neville Chamberlain launched the Birmingham Municipal Savings Bank along similar lines – in response to a wave of farm foreclosures at the hands of out-of-state Wall Street banks. It is profit making, and has contributed over $300 million in dividends to the state's finances over the past decade. The main role of the bank is to partner with local banks to provide the loan finance for small business lending on specific deals.

Its lending portfolio of $2.8 billion is mainly these participation loans, which allow local banks to make more loans. That is why North Dakota has 35 per cent more local banks than South Dakota and four times the US average.[11] There have been no local bank failures since 2008 in North Dakota, and no bank in the state has more than 10 per cent of local deposits – the existence of a powerful 'partnership bank' has succeeded in underpinning a diverse banking system.[12]

Other states are planning similar institutions. Oregon, Washington and Massachusetts introduced bills in their state legislatures in January 2012 to launch their own state banks. Maryland has followed suit since. Illinois, Hawaii and Virginia are already looking into the idea. Virginia has gone even further, giving itself the power to issue its own currency in the event that the Federal Reserve defaults.

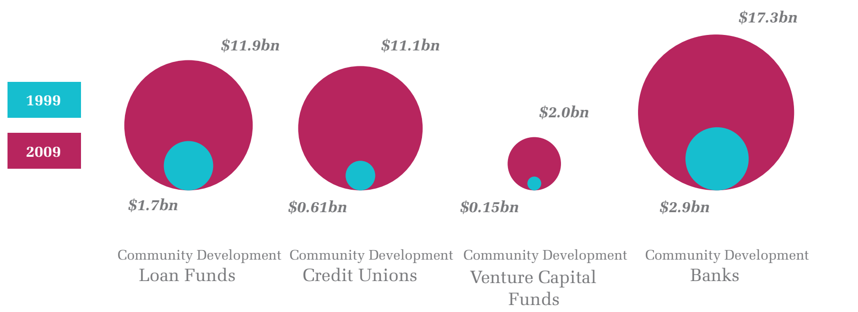
Community Development Finance Institutions

The Community Development Finance Institutions (CDFI) sector in the US has $30 billion in assets, serving low-income communities, both inner city and rural, with a specific remit for serving people who are financially excluded. The sector includes mainly community development banks and credit unions, which are involved with both lending and investing. There are also some community development loan funds, which finance small businesses, housing and community service organisations, operating usually on a not-for-profit basis, as well as community development venture funds.

The growth of the sector is again linked to the CRA, which laid duties on all financial institutions to lend in neighborhoods where they were prepared to accept deposits. After 1995, the resources to CDFIs were boosted because investment in CDFIs qualified as community reinvestment under amendments to the law.

The various structures for community investment in the US help to leverage private investment of many multiples of the injections of federal money thereby effectively ‘filling in the gaps’ of solely private provision. (US CDFIs also demonstrated lower default rates on loans to sub-prime borrowers than larger banks, indicating more responsible lending practices).[13] Further boosts have been given

Figure 6: Growth in US Community Finance Assets (1999-2009)



Source: US SIF - The Forum for Sustainable and Responsible Investment, 2010 Trends Report

to the sector since 1995. A major injection of $100 million came from the Federal Government into the CDFI fund in 2009. Designed for lending on, the evidence suggests that this had been achieved within 90 days. This year, a further $300 million will go into the sector from the fund to support small businesses.

The US community finance sector is 10 to 15 years ahead of the development of similar institutions in the UK, and the expansion in the US over the past decade gives some indication of the potential here if the right policies and investment structure are put in place in the UK (Figure 6). This is examined further in Chapter three.

What can we learn?

Though they take contrasting approaches, and there are difficulties in taking their experience and transplanting it wholesale into the UK context, both the US and Germany have been successful in maintaining credit flow to small businesses. For example, between 2007 and 2010, there was a 24 per cent fall in the number of successful loan applications made by SMEs in the UK compared to a nine per cent fall in Germany over the same time period.[14] Similarly, in the US, the SBA raised its small business loans in 2010. Signs such as these suggest other countries have a model more effective in distributing credit to small firms than the UK.

Some themes emerge in the report, which explain why that might be the case, including:

- **The effects of competition**. As recognised by the ICB report, the UK banking market is highly concentrated with high barriers to entry. In contrast, entry into the US retail banking sector is relatively straightforward, thereby increasing competition. Similarly, the more regulated German model has a much lower level of market concentration.

- **The benefits of a local banking network**. In both the US and especially Germany, where the Sparkassen market is geographically defined, banks have a strong local focus. Banks’ performance is often linked directly to their local economy.

Box 4: Recommendations for further banking reform

- Once the banks are on a firm financial footing, the Government should consider ways to develop a more local banking structure, building on and using the existing framework of the taxpayer-owned banks. The benefit of a local banking structure, with decision makers close to their customers, is a key strength of both the US and German banking models.

- The Government should also consider how it might help create 'plain vanilla' financial institutions not beholden to their shareholders and returns on capital but with a wider set of public obligations. Again, the German Sparkassen is a model that could be considered. Similar objectives could be reflected in the terms of a UK banking licence.

- In the short-term, the Government should introduce a UK Community Reinvestment Act to increase transparency in the sector, and help direct credit to where it is needed most. Consumers and businesses can then see the extent to which their banks are using deposits to serve the needs of local markets.

- A bolder step would be to consider the creation of the UK's own Small Business Administration, similar to that of the United States. A UK institution would then be charged with developing loan products suited to the needs of small businesses, and provide a distribution mechanism to help get finance to small businesses.

- **Transparency**. In the US, financial institutions are obliged to reveal the amount of money they keep in their local areas under the terms of the Community. Reinvestment Act. Similarly, the boardroom structure of the German banks with stakeholder representation achieves similar results.

- **Investment approach.** In Germany, the dual focus of regional banks on both their financial position and their wider social role has meant lower rates of return on capital but delivered greater stability and long-term support for small businesses – attributes small firms value highly.

- **An active state role.** In the US, the SBA has used the wide network of local financial institutions to distribute quickly SBA loan programmes for small businesses as part of its recovery strategy. Similarly, the German Sparkassen has played a critical role in keeping credit flowing to small firms through the credit crisis.

- **A small business administration.** Alongside its banking structure, an important further element in the US model is the role of its SBA to develop and tailor Government backed loan products for small firms, and to orchestrate their distribution through the banking network.

3. Non-Bank Channels

Introduction

When the Government announced credit easing in 2011, it described this as a route to make loans cheaper to small businesses through the banks. It also said that they would be looking at options to provide finance to providers in areas such as leasing, online platforms and other viable routes. As the experience of the US has shown, well-targeted public interventions can leverage significant private funding for institutions such as CDFIs and the FSB welcomed this approach.

This chapter looks at a number of small business funding models operating in the UK and elsewhere, to see where opportunities for growth are and where Government can help boost these business models. These examples are not unrealistic nor are they outside of the principle of competition as recommended by the ICB, or the policy tool of credit easing. In accessing which models we have described below, the FSB chose working models which can be scaled-up and those with a proven track record in supplying finance to small businesses.

The options which the FSB has chosen are:

- Community development finance institutions
- Business-to-business credit
- Peer-to-peer lending
- Business angels and small business private equity
- Asset finance and leasing
- SME debt bonds

The FSB did consider other options for non-bank channels but did not include those in this document as they proved either too risky in the use of public finance, or unachievable. These included items such as crowd funding and regional stock exchanges, along with dismantling the state owned banks through UK Financial Investments Limited. The options which are discussed and the recommendations are practical and currently operational.

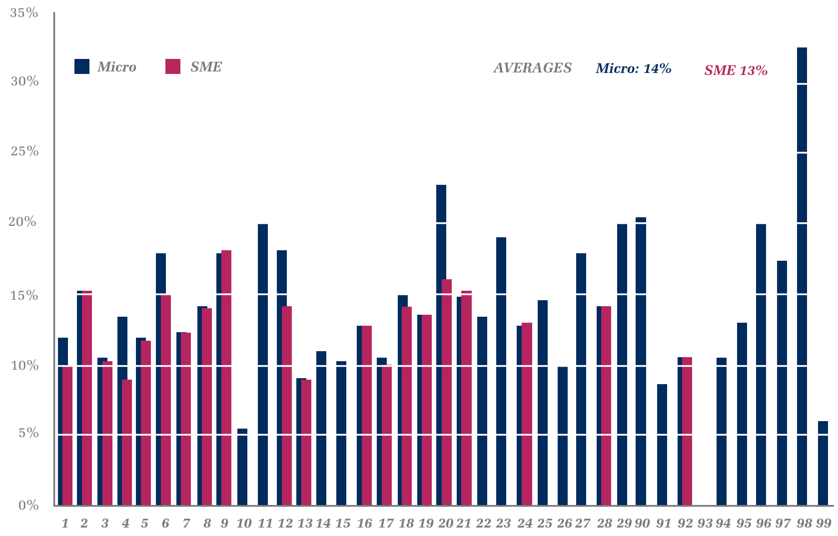
Community Development Finance Institutions

CDFI's are social enterprises which operate in all regions of the UK. Their main objective is to target finance at a non-exploitative rates to underserved markets that are unable to secure mainstream finance. As Chapter two showed, it is a long-established institution in the lending and savings market in the US. One of the beneficial aspects of CDFIs is the willingness to lend to micro and start-up businesses, which are facing a particular problem in the current climate.[15]

As CDFIs lend in specialist areas and sectors, they are able to serve a section of the business community that often finds it hard to access finance, namely start-ups as well as areas of deprivation. Business start-ups are often categorised as higher risk for banks and as such, CDFIs can play an important part in filling this gap.

Research conducted by the CDFA demonstrated the role CDFI's have played in these challenging areas. It found that between March 2011 and early 2012, CDFIs provided 1,500 loans worth £23 million and created and protected 1,350 UK businesses and nearly 6,000 jobs.

Figure 7: CDFA Annual member survey 2010/2011, CDFA (bars represent each CDFI)



Demand for loans from CDFIs has outstripped supply, reflecting the difficulties some businesses have had in sourcing finance from bank sources. Instead of being the last resort, CDFI is becoming the first choice asking the question whether more could be done to stimulate this market to meet demand.

Additionally, many CDFIs plug a mentoring capacity to develop the skills of business people and the knowledge base of the owners into loans for small businesses and start-ups. This in turn makes the investment slightly less risky, however, it is still predicated on a sound business model.

Anecdotal evidence from FSB members and from the CDFA highlights that the cost of finance through this model can be more expensive than bank finance (Figure 7). Though the cost of money reflects the risk, CDFI loans are for businesses that have been rejected by the high street banks or unable to raise the finance or security from elsewhere – it adds to the case that Government funding, as seen in the US, could bring down the cost of capital for these businesses who are often starting-up and operating in challenging environments.

In comparison to the US, the CDFI movement in the UK is much smaller, even when data is adjusted for the size of its economy.[16] Some of this can be represented by the Community Development Banks which do not exist in the UK, and Community Development Credit Unions, which are not considered part of the business finance portfolio of the UK. But even discounting the contribution of Community Development Banks

Box 5: Recommendations for CDFIs

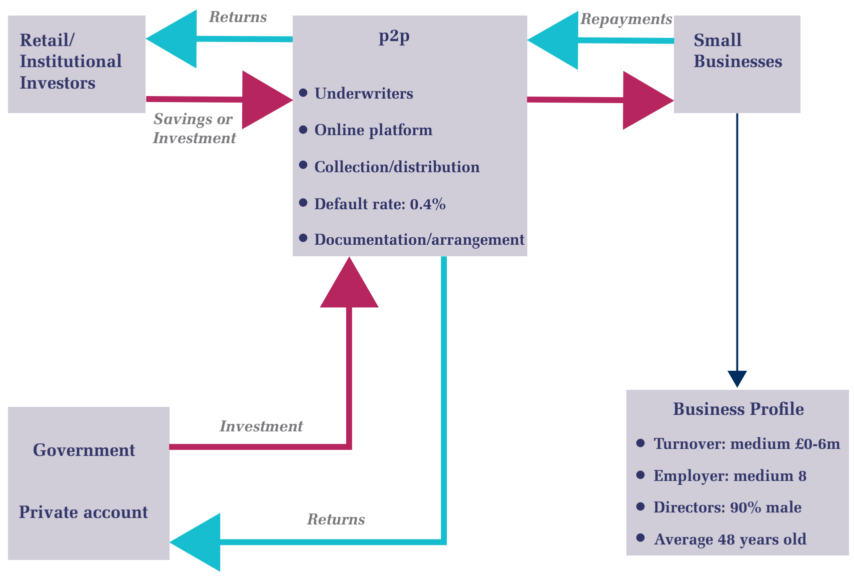
- Responsibility for CDFIs is currently somewhat unclear and fragmented, with different government departments (BIS, DWP, OCS) responsible for different aspects. The Government should identify one department which co-ordinates community development finance. The FSB and the industry body, the Community Development Finance Association (CFDA), suggest it should be HM Treasury. CDFIs need to be brought into the mainstream. Currently there is an ad hoc referral scheme from local banks. If CDFIs are to grow and expand, a formal referral route, as outlined in the Project Merlin agreement, should be implemented.

- The Government should look to the US experience, and see how best to use public resources to help these institutions expand and lower the cost of capital for those starting-up and operating businesses in less advantaged areas.

- Further, the FSB recommends the Government to review and consult on a Community Reinvestment Act in the UK to see how that might support the development of the UK CDFI community.

- When affordable, well-targeted tax incentives could help boost the sector. The FSB is pleased that the Government is looking at the Community Investments Tax Relief and hopes any reforms will go some way to change the behaviour of investors.

Figure 8: Peer-to-peer lending and possible Government involvement



and Credit Unions, the Community Development Loan Funds and Community Development Venture Capital Funds still account for £2 billion in outstanding loan portfolio compared to £273.6 million in the case of the UK.

Peer-to-Peer Lending

Of all the finance models in the UK, this is the newest and can be seen as one of the most innovative methods of both raising capital and investing. While problems remain in this model (start-up companies cannot access finance through it), many businesses now see this model as a tool to entirely remove the banking structure from debt books.

Funding Circle, RateSetter and Zopa are the major operators in this market. They have increased their business by attracting greater numbers of investors and small firms, and acting as the channel to bring those to groups together. As of December 2011, Funding Circle had lent nearly £20 million to 480 small businesses, and 42 per cent was of growth finance (investment, additional staff, etc).

The step-change that is needed for it to become a model that can address the supply side (i.e. investors) to meet the demand (from small businesses) is where the Government can use the principles of increasing competition and the tool of credit easing to promote these models. An example of Government intervention is shown in Figure 8.

Government intervention to boost this business model is an option as stated by HM Treasury:

"In addition to its intention to invest through managed funds, HM Treasury will also consider the potential to invest through other non-bank lending channels. This could include providers of alternative types of finance (such an invoice financing and leasing), and non-traditional lending relationships (such as online platforms, and other ways of directly accessing investors)."[17]

The figure above shows a simplistic illustration of how peer-to-peer organisations work and their relationship with both investors and small businesses, and a possible route for Government involvement. Investment from the Government in these areas would replicate the public/ private relationship that is occurring in

Box 6: Recommendations for peer-to-peer lenders

- The Government and regulators must show the future importance of this funding model by fully engaging the p2p Finance Association along with the players in this market. This should start by bringing these players into a fully recognised regulatory environment that would help them attract a greater number of institutional investors to meet the demand from small businesses.

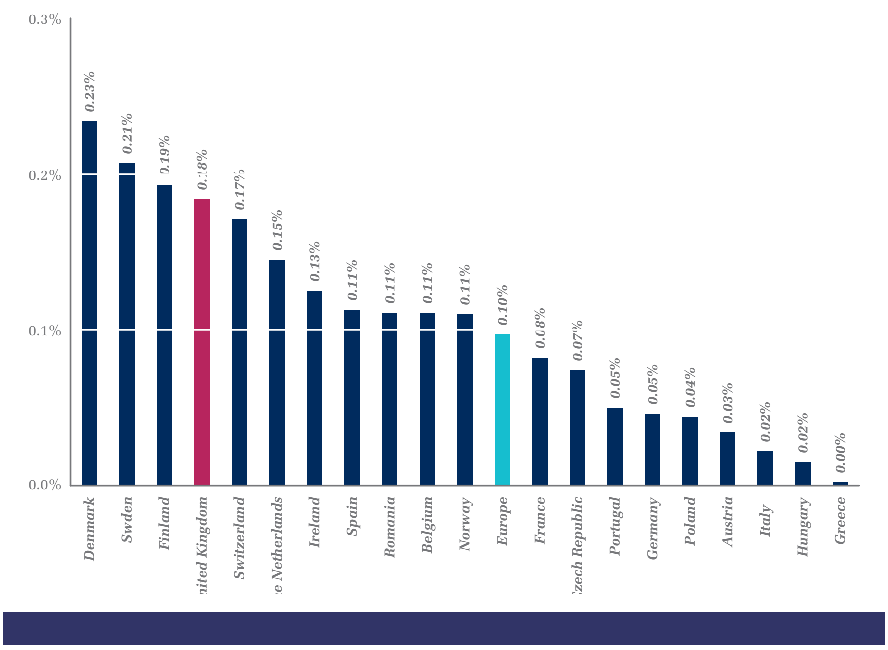
- Once within the regulatory environment, the Government should create investor accounts in the peer-to-peer firms that lend to small businesses and use this as an alternative route to the banks under the credit easing umbrella. This type of intervention would fit into the ICB recommendation of increasing competition within the SME credit market and also help increase the scale of this model.

the Business Finance Partnership and previous equity schemes.

To establish scale in this market, the Government could therefore consider creating its own investor accounts in the recognised peer-to-peer funders. As such, the Government can decide the risk profile of the firms it wants to invest in (or it can be done through Government agencies such as Capital for Enterprise, or by private funds) and will provide a level of confidence to leverage funds from other retail investors. Government should then use a simple dividend-invest mentality and keep investing through the account.

As stated, this model does not at the moment support start-up financing – businesses need a credit history to apply for funds. For peer-to-peer lenders to reach their full capacity as disruptive business models, they need to bring these businesses into the fold, as well as offering more diversified financing which helps cash-flow. However, even with these small shortfalls, the model is well-liked by businesses that use this as a source of finance, and for investors looking for returns.

Figure 9: Venture capital deals as proportion of GDP, 2007 (EVCA Yearbook 2008)



Private Equity and Business Angels

The UK has a thriving business angel community and leads Europe in terms of the amount of SME venture capital raised. In terms of venture capital deals as a proportion of GDP in 2007, the UK is above the European level and achieves the fourth highest scale of venture capital activity of any European country (see Figure 9).

It is important for policy makers to understand that from a business perspective there is difference in terms of value and perception between venture capital and business angel finance. For many small businesses they are comfortable with business angels and know the networks around the country. They are also aware that business angel finance often brings with it an experience level and soft-mentoring process which is not always available through venture capital finance.

While this form of finance is not right for all small businesses the Government should continue looking into this area for additional growth and promotion to the UK SME sector. Research conducted by the City of Lending[18] shows that the few firms that currently take advantage of this model of finance produce a larger weight of job creation and profits than less entrepreneurial start-up businesses.

Moves by the Government to stimulate lending through the Seed Enterprise Investment Scheme (SEIS) are welcomed as is the capital gains holiday for the financial year 2012–2013. The FSB recommends that policy is reviewed regularly in this area, especially after the one year grace period of capital gains received though the SEIS.[19] If this proves a successful policy item and changes behaviour among investors – in terms of initial investing and action on profits – it should be considered as a permanent reduction. The review should also look at the extent to which small businesses are promoting themselves through the SEIS.

The FSB would like to see a greater Government emphasis on this form of finance for specific sectors (as the Danish Copenhagen Cleantech Cluster[20]), and additional research by BIS to ascertain a fuller picture of the business angel environment in the UK. While the sector remains strong, clear data and trends are needed for policy shifts.

Box 7: Recommendations for business angels

- The FSB recommends that greater research is carried out into business angels as data is hard to compile, mainly due to the varied network of business angel networks and ad-hoc providers. Without such research, policy shifts will be hard to define.
- The new Seed Enterprise Investment Scheme is a beneficial move and the one-year capital gains holiday should be made permanent if it proves successful at increasing deals, and the re-investment of profits in new deals which benefit small businesses.
- It is also important that businesses that have the potential to access and benefit from this type of finance should be targeted in terms of advice. This can be done through more work being done by provider networks, business groups and the Government. It is important that the benefits are shown, as well as the pre-application work (becoming 'investment ready') and the funding profile needed over a period of time.

Asset finance and leasing

Asset finance is the provision of finance to businesses and public sectors for fixed capital investment, and accounts for a quarter of all UK fixed capital investment. It is used by around one in three small businesses with any external borrowing. Around 750,000 small businesses are currently relying on it to some extent. Finance is used to buy or rent equipment through hire purchase and leasing, on longer agreements than many bank loans to purchase capital equipment such as plant and machinery, technology and vehicles.

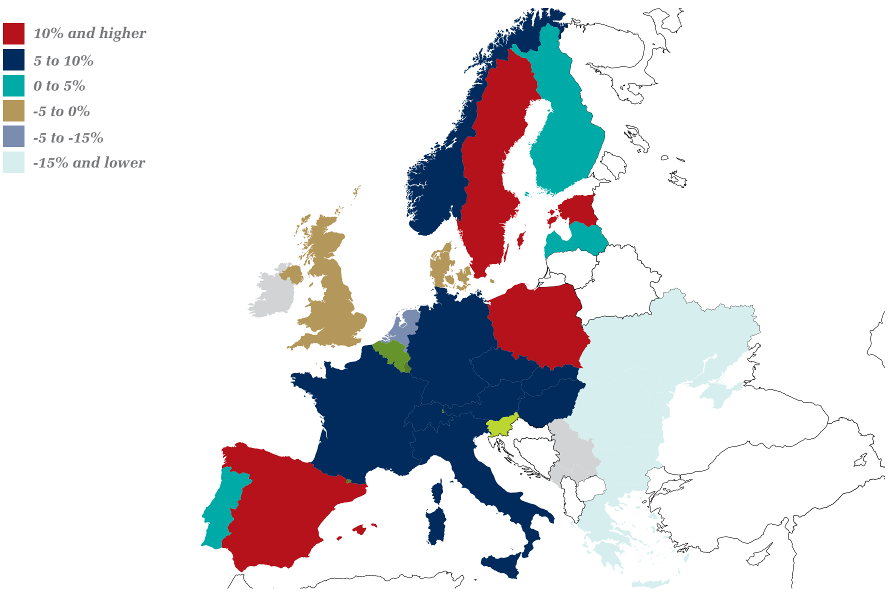
The attractiveness of asset finance is that it is more predictable. Asset finance agreements will not be cancelled by lenders (due to the structure and contractual nature of deals), which helps all businesses, especially those with limited capital. A further key benefit of this finance form is the method of security. Usually the credit line is secured entirely on the back of the asset being leased rather than any other business or personal asset.

Across Western Europe, leasing is a growth area for SME financing. However, as Figure 10 shows, new leasing business in the UK is contracting (2010).[21]

This should be of concern for UK policy makers as leasing is an ideal method of business investment and will help SMEs who want to build in flexibility to their debt finance and asset purchase strategy. This means should be an attractive alternative to bank finance, and while the rate of success by application has decreased, from only one per cent being declined in 2007 to the current seven per cent now, success rates are higher compared to standard bank loans.

An additional concern for non-bank asset finance organisations is the complex and shifting tax system. Changes to the tax system, including the lower rate of capital allowances, the 'long-funding' lease rules, and especially the introduction of time-

Figure 10: New leasing growth rates by country 2010 (source: Leaseurope)



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Box 8: Recommendations for asset backed finance

- Asset backed finance needs a greater market penetration and awareness amongst businesses. The Government should look at bringing this finance route into the £1 billion Business Finance Partnership and other Government lending schemes (such as the Enterprise Finance Guarantee).
- More sensitivity is needed when changing the tax system. Changes to the capital allowance rate have had an adverse impact on investors, as has regular changes to the tax system. When relevant changes to the tax system take place, impact assessments should reflect this in the future.

apportionment of capital allowances in 2008, have further impacted adversely on the cash-flow of independents, making it harder to grow the business.

SME Debt Bond Market

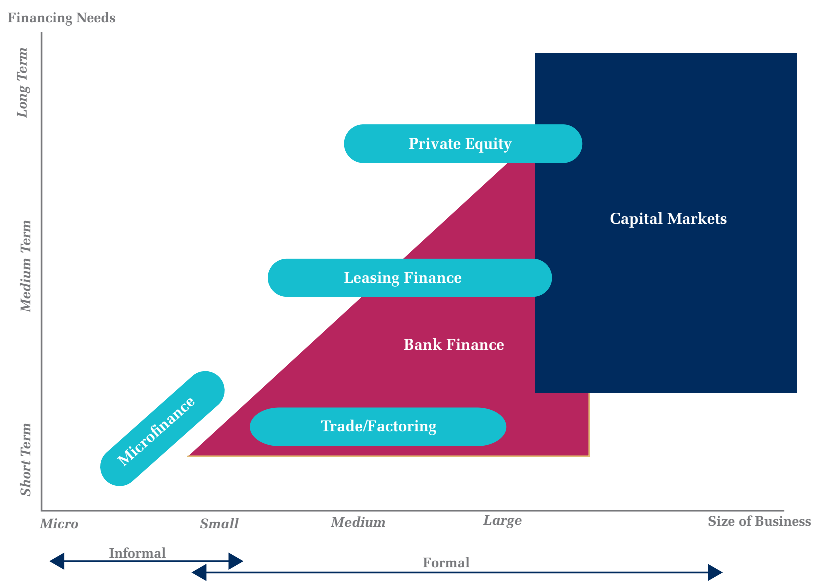
The FSB understands the reticence of many small businesses and start-ups to draw equity finance and reduce the ownership structure. However, for a minority of small firms with a need for greater funding and an eye on growth, Recognised Investment Exchanges (RIEs) can be an attractive route to issue shares. They also offer the potential for small business bonds.

The FSB would now like the Government to explore an imaginative, but very realistic route for small firms to access the capital markets through RIEs.

The benefit for small businesses that have high growth potential and a strong entrepreneurial spirit would be to access finance through investors while retaining full ownership of the business. The benefit for investors, over the tax incentives which already exist, is a diversification of portfolio and potential rates of return above the standard rate.

The FSB suggests that this would be appealing for small businesses as it removes one of the barriers of equity finance. While the capital markets and private equity remain open to large and larger medium businesses, smaller firms with the attributes of high growth potential remain locked out. A proposition which allows small businesses to raise sums of £250,000 and above would fill the funding gap for micro and small businesses that need investment grade finance for the mid to long-term (see Figure 11).

Figure 11: Forms of finance and firm size



To make a small business debt bond work, the Government could use the same mechanism for credit easing – using its AAA credit rating to lower the cost of borrowing – to guarantee a portion of an individual debt bond, or a bundle of debt bonds. The bundles of debt bonds can be issued by region or by sector and may prove attractive for specific investors who have experience of preference when investing.

As such, a market does not currently run in the UK. To test the viability of this business model, one option could be to run a pilot with a recognised RIE that has experience in the small business community. As no new licence from the FSA would be required, a pilot scheme would be easily set up (in a matter of weeks from the discussions the FSB has had with one RIE). As with the bank route of cheaper finance, credit easing could be used to reduce the risk to investors through an enhanced credit rating on the debt bond or bundle. While appreciating the commercial realism for investors and a privately-owned RIE, a bundle

Box 9: Recommendations for a SME debt bond market

- To evaluate the viability of an SME bond market, the Government should put in place a pilot scheme to see the demand and supply from small businesses and investors for an SME bond and its operational viability. This could be done quickly using existing FSA licensed RIEs.

- The Treasury should use credit easing to enhance the credit rating worthiness of singular debt bonds or of bundles of bonds issued by small firms.

- If the pilot is successful and the relationship between credit easing and the RIE works on a basis of full transparency, the same offering by the Government should be extended to the entire RIE network in the UK.

mechanism would allow firms to raise smaller levels of finance than single-issue debt bonds.

Mutual credit schemes and complementary currencies

Invoice factoring is not the only way that small companies can release cash from their outstanding debtors. There are various ways in which SMEs can create mutual liquidity using their invoices, of which perhaps the longest running example is the Swiss WIR. This was founded in Zurich in 1934 in response to the difficulty that many smaller companies experienced in obtaining working capital finance from banks. It currently has 60,000 members and made CHW 1.627 billion in transactions in 2010. It is a not-for-profit organisation. According to the co-operative's statutes

"Its purpose is to encourage participating members to put their buying power at each other's disposal and keep it circulating within their ranks, thereby providing members with additional sales volume."

The WIR operates effectively as a complementary currency system, with businesses able to trade with one another using WIR credits alongside Swiss Francs. The credit is issued by the Co-operative WIR Bank in just the same way as a standard loan but at zero or very low rates of interest and can be used for settlement between all participating SME members. Originally these WIR credits were effectively mutually accepted IOUs based on trust. However, as the scheme grew, businesses were required to provide collateral to back their WIR. Businesses that are willing to accept WIR are listed in a directory, and academic research has concluded that the currency is highly counter-cyclical.[22] In other words, use of the currency increases during recessions whereas bank finance tends to contract at the down stage of the economic cycle.

A large scale scheme is currently being introduced in Uruguay with the backing of the Government, The Commercial Credit Circuit (C3).[23] The Uruguayan C3 (commercial credit circuit) model involves monetising small firms' invoices to enhance their liquidity. The credits can be spent with all other participating SMEs and are accepted in lieu of taxes by the Government and utility payments by national energy suppliers. (The tax office, the national pension fund and several important companies offering electricity, gas, housing, telephone and internet-services are all members of the scheme).

Such schemes are analogous to large multi-national companies with many trading subsidiaries. The subsidiary companies in the group do not need cash to trade with one another – the inter-company accounting system maintained by the group can net off debtors and creditors within the system without requiring each subsidiary to access potentially expensive bank credit to finance their working capital.

Box 10: Recommendations for mutual credit schemes

- Though it has been in operation for some time, the Swiss invoice factoring model is little known in the UK. Nonetheless, the evidence shows it can offer benefits for small businesses. The Government should therefore examine what, if any, barriers there are to this form of finance in the UK and to consider if there is an opportunity for large institutions to support their foundation.

4. Conclusions

The background to this paper has been the FSB's longstanding interest in finance, and the ability of our members and other small businesses to access finance on reasonable terms. The credit crunch of 2008 raised questions about the structure of the UK banking sector, including the level of competition in an area dominated by a few large players, and the general issue of how small firms accessed finance to support their activities.

Many of the systemic issues highlighted by the credit crisis and subsequent Government intervention to support the UK's major banks have been addressed by the ICB's report, which put forward a range of recommendations. The Government adopted these recommendations in full, something the FSB strongly supported.

While the ICB has put forward recommendations to increase competition among the high street banks, it is largely predicated on a 'business as usual' model. One of the aims of this report was to look beyond the current banking model, and to see what lessons might be drawn for the UK from the contrasting banking models found in the US and Germany to improve the credit market for small firms in the UK.

The lessons from Germany and the US

Though they take very contrasting approaches, both these countries' models have allowed credit to flow to small businesses even during the economic difficulties of recent years. Between 2007 and 2010, there was a 24 per cent fall in the number of successful loan applications made by SMEs in the UK compared to a nine per cent fall in Germany over the same time period. In 2010, the SBA increased credit to small businesses through its loan programmes.

A number of themes emerged that might have explained the trends lending to small firms, including the local nature of the banking system, the degree of transparency and the investment approach, with the German banks having a wider social remit written into their constitutions, and the discipline of the CRA in the US.

Many of these attributes are not present in the UK's institutional framework. While the ICB's recommendations are welcome, they are unlikely to deliver such benefits, with barriers to entry to the UK banking market remaining high. Other approaches need to be looked at to see if similar benefits can be captured in the UK.

Options for banking reform

With two large banks effectively under public ownership, the Government should look at its shareholdings and consider using them to create models that could deliver the benefits seen in the US and Germany. The FSB appreciates this is a radical option. However, it is hard to see the market producing an outcome that delivers a banking system that answers the needs of small business and certainly not in the immediate future by itself.

The FSB accepts that the immediate focus of the taxpayer-owned banks is rightly on restoring their financial position; such a restructuring would therefore be for the medium-term. Nonetheless, the FSB believes this should be given serious consideration and for the costs and benefits of adopting this model for UK-plc be thoroughly examined. In the short-term, the FSB can see no reason why a functioning CRA in the UK could not be put in place to shine a light on the provision of banking services at the local level. One option that could be closely examined is to remodel these banks, making their activities geographically defined along the lines of the German Sparkassen, with a similar backing of a large institution with all the scale economies that would bring.

More radically, what comes through from the German and Swiss examples is a counter-argument to the notion that focused and 'plain vanilla' banks do not make commercial sense in modern-day banking. This report highlights that when banks are not beholden to their shareholders and markets, returns on capital can be made and profits enjoyed. A similar approach would run counter to the management model of the UK banks, and may require either ongoing state involvement or legislative changes to reorient the banks' objectives to include wider social goals and an acceptance of lower returns in exchange for supporting a wider range of businesses.

Non-bank finance

This report has shown that there is a suite of alternatives available to small businesses. Many are innovative, reflecting the wealth of financial expertise which the UK has in abundance. Given this position of strength, these alternatives should be expected to flourish as the financial services industry spots new opportunities.

While banking products in the form of overdrafts and loans (both secured and unsecured) remain the main provision of credit to small businesses, the FSB expects other options for small business to become more widely available: leasing for machines and vehicles; CDFI's; business angel networks; or innovative 'disruptive' business models such as peer-to-peer lenders who bring the investor and the credit seeker together.

What is needed to achieve that goal is for policy makers to be bold and imaginative in their approach, and put in place reforms that bring these models into the mainstream, and bring about a behavioural shift among small businesses. To do so, the report has highlighted a number of ideas to boost these non-bank routes to finance, and to provide a further element of competition and innovation in the small business market. Many either have no or low cost, or money has already been identified.

The FSB hopes these thoughts and recommendations are a helpful addition to the debate around small business finance, and will be reflected in the review being undertaken by Tim Breedon of Legal and General, who has been tasked with looking at alternative finance by BIS. Our hope is that the review will bring forward clear and tangible policy moves to increase the scale of alternative forms of finance in the years to come, and that these currently 'alternative' forms of finance will become mainstream and widely available to micro and small firms.

"Given this position of strength, these alternatives should be expected to flourish as the financial services industry spots new opportunities"

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Glossary

FSB	Federation of Small Businesses
nef	New Economics Foundation
SME	Small and medium sized enterprises
ICB	Independent Commission on Banking
SBA	Small Business Administration
DWP	Department for Work and Pensions
HMT	Her Majesties Treasury
BIS	Department for Business, Innovation and Skills
CDFA	Community Development Finance Association
CDFI	Community Development Finance Institutions
FSA	Financial Services Authority
RIE	Recognised Investment Exchange
ONS	Office for National Statistics
CRA	Community Reinvestment Act
GDP	Gross domestic product
EVCA	European Private Equity and Venture Capital Association
SEIS	Seed Entperprise Investment Scheme
EFG	Enterprise Finance Guarantee
CHW and WIR	Alternative complimentary Swiss currency

Federation of Small Businesses
The UK's Leading Business Organisation

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Response from the Board of Finance Wales plc

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National Assembly for Wales

Finance Committee Inquiry – Finance Wales

Response of the Board of Finance Wales plc

January, 2014

Introduction

This is the response of Finance Wales' board to the invitation to provide evidence in relation to the Finance Committee's short inquiry to consider the current and future role of Finance Wales.

This response includes 4 appendices.

Q1 The role and strategic purpose of Finance Wales

a) Should it be self-financing by operating on commercial investor principles, or should it primarily support the economic development priorities of the Welsh Government?

- Firstly it is important to recognise the somewhat unique structure of the Finance Wales Group which encompasses both Fund Holding company activities and Fund Management company activities, making the investments from these funds on a commercial basis. The principle of being self-financing applies differently to these two quite distinct segments, namely fundholding operations and commercial fund management operations.
- For the avoidance of doubt Finance Wales does not benefit itself from any income from the funds it manages apart from the agreed management fees. All interest and fees paid by SMEs in respect of loans and investments are retained within the funds themselves and form part of the potential legacy for future funds to invest in the next generation of SMEs.
- At the Funds level Finance Wales raises funds from both public and private sources with the overall aim of returning all capital to stakeholders plus a suitable return as required. Thus sources of capital such as the European Investment Bank (EIB) and Barclays look for the return of capital and a commercial financial return thereon as a first call on the fund. The public money via European Structural Funds such as European Regional Development Funds (ERDF) and Welsh Government capital monies require the creation of legacy funds for future investment in the next generation of SMEs and economic development through a series of outputs such as jobs created and safeguarded, but without a requirement for a commercial return on the capital. In our latest forecasts for the Wales JEREMIE Fund[1] as an example, Finance Wales is forecasting a shortfall of 17% in the return of public capital. This amounts to a shortfall of some £14m out of the total likely public sector capital of £82m, which could be construed as representing the economic development element within the funds.
- We would stress, however, that we do not regard commercial returns and economic development as in any way mutually exclusive. We seek to achieve

[1] The Wales JEREMIE Fund (Joint European Resources for Micro to Medium Enterprises) is a £150m fund that helps Finance Wales to provide finance to SMEs. Finance Wales secured £75m from the European Investment Bank (EIB) and European Regional Development Fund (ERDF) backing to create the first JEREMIE fund in the UK.

both of these objectives, reflecting the diverse requirements of the different stakeholders in the funds.

- The Finance Wales Group aims to fully cover its operating costs and be self-financing from a mixture of fund management fees, currently ca. £6.5m and fundholding fees ca. £4.0m.
- Fund management fees are generally agreed via an open fund management procurement exercise or at market rates. Typically these are between 2%-3% p.a. and are set for the investing period of the funds, which are typically 5 years.
- Fund Holding fees are agreed in line with EC guidelines which permit fees of between 1%-2% p.a. Currently the Holding Fund fees charged by Finance Wales plc are set at 1.5% as the mid-point in this range and these are set out in the Finance Wales Group's Business Plan 2013/14 which was submitted to the Welsh Government for approval in May 2013. These are covered by £1.6m taken directly from the Funds and ca. £2.9m via the Welsh Government in the form of an annual grant-in-aid payment. At £2.9m in 2013/14 this represents the only revenue support currently provided to Finance Wales and compares to a figure of £5.6m in 2008/09. It remains the strategy of the Finance Wales Board to continue to reduce this year on year, as new fund management contracts are acquired, with a view to becoming self-financing without calling further on the public purse.

b) How do banks operate alongside public bodies such as Finance Wales and, how could this be improved?

- Banks work very closely with Finance Wales – our current major introducers of business are Barclays and Lloyds. These account for 36% of our referrals.
- In total Finance Wales has provided funding of £115m from its main Wales JEREMIE Fund up to 30th September 2013 and this has helped raise an additional £133m funding from private sector sources, primarily banks and other financial institutions such as other private equity and venture capital companies, making total funds of £248m available for Welsh SMEs.
- We have very strong relationships, through our offices across Wales, with all the local Regional Directors and Managers and there are high levels of cross–referrals made. These relationships have been forged over many years and are key to providing support for SME customers of all banks in Wales.
- Both the EIB (see later) and Barclays have been stalwart supporters and lenders to Finance Wales over many years with total facilities agreed of £155m over this period.
- Barclays, RBS and Santander are also keen to lend directly to Finance Wales, alongside the British Business Bank, to enable it to invest in Welsh SMEs in connection with the proposed Finance Wales/Welsh Government Wales Mid-Market Fund of £80m.

- We continually seek to broaden and improve these relationships as new providers appear such as Handelsbanken. This remains a key focus for Finance Wales going forwards.

Q2 Current performance

a) Has Finance Wales achieved appropriate outcomes in areas such as jobs created/safeguarded, business support, return on investment, economic impact, associated private sector investment etc.?

- In summary the following key total outputs have been achieved by Finance Wales since its inception in 2001:
  - Jobs created 13,068
  - Jobs safeguarded 19,986
  - Private Sector Leverage £447m
  - Amount invested £275m
  - Number of enterprises supported 3,066

- Please see Appendix 1 for a more detailed breakdown of the outputs and performance against actual targets in our current active Funds.
- These outputs are agreed between Finance Wales and WEFO/the Welsh Government at the set-up of each fund and are monitored quarterly by way of formal reports.
- In addition, these outputs are subject to formal mid-term and final evaluations by independent consultants, commissioned jointly by Finance Wales, the Welsh Government and WEFO. An executive summary of the latest evaluation report on the Wales JEREMIE Fund completed by Regeneris in February 2012 is attached at Appendix 2. For some of the economic development outputs, the deteriorating economic circumstances of recent years has had a major effect, e.g. high unemployment rates and low levels of job creation; paucity of bank lending, etc.

Q3 Interest rates charged

a) Are these appropriate relative to those charged in the private sector or other sources, and given State Aid requirements?

- We believe that our interest rates are indeed appropriate and in line with those charged by the private sector whilst being fully compliant with State Aid requirements
- We provide at Appendix 3 a copy of the formal response that Finance Wales has provided to the Welsh Government in respect of the Access to Finance Review which addresses these aspects.

b) Should interest rates charged by Finance Wales be commensurate with risk?

- The Management Arrangement, which governs the relationship between Finance Wales and the Welsh Ministers, acting by the Welsh Government, is our current governing document and sets out the remit and purpose of Finance Wales.
- The first paragraph of the General Purposes and Aims (section 3.1) states that:

  'The Company shall be managed as a group of commercial development funds to provide businesses in Wales with flexible and sustainable finance for their development. Its activities seek to address market failure in this area and stimulate new investment by the private sector'

- This document has been regularly reviewed by Finance Wales and the Welsh Government, most recently in June 2013 and no changes have ever been made to this primary objective. Moreover each year Finance Wales submits a formal Business Plan to the Welsh Government setting out clearly the core strategic aims of Finance Wales for the coming year.
- The Chairman of the Finance Wales Board also meets with the Minister regularly to ensure alignment with Welsh Government policy and to consider new initiatives.
- This focus on commercial development funds requires that we adopt a commercial interest rate policy commensurate with the risk profile of each SME to whom we lend.
- Please see Appendix 3 regarding the actual rates charged by Finance Wales, the level of risk premiums charged and the related State Aid considerations around EC Reference rate methodology for further details.
- Because the majority of Finance Wales' funds have to attract at least 50% private sector capital it is critical that the appropriate commercial risk judgements are made and these are reflected in the underlying financial models that are carefully reviewed by the private sector banks involved, being primarily Barclays and the EIB.
- Both banks have been very clear in our discussions at the time that the funds were originally set up and in their recent responses to the Access To Finance Review, that any deviation from this commercial risk-based approach would be detrimental to their view of the funds and could possibly limit their future support if Finance Wales were to move away from this approach.
- A similar view has also been expressed to senior officials of Finance Wales by the British Business Bank in connection with the proposed £80m Wales Mid-Market Fund noted above.
- These are the inherent challenges of managing public/private mixed funds as required by EC State Aid guidelines. In devising its investment strategy and risk

appetite, Finance Wales seeks to balance these two requirements, as noted above in our response to Question 1(a).

Q4 Value for Money

a) Does Finance Wales provide value for money to the Welsh Government, and how does it compare relative to other forms of public intervention and support?

- We believe that Finance Wales does provide very good value for money to the Welsh Government, as demonstrated by the outputs achieved as detailed above in response to Q2.
- As noted above Finance Wales has sought to reduce the current Welsh Government grant-in-aid contribution year on year from a figure of £5.6m in 2008/09 to the current ca. £2.9m.
- Our Board's objective is to increase further the level of self-financing in the coming 2-3 years as JEREMIE 2 and other new funds come on stream.
- Our recent support for the Housing and Regeneration Department's Help to Buy - Wales initiative is a further example of providing value for money, where we are providing a back office service at cost to that Department rather than them seeking a more expensive private sector alternative. Here the relative scale of Finance Wales allows it to absorb the management of additional funds cost effectively.
- We have also offered and provided due diligence advice to the Department for Economy, Science and Transport and the Department for Housing and Regeneration on a range of projects at nil cost.
- As noted above both our Holding Fund and Fund Management costs are benchmarked against the market, either via public procurement exercises or against standard EC guidelines.
- All of these activities are managed with a current staff headcount of 121.
- Within the recent Regeneris mid-term evaluation Report (December 2013) on all three of the English JEREMIE Funds, it noted that all JEREMIE funds in the UK offer considerable value for money compared to the alternative of providing grants. This is due to their ability to attract matched funding and return legacy funds for the benefit of future generations of SMEs.
- The public sector capital grant per gross job created in the Wales JEREMIE Fund is around £31k as at 30/09/13. Including the currently projected legacy of c.83% of public funds returned, this drops to c. £5k per new job created.
- Additionally and bearing in mind the current extremely difficult employment conditions prevailing, if we include the total numbers of jobs safeguarded as a result of the investments made by Finance Wales the equivalent combined figures are 8,300 jobs created/safeguarded in the Wales JEREMIE Fund to 31/12/13.

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Q5 Arrangements for future sources of finance

a) What potential forms of finance should be considered by Welsh Government for Finance Wales (including sources such as European Funds and the European Investment Bank)?

- Finance Wales in collaboration with the Welsh Government actively seeks new potential sources of funds from a range of private and public sector sources as set out below.
- These are in addition to the existing sources such as the European Structural Funds (ERDF), the European Investment Bank, Barclays Bank and the Welsh Government, where we have successfully accessed funds totalling £363m in recent years of which £155m has come from the private sector.
- As noted elsewhere we are currently in dialogue with the British Business Bank, Barclays, Santander and RBS to establish a £80m Wales Mid-Market Fund for SMEs, to be launched hopefully later this year.
- This fund will also involve us seeking to raise £10m from Welsh-based Pension Funds and initial meetings are planned for January 2014.
- We continue to actively consider all possible sources of potential capital, such as the European Investment Fund with whom we have established relationships arising from the Wales JEREMIE Fund.
- In addition to proactively seeking new sources of funds, we are also active in seeking to raise new innovative funds to support Welsh based SMEs.
- In response to a request from the Minister for Economy, Science and Transport in May 2012, to look at other potential forms of support for SMEs, Finance Wales undertook a series of staff workshops over the summer of 2012 and submitted a number of proposals for consideration in November 2012. These were in addition to the Wales SME Investment Fund of £40m which launched in 2012 and the Wales Micro-business Loan Fund of £6m which launched 2013.
- Four additional funds were proposed which included the Wales Property Development Fund of £10m launched in May 2013, plus three further funds; a £20m Working Capital Fund, a £7.5m Proof of Concept Technology Fund and a £25m Management Succession Fund. These are now under consideration and will hopefully be launched shortly.
- It is proposed that the Management Succession Fund will also involve support from Welsh Local Authority Pension funds as the private sector match alongside the Welsh Government for State Aid purposes.
- As noted above, Finance Wales has also worked on a bid to the British Business Bank (BBB) during 2013, for a new Wales Mid-Market Fund. This was submitted to the BBB in September 2013 and was agreed in principle in December, with a formal submission due to be submitted by the end of February 2014.

- During the second half of 2013, Finance Wales has also formulated plans with WEFO, the Welsh Government and the EIB for a follow-up to the current Wales JEREMIE Fund. Positive discussions were held with both WEFO and the EIB in December 2013 and we are meeting with the EIB again in March 2014 at their request to discuss our proposals more fully. In the meantime we have commissioned Regeneris (see also above) to undertake a detailed Capacity Analysis on the current extent of market failure in access to finance for SMEs across Wales. This will involve a series of consultation workshops across Wales in February and we expect their Report to be available in late February. This will form the basis for a detailed State Aid Notification to be submitted to the European Commission and a framework to discuss with WEFO, the Welsh Government and the EIB, the likely scale and mix of products to be included.
- The development of a second Wales JEREMIE Fund is a major plank of Finance Wales' strategic planning for the period 2013-2015. Based on our previous experience in developing the first ever EIB-backed JEREMIE Fund in Europe in 2007-09, we are aware that the development of a JEREMIE Fund takes a minimum of two years, hence the early planning already being undertaken to ensure that Welsh SMEs are able to seamlessly access funding once the current JEREMIE Fund is closed in September 2015.

b) The stage 2 report proposes that it should be less confusing for Welsh SMEs if all sources of finance, including UK programmes, were combined. Would it be beneficial to devolve a proportion of UK public support programmes to be administered in Wales?

- Whilst it is proper to review these arrangements and challenge conventional wisdom, there are a number of factors to be taken into account. These need to be fully debated and assessed carefully before considering such a significant change in the current structures.
- The Access To Finance Review does recommend that all funding and business support activities should be merged into a Wales Development Bank. This may make access to finance less confusing but historically in Wales, Scotland, Northern Ireland and England these two functions have been kept separate.
- This is to ensure that the best advice to SMEs is properly and independently sourced and at arms' length from the sources of funding themselves. This avoids potential conflicts of interest and allows expectations of a favourable response to be managed properly.
- This may not be possible in a much larger all-embracing organisation that combines business support and delivery of funding in one place.
- It should also be recognised that the current business support mechanism, Business Wales, was itself only restructured and launched in January 2013 under a three year contract and debatably it is too early to assess its full impact at this time.

- On the issue of a wider proportion of UK public support programmes being administered in Wales, we would merely note that many UK schemes have already been introduced in Wales, e.g. the Help to Buy - Wales scheme, the UK Start-Up Loan scheme. Enterprise Finance Guarantee Accreditation was acquired in 2013 by Finance Wales.
- Some schemes such as the EIS/SEIS are controlled by HM Treasury as both involve taxation issues. Others such as the Enterprise Capital Funds (ECFs) are available in Wales already although very few ECF managers visit Wales and Finance Wales is already able to fill this equity gap from its existing funds.
- The Access To Finance Review suggests that the Business Growth Fund should also be moved but this is not a public support mechanism, as it is being backed solely by the High Street Banks with no public money involved.
- There are also risks in combining both advice and commercial funding into one Welsh Government body in terms of losing the valuable “venture capital investor exemption” which is currently available to Finance Wales as an arms-length commercial enterprise. Any changes in this arrangement need to be carefully assessed as it could impact on the definition of what constitutes an SME. This could make some SMEs ineligible for Finance Wales funds under current European Commission guidelines and potentially ineligible for R & D tax relief.

Q6 Corporate Structure of Finance Wales

a) Is the current structure fit for purpose and what potential alternative models could be considered?

- Please see attached as Appendix 4 a summary of the current Finance Wales Corporate Structure and Governance. This may help inform the Committee of the complex governance and regulatory controls that Finance Wales, as a financial institution is subject to.
- In addition there are a range of State Aid considerations to be considered and which have been covered in more detail as part of our formal response to the Access To Finance Review (Appendix 3).
- This corporate structure has evolved over many years as circumstances require in conjunction with the Welsh Ministers.
- The current arms-length commercial investment decision-making model has a number of benefits for Welsh SMEs.
- The structure allows Finance Wales to offer flexible funding options, whether they are equity or debt based, tailored specifically to each Welsh SME’s individual need based on its experience of funding SMEs over many years.
- This independent commercial approach allows us to bring other commercial investors to the table who would be less inclined to offer co-investment support if Finance Wales was perceived to be operating on a non-commercial basis.

- It also allows us to build long term successful relationships with SMEs and enables us to offer follow-on funding speedily based on known track records.
- Moreover under the current structure, Finance Wales holds key FCA and CCA regulatory authorisations and licences and any proposed change in structure would need to be carefully considered as the current licences may no longer be valid. See also comments above in response to Question 5, regarding the "venture capital investor exemption" considerations.
- Finally, consideration needs to be given to the European State Aid Risk Capital Guidelines which cover all Finance Wales current funds in looking at potential alternative models. These require that all "investments are profit driven". Similarly all Fund Managers need to operate a "commercially sound investment strategy" and be suitably incentivised to do so.
- As such it is the firm view of the Board of Finance Wales that the current structure is fit for purpose and should remain in place. It offers great flexibility to respond to the needs of the Welsh Government, whether on new schemes such as Help to Buy - Wales, or in the creation and establishment of new funds, such as those noted in Q5.

Q7 Activities of the Finance Wales Group in the North of England

a) Is this of benefit to the economy and SME businesses of Wales?

- We firmly believe that these activities are beneficial to the Welsh economy and SME businesses in Wales.
- It would perhaps be helpful to set out the background and original circumstances in 2008-09 when the decision to undertake activities outside Wales was discussed and finally agreed with the then Minister for Business, the Economy and Transport in early 2010.
- As part of the due diligence commissioned by the EIB in 2008, the European Investment Fund (EIF) undertook a detailed review of Finance Wales on behalf of the EIB. During that review discussions arose regarding the possibility of Finance Wales becoming involved in a Fund Manager capacity in other JEREMIE Funds in England that the European Investment Fund (EIF) were also involved with. (At that time, the EIF had the mandate from the European Commission to work with and advise all Member States who were considering the setting up of JEREMIE Funds.)
- As a result of other high level discussions with the EIF at that time, our working assumption was that future ERDF Structural Funds might not be available in Wales due to new Member States from the Eastern Bloc joining the EU. The EIF also expressed the view that looking to the creation of future funds post JEREMIE a potential fund raising would likely only work on a pan-UK basis.
- As a consequence the Board of Finance Wales agreed with the full consent of the Minister to enter into fund management contracts outside of Wales in the North East and subsequently the North West of England.

- The underlying principle of this agreement was that no Welsh funds should be expended outside of Wales and any such contracts would be self-financing or result in a net inflow of funds into Wales.
- Finance Wales created a new subsidiary company, FW Capital Ltd, which then successfully bid under open OJEU procurement rules against other private sector fund managers to manage sub-funds on a profitable basis during 2010/11. These contracts are managed locally using local staff, with oversight from our Cardiff and St Asaph offices. All local costs are covered directly from the fees payable on these contracts with a sizeable additional contribution towards central overheads in Wales.
- To date profits of £1.2m have been earned on these contracts which sit in cash in the FW Capital bank accounts. These monies are freely available to fund Finance Wales' activities in Wales for the benefit of Welsh SMEs and the Welsh Government.
- Further profits are likely to accrue of at least an additional £1m over the life of these contracts.
- In addition to these funds, Finance Wales receives an annual payment of £251k from FW Capital to fund its central overheads for the lifetime of these contracts. This has allowed us to fund and create further employment in Wales for additional Head Office staff without any further call on the public purse in Wales.
- Overall these monies have helped directly to contribute towards the reduction in the annual Grant-in-Aid noted earlier in this submission.
- In addition to these financial benefits, having a presence in these English regions gives the Finance Wales Group the opportunity to identify and then implement in Wales best practice ideas on new funds and support for SMEs – the Performance Bond Fund mentioned earlier is a concrete example of this.
- There are also wider non-financial benefits in strengthening our pools of Non-Executive Directors, co-investors and advisers who can also be introduced to work to the benefit of Wales' SMEs.
- Finally this also strengthens Finance Wales' network of funders and reinforces its relationships with BIS, DCLG, the EIB, and the EIF and of course the British Business Bank.
- This strengthens Finance Wales' reputation as a prudent, commercial investor and puts us in a stronger position to secure further fundraisings, such as those outlined in Q5. This is clearly of great benefit to the Welsh economy and the SME businesses of Wales.

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National Assembly for Wales

Finance Committee Inquiry – Finance Wales

Response of the Board of Finance Wales plc

Appendix 1: **Output Key Performance Indicators**

January, 2014

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Appendix 1: Output Key Performance Indicators (KPIs)

Wales SME Investment Fund

KPI's Achieved to 31/12/13					
To: 31/12/13	No. of Investments	No. of Start Ups	Direct Investment (£'000)	PSL (£'000)	Jobs Created/Saved
Actual:					
Equity	4	0	1,547	1,970	33
Mezzanine	11	2	3,668	3,956	152
Loans	23	4	4,343	3,691	556
Total	**38**	**6**	**9,559**	**9,617**	**741**
Baseline	**55**	**n/a**	**9,333**	**9,333**	**467**
Achievement	69%	n/a	102%	103%	159%
Variance	**(17)**	**n/a**	**226**	**284**	**274**

Wales Micro-business Loan Fund

KPI's Achieved to 31/12/13					
To: 31/12/13	No. of Investments	No. of Start Ups	Direct Investment (£'000)	PSL (£'000)	Jobs Created/Saved
Actual	**73**	**28**	**1,463**	**1,585**	**424**
Baseline	**70**	**n/a**	**700**	**350**	**70**
Achievement	104%	n/a	209%	453%	606%
Variance	**3**	**n/a**	**763**	**1,235**	**354**

Wales Property Development Fund

KPI's achieved to 31/12/13						
To: 31/12/13	No. of Investments	No. of Start Ups	Direct Investment (£'000)	PSL (£'000)	Direct Jobs Created	Jobs Safeguarded
Actual	**3**	**0**	**530**	**100**	**20**	**11**
Baseline	**5**	**n/a**	**3,375**	**1,013**	**71**	**87**
Achievement	60%	n/a	16%	10%	28%	13%
Variance	**(2)**	**n/a**	**(2,845)**	**(913)**	**(51)**	**(76)**

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Wales JEREMIE Fund

KPI's Achieved to 31st December 2013								
To: 31/12/13	**No. of Enterprises**	**Jobs Created**	**Jobs Safeguarded**	**Direct Investment (£'000)**	**PSL (£'000)**	**Collaborative R&D**	**Products, Processes or Services Registered**	**New or Improved Products, Processes or Services Launched**
Equity	60	520	1,084	52,030	76,413	18	20	22
Mezzanine	27	118	564	17,398	26,126	2	0	3
Loans	417	1,414	4,590	50,526	32,932	8	2	16
Total	504	2,052	6,237	119,954	135,471	28	22	41
Baseline	541	3,710	n/a	141,250	149,955	14	18	21
Variance	**(37)**	**(1,659)**	**n/a**	**(21,296)**	**(14,484)**	**14**	**4**	**20**
% Achieved	**93%**	**55%**	**n/a**	**85%**	**90%**	**200%**	**122%**	**195%**

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National Assembly for Wales

Finance Committee Inquiry – Finance Wales

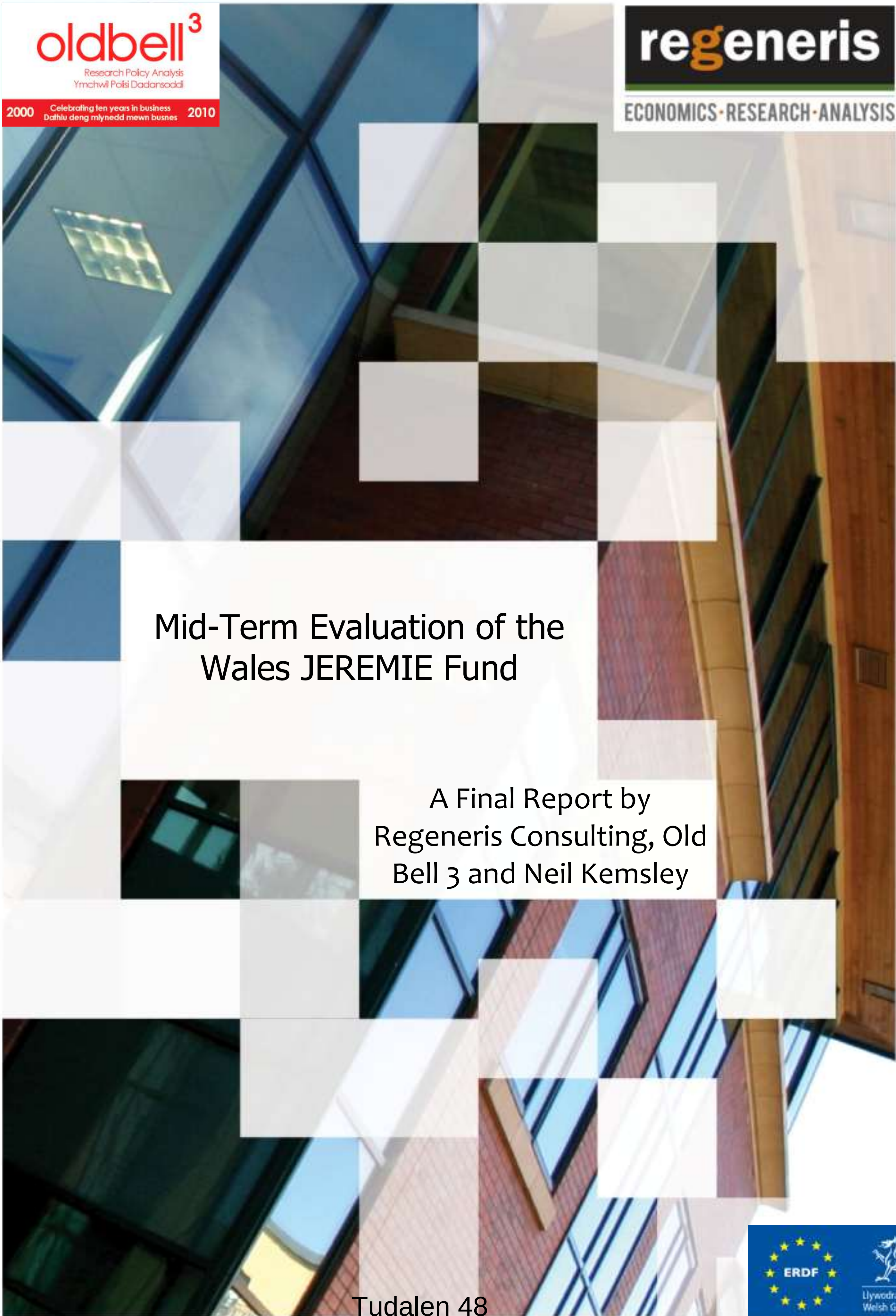
Response of the Board of Finance Wales plc

Appendix 2: Mid-Term Evaluation of the **Wales JEREMIE Fund**

January, 2014

oldbell 3
Research Policy Analysis
Ymchwil Polisi Dadansoddi
2000 Celebrating ten years in business
Dathlu deng mlynedd mewn busnes 2010

regeneris
ECONOMICS·RESEARCH·ANALYSIS



Mid-Term Evaluation of the Wales JEREMIE Fund

A Final Report by
Regeneris Consulting, Old
Bell 3 and Neil Kemsley

ERDF
Llywodraeth Cymru
Welsh Government
Ewrop & Chymru: Buddsoddi yn eich dyfodol
Cronfa Datblygu Rhanbarthol Ewrop
Europe & Wales: Investing in your future
European Regional Development Fund

Finance Wales, Welsh European Funding Office & Welsh Government

Mid-Term Evaluation of the Wales JEREMIE Fund

February 2012

Regeneris Consulting Ltd

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Faulkner Street
Manchester M1 4DY
0161 234 9910
www.regeneris.co.uk

Executive Summary

i. Regeneris Consulting, with Old Bell 3 and Neil Kemsley, were commissioned by Finance Wales to carry out the mid-term evaluation of the Wales JEREMIE Fund. The evaluation was guided by a Steering Group consisting of Finance Wales, the Welsh Government and Welsh European Funding Office.

ii. The Wales JEREMIE Fund was the first of its type to be launched in the UK and one of the first in the European Union. It became operational in 2009 and makes available £150 million in loan, mezzanine and equity finance for Welsh small and medium sized enterprises (SMEs). The Fund secured a £75 million loan from the European Investment Bank, a £60 million grant contribution from the ERDF Convergence and Competitiveness Operational Programmes and a £15 million contribution from Finance Wales. The Fund is managed and delivered by Finance Wales, a subsidiary of the Welsh Government.

iii. The JEREMIE Fund is expected to make an important contribution to the vitality of Wales' base of SMEs. Its primary purpose is to invest in new and established SMEs to produce good commercial returns for the Fund, and generate a substantial legacy fund for Wales. The Fund is expected to support more than 800 businesses over its five year investment period to 2014, to lever in significant amounts of new private sector investment and contribute to the creation of around 15,500 new jobs across Wales.

iv. The objectives for the evaluation were set by the Steering Group consisting of:

- (1) An assessment of the continued strategic need and fit of the JEREMIE Fund
- (2) A comprehensive assessment of the performance of the Fund and prospects over the investment and recovery period
- (3) An interim assessment of the economic and business impacts of the Fund
- (4) A review of the adequacy of the governance and management arrangements
- (5) Recommendations to strengthen the operation and management of the Fund and to guide the future approach to FEIs in Wales.

Main Conclusions

v. Finance Wales and the JEREMIE Fund have become key assets for the Welsh economy. Finance Wales has established itself as a critical part of the business finance landscape, steadily building a strong profile with an expanding network of intermediaries and a growing reputation as a professional and commercial facing operation. The scale of funding it makes available to Welsh SMEs at a time when the economic climate and conditions in the business finance market are particularly challenging mean that the rationale for its existence has strengthened further since the Fund's development.

vi. The evaluation evidence suggests that the mix of financial instruments available through the JEREMIE Fund, its investment strategy and its individual investment portfolios are appropriate to the market and the needs of Welsh SMEs. It is underpinned by a clear rationale to correct the market failure in terms of the supply of venture capital on a commercial basis to Welsh SMEs, rather than to provide cheap finance or support business propositions which are weaker/riskier than those that would be acceptable to commercial lenders and venture capitalists in more well-supplied parts of the UK. The investment strategy is enabling the Fund to deliver an investment portfolio which offers the required level of investment risk and reward, but which also recognises its obligations to the European Investment Bank and to the Welsh ERDF programmes.

vii. The development process for the Fund is assessed as being largely sound and prudent. The exception to this assessment is that the target set for gross job creation in the business plan was set at too high a level. The evaluation recognises that the approach to forecasting job creation outputs, using past achievements of Funds in the Objective 1 programme, may have appeared reasonable at the time the business plan was prepared.

viii. Overall, the evaluation has concluded that the Fund is being implemented and managed effectively. Investment targets through the first period of its operations have largely been met, while both the investment strategy and the Fund's operations have been adjusted and strengthened in response to emerging patterns of investment activity and performance. By September 2011 the Fund had invested £74m through 493 investments (compared to a target of £70m and 466 investments).

ix. The overriding message about Finance Wales' approach to the Fund is of an organisation that is committed to lesson learning and improvement. This is recognised by the organisation's network of external partners who have a positive view of the expertise and professionalism of its fund management, and who have been largely positive about its investment decision making process.

x. Looking forward, the Fund is on target to meet its lifetime investment, realisation and repayment targets. Finance Wales has revised its initial business plan targets and, whilst still subject to much uncertainty, is hopeful of repaying the initial £60m ERDF investment. Whilst Finance Wales is right to be cautious in making these predictions, on balance the evaluation concludes that the Fund's investment and realisations targets are achievable given the way that it has built and manages its portfolio.

xi. Although most of the investments are at an early stage, there is some evidence that the expected economic development impacts have already started to come to fruition. However, the evaluation has pointed to a need to revisit its job creation target. The target was set at a time when Wales and the UK economy had experienced several years of job growth in an expanding economy. The depth and duration of the current recession has inevitably made many SMEs more cautious about both investment for expansion and recruitment, and the investee survey (and follow-up qualitative research) for this evaluation would seem to confirm this. With three years remaining of the Fund's investment period, this would be an appropriate time to use the evidence of performance to date and the forecast evidence to review the target.

xii. The market failures that were central to the rationale for the scale and composition of the Wales JEREMIE Fund remain and in some respects have intensified as an exceptional set of circumstances continue to affect SMEs and the financial services sector. The evaluation has concluded that the case for large scale resources will continue to be strong through the remainder of this ERDF programme and probably well beyond that. Early consideration by the Welsh Government, working with Finance Wales, of successor arrangements to the current JEREMIE project is essential. This needs to continue to emphasise the balance to be struck between providing investment to SMEs to address market failures and delivering economic development benefits.

Recommendations For the Current Fund

xiii. The evaluation makes a series of recommendations which identify actions that Finance Wales, WEFO and the Welsh Government should consider over the remainder of the Fund's investment period, and which are intended to assist in shaping future access to finance policy. We have therefore grouped the recommendations into those concerned with the operation of the current fund, as well as those which are concerned with broader policy and future delivery issues.

Recommendation 1: Maintain the Focus on the Successful Delivery of the JEREMIE Fund

xiv. We have concluded that Finance Wales is currently doing a good job in delivering the current JEREMIE Fund. Whilst no major changes are required to the investment and delivery strategy (bar a number of recommendations which follow), there is the need to maintain a clear focus on the successful delivery of JEREMIE Fund during the investment and realisation phases.

xv. Finance Wales are very much aware of some of the key risks which could undermine this focus, including the following: (i) the challenging economic conditions and the implication in terms of a dampening of future demand for equity finance and the need to ensure a sensible risk profile for new investments; (ii) the increased supply of finance to SMEs in Wales (eg. through the launch of a new SME fund), although these will not start investing until much later in 2012 and the SME fund has been designed to avoid sectoral overlap; (iii) there is also the risk the new Finance Wales funds may divert corporate management and fund management resources away from the implementation of the JEREMIE Fund, although it should be able to adapt effectively having created two new teams serving other UK markets.

Recommendation 2: Retain Flexibility to Respond to SME's Demands for Finance and Related Risks

xvi. One of the key aspects of the JEREMIE Fund's performance to date has been the strong demand for debt finance, driven to a large extent by the sharp fall in bank lending (though there are signs that there could be a recovery in supply). Whilst demand for risk capital investment held up strongly up to the end of 2010, it has fallen back during the first two quarters of 2011/12.

xvii. There is no need at the current time to change the balance between loan and equity based investment and indeed the implications of such a step would need to be very carefully considered and justified. However, there is a need to keep a very careful watch on these trends and risks, including a commentary in Finance Wales' quarterly monitoring report to investors. On a related note, if the investment rate is less than expected in the coming years, Finance Wales will need to consider extending the investment period into 2015.

Recommendation 3: Retain Microloans as a Key Element in the JEREMIE Fund

xviii. Micro-loan finance is critical from the perspective of the Welsh economy and the JEREMIE Fund is a key aspect in the provision of this finance. However, Finance Wales' approach places a strong emphasis on lending money to sound commercial propositions and delivering this in a cost-effective manner, which can be at odds with the aspirations of some partners.

xix. The fact that WEFO has clarified that the Local Investment Funds (LIFs) cannot be used to match JEREMIE Fund investments is clearly a major issue in terms of stimulating demand for the microloan fund. While it is essential that business owners themselves share the risk of making new investments (and has become a condition of the microloans fund itself), we welcome plans to provide further information on how grant schemes and JEREMIE can make complementary investments in the same business.

Recommendation 4: Establish a Clearer Consensus between Finance Wales and Welsh Government on the Market Failure Finance Wales is Addressing and Improve Communications

xx. In many regards the relationship between Finance Wales and Welsh Government has been very productive, indeed being an important consideration in the successful approval and launch of the first JEREMIE fund in the UK and one of the first in the EU as a whole. However, there are also a number of respects in which there has been a lack of clarity about the strategic role of Finance Wales and the progress in the delivery of JEREMIE as a key strand of the Welsh Government's enterprise strategy.

xxi. There needs to be a better shared understanding of the rationale which underpins the Fund's structure and approach to what is both a complex and unusual aspect of economic development policy. Finance Wales needs to more effectively communicate the successes which it achieves in helping to stimulate enterprise, innovation and economic growth across Wales. Welsh Government needs to ensure continuity in its liaison with Finance Wales at a senior officer level, something which is vital to a productive partnership approach.

Recommendation 5: Establish an Accurate Analysis of the Cost Base for the JEREMIE Holding Fund

xxii. The evaluation has concluded that the annual allowance in the holding fund costs of £900,000 for its share of the costs of Finance Wales plc is an underestimation of true costs of services and support it receives from Finance Wales plc. The allowance appears to be lower than the comparable costs for the English JEREMIE Funds. Finance Wales has already examined this issue and there is merit in reaching as realistic an assessment as possible of what these true costs are. As discussed later in this section, it will help to inform future delivery approaches. Also from an evaluation perspective, this will be particularly helpful in providing a more robust and accurate basis for judging value for money.

Recommendation 6: Make Minor Changes in the Fund's Indicator Set

xxiii. While the evaluation has not identified a particular need for the Fund to report additional KPIs to the ERDF programmes, there would be some benefit in Finance Wales reviewing how the data it collects is used. Turnover and profit data relating to individual investees is provided prior to the investment decision, and is monitored routinely as part of the Fund's work with its portfolio. This would offer both baseline data and could be used to inform simple measures of turnover and profit growth of the businesses supported. However, the rigorous assessment of gross and net measures of the impact on bottom-line business performance (such as turnover, gross value added and profits) will need to be part of the Fund's final evaluation (although the baseline data will inform this).

Recommendation 7: Review the Fund's Gross Job Creation Target

xxiv. Reflecting on this emerging evidence, we recommend that Finance Wales and WEFO reassess the Fund's lifetime job creation target. This should include a thorough review of the position on monitoring returns from investee businesses to assess the potential uplift in the total associated with returns that currently are not being provided, and an assessment of the extent to which investees that are reporting job creation may see an increase in employment over the remaining investment period and the realisation period. In recessionary conditions, it is reasonable to anticipate some significant lags in the translation of investment into new jobs. Many businesses may well see substantial increases in their order books once conditions improve, with JEREMIE Funds providing a platform for expansion.

Recommendation 8: Annualise KPI Data Collection From Investee Firms

xxv. A comprehensive set of data for baseline purposes is important if the impacts of the Fund are to be accurately assessed. The Fund should ensure that it is securing the most comprehensive reporting data possible on the number of jobs in investee businesses at the time the investment is made and annually thereafter. Finance Wales has already recognised that its initial approach to the collection of jobs data has not proved effective, and the shift of responsibility to its Investment Executives is part of a process of further tightening its approach to implementation.

Recommendation 9: Review Progress on the Collection and Reporting of Data on the Cross-cutting Themes

xxvi. It is understood that an Equality Impact Assessment of the JEREMIE Fund has pointed to Finance Wales being effective in meeting its requirements on equality and diversity through its investment activity. Nevertheless, Finance Wales could be more proactive in its approach to the environmental sustainability systems CCT, both in terms of its reporting and monitoring processes, as well as sign-posting investees to suitable specialists providers where relevant. While no target has been set for the CCT indicators, there are sound reasons for Finance Wales to adopt a more proactive approach to pushing the low carbon and equality and diversity agendas.

Recommendation 10: Refocus the Monitoring Reports

xxvii. To date Finance Wales has produced detailed quarterly monitoring reports to its investors. As the fund evolves, in particular growing its loan book and portfolio of investments, it needs to increase the forward looking aspects of the monitoring report. By the end of 2011/12, the inclusion of a commentary in the monitoring reports on the Fund's income and realisations forecasts (in broad terms), specific provisions and defaults, legacy and KPIs would help give a more rounded picture of performance.

Recommendation 11: Consider Carrying Out Additional Research into Changes in the Welsh Loan Finance Market

xxviii. It is widely recognised that there is limited accurate data available on the scale, characteristics and pattern of changes in the Welsh debt finance market. Commercial sensitivity clearly plays a part here, since banks and other finance providers tend to be reluctant to share data on their loan books. However, this represents an important gap in the ability of Finance Wales and its partners to assess the case for intervention, to establish the Fund's impacts on the debt finance market and to plan for future interventions. Consideration could be given to carrying out new research, perhaps based on a confidential survey of Finance Wales' intermediary network, to explore the current characteristics of the debt market and expectations about future changes in this market.

Recommendations for Future Funds

Recommendation 12: Recognise that there will be a Need for Public Sector Backed Financial Engineering Instruments in the Future

xxix. The evidence examined during the course of the evaluation has very clearly demonstrated that there will be a continuing need for public sector backed financial engineering instruments over the course of the next decade. Whilst substantive market failures persist, this must not however be taken as an open-ended demand upon the public purse to fund finance initiatives aimed at SMEs. Public backed funds need to demonstrate their capacity to generate reasonable returns based upon commercial terms.

xxx. There is continuing uncertainty about the ability of many ERDF backed funds to secure sufficient legacies to enable them to move closer to long term sustainability. Finance Wales is certainly clear in its strategy to establish a sustainable model which enables it to reduce the need for substantial or even any public sector capital support to pump prime new funds on an on-going basis, Indeed, it is taking the necessary steps to secure the cost base, the skills sets and systems and approaches to maximising realisations, which will also support this model. However, it is unlikely to achieve this in the immediate future and the legacy returns it will generate from the Interim Fund, the current JEREMIE fund and the new SME Fund, will be vital in generating the capital necessary to underpin a sustainable model in the future.

Recommendation 13: Begin the Development and Delivery of a Future ERDF Backed Fund

xxxi. There remains a lot of uncertainty about the next ERDF Structural Fund programme, how it will apply in Wales and the ways in which support for financial engineering instruments such as JEREMIE might be pursued through the ERDF regulations. Subject to this uncertainty, we believe that there are very good reasons for Wales to pursue an umbrella fund (or fund of funds), which could again offer the potential economics of scale benefits of a large and coherent investment fund, as well as efficient investment mechanisms and fund management services. However, the ability to achieve a similar fund size to the current JEREMIE fund would depend crucially upon the involvement of other major investors such as the EIB.

xxxii. The development of a preferred approach is complex and we suggest Welsh Government, which leads in this policy area, work with Finance Wales as a key practitioner in SME funds to inform the development of future financial engineering instruments.

xxxiii. If there is to be a successor to the current JEREMIE Fund on a similar scale, there is a strong case for <u>all key aspects</u> of fund management and delivery to be competitively tendered whatever model is eventually adopted. Whilst this will have merit in driving efficiency and value for money for the public sector, it will also stimulate other private sector providers to look to Wales for new opportunities. In the context of a JEREMIE type fund this approach would involve the competitive tendering of both the holding fund and fund management activities. However, if the holding fund activity is to be tendered, it is vital that this strand is completed at an early stage, including the provision for the appointed holding fund manager to undertake the substantive fund development activity and the procurement of the fund managers.

Recommendation 14: Review the Future Revenue Grant Funding of Finance Wales

xxxiv. As highlighted earlier, one of the conclusions from the evaluation is that whilst the rationale for the provision of revenue funding from Welsh Government to Finance Wales is clear, the way in which this supports the operating costs of the current JEREMIE fund is far less clear. In general, it is considered good practice to have clarity in terms of the provision of public sector revenue grant funding and the range and scale of outputs which are being delivered in return. But also, if a more market led approach is to be adopted to the commissioning of future holding fund services, there will be the need for clarity on the fee structure and associated terms for the provision of these services. The revenue grant provided to Finance Wales for any on-going services it provides on behalf of Welsh Government would need to be revised in light of this arrangement.

Recommendation 15: Remain Mindful of the Lessons and Good Practice in Developing and Implementing Financial Engineering Instruments.

xxxv. The lessons and aspects of good practice in the design and implementation of public sector backed financial engineering instruments need to be taken into account in designing and delivering any new FEIs. There needs to be clarity in terms of the skills and expertise required to design a new fund, including business development, corporate finance, and economic development policy, delivery and funding.

xxxvi. Many of these skills reside with Finance Wales, and the relationship between WEFO, the Welsh Government and Finance Wales which has steered the development and delivery of the JEREMIE Fund to date, should have an important part to play in shaping future arrangements.

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Access To Finance Review - Stage 2

Response of the Board of Finance Wales plc

December, 2013

Introduction

This is the Finance Wales plc Board Response to the Professor Dylan Jones-Evans Stage 2 Report, released on 12th November 2013.

The Response that follows comments on the four key areas identified within the Report, namely Banks' Lending Patterns to SMEs, Alternative Sources of Funding, Finance Wales and the Development Bank for Wales.

1. Banks' Lending Patterns

Essentially the content here is largely an update on the previous Stage 1 Review releases in June 2013 and incorporates data from the SME Monitor Quarter 2 review and the British Bankers Association, Banks' support for SMEs – Quarter 2, 2013 review. These reports contain high level data on lending in Wales and related data on interest rates where available.

As the comments on the data are largely factual and in the public domain, we have no specific comments to make on this aspect of the Review.

We would endorse the view that the Banks are taking a tougher stance on lending to SMEs generally, in particular in how they assess risk and value available collateral. In practice we have seen no substantive evidence of the Banks returning to the SME marketplace, apart from selectively for fully secured lending into the corporate end of the market, i.e. SMEs with turnover levels of £25m and above.

We have seen no examples of the High Street Banks lending unsecured to SMEs or in a subordinated position, the two core market areas that Finance Wales ('FW') has always looked to support in its agreed role as a "gap funder".

2. Alternative Sources of Funding

We endorse the comments made on the strong availability of invoice discounting and other asset based lending.

On informal investment (pages 25-27) our comments on the role of Business Angels and xénos are set out below.

The report suggests that Wales should emulate the Scottish business model embodied in LINC Scotland to raise informal and especially angel investment levels in Wales. It makes a recommendation for an equity guarantee scheme for angel investors as a way of stimulating angel investment in Wales. It also discusses various other initiatives that are currently holding back angel investment such as the need for Due Diligence, investee company preparation and a Welsh Angel Co-Fund.

On the specific recommendation for an equity guarantee scheme this needs to be considered in respect of the current tax incentives provided under the various UK Government schemes to encourage angel investment, in particular the Seed Enterprise Investment Scheme (SEIS) and Enterprise Investment Scheme (EIS) HMRC schemes. These schemes are driving angel investment in the UK and if angels were to utilise an equity guarantee scheme then they would not qualify for SEIS and/or EIS. It is recommended that discussions with HMRC are held before implementing such a scheme.

Levels of angel investment in Wales are lower than in Scotland. The reasons for higher levels in Scotland are many, including the private wealth creation generated by the oil and gas industry and lack of competition for angel funds from neighbouring regions. LINC is the equivalent of the UKBAA as a national organisation of which xénos is one of 24 members. Comparing xénos activity levels with LINC's is like comparing one of LINC's members with all their membership. LINC also includes HALO the Irish (North and South) angel network so the statistics are not just related to Scotland.

However, the Report does address the question of how angel activity in Wales can be increased. The range of proposals in the report (p26) is to be welcomed and xénos agrees with most of them. The move towards syndication in the Welsh angel market is not as strong as in Scotland or England and where it happens xénos has been the instigator. So the proposal to encourage small groups of angel investors (syndicates) may not be so appropriate in Wales.

The report asks if xénos should change its operational model. xénos has sought to continue to respond to its various client groups – companies seeking funding; investors and professional advisers. It has changed accordingly as well as moving towards a more commercial model to ensure its longevity. Most importantly the xénos model of collaboration with other networks to increase deal making, working with a specialised fund to offer gap funding and more proactive approach to investors has resulted in the Network responding to change and increasing its completion levels by nearly 3 fold. It is continuing to develop to meet changing market demands and the recent Dragon Fund is an example of this. The Report's recognition of the importance of the informal market is to be welcomed, and xénos sees itself as being an important contributor to the development of this funding sector in Wales for the foreseeable future.

On Venture Capital (VC) there are some misleading comments on Finance Wales investment team's links with other VCs (p28). In practice very few VC teams have "formal" relationships with one another unless via a joint venture agreement which are very rare in the industry. The vast majority of linkages are at a personal level.

These are then manifested in co-investment on a deal by deal basis and our Annual Review (issued to the Access to Finance Review and now attached here as an Appendix) incorporates details of a selection of these firms. As noted in the Review (p 28) we do have a Memorandum of Understanding (MOU) with Fusion IP, which has recently been renewed. Fusion is one of our key co-investors in venture capital in Wales with seven companies where we are co-invested. We also have regular meetings with and have agreed an informal arrangement to refer deals to and from the Business Growth Fund (BGF). It should be noted that many VCs no longer operate in the early stage pre-revenue space which Finance Wales operates in (e.g. 3i, Amadeus etc.), thus this is a relatively small tight knit group anyway, where Finance Wales plays a prominent role in Wales.

Turning to Peer 2 Peer Lending and Crowdfunding, we agree these are rapidly growing areas and becoming a key part of the alternative investment marketplace. In recognition of this we have held a number of discussions with many of the existing players during 2013 and in October, we launched an in-house review of how Finance Wales can address this emerging market. Finance Wales is looking at the possibility of creating a suitable internet platform for both equity and lending products and has commissioned an independent review to inform its thinking which will be available in January 2014.

We have already proposed to the Minister in October 2012 the possibility of creating an Entrepreneurs' Fund of £5m and a Technology Seed Fund of £7.5m. The latter is now incorporated in the FTR Funding recently agreed.

3. Finance Wales

For ease of reference we summarise our views under separate headings:

Finance Wales' Strategy and Remit

There are comments in the Review (p39) suggesting that there has been a "change of direction from the original focus" which seem misplaced. Whilst the Review refers to the initial Finance Wales mission statement in 2001 (p39), it makes no reference to the current governing document that now covers our remit – the Management Arrangement. This was originally drafted in 2006 when the direct ownership of Finance Wales moved from the WDA to the Welsh Ministers. The first paragraph of the General Purposes and Aims (section 3.1) states that -

'The Company shall be managed as a group of commercial development funds to provide businesses in Wales with flexible and sustainable finance for their development. Its activities seek to address market failure in this area and stimulate new investment by the private sector'

This document has been regularly reviewed by Finance Wales and the Welsh Government since then, most recently in June 2013 and no changes have ever been made to this primary objective. Moreover each year Finance Wales submits a formal Business Plan to the Welsh Government setting out clearly the core strategic aims of Finance Wales for the coming year. The Chairman meets with the Minister regularly to ensure alignment with Welsh Government policy and to consider new initiatives. A further example of the alignment of its execution capability and flexibility is the latest 'Help to Buy' residential shared equity housing scheme which has been swiftly launched on a very tight timeline by Finance Wales in conjunction with the Housing and Regeneration Department. We therefore do not follow and indeed refute the assertion of a change of direction, particularly on any kind of a unilateral basis. The same section of the Review (p39/40) suggests that Finance Wales became "focused on developing itself as an independent fund with its role as an arm of the Welsh Government becoming a secondary issue." This is pure conjecture on the part of the Author of the Review and has no basis whatsoever. Similar language of "reluctance" and "reticence" appear later on the same page and elsewhere as well as in the previous June Review, without any evidence to support such assertions.

The question of 'independence' has only ever applied to investment decisions which are properly made at arm's length from the public sector (this has been enshrined from the outset in all Finance Wales' investment activities).

'Independence' should also not be confused with our efforts to become self-financing which in 2010 were in response to a reduction in the direct Grant in Aid from the Welsh Government (£5.1 million in 2011/12 to £4.1 million in 2013/14) and the uncertainty of securing future funds either from Europe or from the Welsh Government. The Finance Wales Board therefore initiated a plan, which included cost reductions, operational efficiency improvements and the pursuit of additional sources of income. These measures were still aligned with our remit of providing commercial funds in a sustainable way.

The prospects for a future JEREMIE Fund in Wales were very uncertain and the need to raise private funds in the future seemed likely. This led to the pursuit of Fund Management opportunities outside Wales which were intended to establish a track record which would assist in raising funds for Wales in the future (and contribute to central costs thus enabling our activities in Wales to continue at the same and subsequently increased levels despite the reduction in Direct GIA from the Welsh Government). In the current financial year the Direct Grant is now £2.891m. It is important to note that these activities were staffed and funded locally and did not detract from our activities in Wales.

Independence in terms of ownership of Finance Wales or a reclassification only arose in 2009/10 when, in consultation with the Welsh Government, options were being considered to enable Finance Wales' borrowings to remain off balance sheet. Once this situation was resolved no further discussions around a change of ownership or reclassification took place.

Elsewhere the Review correctly states that “money with management” was considered to be an important element in improving investment opportunities in Wales, but incorrectly states that “this approach was quietly discontinued several years ago.” In fact, those support programmes (e.g. Access to Capital) and the associated staff and financial resources were transferred to the Welsh Government following a Strategic Review of Finance Wales which was undertaken when ownership of Finance Wales was transferred to the Welsh Ministers in April 2006. These programmes continue today in Business Wales.

In our view therefore Finance Wales has, since 2005/06, pursued a sustainable commercial strategy which has driven the investments we have made and the interest rates charged, in full agreement with and consent from the Welsh Government, as noted by the Minister in her response to the Review on 12th November.

There has been no change in strategy and we simply do not accept the allegation (p43) that there is “evidence of reluctance by Finance Wales to fully embrace its role in supporting SMEs and economic development in Wales and its apparent confusion over its commercial ambitions with its development responsibilities.” Our track record of raising £363million in Funding, (comprising £108m from the Welsh Government/Finance Wales, £100m from ERDF and £155m from the private sector); investing over £268m in Welsh SMEs; creating and safeguarding over 32,000 jobs and leveraging in circa £443m of private sector leverage, tells a very different tale.

Cost of lending to SMEs

This is the one part of the Review that appears to have attracted most attention in the media and in Plenary and has been the subject of further press articles published by the Author of the Review in recent days. This is a pity as it detracts from the main thrust of the Review.

Having said this, it was very clearly a key area to be reviewed and in contrast to the High Street Banks, Finance Wales willingly made available to the Review a very large amount of data on every one of the 1,713 loans made by Finance Wales since 2001. This included amount, date, term and interest rate. We also provided full detail of our current pricing matrix and details of our approach to risk pricing, although for understandable reasons of confidentiality we did not allow this to be published in the Review itself.

Unfortunately this data has only been used selectively in the Review and does not properly reflect the totality of Finance Wales' approach to pricing loans. We appreciate that the assessment of a suitable risk premium and the judgement of the value of collateral and Loss Given Default (LGD) ratios are a highly complex and in some cases esoteric matters, but most senior bankers and accountants will recognise that these are an integral part of any financial institution's risk pricing.

Much is made of the impact of EC Reference Rates (see a fuller analysis of these under State Aid Considerations below) but what has been overlooked is that like any other financial institution, the constituent parts of any pricing matrix for loans comprise three ingredients. These are (i) the cost of capital, (ii) the collateral rating, and (iii) the risk premium (LGD).

Whilst the Review acknowledges that in Finance Wales' formal response to the Minister on Part 1 of the Review (p33), Finance Wales made the point that its interest rates reflect that it adopts a greater tolerance towards higher risk SME lending and as a result incurs higher default rates. This acceptance is not borne out in the subsequent commentary, which to all intents and purposes chooses to ignore the risk premium argument (the LGD). This despite footnotes on pages 36-38 referring to what the LGD actually is.

As we stated in our submission most SMEs fall into the lower risk ratings (p37) and generally offer low or nil levels of collateral. These two ingredients comprise to form the basis of the risk premium.

The suggested rates put forward by the Review itself at 4.99% (p38) suggest a 100% level of collateralisation and a higher end SME rating of "BB". In practice Finance Wales usually lends with nil-50% collateral and most SMEs fall into either the lower B or CCC rating, suggesting Finance Wales' current average rate of 10% is in line with acceptable market rates and properly reflects the risk premium.

Moreover if we were to move to lower interest rates as suggested and maintain viable and sustainable funds , we would need to move to a tighter risk appetite and would not be able to support the riskier end of the SME spectrum at a BB rating or lower. This would potentially disenfranchise a large group of businesses that we are currently supporting. We have considered this and believe that we would need to tolerate loan defaults of no more than 5% as compared to the current budgeted levels of 10% to sustain an equivalent Fund performance (see also below under Future Options). We are aware that other respondents to the Consultation exercise have independently commented on this aspect and it is perhaps better for their views to be heard and considered alongside the comments contained here.

Equally relevant is the fact that Finance Wales' two main investing Funds – the Wales JEREMIE Fund and the Wales SME Investment Fund have 50% backing from the European Investment Bank (EIB) and Barclays respectively. The financial models on which their lendings are based includes a base case forecast of 10% fixed interest rates throughout the life of the banks' loans. Both Banks have set financial covenants based around these rates and the corresponding defaults. Any material variation in the financial models, as proposed, would therefore very likely require the consent of these funders and would materially reduce their perceived comfort with the ability of the funds to repay their obligations. These loans are legally binding contractual arrangements and any material changes such as those proposed in this Review could put these arrangements at risk. In the case of the ERDF funding in JEREMIE this would also threaten the perceived "legacy" funds to be returned to allow future investment in the next generation of SMEs once the EIB is repaid. We have calculated that to reduce average interest rates by 5% across the Board in a similar £60m JEREMIE Sub Loan Fund would reduce the "legacy " of the Loan sub fund by circa one third from £27.5m to £18.5m.

These are important considerations as any reduction in interest rates as proposed could reduce the availability of both matched private sector funding, and possibly legacy EC funding in the future, to support future funds such as a JEREMIE 2 Fund to the detriment of Welsh SMEs.

There is also the question of value for money in respect of public money and the issue of securing an appropriate commercial return for the taxpayer as a stakeholder from public/private backed funds.

The implications for future funds are covered in more detail later in this submission.

State Aid

This is a complex area but the comments within the review regarding GBER and De Minimis are misleading and inaccurate. We have instructed Eversheds to prepare an overview of these aspects and this is attached as an Appendix to this submission. This overview comments in some detail on the EC Reference Rates issue and the GBER and De Minimis issues and fundamentally disagrees with many of the comments in the Review.

It is also worthy of note that as with the question of interest rates, the current investing funds operate under contractual obligations with very different State Aid arrangements which cannot be unilaterally changed without reference to the Commission. The Wales JEREMIE Fund operates under a formal State Aid Notification as the Author of the Review is aware. The Wales SME Investment Fund operates under a MEIP arrangement based on an independent consultant's review. As noted in the Eversheds' overview (sections 4.7 and 4.8), Finance Wales cannot "unilaterally start providing subsidised loans because by doing so it would be in breach of various obligations it holds".

Equally relevant is the current updated State Aid Risk Guidelines and the latest revised draft GBER guidelines, both due to be implemented in June 2014. These make clear reference to a requirement that all "investments are profit driven" and the Fund should operate "a commercially sound investment strategy". Neither of these appears compatible with the proposals outlined in the Review.

4. The Wales Development Bank

Whilst perhaps conceptually attractive to some respondents on a macro level, as with previous proposals earlier in 2012 from both the Welsh Conservatives and Plaid

Cymru, the practical implications of such a proposal throw up far-reaching complications. Amongst these are regulatory issues, the possible need for a banking licence, capital adequacy requirements, conflict management and state aid considerations.

These are highly complex issues which will clearly take several months to be considered and worked through with the appropriate authorities if this approach is accepted as a viable change of direction.

Of more practical immediate consideration is the fact that all Finance Wales' existing funds are subject to legally binding obligations with third parties, as noted above which run to 2017 and beyond. Similarly the new Business Wales structure was also only set up in January 2013 under contractual arrangements, which we believe to run for three years.

The suggestion that all of these can be transferred across to the new Bank, needs much further careful and considered reflection in our view. No one could easily argue against the 5 Principles proposed by the Review (p8) although the key phrase in Principle 1, on the issue of access to funding is, in our view the words "every **viable** business". There are clearly very differing views between a commercial investor/lender and a purely economic investor on what constitutes a viable business.

If the Development Bank does wish to provide risk graded B-CCC SMEs with lower interest loans than Finance Wales currently supplies, then where would the matched private funding be found? The likelihood is that the Welsh Government would need to write a very large cheque from public funds to achieve this goal. The Review's references to other countries providing such Subsidised funds do not mean that the Welsh Government will necessarily wish to do similarly and this deserves careful consideration as to value for money considerations let alone State Aid matters.

5. Future Options

As we have noted above to implement some of the changes in the Review would be extremely difficult for the existing Funds on a number of levels.

We have summarised some of the approximate financial "costs" of operating a loan fund at lower average interest rates of 5%. This could well make it extremely difficult to raise matched private bank loans at the current leverage levels of 50%. This would suggest additional public money would need to be committed – perhaps 60% or slightly higher, which could lead to State Aid issues in itself.

Some form of interest rate subsidy outside of the Funds might be a possible solution under some form of de minimis state aid arrangements (perhaps a Funding for Lending (Wales) Scheme), but again this could still fail a state aid test as outlined by Eversheds and could cost an additional circa £9m for even a modest fund of £60m based on the models we have run as outlined above.

We should also recognise that we are currently in an exceptionally low interest rate environment; with nearly all economic forecasters suggesting that base rates will likely return to their long term average of 5% by 2016 or earlier. This will coincide with the launch of follow-on funds such as JEREMIE 2 and will need to be factored into any assessment of the likely costs of such a scheme.

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Over the past 2 years Finance Wales, under its existing structure, has successfully conceived and delivered a number of new initiatives for the Minister, such as the Wales SME Investment Fund, the Wales Micro-business Loan Fund and the Wales Property Development Fund, as well as the development of new roles as Sector Ambassadors within the Finance Wales Group. The current structure of Finance Wales operating funds for the Welsh Government at arm's length, but providing independent commercial investment decision making, has proven highly flexible and allows State Aid compliant funds to be created to deliver valuable economic development outputs.

6. Conclusions

This Review brings a useful external perspective on the challenges of the access to finance for SMEs, as the Minister has noted in her statement on 12th November. As such it is to be welcomed. However, it is disappointing to the Board of Finance Wales that many of the statements contained in the Review are based largely on misconceptions of the current role and remit of Finance Wales and misunderstandings of the risk based considerations that any lender or investor in the real world needs to take into account.

We believe that Finance Wales has faithfully followed its remit from the Welsh Government in recent years and has delivered both viable and sustainable funds for Welsh SMEs with a level of risk appetite that generally exceeds that of the Banks and other funding providers. We remain fully committed to supporting the growth and development of Welsh SMEs as part of the Welsh Government's economic development plans, by developing commercial funds with both public and private sector capital. We also continue to look for innovative ways to deliver funding as our recent submissions to the Financial Transaction Reserve and our future plans to develop a potential peer to peer/crowdfunding platform for Welsh SMEs have demonstrated.

Finance Wales already has/does many of the things that are proposed for the Development Bank e.g. it is a regulated business already; it has successfully leveraged private sector funds at the fund and at the deal level; it does attract capital to Wales that would not otherwise be here, acting as a gap funder, etc. and there is clearly scope to build on this without the time consuming and costly creation of a wholly new organisation (which is indeed acknowledged in the report).

The Board is committed to working with the Minister and her officials to ensure that the activities of Finance Wales remain relevant to Wales and to exploring new opportunities.

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National Assembly for Wales

Finance Committee Inquiry – Finance Wales

Response of the Board of Finance Wales plc

Appendix 4: **Finance Wales Group Corporate Structure and Governance**

January, 2014

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Appendix 4:
Finance Wales Group Corporate Structure and Governance, as at January, 2014

The Group

Finance Wales plc. is a wholly owned subsidiary of the Welsh Ministers acting through the Welsh Government. The Finance Wales Group is comprised of Finance Wales plc., a number of subsidiary companies and a joint venture (see Annex 1).

The Finance Wales Group provides fund holding and fund management services targeted at supporting small to medium sized enterprises (SMEs).

Companies within the Group operate the Wales JEREMIE Fund, the Small Loan Fund, the Rescue and Restructuring Fund, the Wales SME Investment Fund, the Micro-business Loan Fund, the Life Sciences Fund, the Wales Property Development Fund and Help to Buy - Wales.

Finance Wales Investments also manages and provides portfolio services for various funds including the Wales JEREMIE Fund, the Wales SME Investment Fund, Wales Micro-business Loan Fund as well as Technology Commercialisation Centre, the Wales Creative IP Fund, the Finance Wales Investment III Fund, the Objective 1, Objective 2 and Objective 2 Transitional Funds.

There are two funds which are managed by fund managers outside the Group namely the Wales Life Sciences Investment Fund managed by Arthurian Life Sciences Limited and £1m of the Micro Loan Fund which is managed by the Wales Council for Voluntary Action (WVCA).

xénos – The Wales Business Angels Network Limited which introduces investors to businesses seeking growth funding is operated by Finance Wales.

FW Capital Ltd is authorised and regulated by the Financial Conduct Authority. This part of the Group is responsible for managing a £17 million equity fund in the North East of England, £10 million Tees Valley Catalyst Fund and loan and mezzanine funds totalling £45 million in the North West of England.

Governance

Although Finance Wales plc. is not required to comply with the UK Corporate Governance Code issued by the Financial Reporting Council the directors are committed to applying the underlying principles of the Code, having regard to the size of the company.

Board of directors

The Board consists of a non-executive Chairman and five non-executive directors, together with two executive directors, the Chief Executive and the Director of Finance and Administration, as listed below:

Ian Johnson – Chairman	Sian Lloyd-Jones – Chief Executive
Ivar Grey	Margaret Llewellyn OBE
Clive John	Kevin O'Leary – Director of Finance & Administration

Huw Morgan Christopher Rowlands – Senior Independent Director

The Board meets regularly in addition to an annual strategy review. A Board performance and evaluation process is in place. It is an internal exercise based on an evaluation questionnaire which is conducted by the Chairman and Senior Independent Director, Succession planning and strategic input to exit activity were highlighted as areas for specific focus over the last twelve months. This process is itself reviewed by Mazars, as Internal Auditors to provide an independent check.

The Board of directors have a variety of professional backgrounds with relevant skills and experience. The Board receive monthly management information in respect of the Group's financial and non-financial performance. It is the role of the Board to challenge the information provided and ensure that it is fit for their purpose. In accordance with the Management Arrangement an observer from the Welsh Government or their alternate attends all Board meetings and is provided with information as it is disseminated to Board members.

Board Committees

The following Board committees have been set up, each with its own terms of reference, procedures, responsibilities and powers:

Audit Committee

The Finance Wales Group Audit Committee comprises two non-executive members:

- Mr Ivar Grey (Chairman)
- Mrs Margaret Llewellyn OBE

The Audit Committee's duties include inter alia:

- To review the effectiveness of the group's internal control and risk management systems.
- To ensure that adequate processes and mechanisms are in place for the management of risk.
- Reviewing the scope and results of work of both the internal and external auditors.
- Reviewing the annual financial statements and related policies and assumptions.

The Audit Committee meets quarterly. It is normally attended by the Chief Executive and the Director of Finance and Administration together with the internal and external auditors, the Welsh Government Department for Business, Enterprise, Technology and Science Group Finance Director and the Senior Corporate Governance Manager.

In addition to the quarterly meetings the Audit Committee also has private meetings with the management, internal and external auditors at least once a year.

Feedback on the business of the Audit Committee is given to the Board and the minutes are circulated to the Welsh Government Corporate Governance Committee.

Remuneration Committee

The Remuneration Committee comprises two non-executive members:

- Mr Clive John (Chairman)
- Mrs Margaret Llewellyn OBE

The Remuneration Committee is responsible for advising the Chief Executive and the Board on matters relating to recruitment and remuneration policies, and reporting to the Board as necessary.

The Chief Executive and HR Consultant normally attend the Remuneration Committee.

Nomination Committee

The Nomination Committee now comprises all members of the Board. The Nomination Committee is responsible for matters relating to identifying and nominating candidates for Board vacancies and for the process of recruitment of both executive and non-executive directors.

Valuations Committee

The Board has recently established a Valuations Committee which is comprised of members of the Senior Management Team. The purpose of the Valuations Committee is to assist the Board in fulfilling its oversight responsibilities in respect of the valuation of assets and legacy forecast.

Conflicts Committee

The Conflicts Committee is comprised of two non-executive members and one executive member of the Board. The purpose of the Conflicts Committee is to ensure that Finance Wales has appropriate procedures in place for managing conflicts of interest in accordance with financial services best practice.

Investment Committee

The Investment Committee oversees investment related activities for all funds on behalf of Finance Wales companies in accordance with the Investment Operating Guidelines and respective Facility Agreements. It considers recommendations for investments of in excess of £500k.

Internal Control

Responsibility for the management of the risks relating to the operations of Finance Wales lies with its Board of directors. The directors acknowledge that they are responsible for the company's system of internal control and for reviewing its effectiveness.

Additionally the Chief Executive has personal responsibilities analogous to those of the Accounting Officer of a public body. These responsibilities are detailed in the Management Arrangement. This includes responsibility for reviewing the effectiveness of the system of internal control. Her review of the effectiveness of the system of internal control is informed by the work of the company's internal auditors who operate to Government Internal Audit Standards. They submit regular reports, which include their independent opinion on the adequacy and effectiveness of the company's system of internal control together with recommendations for improvement.

Finance Wales has in place its own Risk Management Policy and Risk Register. The individual risks contained in the Finance Wales Risk Register have been consolidated into a Finance Wales Strategic Risk Map which is reviewed regularly by the Senior Management Team, Audit Committee and Board. The company's risk management arrangements have been approved by the Board and key risks are brought to their attention on a regular basis.

Financial risk management objectives and policies

The principal business of the company is investment and, as such, exposure to and management of portfolio risk is an inherent feature of this activity, particularly given the area of the market in which the company operates. The current economic climate provides significant challenges for such funds which the company continues to address in a managed way.

Finance Wales operates a series of rigorous processes to ensure the probity and quality of all investments made, including internal or external due diligence as required. Certain appropriate individuals have delegated authority to sanction lower value investments, beyond which they are sanctioned by the Investment Committee which meets on a regular basis. The Group's current internal auditors, Mazars and external auditors, Deloitte, appraise investment activity both by way of sampling individual investments and at the corporate level as part of the statutory accounts preparation.

The Wales JEREMIE Fund, which has the bulk of current funds available for investment is also subject to scrutiny by the Welsh Government's European Funds Audit Team (EFAT).

It is also worth noting that all the processes were subject to diligence by Finance Wales' private investors such as Barclays Bank and the EIB, and they form part of Finance Wales' contractual obligations to these stakeholders. This diligence also includes such matters as setting the investment operating guidelines and other internal control mechanisms. The activities undertaken by FW Capital Limited are also subject to regulation by the Financial Conduct Authority.

The Group's activities expose it to a number of financial risks including cash flow risk, credit risk and liquidity risk:

- **Cash flow risk:** The Group, borrows funds and subsequently lends to companies, makes use of appropriate hedging policies where necessary, to mitigate the risk of interest rate exposure. Interest-bearing assets and liabilities are held at fixed rate to ensure certainty of cash flows.
- **Credit risk:** The Group's financial assets are bank balances and cash, loan receivables and investments. The credit risk is primarily attributable to its loan receivables. The amounts presented in the balance sheet are net of allowances for doubtful debt. An allowance for impairment is made where there is an identified loss event which, based on previous experience, is evidence of a reduction in the recoverability of the cash flows.

The credit risk on derivative financial instruments is limited because the counterparties are banks with high credit-ratings assigned by international credit-rating agencies. There is no significant concentration of credit risk as its exposure is spread over a large number of counterparties and companies.

- **Liquidity risk:** In order to maintain liquidity to ensure that sufficient funds are available for on-going operations and future developments, the group uses long-term debt finance.
- **Counterparty risk**: The Company recognises this as a significant risk given the general instability exhibited by financial institutions in recent times. The Company has adopted a Treasury Management policy to address this risk and takes steps to ensure that any cash held, is in a range of institutions who meet the bank rating criteria set out in the policy.

Relationship with External Governance Bodies

Welsh Government Corporate Governance Committee

Copies of Audit Committee minutes are routinely provided to this committee. An annual governance statement is also provided, which highlights the work that has been carried out during the year.

Financial Conduct Authority (FCA)

Both FW Capital Limited and the staff who undertake regulated activity are required to be approved by the FCA. As a regulated body FW Capital is required to submit monthly, quarterly and annual reporting requirements to the FCA. Our external auditors are also required to provide a statement of compliance to the FCA confirming compliance with the rules or guidance during the preceding twelvemonths and where appropriate any remedial action.

The National Crime Agency (NCA)

Given the financial nature of the work undertaken by Finance Wales and the number of businesses it engages with, there is regrettably a high potential for fraud and money laundering to take place. Whilst the appropriate level of pre investment diligence is always undertaken, it remains difficult to eliminate any chance of financial crime. Accordingly all members of staff are trained to recognise any signs of potential financial crime. The Group has a designated Money Laundering Reporting Officer (MLRO) whose responsibility is to liaise with the individual raising any suspicion and make a report to NCA as required.

Office of Fair Trading (OFT)

A number of Finance Wales' subsidiary companies hold consumer credit licences. Accordingly the Money Laundering Regulations 2007 apply to those businesses and their supervisor is Office of Fair Trading ('OFT'). The OFT have powers to take enforcement action where appropriate against Finance Wales if it fails to put in place the required anti-money laundering system and controls, or fails to register with the OFT when required to do so. They also have powers to prosecute and to impose civil financial penalties.

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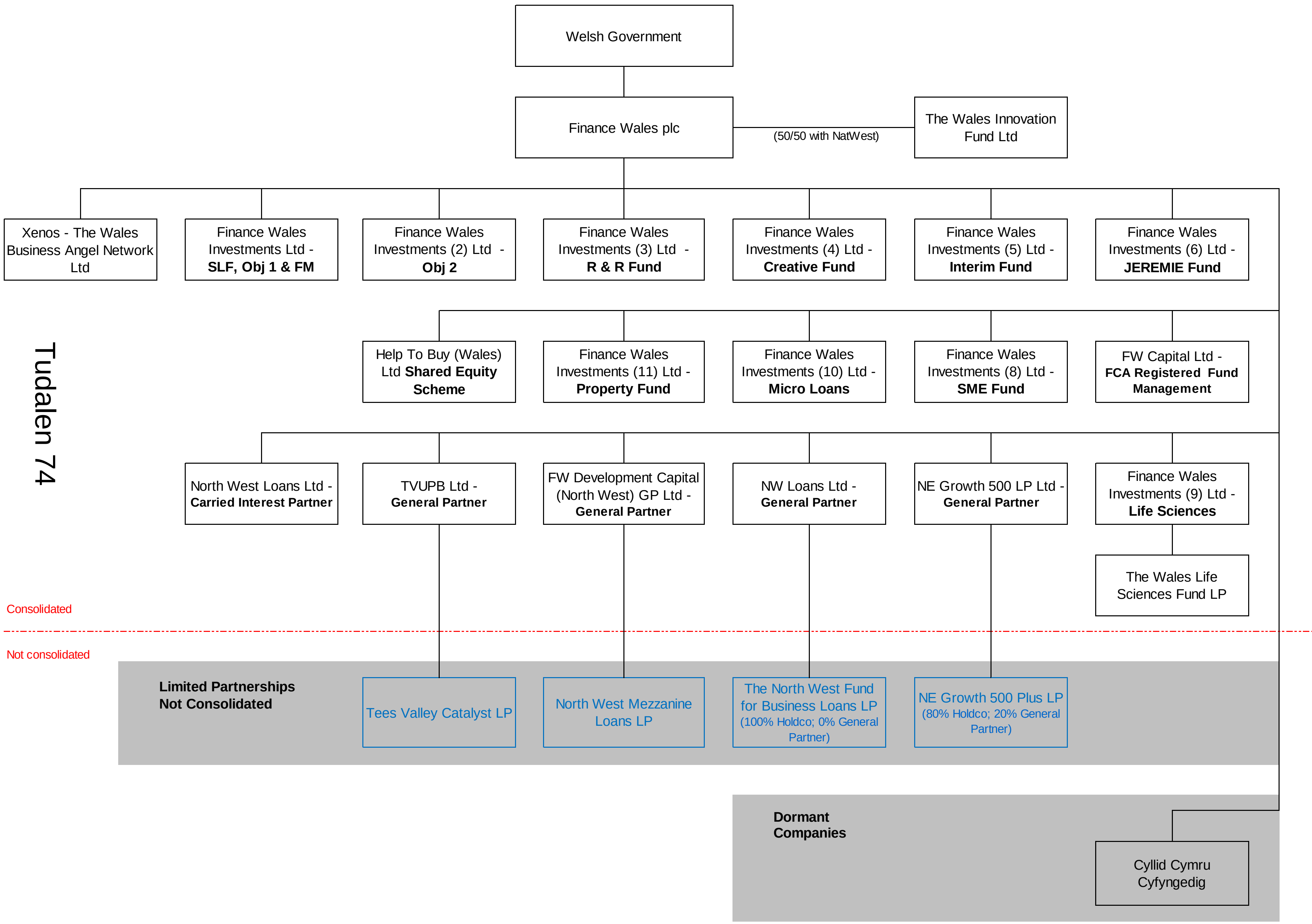
As part of the UK Government's programme of regulatory reform for financial services, the Financial Conduct Authority will take over regulation of consumer credit from the Office of Fair Trading on 1 April 2014. This brings the conduct of business regulation under a single financial services regulator.

As part of the transitional arrangements a number of Finance Wales companies have registered for 'interim permission' and will be applying for full permission to carry on regulated credit activities in due course.

ENDS

Finance Wales Group - Oct 2013

Appendix 4



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Finance Wales Inquiry
Response from the Board of Finance Wales plc -
Evershed State Aid Advice

Review of access to Finance Review – Stage 2 Review

Assessment of State Aid element of the Review

1. **Introduction**

1.1 The purpose of this Report is to provide a review of the comments made by Professor Dylan Jones-Evans within his report headed "Access to Finance Review – Stage 2 Review" ("the Review") in the context Finance Wales activities in providing loan finance and the application of the EU State aid rules to the provision of such loan finance.

1.2 The contents of this Report relate to State aid compliance issues only in the context of the Review and have been produced by Eversheds for the benefit only of its client, Finance Wales, and Eversheds' duty of care in respect of the contents of this Report apply only in respect of Finance Wales. Should Finance Wales disclose this Report to any third party, the legally privilege nature of this Report is likely to be lost and Eversheds shall owe no duty of care to any such third party.

2. **Executive Summary**

2.1 It is considered that the Review appears to be incomplete in terms of its assessment of the State aid rules and how they apply to loans made by Finance Wales. In particular, the Review does not reflect that:

2.1.1 Use of methodology set out in the Reference Rate Communication only provides for a proxy for the market rate in the absence of an actual market rate; and

2.1.2 the methodology set out in the Reference Rate Communication is not applicable in circumstances where the risks in terms of the loan are abnormally high. This is the case, in particular, where the loan is subordinated in any way and also potentially where there is no security provided.

2.2 The review does not seem to appreciate that use of the General Block Exemption Regulation is not a given in terms of justifying subsidised loans by Finance Wales and that any aid would need to be in compliance with the requirements of the General Block Exemption Regulation and, in particular, will need to be applied as against relevant eligible costs in order to be permitted. Whilst this is not an issue in terms of use of De Minimis aid Block Exemption, de minimis aid is a finite resource for any entity and may have already been utilised or may be needed at a later date by relevant entities to cover costs that cannot otherwise be justified in State aid terms.

2.3 The review does not seem to appreciate that in a number of cases (in particular, the Finance Wales JEREMIE Fund) it is not within Finance Wales' purview to simply change the basis, unilaterally, on which funds are applied to the end recipients.

2.4 Whilst reference is made to State aid advice being sort it is unclear if this was on a generic basis or linked specifically to the actual funds and the nature of the deals that Finance Wales undertakes. Our view is that the review seems to be based on what the general State aid principles are rather than advice specific to their application to the nature of the deals that Finance Wales undertakes

3. **The cost of borrowing and the EU reference rate**

3.1 The provisions of the Review included suggestions that Finance Wales can lend (without the risk of granting State aid) at a rate of no less than those calculated in accordance with the methodology set out within the Communication from the Commission on the revision of the method for setting the reference and discount rates.("the Reference Rate Communication")[1]. This is considered to be an incomplete assessment of how the State aid rules apply to loans by public bodies and, in particular, does not take into account the fact that the reference rate provides for a "proxy" for the market rate in the absence of there being a market rate rather than operating as a definitive rate for lending by public bodies in all circumstances.

3.2 The State aid rules and, in particular, the application of the so called market economy investor principle/market economy lender principle (MEIP/MELP) operate on the basis that aid issues will not arise if public funds are applied on the same basis as those that would be offered by a prudent private sector investor/lender motivated by profit, if presented with the same circumstances. It is, therefore, considered that if the market rate is actually higher than that based on use of the reference rate methodology then simply relying on the reference rate (as a proxy for the market rate) raises the potential for such a loan still to contain elements of State aid. This point is recognised in guidance[2] issued by the Department of Business of Innovation and Skills, in the response of the Question *"What is the Commission reference rate? Is there aid when I use the reference rate?"* where it is stated that :-

> "*the Commission's reference rate was put in place for member states to be used as a proxy for the market rate. However, particularly in light of recent economic crisis and credit freeze, you should consider whether the*

[1] Communication from the Commission on the revision of the method for setting the reference and discount rates *OJ C 14, 19.1.2008, p. 6–9*

[2] BIS State aid: Frequently asked questions. May 2012

reference rate genuinely reflects the rate which would be available to the beneficiary on the market. If you provide finance on better terms than would have been available on the market then there will still be aid to them, regardless of the reference rate.

Therefore the reference rate plus the appropriate margin based on the credit rating of the company offered, as set out in the reference rate communication, is considered as a ***minimum rate*** *rather than a definitive guide to the rate which should be used".*

3.3 It is considered that this guidance is consistent with MELP as if use of the reference rate methodology provides for a rate which is demonstrably lower than that which would be offered by the market (in comparable circumstances) then there would be a clear benefit to the recipient entity as a result of the application of State resources (in the form of the state loan).

3.4 It is also noted within the Review that reference is made (at footnote 44) to an article written by Professor Nicolaides[3] and within that article Professor Nicolaides expressly states (within the first paragraph of section ii.2.1 – Reference rate) the following:-

"the Reference Rate is a proxy for the market rate of interest and can be used in the absence of corresponding market rates".

This clearly indicates that a rate calculated using the reference rate methodology should only be relied upon in State aid terms where there is no corresponding market rates. This in turn suggests that if there is such a corresponding rate then that rate rather than the rate calculated using the reference rate methodology should be used in order to demonstrate no benefit to the recipient entity

3.5 In addition to a rate calculated using the reference rate methodology only amounting to a proxy for the market rate (in the absence of any corresponding market rate of interest), it is considered that the methodology is only relevant in calculating the proxy rate in limited circumstances where the loan terms are standard in nature and, in particular, where there is no element of subordination in respect of the public sector loan against any other private sector debt.

3.6 The EC within a number of State aid decisions[4] have expressly indicated that the Reference Rate Communication cannot directly be applied for the assessment of subordinated loans and that it is of the opinion that it only applies to senior debt. Within these decisions, the EC has expressly referred to "subordinated loans constitute a special situation" and that special situations are caught by the

[3] Financial Engineering Instruments and their Assessment under EU State aid Rules – Phedon Nicolaides

[4] State aid N 689/09 – Germany KfW loan scheme "Capital for jobs and investments and N55/2008 - GA/ERDF subordinated loan scheme for Brandenburg

introductory sentence relating to loan margins within the Reference Rate Communication, which underlines that "the following loan margins are to be applied ***in principle*** depending on the rating of the undertaking concerned and the collateral offer". The qualification "in principle" allows the Commission to deviate from the grid in justified circumstances".

3.7 It is considered that the reference to "special circumstances" and "justified circumstances" is intended to cover circumstances where public loans made carry additional risk (e.g. are subordinated) and will potentially cover not only loans that are made on a subordinated basis but also those that can be regarded as containing unusual terms which would increase the risk for the lender over that covered by standard lending conditions. It is considered such special circumstances could include where no security is offered. This conclusion is based on the definition of debt instruments under the EC Risk capital Guidelines[5] which refers to them as :

"loans and other funding instruments which provide the lender/investor with a predominant component of fixed minimum remuneration and are at least partly secured"

3.8 As a result it is considered simplistic to argue that lending at a rate based on the use of the methodology set out in the Reference Rate Communication can be relied upon by Finance Wales in all circumstances in relation to loans that they provide in order to demonstrate that such loans contain no aid.

3.9 It is noted at paragraph 2 of page 39 of the Review that reference is made to the following feedback provided by an SME:-

> "I am surprised to see that the offer on the table is more expensive in interest rates compared to the existing High Street overdraft in place, that personal security is required and are the same if not more stringent as those for the Bank…"

Whilst the details of this example are not known, it is possible that the Finance Wales' loan was subordinated in some way to the existing bank debt and therefore the use of the Reference Rate Communication to calculate the interest rate would not be relevant. It would be entirely consistent with commercial lending principles for a subordinated debt (being at greater risk) to be provided at a higher rate than any senior debt.

[5] Community guidelines on state aid to promote risk capital investments in small and medium-sized enterprises (Text with EEA relevance) *OJ C 194, 18.8.2006, p. 2–21*

4. Use of the General Block Exemption Regulation and the De Minimis Aid Block Exemption Regulation.

4.1 A theme throughout section five of the Review is the view that Finance Wales could simply reduce interest rates on the loans they provide, with such interest rate subsidies being justified under either the General Block Exemption Regulation ("GBER") or the De Minimis Block Exemption Regulation. Whilst it is clear that loans by Finance Wales at subsidised rates are potentially capable of being provided under these Block Exemption Regulations, it is considered that the references in the Review as to how this can be achieved are not complete in nature.

4.2 In respect of the terms of the GBER, any aid (i.e. interest rate subsidy) in order to fall within the safe harbour provided by the GBER must comply with its general provisions as well as those specific to the relevant measure being relied upon to justify the aid within the GBER. In terms of specific measures funding can, as a general rule, only be applied as against specific eligible costs. On this basis, in order for Finance Wales to be able to provide subsidised loans in compliance with the GBER, the relevant recipients and Finance Wales must be able to demonstrate that the loans (and the subsidies entailed in the same) will be applied as against such eligible costs. Without such evidence it is not possible for such an interest rate subsidy to be justified in State aid terms on the basis of compliance with the GBER.

4.3 It should be noted that the GBER does not provide for a carte blanche approach in terms of the provision of State aid with such aid being required to be targeted towards specific areas. For example, the Regional Investment and employment aid and SME investment and employment aid measures require that funding only be applied towards "initial investment costs" (as defined within the GBER). Other measures such as those relating to environmental aid and R&D aid are even more specific in terms of eligible costs to which aid must be applied. Whilst the Review refers to SMEs located in assisted areas it does not refer to the need for any aid to be applied as against relevant eligible costs.

4.4 It is therefore not simply a case of stating that Finance Wales can provide subsidised loan based on the GBER, as there would always be a question as to whether the proposed use of the loan complies with the requirements of the GBER in general and the specific measure in the GBER being relied upon. The fact that an SME is located in an assisted area does not mean it is automatically capable of receipt of a subsidised loans from Finance Wales as it will be dependent on whether the aid is applied/capable of being applied towards eligible initial investment costs.

4.5 In terms of application of De Minimis aid, in accordance with the De Minimis aid block Exemption, whilst there are no restrictions in terms of costs as against which aid may be applied, it is considered that again the approach taken within the Review does not provide the full picture. In particular, the Review does not seem to take into account the possibility that SMEs may already have utilised some or all of their De Minimis entitlement at the point in time that the Finance Wales loan is given or alternatively may still require that De Minimis allocation to enable them to receive funding for costs which would otherwise not be capable of being funded under any other State aid rules (this would particularly be the case in relation to operating aid).

4.6 It is also noted that reference is made within the Review to De Minimis aid not being required to be cumulated with any aid other than De Minimis said (see footnote 46). This is factually incorrect as paragraph 11 of the De Minimis Block Exemption Regulation expressly states the following:-

> "in order to avoid circumvention of maximum aid intensity provided in different community instruments, De Minimis aid should not be cumulated with State aid in respect of the same eligible costs if such cumulation would result in an aid intensity exceeding that fixed in these specific circumstances in each case by a block exemption regulation or decision adopted by the Commission".

This wording is also mirrored within the GBER (Article 7(3)).

This therefore requires that evidence be obtained in advance of any subsidised loan being offered not only as to any de minimis aid previously received/committed to be being received but also any other aid already received/committed to be received on the basis of approved State aid schemes/other Block Exemptions in relation to costs which any Finance Wales loan would be applied base on de minimis aid.

4.7 A further point that does not seem to be addressed within the Review is that there may be a number of circumstances in which Finance Wales is precluded from providing subsidised loans on the basis of existing State aid decisions and/or its relationship with third parties. By way of example, reference is made at various points within the Review to the Finance Wales JEREMIE Fund and loans provided by Finance Wales under that Fund. This Fund is subject to an existing State aid approval[6] and within that approval it is expressly stated (at paragraph 20) that all loans will be provided under normal market conditions. The provision of subsidised loans would amount to a significant change to the basis on which the EC approved the Finance Wales JEREMIE Fund.

[6] N700/2007 Finance Wales JEREMIE Fund

4.8 In addition, the basis on which the Finance Wales JEREMIE Fund operate needs to be in compliance with the basis on which the ERDF funding is required to be applied based on the relevant ERDF application and offer letter. The offer letter would undoubtedly require the ERDF funds to be applied in a manner consistent with the requirements of the State aid decision and therefore would not allow Finance Wales to provide loans (without variation) other than on commercial terms. The changes to this position would require approval not only from the European Commission (via WEFO) in terms of the basis on which any ERDF funds and match funding are applied through the fund, but also the European Investment Bank ("the EIB") which provided 50% of the funding towards the Finance Wales JEREMIE Fund as a whole. Finance Wales is, therefore, due to the basis on which the Finance Wales JEREMIE Fund was set up and approved unable to simply unilaterally start providing subsidised loans because by doing so it would be in breach of various obligations it holds in relation to operation of the Finance Wales JEREMIE Fund. Changes to the basis on which funds are applied, if not approved in advance, would be inconsistent with the basis on which it was approved (in terms of both the State aid and ERDF rules) and potentially obligations held to other funders (i.e. the EIB)

22nd November 2013

Eversheds LLP

Finance Wales Group

Annual review 2012-13

Our mission

“To maintain our position as the UK’s leading SME fund manager, delivering commercial investments from public and private funds to support and encourage SME growth and create sustainable businesses in Wales, fully aligned with Welsh Government policies.”

Welcome

Finance Wales was established in 2001 as a result of a Welsh Government policy to increase the availability of commercial investment to Welsh small and medium-sized businesses (SMEs). We focus on growth SMEs and in recent years we've provided a critical source of investment for start-ups as well as established SMEs.

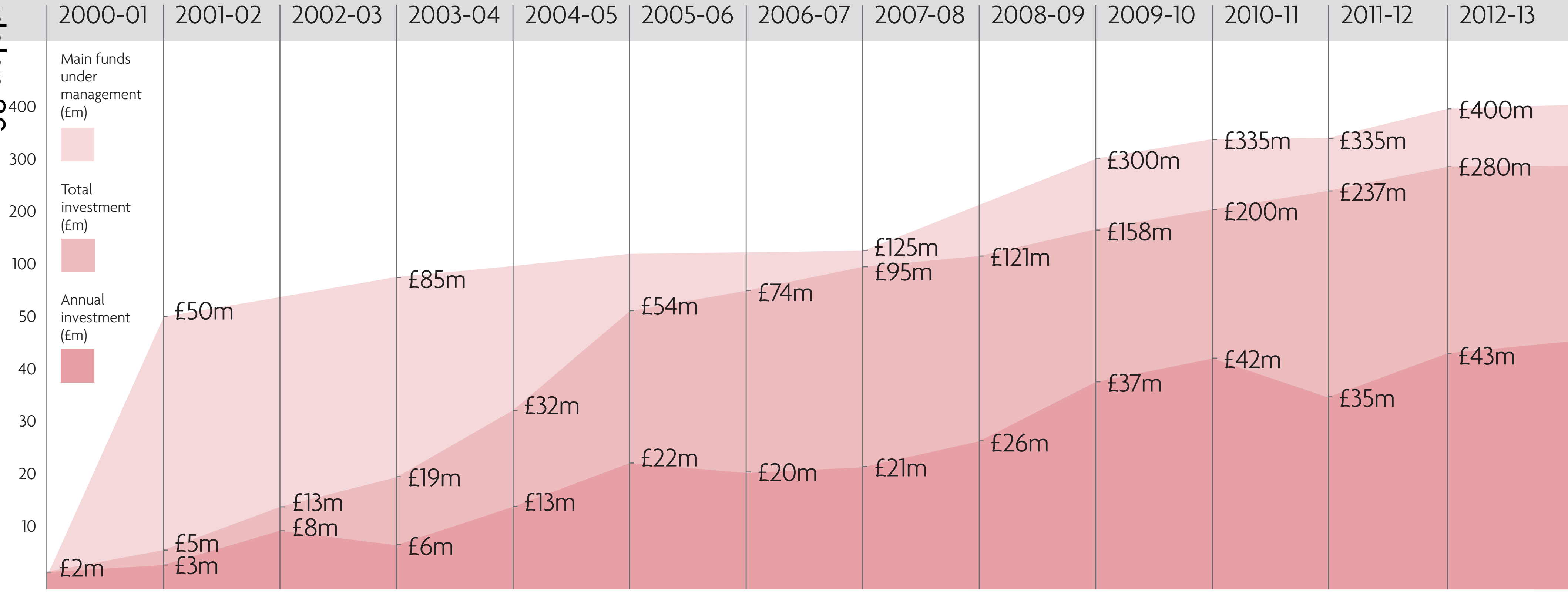
Today, the Finance Wales Group is one of the UK's largest SME investors. Headquartered in Cardiff, we operate through our Finance Wales and FW Capital brands and have local offices in the areas we invest in. xénos, the Wales Business Angel Network is also part of the Group.

The Group currently manages funds approaching £400m and has invested over £288m through 3101 investments to date. These investments have leveraged an additional £455m private sector investment.

2012-13 highlights

Finance Wales £31m invested, 189 debt and equity investments, £22m private sector leverage. FW Capital £12m invested, 63 debt and equity investments, £7m private sector leverage. New funds £40m Wales SME investment fund, £6m Wales Micro-business Loan Fund. Extra £10m for North West Loans Plus Fund

Investment history



Investing in growth SMEs

The right investment at the right time

We're currently investing funds in SMEs in Wales as well as the North East and North West of England. In 2012-13 we started investing the £40m Wales SME Investment Fund and the £6m Wales Micro-business Loan Fund. Building on our success, we also started investing an additional £10m in the North West from The North West Fund for Loans Plus.

Investing at all stages, we provide SMEs in a wide range of sectors with debt, mezzanine and equity investments to help them achieve their growth plans. We assess each business plan individually, tailoring any investment to meets the SME's needs.

We invest for long-term growth and can invest follow-on rounds as an SME grows. We know the backing of a strong investor can play a key role in an SME's success and our experienced investment staff build long-term relationships with the businesses we invest in.

As our reputation has grown, we've built an extensive network in the corporate finance sector and also focused on building relationships with partner investors to increase the amount of investment available to the SMEs we invest in. We're a committed co-investor and we partner with leading UK fund managers, banks as well as business angels and others.

> “The Wales JEREMIE Fund is recognised as one of the most successful funds of its type. Welsh SMEs can access the most comprehensive source of growth capital available in the UK from Finance Wales.”

Ian Johnson, Chairman, Finance Wales Group

Proud co-investors

Disruptive Capital Finance Vanguard Atlantic ERA Technology
Notion Capital Longbow Oxford Technology ECF
Porton Capital Altima Partners E-Synergy
IP Group New Hill Management Rainbow Seed Fund
Mercia Technology Fund Midven Fusion IP

Regional focus

Wales

Finance Wales has been backing Welsh SMEs at all growth stages since 2001. We've continued to invest through the tough economic conditions since 2008, launching the £150m Wales JEREMIE Fund in 2009. In 2012-13 we started to invest two new Welsh Government funds, making a further £46m available to Welsh SMEs.

The Welsh Government-backed £40m Wales SME Investment Fund and £6m Wales Micro-business Loan Fund complement the Wales JEREMIE Fund. This has increased the number of businesses potentially eligible for investment from Finance Wales, including those selling goods and services to consumers rather than businesses.

We have staff based throughout Wales at offices in Cardiff, Llanelli, Newtown and St Asaph. We're committed to backing all types of Welsh SMEs from start-ups through to more established businesses. Finance Wales can invest from £1,000 to £2m at a time and up to a total of £5m in one SME through follow-on investments.

We encourage our locally based staff to understand the businesses we invest in to make sure our investments are tailored to their needs and structured to underpin their long-term growth. We also use our expertise and experience to work with businesses as they grow to maximise the benefit of our investment.

2012-13 highights

- £31m invested through 189 debt and equity investments
- £22m additional investment leveraged
- £9m invested in high-growth, IP-rich Welsh technology-based businesses
- £7m co-invested through 18 investments
- 5 exits, including largest to date with a 2.4X return
- Enterprise Finance Guarantee lender accreditation achieved

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xénos, the Wales Business Angel Network works with businesses to prepare them for investment and then matches them with private investors from its extensive database. It facilitated £2.2m of business angel investment in 20 Welsh SMEs in 2012-13. Network membership currently exceeds 120 registered UK and overseas-based business angels investing in a wide range of Welsh SMEs.

Established in 1997, xénos continues to facilitate investment in Welsh SMEs. It also encourages syndicated investment, strengthening its relationships with other networks such as the South West Angel and Investor Network (SWAIN). xénos also boosted its professional services network in 2012-13.

2012-13 highlights

- £2.2m of business angel investment facilitated in 20 SMEs
- £1.7m additional private investment leveraged
- Over 120 registered business angels investing in all types of businesses
- £19m of private investment in 182 Welsh SMEs facilitated since 1997

Regional focus

The North East

FW Capital can structure single-round debt, mezzanine and equity investments of between £350,000 and £1.25m in SMEs based throughout the North East of England from the North East Growth Plus Fund. We manage the fund, which is part of the £125m Finance for Business North East JEREMIE Fund, for North East Finance.

Our Newcastle-based team structures growth investments for established SMEs based in Northumberland, Tyne and Wear, Durham and the Tees Valley. We can also back the SMEs we invest in with follow-on rounds as they grow and in 2012-13 we invested a follow-on round in Gateshead-based Propeller Holdings.

2012-13 highlights

- £3.2m invested through 8 investments
- £3.1m additional investment leveraged
- 1 follow-on investment

Regional focus

FW Capital

The North West

Building on our success in the North West, we started investing an additional £10m in 2013 when the £35m North West Fund for Business Loans was increased by £10m and renamed The North West Fund for Loans Plus. The Loans Plus Fund provides established SMEs in the North West with loans and mezzanine finance from £50,000 to £750,000 – up from the previous maximum of £250,000.

Our North West team operates from offices in Liverpool, Manchester and Preston and works with SMEs to provide loans for a range of purposes, including owner-occupier property purchases, asset/equipment purchases or working capital requirements.

2012-13 highlights

- £8.7m invested through 55 loans
- £3.5m additional investment leveraged
- Started investing an additional £10m in the North West from The North West Fund for Loans Plus

Main funds under management

Finance Wales

Fund	Size	Stakeholders	Remit	Coverage	Status
Wales Property Development Fund Launched May 2013	£10m	Welsh Government	Short-term property development loans	Wales	Investing
Wales Micro-business Loan Fund	£6m	Welsh Government	Start-up Development capital	Wales	Investing
Wales SME Investment Fund	£40m	Welsh Government Barclays Bank	Development capital Succession Acquisition	Wales	Investing
Wales JEREMIE Fund	£150m	European Investment Bank Welsh Government European Regional Development Fund	Early stage/Technology ventures Development capital Acquisition	Wales	Investing
Interim	£30m	Barclays Bank Welsh Government	Early stage/Technology ventures Development capital Succession Acquisition	Wales	Closed
Objective 1	£45m	Barclays Bank European Regional Development Fund	Early stage/Technology ventures Development capital Acquisition	Wales	Closed
Objective 2	£35.9m	Barclays Bank Welsh Government European Regional Development Fund	Early stage/Technology ventures Development capital Acquisition	Wales	Closed

FW Capital

Tees Valley Catalyst Fund Launched June 2013	£10m	Tees Valley Unlimited Stockton-on-Tees Borough Council Regional Growth Fund	Security for performance bonds	Tees Valley	Investing
North East Growth Plus Fund	£20m	European Investment Bank European Regional Development Fund North East Finance	Development capital	North East of England	Investing
The North West Fund for Loans Plus	£45m	European Investment Bank European Regional Development Fund North West Business Finance	Development capital	North West of England	Investing

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Financial summary 2012-13

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	2011-12	2012-13
	£000	£000
Investment and fee income	9,616	8,767
Profit/(loss) on disposal of equity investments	(1,089)	457
Other income/ERDF grant release	4,769	7,631
Welsh Government support	4,222	3,147
Total income	**17,518**	**20,002**
Administrative costs	(12,394)	(13,679)
Impairments/provisions	(13,617)	(13,372)
Operating profit/(loss)	**(8,493)**	**(7,049)**
Net interest and other movements	(463)	(1,593)
Profit/(loss) before taxation	**(8,956)**	**(8,642)**

2012-13 financial highlights

- The sale of our stake in Unite Technologies contributed to our profit from the disposal of our equity investments
- We continued to reduce our reliance on Welsh Government support as our fund management fee income increased
- Our impairments/provisions were slightly lower despite economic conditions
- Our administrative costs rose as we recruited new staff to invest the Wales SME Investment and Wales Micro-business Loan Funds

Our future

A sustainable long-term investment company

SMEs play a key role in the economy and their success not only means a stronger economy, but also better returns on our investments so we can continue to back SMEs in future. The Finance Wales Group is a leading UK SME fund manager and we aim to be a sustainable long-term investment company. We raise our funds from a range of commercial and public sources and we need to ensure we achieve effective returns when we invest these funds. The fees we earn on the funds we manage also contribute to running costs and sustainability.

Find out more

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The Finance Wales Group is committed to investing in SMEs and helping them to maximise their growth plans by providing the right investment at the right time.

To find out more about us, please visit one of our web sites:

FINANCE WALES
CYLLID CYMRU
www.financewales.co.uk

FW Capital
www.fwcapital.co.uk

xénos
www.xenos.co.uk

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Finance Wales Group

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Available in Welsh and other formats. Please contact us to discuss your needs.

Company Registration No. 4055414

FINANCE WALES PLC

Report and Financial Statements

31 March 2013

REPORT AND FINANCIAL STATEMENTS 2013

CONTENTS

OFFICERS AND PROFESSIONAL ADVISERS

DIRECTORS

Ian Johnson	(Chairman)
Sian Lloyd-Jones	(Chief Executive)
Clive John	(non-executive)
Michael Killick	(non-executive) resigned 31 May 2013
Ivar Grey	(non-executive)
Chris Rowlands	(non-executive)
Margaret Llewellyn OBE	(non-executive) appointed 1 September 2012
Kevin O'Leary	(Director of Finance and Administration)

SECRETARY

Judi Oates

REGISTERED OFFICE

Oakleigh House
Park Place
Cardiff
CF10 3DQ

BANKERS

Barclays Bank Plc
PO Box 69
Queen Street
Cardiff
CF10 1SG

AUDITOR

Deloitte LLP
5 Callaghan Square
Cardiff
CF10 5BT

DIRECTORS' REPORT (continued)

The directors present their annual report and the audited financial statements for the year ended 31 March 2013.

BUSINESS REVIEW AND PRINCIPAL ACTIVITIES

Finance Wales plc (the Company) acts as a holding company. The activities of the Finance Wales plc group of companies, which comprise its subsidiaries, consist of the provision of financial services to Small and Medium Sized Enterprises ("SMEs").

This year was the third full year of investment for the £150 million JEREMIE Fund, which has a pan-Wales remit. 50% of this fund has been borrowed from the European Investment Bank, 40% has been granted from the European Regional Development Fund, which is managed in Wales by the Welsh European Funding Office, and the remaining 10% was provided from the group's own resources. The Small Loan Fund and the Rescue and Restructuring Fund also continue to invest.

New funds which commenced during the year include the £40 million Wales SME Fund, a £6 million Wales Micro-business Loan Fund and a £50 million Welsh Life Sciences Fund, all set up at the behest of and funded by the Welsh Government.

The group also manages portfolios which include the Technology Commercialisation Centre investments inherited from the former Welsh Development Agency, the Wales Creative IP Fund and the equity, mezzanine and loan funds which invested in the Objective 1, Objective 2 and Objective 2 Transitional areas of Wales. The group also manages the portfolio of the Finance Wales III Fund, a £30million fund which commenced investment in 2007 and is now fully invested.

The directors note that the rate of investment across the group has increased when compared with the previous financial year. This is largely as a result of macro-economic factors influencing demand for capital and the ability to service a wider market through the provision of new funds. Throughout the year ended 31 March 2013, Finance Wales plc continued to operate a venture capital brokerage scheme, xènos – The Wales Business Angels Network Limited. In conjunction with the Welsh Government and other appropriate bodies, the company continues to develop its suite of products to support the development of SMEs in Wales and the generation of sustainable economic growth.

During the year the group relocated two of its satellite offices; the West Wales office was relocated from Swansea to Llanelli and the St Asaph Office to other premises on the same business park in St Asaph.

The group, through its subsidiary, FW Capital Ltd continues to manage an equity fund in the North East of England, which it has reduced from £20 million to £17 million in the light of the current economic climate. In addition the group continues to manage a £35 million loan fund in the North West of England also through the FW Capital Limited subsidiary company, which is a business regulated by the Financial Conduct Authority (FCA).

Finance Wales plc is continuing to seek to expand its range of investment funds and is also seeking fund management opportunities in the wider market. Two of these opportunities materialised during the financial year. The group successfully bid for a £20 million mezzanine fund in the North West, £10 million of which was outsourced to Enterprise Ventures to manage. Additionally the group will also be setting up a £10 million Performance Bond Fund in the North East, following success in a procurement exercise.

In March 2013, the Welsh Government also provided £10 million to set up a Property Development Fund which will begin investing in the new financial year.

The annual results for the group are set out in the consolidated income statement on page 11. The company made 285 investments during the year, at a total of £43.2 million (£13.0 million equity investments; £30.2 million loan investments) compared with 222 investments made, at a total of £35.4 million (£12.7 million equity investments; £22.7 million loans), in the prior year. Gains of £1.51 million were recognised in respect of equity realisations in the current year but losses of £1.1 million also arose. Both of these figures relate to funds held rather than the total under management. No gains were recognised in the prior year. Turnover has reduced by 9% during the year. The group has made a loss for the year of £8.6 million (2012 – a loss of £9.0 million) which is largely as a result of the continuing high level of impairments.

The group's investment activity leveraged other investment of £28.6 million during the year and safeguarded 2,293 jobs. The impairment charge, £13.4 million (2012 - £13.6 million) reflects a number of large historic investments, where a trigger event has now made impairment the appropriate course of action.

As shown on page 13, the group has net assets of £136 million at 31 March 2013 compared with net assets of £127 million at 31 March 2012.

DIRECTORS' REPORT (continued)

BUSINESS REVIEW AND PRINCIPAL ACTIVITIES (continued)

Going concern

The current economic environment is challenging. The group provides financial services to SMEs and is working closely with management at investee companies to support and help them manage the effects of the current economic environment.

The group's business activities, together with the factors likely to affect its future development, performance and position, its financial position at the balance sheet date, its cash flows and the liquidity position, are set out in the directors' report on pages 2 to 7. In addition, note 23, Financial Instruments, includes the group's objectives and policies and process around managing capital risk; its financial risk management objectives; and its exposure to market, credit and liquidity risk. The group is financed through external bank borrowings and grant funding, provided by the Welsh Government and European Structural Funds.

The group's bank borrowings are secured by charges on accounts containing un-invested cash and security over the investments. Further details of the group's loan facilities in place at 31 March 2013 are given in note 19.

At the year-end, the group met all the covenant requirements associated with the loans. Covenants are calculated on a monthly basis and tested quarterly in accordance with the loan agreements. The group forecasts demonstrate that the group will meet all covenants over the foreseeable future.

Finance Wales plc's ultimate parent, the Welsh Ministers, acting through the Welsh Government has indicated in a letter of support that they will continue to provide both revenue and capital support at a level sufficient to enable Finance Wales plc to continue as a going concern, until at least 30 September 2015.

The group's forecasts and projections, taking account of likely changes in trading performance and the financial support of the Welsh Government, show that the group will be able to operate within the level of its current facility over the next 12 months from the signing of this report.

After making enquiries and having reviewed the forecasts for the group, the directors believe there are no material uncertainties that lead to a significant doubt on the group's ability to continue in business over the next 12 months. The directors have a reasonable expectation that the company and the group have adequate resources to continue in operational existence for the next 12 months. Thus, they continue to adopt the going concern basis in preparing the annual report and accounts.

PRINCIPAL RISKS AND UNCERTAINTIES

Appropriate policies to prevent Financial Crime including Customer Diligence are in place, in accordance with current best practice.

Financial risk management objectives and policies

The principal business of the group is investment and, as such, exposure to and management of portfolio risk is an inherent feature of this activity, particularly given the area of the market in which the group operates. The current economic climate provides significant challenges for such funds which the group continues to address in a managed way.

The group's activities expose it to a number of financial risks including cash flow risk, credit risk, liquidity risk and regulatory risk.

The use of financial derivatives is governed by the company's policies approved by the Board of directors, which provide written principles on the use of financial derivatives to manage these risks. The group does not use derivative financial instruments for speculative purposes.

Cash flow risk

The group, which borrows funds and subsequently lends to companies, makes use of appropriate hedging policies where necessary, to mitigate the risk of interest rate exposure. Interest-bearing assets and liabilities are held at fixed rate to ensure certainty of cash flows.

DIRECTORS' REPORT (continued)

PRINCIPAL RISKS AND UNCERTAINTIES (continued)

Credit risk

The group's financial assets are bank balances and cash, loan receivables and investments.

The group's credit risk is primarily attributable to its loan receivables. The amounts presented in the balance sheet are net of allowances for doubtful debt. An allowance for impairment is made where there is an identified loss event which, based on previous experience, is evidence of a reduction in the recoverability of the cash flows.

The credit risk on derivative financial instruments is limited because the counterparties are banks with high credit-ratings assigned by international credit-rating agencies.

The group has no significant concentration of credit risk as its exposure is spread over a large number of counterparties and companies.

Liquidity risk

In order to maintain liquidity to ensure that sufficient funds are available for on-going operations and future developments, the group uses long-term debt finance.

The group result is not seen in itself as anything but part of the normal pattern for businesses involved in making long-term investments.

Regulatory Risk

The group undertakes some investment management activity that is regulated by the FCA. The group has established controls and processes as defined by the FCA to provide orderly management of client assets which is overseen by the group secretary and Director of Finance and Administration.

Work is also being undertaken to understand the potential impact if it is found that any of the provisions of the Alternative Investment Fund Managers Directive (AIFMD) become applicable to the Group.

Interest rate swaps

In order to manage interest rate risk on borrowings, the group has entered into interest rate swaps; details of these financial instruments are provided in note 23 to the financial statements.

CORPORATE GOVERNANCE

The company is not required to comply with the Combined Code on Corporate Governance issued by the Financial Reporting Council and, accordingly, does not report on how it has applied the principles therein or on the extent to which it has complied with the provisions therein throughout the year.

However, the company's directors are committed to applying the relevant principles of the Combined Code, where applicable having regard to the size of the company, an illustration of which is given below.

Group structure

During the financial year, Finance Wales plc was a wholly-owned subsidiary of the Welsh Ministers acting through the Welsh Government.

Board of directors

The current Board consists of a non-executive Chairman and four non-executive directors, together with the Chief Executive and the Director of Finance and Administration, who are the two executive directors. The directors, who have served throughout the year, unless stated otherwise, are set out on page 1.

The Board meets regularly in addition to an annual strategy conference which takes place off-site.

A Board performance and evaluation process is in place. It is an internal exercise based on an evaluation questionnaire which is conducted by the Chairman and Senior Independent Director in accordance with the Combined Code on Corporate Governance. Chris Rowlands is the Senior Independent Director.

DIRECTORS' REPORT (continued)

CORPORATE GOVERNANCE (continued)

Board committees

The following Board committees have been set up, each with its own terms of reference, procedures, responsibilities and powers:

Audit Committee

The Finance Wales Group Audit Committee comprises two members:

- Mr Ivar Grey (Chairman)
- Mrs Margaret Llewellyn OBE

The Audit Committee's duties include inter alia:

- To review the effectiveness of the group's internal control and risk management systems.
- To ensure that adequate processes and mechanisms are in place for the management of risk.
- Reviewing the scope and results of work of both the internal and external auditors.
- Reviewing the annual financial statements and related policies and assumptions.

The Audit Committee meets quarterly. It is normally attended by Finance Wales plc's Chief Executive and the Director of Finance and Administration together with the internal and external auditors, the Welsh Government Department for Business, Enterprise, Technology and Science Group Finance Director and the Senior Corporate Governance Manager.

The internal and external auditors also meet the Audit Committee without management present.

Feedback on the business of the Finance Wales plc Audit Committee is given to the full Board and the minutes to the Corporate Governance Committee of the Welsh Government.

Remuneration Committee

The Finance Wales Group Remuneration Committee comprises two members:

- Mr Clive John (Chairman)
- Mrs Margaret Llewellyn OBE

The Remuneration Committee is responsible for advising the CEO and the Board on matters relating to recruitment and remuneration policies, and reporting to the Board of directors as necessary.

The Chief Executive of Finance Wales plc normally attends the Remuneration Committee.

Nomination Committee

The Finance Wales Group Nomination Committee comprises seven members:

- Mr Ian Johnson (Chairman)
- Ms Sian Lloyd-Jones
- Mr Christopher Rowlands
- Mr Ivar Grey
- Mr Clive John
- Mrs Margaret Llewellyn OBE
- Mr Kevin O'Leary

The Nomination Committee is responsible for advising the Board on matters relating to identifying and nominating candidates for Board vacancies and for the process of recruitment of both executive and non-executive directors, reporting to the Board of directors on these matters as necessary.

DIRECTORS' REPORT (continued)

CORPORATE GOVERNANCE (continued)

Accountability and audit

Financial reporting

A report on the responsibilities of the directors in relation to financial statements follows.

Internal control

The directors acknowledge that they are responsible for the company's system of internal control and for reviewing its effectiveness.

Additionally, Ms Sian Lloyd-Jones, the Chief Executive of Finance Wales plc, has personal responsibilities analogous to those of the Accounting Officer of a public body. These responsibilities are set out in Managing Public Money guidance and also in Finance Wales plc's Management Arrangement which governs its relations with the Welsh Government. The Chief Executive should ensure that a sound system of financial control exists which supports the group's policies, aims and objectives, set by its Board and the Welsh Government, whilst safeguarding the group's assets.

The system of internal control is designed to manage rather than eliminate the risk of failure to achieve policies, aims and objectives. It can therefore only provide reasonable and not absolute assurance of effectiveness.

The system of internal control is based on an on-going process designed to identify and prioritise the risks to the achievement of the group's policies, aims and objectives, to evaluate the likelihood and potential impact of those risks, and to manage them efficiently, effectively and economically, and is regularly reviewed by the Board. A system of internal control which accords with the Turnbull Guidance has been in place in the group throughout the year ended 31 March 2013 and up to the date of approval of these financial statements. The system also complies with HM Treasury guidance and Welsh Government requirements.

Responsibility for the management of the risks relating to the operations of Finance Wales plc lies with its Board of directors. Finance Wales plc has in place an internal risk management committee and Risk Register. It is also integrated into the wider risk management process of the Welsh Government by means of the various assurances and input to the Departmental Corporate Governance Committee. The individual risks contained in the Finance Wales plc Risk Register have been consolidated into a Finance Wales plc Strategic Risk Register and Map which are reviewed regularly by the Management Team, Audit Committee and Board. The company's risk management arrangements have been approved by the Board of directors. The key strategic and operational risks are brought to the Board's attention on a regular basis.

The Chief Executive has responsibility for reviewing the effectiveness of the system of internal control. Her review of the effectiveness of the system of internal control is informed by the work of the company's internal auditors who operate to Government Internal Audit Standards. They submit regular reports, which include their independent opinion on the adequacy and effectiveness of the company's system of internal control together with recommendations for improvement.

DIVIDENDS

The directors do not recommend the payment of a dividend (2012 - £nil).

SUPPLIER PAYMENT POLICY

Finance Wales plc. is committed to the prompt settlement of invoices and other claims for payment.

In the case of goods, services and other claims, where the supply has been satisfactorily completed, the group's objective is to pay within 30 days of the receipt of an invoice or other valid claim for payment.

As at 31 March 2013, 24 days' invoices were outstanding (2012 – 21 days).

DIRECTORS' REPORT (continued)

AUDITOR

In the case of each of the persons who are directors of the company at the date when this report is approved:

- so far as each of the directors is aware, there is no relevant audit information of which the company's auditor is unaware; and
- each of the directors has taken all the steps that they ought to have taken as a director to make themselves aware of any relevant audit information and to establish that the company's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of s418 of the Companies Act 2006.

Deloitte LLP have expressed their willingness to continue in office as the company's auditor and a resolution to reappoint them will be proposed at the forthcoming Annual General Meeting.

Approved by the Board of Directors
and signed on behalf of the Board

Judi Oates
Company Secretary

Date 22 July 2013

DIRECTORS' RESPONSIBILITIES STATEMENT

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors are required to prepare the group financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union and have chosen to prepare the parent company financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period.

In preparing the parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

In preparing the group financial statements, International Accounting Standard 1 requires that directors:

- properly select and apply accounting policies;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRSs are insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
- make an assessment of the company's ability to continue as a going concern.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF FINANCE WALES PLC

We have audited the financial statements of Finance Wales plc for the year ended 31 March 2013 which comprise the Consolidated Income Statement, the Consolidated and Parent Company Balance Sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Changes in Equity, the Consolidated Statement of Comprehensive Income and the related notes 1 to 39. The financial reporting framework that has been applied in the preparation of the group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the group's and the parent company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

We also report to you our opinion as to whether in all material respects the expenditure and income have been applied to the purposes intended by the Welsh Government and conform to the authorities which govern them.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the group's and the parent company's affairs as at 31 March 2013 and of the group's loss and the parent company's loss for the year then ended;
- the group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the parent company financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice;
- in all material respects the expenditure and income have been applied to the purposes intended by the Welsh Government and conform to the authorities which govern them; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF FINANCE WALES PLC (continued)

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Elanor Gill

Elanor Gill (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
Cardiff, United Kingdom

Date 22 July 2013

CONSOLIDATED INCOME STATEMENT
Year ended 31 March 2013

	Note	2013 £	2012 £
Revenue	4	8,766,970	9,616,061
Administrative expenses:			
Impairments against loans receivable		(6,581,264)	(7,983,060)
Impairments against financial assets classified as available-for-sale		(5,358,631)	(4,943,891)
Impairments against financial assets classified as fair value through profit or loss		(1,431,896)	(689,586)
Other administrative expenses		(13,679,059)	(12,393,721)
Total administrative expenses		(27,050,850)	(26,010,258)
Other operating income:			
Release of ERDF grant income		7,630,881	4,768,739
Contribution towards administrative expenses from ultimate parent undertaking		3,147,452	4,222,464
Gains/(losses) from the disposal of equity investments		457,483	(1,089,345)
Total other operating income		11,235,816	7,901,858
OPERATING LOSS	5	(7,048,064)	(8,492,339)
Investment revenue	7	1,501,154	820,771
Finance costs	8	(2,058,895)	(2,782,535)
Other gains/(losses)	9	(1,035,495)	1,499,127
LOSS BEFORE TAXATION		(8,641,300)	(8,954,976)
Tax	11	-	-
LOSS FOR THE FINANCIAL YEAR		(8,641,300)	(8,954,976)

All activities derive from continuing operations

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
Year ended 31 March 2013

	2013 £	2012 £
Loss for the financial year	(8,641,300)	(8,954,976)
Available-for-sale financial assets		
Profits arising during the year	491,140	1,924,112
Actuarial gain/(loss) on defined benefit pension scheme	560,000	(1,050,000)
Other comprehensive income for the year	1,051,140	874,112
Total comprehensive expense for the year	(7,590,160)	(8,080,864)

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
Year ended 31 March 2013

	Public equity £	Share capital £	Capital reserve £	Profit and loss account £	Total £
Balance at 1 April 2012	134,556,334	12,500	10,100	(7,628,107)	126,950,827
Loss for the financial year	-	-	-	(8,641,300)	(8,641,300)
Profits on revaluation of available-for-sale investments taken to equity	-	-	-	491,140	491,140
Actuarial gain on defined benefit pension schemes	-	-	-	560,000	560,000
Additional public equity	16,000,000	-	-	-	16,000,000
Balance at 31 March 2013	150,556,334	12,500	10,100	(15,218,267)	135,360,667

CONSOLIDATED BALANCE SHEET
As at 31 March 2013

	Note	2013 £	2012 £	2011 £
NON-CURRENT ASSETS				
Property, plant and equipment	12	102,223	113,116	84,485
Investments in associates	13	4,773,311	6,087,518	4,886,277
Investments in joint ventures	15	-	-	-
Available-for-sale financial assets	14	19,652,112	16,439,523	17,204,673
Trade and other receivables	16	34,667,370	36,658,274	37,054,505
		59,195,016	59,298,431	59,229,940
CURRENT ASSETS				
Trade and other receivables	16	17,299,663	17,021,565	13,879,564
Cash and cash equivalents	17	133,681,099	146,331,669	87,161,162
		150,980,762	163,353,234	101,040,726
TOTAL ASSETS		210,175,778	222,651,665	160,270,666
CURRENT LIABILITIES				
Trade and other payables	20	(2,099,012)	(1,485,909)	(1,879,266)
Borrowings	19	(4,100,000)	(9,500,000)	(6,755,000)
Derivative financial instruments	18	(357,942)	(659,105)	(778,768)
Deferred income	22	(8,702,108)	(7,129,536)	(8,048,252)
		(15,259,062)	(18,774,550)	(17,461,286)
NET CURRENT ASSETS		135,721,700	144,578,684	83,579,440
NON-CURRENT LIABILITIES				
Borrowings	19	(53,500,000)	(63,800,000)	(79,450,000)
Trade and other payables	20	-	(798)	(24,460)
Retirement benefit obligations	21	(1,940,000)	(2,690,000)	(1,910,000)
Deferred income	22	(4,116,049)	(10,435,490)	(10,893,229)
		(59,556,049)	(76,926,288)	(92,277,689)
TOTAL LIABILITIES		(74,815,111)	(95,700,838)	(109,738,975)
NET ASSETS		135,360,667	126,950,827	50,531,691

CONSOLIDATED BALANCE SHEET (continued)
As at 31 March 2013

	Note	2013 £	2012 £	2011 £
EQUITY				
Public equity		150,556,334	134,556,334	50,056,334
Share capital	24	12,500	12,500	12,500
Capital reserve		10,100	10,100	10,100
Retained (deficit)/earnings		(15,218,267)	(7,628,107)	452,757
TOTAL EQUITY		135,360,667	126,950,827	50,531,691

The financial statements of Finance Wales plc, registered number 4055414, were approved by the Board of Directors and authorised for issue on 22 July 2013.

Signed on its behalf by

S Lloyd-Jones
Director

CONSOLIDATED CASH FLOW STATEMENT
Year ended 31 March 2013

	Note	2013 £	2012 £
Net cash outflow from operating activities	26	(12,157,071)	(10,115,626)
Investing activities			
Interest received		1,501,154	820,771
Purchases of equipment		(45,758)	(77,103)
Net cash used in investing activities		1,455,396	743,668
Financing activities			
Interest paid		(2,248,895)	(3,052,535)
Repayments of borrowings		(15,700,000)	(12,905,000)
Public equity received		16,000,000	84,500,000
Net cash from financing activities		(1,948,895)	68,542,465
Net increase in cash and cash equivalents		(12,650,570)	59,170,507
Cash and cash equivalents at beginning of year		146,331,669	87,161,162
Cash and cash equivalents at end of year		133,681,099	146,331,669

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

1. GENERAL INFORMATION

Finance Wales plc is a company incorporated in the United Kingdom under the Companies Act 2006. The nature of the group's operations and its principal activities are set out in the directors' report.

ADOPTION OF NEW AND REVISED STANDARDS

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union as they apply to financial statements of the group for the year ended 31 March 2013 and applied in accordance with the Companies Act 2006.

At the date of authorisation of these consolidated financial statements, the following Standards and Interpretations which have not been applied in these consolidated financial statements were in issue but not yet effective:

IFRS 9	Financial Instruments – Classification and Measurement
IFRS 7 (amendments)	Financial Instruments – Disclosures
IFRIC 14 (amendment)	Prepayments of a Minimum Funding Requirement
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments
IFRS 10	Consolidation
IFRS 11	Joint Ventures
IFRS 12	Disclosure of interests in other entities
IFRS 13	Fair Value Measurement
IAS 19	Post-employment benefits

The directors anticipate that the adoption of these standards and interpretations in future periods, with the exception of IFRS 9, will not have a material impact on the financial statements of the group. The impact of IFRS 9 is being considered but any impact cannot be quantified at this stage.

2. ACCOUNTING POLICIES

Basis of preparation

These accounting policies are based on the IFRSs, IASs and IFRIC interpretations as adopted by the EU (collectively "IFRS").

The financial statements have been prepared on the historical cost basis, except for the revaluation of certain financial instruments. The principal accounting policies adopted, which have been applied consistently in the current and the prior financial year, are outlined below.

These financial activities are presented in pounds sterling because that is the currency of the primary economic environment in which the group operates.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

2. ACCOUNTING POLICIES (continued)

Basis of consolidation

The consolidated financial statements comprise Finance Wales plc (the Company) and its subsidiary undertakings, as listed in note 32 of the company financial statements.

The purchase method of accounting is used to account for the acquisition of subsidiaries. The cost of an acquisition is measured at the fair value of the consideration plus costs directly attributable to the acquisition. The excess of the cost of the acquisition over the group's share of the fair value of the net identifiable assets of the subsidiary acquired is recorded as goodwill. Intragroup transactions, balances and unrealised gains on transactions between group companies are eliminated; unrealised losses are also eliminated unless costs cannot be recovered. Where necessary, accounting policies of subsidiaries have been changed to ensure consistency with the policies adopted by the group.

Going concern

The current economic environment is challenging. The group provides financial services to SMEs and is working closely with management at investee companies to support and help them manage the effects of the current economic environment.

The group's business activities, together with the factors likely to affect its future development, performance and position, its financial position at the balance sheet date, its cash flows and the liquidity position, are set out in the directors' report on pages 2 to 7. In addition, note 23, Financial Instruments, includes the group's objectives and policies and process around managing capital risk; its financial risk management objectives; and its exposure to market, credit and liquidity risk.

The group is financed through external bank borrowings and grant funding, provided by the Welsh Government and European Structural Funds.

The group's bank borrowings are secured by charges on accounts containing un-invested cash and security over the investments. Further details of group loan facilities in place at 31 March 2013 are given in note 19.

At the year-end, the group has met all the covenant requirements associated with the loans. Covenants are calculated on a monthly basis and tested quarterly in accordance with the loan agreements. The group forecasts demonstrate that the group will meet all covenants over the foreseeable future. Revenues from the repaid Objective 1 and Objective 2 funds will now be directed to reduce the debt burden in respect of the equity related loans.

Finance Wales plc's ultimate parent, the Welsh Ministers, acting through the Welsh Government has indicated in a letter of support that it will continue to provide both revenue and capital support at a level sufficient to enable Finance Wales to continue as a going concern, until at least 30 September 2015.

The group's forecasts and projections, taking account of likely changes in trading performance and the financial support of the Welsh Government, show that the group will be able to operate within the level of its current facility over the next 12 months from the date of signing this report.

After making enquiries and having reviewed the forecasts for the group, the directors believe there are no material uncertainties that lead to a significant doubt on the group's ability to continue in business over the next 12 months. The directors have a reasonable expectation that the company and the group have adequate resources to continue in operational existence for the next 12 months. Accordingly, they continue to adopt the going concern basis in preparing the annual report and accounts.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

2. ACCOUNTING POLICIES (continued)

Property, plant and equipment

Property, plant and equipment are shown in the balance sheet at their historical cost less accumulated depreciation and impairment. Historical cost includes expenditure that is directly attributable to the acquisition and installation of the items. Subsequent costs are included in the assets' carrying amounts or recognised as a separate asset as appropriate only when it is probable that future economic benefits associated with them will flow to the group and the cost of the item can be measured reliably. All other repairs and maintenance are charged to the income statement as incurred.

Depreciation is provided so as to write off the initial cost of each asset to its residual value on a straight-line basis over its estimated useful life as follows:

Fixtures and fittings	3 to 4 years

The assets' residual values and useful lives are reviewed and adjusted, if appropriate, at each balance sheet date. Where the carrying amount of an asset is greater than its estimated recoverable amount, it is written down immediately to its recoverable amount. Gains and losses on disposals are determined by comparing proceeds with carrying amounts. These are included in the income statement.

Investments in associates

An associate is an entity over which the group is in a position to exercise significant influence, but not control or joint control, through participation in the financial and operating policy decisions of the investee. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

The group has taken a scope exemption available in *IAS 28 Associates* for accounting for associates held by venture capital organisations, mutual funds, unit trusts and similar entities if the associate is measured at fair value through profit and loss.

The group looks for capital growth rather than income return from its investments. The 'venture capital' investments are held as part of an investment portfolio where their value is through their marketable value rather than as a medium through which Finance Wales carries out its business. Finance Wales aims to generate a growth in the value of its investments in the medium term and usually identifies an exit strategy or strategies when the investment is made. The investments are in businesses unrelated to Finance Wales's business. The investments are managed on a fair value basis.

Investments in associates are designated as at fair value through profit and loss.

Measurement of associates at fair value through profit and loss is consistent with the group's documented Risk Management and Investment Strategy.

Jointly controlled entities

A joint venture is an entity over which the group has joint control, and joint ability to govern financial and operating policy decisions of the economic activity so as to obtain benefits from it.

The group accounts for its jointly controlled entities by means of an equity method of accounting.

Revenue recognition

Turnover represents sales of business support services, interest receivable on loans, application fees, arrangement fees and fund management fees which are each recognised in the period in which they arise.

Interest income is recognised when it is probable that the economic benefits will flow to the group and the amount of revenue can be measured reliably. Interest income is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount on initial recognition.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

2. ACCOUNTING POLICIES (continued)

European Regional Development Fund ("ERDF") grant income

Grant income receivable in support of revenue expenditure is recognised in the income statement as utilised in accordance with the conditions applicable in the offer documentation.

Where grants for the partial funding of investments are received in advance of defrayal, a liability to repay the grants is recognised until such time as the cash is utilised in accordance with the terms of the offer documentation.

Grants for the partial funding of investments which are received in advance of defrayal are treated as deferred income. Such deferred income is amortised to the income statement when investments are made and the conditions set out in the offer documentation have been met. Income taken is equal to the level of grant utilised supporting investments.

Financial instruments

Financial assets and financial liabilities are recognised when the group becomes a party to the contractual provisions of the relevant instrument. Financial assets are derecognised when the rights to receive benefits have expired or been transferred, and the group has transferred substantially all risks and rewards of ownership. Financial liabilities are derecognised when the obligation is extinguished.

Non-derivative financial assets are classified as either receivables or cash and cash equivalents. They are stated at amortised cost using the effective interest method, subject to reduction for allowances for estimated irrecoverable amounts. A provision for impairment of trade receivables is established when there is objective evidence that the group will not be able to collect all amounts due according to the original terms of those receivables. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, and is recognised in the income statement. For interest-bearing assets, their carrying value includes accrued interest receivable.

Cash and cash equivalents include cash in hand and deposits held on call, together with other short-term highly liquid investments. Non-derivative financial liabilities are stated at amortised cost using the effective interest method. For borrowings, their carrying value includes accrued interest payable, as well as any unamortised issue costs.

The group transacts derivative financial instruments to manage the underlying exposure to interest rate risks. The group does not transact derivative financial instruments for trading purposes. However, as the group has decided not to hedge account for its derivative financial instruments as permitted under IAS 39 *Financial Instruments: Recognition and Measurement*, they are carried at fair value through profit and loss (FVTPL). Derivative financial assets and liabilities are stated at fair value, which includes accrued interest receivable and payable where relevant. Changes in fair values are recognised in the income statement in the period in which they arise.

Financial assets

All financial assets are recognised and derecognised on a trade date where the purchase or sale of a financial asset is under a contract whose terms require delivery of the investment within the timeframe established by the market concerned, and are initially measured at fair value, plus transaction costs, except for those financial assets classified as at fair value through profit or loss, which are initially measured at fair value.

Financial assets are classified into the following specified categories: financial assets 'at fair value through profit or loss' (FVTPL), 'available-for-sale' (AFS) financial assets and 'loans and receivables'. The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

2. ACCOUNTING POLICIES (continued)

Effective interest method

The effective interest method is a method of calculating the amortised cost of a financial asset and of allocating interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts (including all fees on points paid or received that form an integral part of the effective interest rate, transaction costs and other premiums or discounts) through the expected life of the financial asset, or, where appropriate, a shorter period.

Income is recognised on an effective interest basis for debt instruments other than those financial assets classified as at FVTPL.

Financial assets at FVTPL

Financial assets are classified as at FVTPL where the financial asset is designated as FVTPL under the scope exemption for measuring associates as noted above.

Financial assets at FVTPL are stated at fair value, with any resultant gain or loss recognised in profit or loss. The net gain or loss recognised in profit or loss incorporates any dividend or interest earned on the financial asset. Fair value is determined in the manner described in note 23.

Available-for-sale financial assets

Listed shares held by the group that are traded in an active market are classified as being AFS and are stated at fair value. The group also has investments in unlisted shares that are not traded in an active market but are also classified as AFS financial assets. Fair value is determined in the manner described in note 23. Gains and losses arising from changes in fair value are recognised directly in equity. Impairment losses, interest calculated using the effective interest method and foreign exchange gains and losses on monetary assets are recognised directly in profit or loss. Where the investment is disposed of or is determined to be impaired, the cumulative gain or loss previously recognised in the investment's revaluation reserve is included in profit or loss for the period.

Dividends on AFS equity instruments are recognised in profit or loss when the group's right to receive the dividends is established.

Loans and receivables

Trade receivables, loans, and other receivables that have fixed or determinable payments that are not quoted in an active market are classified as loans and receivables. Loans and receivables are measured at amortised cost using the effective interest method, less any impairment. Interest income is recognised by applying the effective interest rate, except for short-term receivables when the recognition of interest would be immaterial.

Impairment of financial assets

Financial assets are assessed for indicators of impairment at each balance sheet date. Financial assets are impaired where there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the asset have been impacted.

For financial assets classified as AFS, a significant or prolonged decline in the fair value of the asset below its cost is considered to be objective evidence of impairment. For all other financial assets, including redeemable notes classified as AFS, objective evidence of impairment could include:

- significant financial difficulty of the issuer or counterparty; or
- default or delinquency in interest or principal payments; or
- it becoming probable that the borrower will enter bankruptcy or financial reorganisation.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

2. **ACCOUNTING POLICIES (continued)**

Impairment of financial assets (continued)

For certain categories of financial asset, such as loans receivable, assets that are assessed not to be impaired individually are subsequently assessed for impairment on a collective basis. Objective evidence of impairment for a portfolio of financial assets could include the group's past experience of recovery, and the levels and trends of specific impairments made as well as observable changes in national or local economic conditions that correlate with default.

The impact of forbearance is also considered. Forbearance has not materially impacted impairment provision requirements during the year; the collective provision is deemed to provide sufficient provision for impairment.

The carrying amount of the financial asset is reduced by the impairment loss through the use of an allowance account. Subsequent recoveries of amounts previously written off are credited against the allowance account. Changes in the carrying amount of the allowance account are recognised in profit or loss.

When an AFS equity instrument is considered to be impaired, cumulative gains previously recognised in equity are reclassified to profit or loss in the period.

With the exception of AFS equity instruments, if, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed through profit or loss to the extent that the carrying amount of the investment at the date the impairment is reversed does not exceed what the amortised cost would have been had the impairment not been recognised.

In respect of AFS equity instruments securities, impairment losses previously recognised through profit or loss are not reversed through profit or loss. Any increase in fair value subsequent to an impairment loss is recognised directly in equity.

Cash and cash equivalents

Cash and cash equivalents comprise cash on hand and demand deposits, and other short-term highly liquid investments that are readily convertible to a known amount of cash and are subject to an insignificant risk of changes in value.

Derecognition of financial assets

The group derecognises a financial asset only when the contractual rights to the cash flows from the asset expire; or it transfers the financial asset and substantially all the risks and rewards of ownership of the asset to another entity. If the group neither transfers nor retains substantially all the risks and rewards of ownership and continues to control the transferred asset, the group recognises its retained interest in the asset and an associated liability for amounts it may have to pay. If the group retains substantially all the risks and rewards of ownership of a transferred financial asset, the group continues to recognise the financial asset and also recognises a collateralised borrowing for the proceeds received.

Financial liabilities and equity

Debt and equity instruments are classified as either financial liabilities or equity instruments according to the substance of the contractual arrangements.

Equity instruments

An equity instrument is any contract that evidences a residual interest in the assets of the group after deducting all of its liabilities. Equity instruments issued by the group are recorded at the proceeds received, net of direct issue costs.

Financial liabilities

Financial liabilities are recognised as either financial liabilities at FVTPL or other financial liabilities.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

2. ACCOUNTING POLICIES (continued)

Provisions

A provision is recognised when the group has a present legal or constructive obligation as a result of a past event, and where it is probable that an outflow will be required to settle the obligation. Provisions are measured at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date and are discounted to present value where the effect is material.

When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, a receivable is recognised as an asset if it is virtually certain that reimbursement will be received and the amount of the receivable can be measured reliably.

Other financial liabilities

Other financial liabilities, including borrowings, are initially measured at fair value, net of transaction costs. Other financial liabilities are subsequently measured at amortised cost using the effective interest method, with interest expense recognised on an effective yield basis. The effective interest method is a method of calculating the amortised cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments through the expected life of the financial liability, or, where appropriate, a shorter period.

Derecognition of financial liabilities

The group derecognises financial liabilities when, and only when, the group's obligations are discharged, cancelled or they expire.

Derivative financial instruments

The group enters into interest rate swaps to manage its exposure to interest rate risk. Derivatives are initially recognised at fair value at the date a derivative contract is entered into and are subsequently remeasured to their fair value at each balance sheet date. A derivative with a positive fair value is recognised as a financial asset whereas a derivative with a negative fair value is recognised as a financial liability. The resulting gain or loss is recognised in profit or loss immediately unless the derivative is designated and effective as a hedging instrument, in which event the timing of the recognition in profit or loss depends on the nature of the hedge relationship. A derivative with a positive fair value is recognised as a financial asset whereas a derivative with a negative fair value is recognised as a financial liability.

A derivative is presented as a non-current asset or a non-current liability if the remaining maturity of the instrument is more than 12 months and it is not expected to be realised or settled within 12 months. Other derivatives are presented as current assets or current liabilities.

Embedded derivatives

Derivatives embedded in other financial instruments or other host contracts are treated as separate derivatives when their risks and characteristics are not closely related to those of the host contracts and the host contracts are not measured at fair value through profit or loss.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

2. ACCOUNTING POLICIES (continued)

Public equity

The Welsh Ministers, acting through the Welsh Government, have from time to time provided funds for investment purposes. These funds have largely been accounted for within Finance Wales Investments Limited (Small Loans Fund), Finance Wales Investments (3) Limited (Rescue and Restructuring Finance), Finance Wales Investments (4) Limited (the Creative Industries Fund), Finance Wales Investments (5) Limited (the Interim Fund), Finance Wales Investments (6) Limited (the JEREMIE Fund), Finance Wales Investments (8) Limited (The Wales SME Investment Fund), Finance Wales Investments (9) Limited (the Welsh Life Sciences Fund) and Finance Wales Investments (10) Limited (the Wales Micro-business Loan Fund). Some of this Welsh Government funding was originally made as Public Dividend Capital (PDC) whilst the remainder was classified as Grant in Aid or Core Funding for Investment purposes.

The funding was to invest in the long-term sustainability of Finance Wales and within the Welsh Government's own accounting arrangements the funds were regarded as being an investment. Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences residual interest in the assets of the group after deducting all of its liabilities. Equity instruments issued by the group are recorded at the proceeds received, net of direct issue costs.

Leasing

Rentals payable under operating leases are charged to income on a straight-line basis over the term of the relevant lease.

Benefits received and receivable as an incentive to enter into an operating lease are also spread on a straight-line basis over the lease term.

Operating profit/loss

Operating profit or loss is stated after charging restructuring costs, but before investment income, finance costs and foreign exchange.

Borrowing costs

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the costs of those assets, until such time as the assets are substantially ready for their intended use or sale.

All other borrowing costs are recognised in the income statement in the period in which they are incurred.

The group has taken advantage of the transitional provision included within IAS23 Borrowing Costs and elected not to capitalise interest on qualifying assets that arose prior to the date of transition to IFRS on 1 April 2008.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

2. ACCOUNTING POLICIES (continued)

Taxation

Tax on the profit or loss for the year comprises current and deferred tax.

Current tax is the expected tax payable on the taxable income for the year, using tax rates substantially enacted at the balance sheet date, and any adjustments to tax payable in respect of previous years.

Deferred tax is provided in full on temporary differences between the carrying amount of assets and liabilities in the financial statements, and the tax base. Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the temporary differences can be utilised. Deferred tax assets and liabilities are not discounted.

Deferred tax is determined using the tax rates that have been enacted or substantively enacted by the balance sheet date, and is expected to apply when the deferred tax liability is settled or the deferred tax asset is realised.

Deferred tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the group and it is probable that the temporary difference will not reverse in the foreseeable future.

Tax is recognised in the income statement, except where it relates to items recognised directly in equity, in which case it is recognised in equity.

Retirement benefits

The group operates a defined benefit pension scheme, now closed to new members, which is administered by Rhondda Cynon Taff County Borough Council. The group accounts for its share of the surplus or deficit and administration costs of this scheme.

The level of contributions made to the scheme and the cost of contributions included in the financial statements are based on the recommendations of independent actuaries.

The scheme assets are an estimate of the group's notional share of the total fund assets measured at market value at each balance sheet date and liabilities are measured using the projected unit method, discounted using a corporate bond rate. The group's notional share of assets is assumed to be invested in the same proportion as the fund as a whole in the different asset classes. The resulting pension scheme surplus or deficit is recognised immediately on the balance sheet, net of deferred tax where applicable, and any resulting actuarial gains and losses are recognised immediately in the statement of comprehensive income.

The group offers a defined contribution scheme administered by Legal and General which is open to those staff who are not members of the Rhondda Cynon Taff County Borough Council. Contributions to this scheme are accounted for as a revenue cost.

3. CRITICAL ACCOUNTING JUDGEMENTS AND KEY SOURCES OF ESTIMATION UNCERTAINTY

Critical accounting judgments and key sources of estimation uncertainty

In the application of the group's accounting policies, which are described in note 2, the directors are required to make judgements, estimates and assumptions about the carrying amounts of assets and liabilities that are not readily apparent from other sources. The estimates and associated assumptions are based on historical experience and other factors that are considered to be relevant. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Critical judgments in applying the group's accounting policies

The following are the critical judgements, apart from those involving estimations (which are dealt with separately below), that the directors have made in the process of applying the group's accounting policies and that have the most significant effect on the amounts recognised in financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

3. CRITICAL ACCOUNTING JUDGEMENTS AND KEY SOURCES OF ESTIMATION UNCERTAINTY (continued)

Going concern

In preparing the financial statements, the directors have concluded that the group is a going concern and have assumed that it will be able to continue to trade in line with its business plan, realising the value of assets and liabilities in the normal course of business.

This judgement has significant impact on the valuation and presentation of the balance sheet as, if the group were no longer a going concern, the carrying value would need to be restated to market value for assets and settlement values for liabilities. Significant items affected would include non-current assets, loans, and deferred income.

Basis of consolidation

The directors use their judgment to make an assessment of whether the Group controls an enterprise by considering the Group's power to govern the financial and operating policies of an enterprise taking into account any potential voting rights. They also consider the Group's ability to use its power to direct the relevant activities of an enterprise and the Group's exposure to the variability of returns. The judgment has a significant impact on the Group's consolidated balance sheet, income statement and cash flow: any enterprise that is controlled requires the financial statements of the enterprise to be included in the Group consolidated financial statements and where an entity is not controlled, consolidation is not required.

Key sources of estimation uncertainty

The key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

Impairment of financial assets

Finance Wales operates a prudent approach to the provisioning against financial assets primarily including investments. Where uncertainty exists, either about the viability of an investee business, or an inability to meet commitments as and when they fall due, a provision will be recognised. Each provision case is proactively managed to identify the causes for concern and to work with investee businesses to effect repayment or recovery of the at risk investment.

In accordance with the accounting policy on impairment of financial assets, a provision is made only when there is objective evidence that a loss has been incurred for which a collective assessment of a group of assets may be undertaken. Such a collective assessment requires input of management judgement and estimation. Management judgement is supported by consideration of underlying trends of historical data regarding the probability of default or failure of the investee business.

Fair value of derivatives and other financial instruments

As described in note 23, the directors use their judgement in selecting appropriate valuation techniques for financial instruments not quoted on an active market. Valuation techniques commonly used by market practitioners are applied. For derivative financial instruments, assumptions are made based on quoted market rates adjusted for specific features of the instrument. Other financial instruments are valued using a discounted cash flow analysis based on the assumptions supported, where possible, by observable market prices or rates. The fair value of derivatives at the balance sheet date was a net liability of £357,943 (2012 - £659,105 net liability).

Deferred tax

The group has tax losses of £16 million available for offset against future taxable profits. In determining the value of the deferred tax asset that can be attributed to these losses, the directors have to estimate likely future taxable profits and the period over which the asset may be recovered. The directors consider the most up-to-date forecasts for the business and assess the risks inherent in achieving those forecasts. At the balance sheet date, no deferred tax asset has been recorded.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

4. REVENUE

An analysis of the group's revenue is as follows:

	2013 £	2012 £
Fees	3,681,965	3,686,935
Dividends	109,170	196,356
Loan interest	4,975,835	5,732,770
Revenue	8,766,970	9,616,061
ERDF grant income	7,630,881	4,768,739
Contribution from the parent undertaking	3,147,452	4,222,464
Total revenue	19,545,302	18,607,264

5. OPERATING LOSS

	2013 £	2012 £
Operating loss has been arrived at after charging		
Depreciation of property, plant and equipment	56,680	48,503
Staff costs (see note 6)	5,630,624	5,299,814
Impairment loss recognised on financial assets classified as available-for-sale	5,358,631	4,943,891
Impairment loss recognised on financial assets classified as fair value through profit or loss	1,431,896	689,586
Impairment loss recognised on loans receivable carried at amortised cost	6,581,264	7,983,060

Auditor's remuneration

	£	£
Fees payable to the company's auditor for the audit of the company's annual accounts	27,021	25,046
Fees payable to the company's auditor for other services to the group:		
Audit of the company's subsidiaries pursuant to legislation	47,139	37,754
Total audit fees	74,160	62,800

	£	£
Other services:		
Tax compliance	49,914	29,580
Other services	76,188	23,844
Total non-audit fees	126,102	53,424

Fees payable to Deloitte LLP and their associates for non-audit services to the company are not required to be disclosed because the financial statements are required to disclose such fees on a consolidated basis.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

6. INFORMATION REGARDING DIRECTORS AND EMPLOYEES

	2013	2012
	£	£
Directors' emoluments		
Emoluments	448,350	421,968

	£	£
Remuneration of highest paid director	210,334	207,246

Two directors (2012 - 1 director) of the company and one director (2012 – two directors) of subsidiary companies were members of the defined benefit pension scheme.

	£	£
Aggregate payroll costs (excluding directors)		
Wages and salaries	4,536,147	4,324,498
Social security costs	455,588	426,794
Pension costs (see note 21)	638,889	548,522
	5,630,624	5,299,814

	No.	No.
Average number of persons employed (excluding directors and agency temps) – administration	102	95

7. INVESTMENT REVENUE

	2013	2012
	£	£
Bank interest	1,451,154	760,771
Net return on pension scheme assets	50,000	60,000
	1,501,154	820,771

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

8. FINANCE COSTS

	2013 £	2012 £
Interest on bank loans and overdrafts	2,038,895	2,772,535
Net cost of pension scheme (see note 21)	20,000	10,000
	2,058,895	2,782,535

9. OTHER (LOSSES)/GAINS

	2013 £	2012 £
Changes in the fair value of investments in associates	(1,336,658)	1,379,464
Changes in the fair value of derivative financial instruments	301,163	119,663
	(1,035,495)	1,499,127

10. CONTRIBUTION BY ULTIMATE PARENT UNDERTAKING

The Welsh Ministers, acting through the Welsh Government, the ultimate parent undertaking, have contributed £3,147,452 (2012 - £4,222,464) towards the administrative expenses of Finance Wales plc (the company).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

11. TAX

	2013 £	2012 £
Current taxation		
UK corporation tax charge for the year	-	-

The difference between the current taxation shown above and the amount calculated by applying the standard rate of UK corporation tax to the loss before tax is as follows:

	£	£
Loss on ordinary activities before tax	(8,641,301)	(8,954,976)
		£
Tax at 24 % (2012 - 26%) thereon	2,073,912	2,328,294
Factors affecting charge for the year		
Non deductible items	(3,197,802)	(1,086,745)
Temporary timing differences	291,061	415,203
Increase in tax losses	(2,442,179)	(2,972,334)
Non taxable income	3,497,842	1,313,694
Taxable share of partnership profits	-	(614)
Utilisation of tax losses	391,504	2,502
Chargeable gains	(614,338)	-
Total taxation charge	-	-

A net deferred tax asset has not been recognised in respect of timing differences relating to provisions of £1,742,859 (2012 - £2,198,410), non-trade financial losses of £6,750,814 (2012 - £5,732,003), excess management expenses of £8,555,735 (2012 - £7,710,119), capital losses of £0 (2012 - £66,000) and temporary differences on fixed assets of £245,489 (2012 - £234,390). The asset would be recovered if there were sufficient suitable future profits to absorb all such assets.

In addition, a net deferred tax asset of £446,200 (2012 - £645,600) has not been recognised in respect of accrued pension costs as there is insufficient evidence that the asset will be recovered.

The reduction in the mainstream corporation tax rate from 24% to 23% from 1 April 2013, to 21% from 1 April 2014 and further to 20% from 1 April 2015 is not anticipated to materially affect the future tax charge.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

12. PROPERTY, PLANT AND EQUIPMENT

Group and Company	2013 £	2012 £	2011 £
Fixtures and fittings			
Cost			
At 1 April	1,033,130	955,997	908,760
Additions	45,787	77,133	47,237
At 31 March	1,078,917	1,033,130	955,997
Accumulated depreciation			
At 1 April	902,014	871,512	824,434
Charge for the year	56,680	48,502	47,078
At 31 March	958,694	920,014	871,512
Net book value			
At the end of the financial year	102,223	113,116	84,485
At the beginning of the financial year	113,116	84,485	84,326

13. INVESTMENTS IN ASSOCIATES

Investments in associates are measured at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* rather than the equity method under the exemption given in IAS 28 to venture capital organisations.

	2013 £	2012 £	2011 £
Investments carried at fair value through profit or loss			
Beginning of year	6,087,518	4,886,277	6,336,020
Additions in year	2,447,020	911,363	1,884,980
Disposals	(934,957)	-	-
Changes in fair value carrying amounts	(1,336,658)	1,379,464	(1,260,297)
Less impairment	(1,489,612)	(1,089,586)	(2,074,426)
End of year	4,773,311	6,087,518	4,886,277

Movement in impairment recognised to date

	2013 £	2012 £
Balance at the beginning of the year	3,881,302	3,191,716
Impairment losses recognised	1,489,612	1,089,586
Disposals in the year	(96,239)	(400,000)
Balance at the end of the year	5,274,675	3,881,302

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

14. AVAILABLE-FOR-SALE FINANCIAL ASSETS

(a) Available-for-sale investments carried at fair value

There are no available-for-sale assets classified as current.

	Non-current		
	2013	**2012**	**2011**
	£	**£**	**£**
Available-for-sale investments carried at fair value			
Equity investments	4,803,054	2,996,933	9,810,252
Creative IP fund investment	9,396,558	9,485,760	9,457,049
Less impairment	(10,567,026)	(9,203,553)	(11,754,349)
	3,632,586	3,279,140	7,512,952

Movement in impairment of available-for-sale investments carried at fair value

	2013	**2012**
	£	**£**
Available-for-sale investments		
Balance the at beginning of the year	9,203,553	11,754,349
Impairment losses recognised	1,363,473	(2,550,796)
Balance at the end of the year	10,567,026	9,203,553

(b) Available-for-sale investments carried at cost

Available-for-sale investments carried at cost	**2013**	**2012**	**2011**
	£	**£**	**£**
Equity investments	31,328,247	30,011,196	19,047,839
HSBC Enterprise Fund	433,333	433,333	433,333
Less impairment	(15,742,054)	(17,284,146)	(9,789,451)
	16,019,526	13,160,383	9,691,721
Total investments	19,652,112	16,439,523	17,204,673

Movement in impairment of available-for-sale investments carried at cost

	2013	**2012**
	£	**£**
Available-for-sale investments		
Balance at the beginning of the year	17,284,146	9,789,451
Impairment losses recognised	3,505,144	7,624,695
Amounts written off as uncollectable	(5,047,236)	(130,000)
Balance at the end of the year	15,742,054	17,284,146

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

15. INTEREST IN JOINT VENTURE

The joint venture relates entirely to The Wales Innovation Fund Limited. Finance Wales plc is entitled to 50% of any distributions or surplus of assets on return of capital of the joint venture under the terms of the share capital owned by Finance Wales plc. The investment is consolidated into these accounts using the equity method under IAS 31. Consequently, the group's share of net liabilities is restricted to the value of the loans made to the joint venture.

	2013 £	2012 £	2011 £
Share of net liabilities	(1,668,840)	(1,668,840)	(1,668,840)
Loans to joint venture	1,668,840	1,668,840	1,668,840
End of year	-	-	-

16. OTHER FINANCIAL ASSETS

Trade and other receivables

	2013 £	2012 £	2011 £
Current assets			
Trade debtors	90,859	105,589	39,618
	90,859	105,589	39,618
Loans receivable carried at amortised cost	20,715,385	18,811,509	16,969,363
Impairment	(4,588,364)	(2,409,740)	(3,402,524)
	16,127,021	16,401,769	13,566,839
Other debtors	983,454	414,431	170,083
Prepayments	98,329	99,776	103,024
	17,299,663	17,021,565	13,879,564
Non-current assets			
Loans receivable carried at amortised cost	60,395,780	74,160,848	65,586,154
Impairment	(25,740,191)	(37,508,397)	(28,545,872)
	34,655,589	36,652,451	37,040,282
Other debtors	11,781	5,823	14,223
	34,667,370	36,658,274	37,054,505

The group enters into agreements to advance loans to Small and Medium Enterprises (SMEs) in Wales. The average term of loans entered into is five years. The interest rate inherent in the loans is fixed at the contract date for all of the loan term. The average effective interest rate contracted approximates 9.8% (2012 – 10.1 %, 2011 – 10.4%) per annum.

The loans advanced are a mixture of unsecured and secured loans. Security is over counterparty assets. The maximum exposure to credit risk of loans receivable for the current and prior period is the carrying amount.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

16. OTHER FINANCIAL ASSETS (continued)

Before accepting any new customer, the group follows its investment operating guidelines to assess the potential customer's credit quality and define customer acceptance. Recoverability of loans advanced is reviewed monthly.

Loans receivable disclosed above include amounts (see below for aged analysis) which are past due at the reporting date but against which the group has not recognised an allowance for doubtful receivables because there has not been a significant change in credit quality and the amounts (which include interest accrued after the receivable is overdue) continue to be considered recoverable.

Ageing of past due but not impaired loan receivables

	2013 £	2012 £
30-60 days	97,525	37,234
60-90 days	284,454	(169,164)
90-120 days	19,781	(109,855)
120+ days	106,675	728,430
	508,435	486,645

Movement in the provision for impairment

	2013 £	2012 £	2011 £
Loans receivable			
Balance at the beginning of the year	39,918,137	31,948,396	28,012,125
Impairment losses recognised	5,741,300	7,983,056	9,004,435
Amounts written off as uncollectable	(15,258,874)	(13,315)	(5,068,164)
Amounts recovered during the year	-	-	-
Balance at the end of the year	30,400,563	39,918,137	31,948,396

In determining the recoverability of loans receivable the group considers any change in the credit quality of the loans receivable from the date credit was initially granted up to the reporting date. The concentration of loan receivable credit risk is limited due to the large number of customers who are unrelated.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

16. OTHER FINANCIAL ASSETS (continued)

Ageing of past due and impaired loans receivable

	2013 £	2012 £
Receivables with <100% impairment		
30-60 days	1,777	(7,697)
60-90 days	1,753	1,717
90-120 days	1,653	(1,827)
120+ days	8,538	9,715
	13,721	1,908
Receivables with 100% impairment	18,919,276	30,681,138
Total	18,932,997	30,683,046

The directors consider that the carrying amount of trade and other receivables approximates their fair value.

17. CASH AND CASH EQUIVALENTS

These comprise cash in hand and deposits held at call with banks. The carrying amount of these assets approximates their fair value.

	2013 £	2012 £	2011 £
Cash and cash equivalents	133,681,099	146,331,669	87,161,162

Cash and cash equivalents comprise cash and short-term bank deposits with an original maturity of three months or less. The carrying amount of these assets is approximately equal to their fair value.

Cash at bank and in hand is restricted to making investments in accordance with the company's principal investing activities.

The credit risk on liquid funds is limited because, not only are the majority of liquid funds are held with the group's principal bankers, Barclays Bank Plc, Lloyds TSB Bank plc and The Royal Bank of Scotland, all banks with high credit ratings assigned by international credit rating agencies; care is take to ensure that there is no significant concentration of credit risk with one particular entity.

18. DERIVATIVE FINANCIAL INSTRUMENTS

	Current		
	2013 £	2012 £	2011 £
Financial assets and liabilities carried at fair value through profit or loss (FVTPL)			
Interest rate swaps	357,942	659,105	778,768

Further detail of financial instruments is provided in note 23.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

19. BORROWINGS

	2013 £	2012 £	2011 £
Bank loans at amortised cost			
Unsecured	2,900,000	5,750,000	8,500,000
Secured	54,700,000	67,550,000	77,705,000
Total borrowings	57,600,000	73,300,000	86,205,000
Amount due for settlement within 12 months	4,100,000	9,500,000	6,755,000
Amount due for settlement after 12 months	53,500,000	63,800,000	79,450,000

All borrowings are in sterling.

The bank borrowings are secured by charges on accounts containing uninvested cash and security over the investments.

The group had three principal bank loans during the year

		Original value	Drawn in	March 2013 outstanding value
Finance Wales Investments (2) Limited	i	19,721,900	Nov 03	-
Finance Wales Investments (5) Limited	ii	15,000,000	Sep 07	2,900,000
Finance Wales Investments (6) Limited	ii	75,000,000	Apr 09	54,700,000

i - Repayable when there is surplus cash or at the end of ten years from inception.
ii - Repayments in line with a schedule to repay the loan over a period of eight years from inception.

Repayments of £12,000,000 (2012 - £8,750,000) were made in the year. Interest is paid annually based on the outstanding daily capital balance at rates between 0.85% and 2.55% above LIBOR rate. See note 23 for further detail on the group's interest rate swaps. The weighted average interest rates paid during the year were 2.68% (2012 – 3.37%).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

20. OTHER FINANCIAL LIABILITIES

Trade and other payables

	2013 £	2012 £	2011 £
Current liabilities			
Trade payables and accruals	(1,673,082)	(1,346,209)	(1,712,827)
Rebates	-	(12,467)	(60,850)
Other creditors	(425,930)	(127,233)	(105,589)
	(2,099,012)	(1,485,909)	(1,879,266)
Non-current liabilities			
Rebates	-	(798)	(24,460)
	-	(798)	(24,460)

Trade payables and accruals principally comprise amounts outstanding for trade purchases and on-going costs. As at 31 March 2013, 24 days' invoices were outstanding (2012 – 21 days).

The group's financial liabilities are carried at amortised cost. The directors consider that the carrying amount of trade payables approximates their fair value.

There are no trade payables past due and the trade payables, rebates and other creditors will be settled within the credit period offered by the counterparty.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

21. RETIREMENT BENEFIT SCHEMES

The group participates in the Local Government Pension Scheme, which is a multi-employer funded scheme providing pensions and related benefits on a final salary basis. The assets of the scheme are held separately from the assets of the company and are administered by Rhondda Cynon Taff County Borough Council. Additional retirement benefits are granted in accordance with the Local Government (Compensation for Premature Retirement) Regulations 1982 and these benefits are provided on a pay-as-you-go basis.

The company and subsidiary undertaking Finance Wales Investments Limited both participate in the Local Government Pension Scheme and disclosures regarding the company's and Finance Wales Investments Limited's defined benefit pension schemes are required under the provisions of IAS 19 "Retirement Benefits", and these are set out below.

Finance Wales plc consolidated pension scheme deficit:

	2013 £'000	2012 £'000	2011 £'000	2010 £'000	2009 £'000
Finance Wales plc	(1,520)	(1,750)	(1,350)	(1,500)	(810)
Finance Wales Investments Limited	(420)	(940)	(560)	(1,410)	(940)
Net deficit	(1,940)	(2,690)	(1,910)	(2,910)	(1,750)

Finance Wales plc ("the company")

IAS 19 information

A full actuarial valuation was carried out at 31 March 2012 by a qualified actuary using revised assumptions that are consistent with the requirements of IAS 19. These assumptions have been updated to 31 March 2013. The information presented below relates to the employees of Finance Wales plc ("the company") only. Investments have been valued, for this purpose, at fair value.

The major assumptions used for the actuarial valuation were:

	2013	2012	2011
Rate of increases in salaries	4.7%	5.1%	5.3%
Rate of increases in pensions in payment	2.8%	2.6%	2.9%
Rate of increase to deferred pensions	2.8%	2.6%	2.9%
Discount rate	4.7%	4.8%	5.4%
Inflation assumption RPI	3.7%	3.6%	3.8%
Inflation assumption CPI	2.8%	2.6%	2.9%

Following the UK Government's announcement on 22 June 2012, the inflation index to be used to derive statutory pension increases has been changed from the Retail Prices Index ("RPI") to the Consumer Prices Index ("CPI"). The change has resulted in a reduction in the pension scheme liability of £1.330m which has been reflected in the statement of comprehensive income during the year.

Post retirement mortality assumptions are as follows:

	31 March 2013	31 March 2012
Males		
Base table	SAPS	SAPS
Scaling to above table rates	90%	90%
Cohort improvement factors (from 2007)	CMI2009	CMI2009
Minimum underpin to improvement factors	1.25%	1.25%
Future lifetime from age 65 (currently aged 65)	23.3	23.2
Future lifetime from age 65 (currently aged 45)	25.2	25.1

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

21. RETIREMENT BENEFIT SCHEMES (continued)

	31 March 2013	31 March 2012
Females		
Base table	SAPS	SAPS
Scaling to above table rates	100%	100%
Cohort improvement factors (from 2007)	CMI2009	CMI2009
Minimum underpin to improvement factors	1.25%	1.25%
Future lifetime from age 65 (currently aged 65)	24.7	24.5
Future lifetime from age 65 (currently aged 45)	26.6	26.5

The market value of the assets in the scheme and the expected rate of return at the balance sheet date for the whole of the Rhondda Cynon Taff County Borough Council Pension Fund were as follows:

	Long-term rate of return expected 2013 % pa	Asset split 2013 %	Long-term rate of return expected 2012 % pa	Asset split 2012 %	Long-term rate of return expected 2011 % pa	Asset split 2011 %
Equities	7.8	68.7	8.1	65.6	8.4	68.3
Property	7.3	5.9	7.6	6.8	7.9	6.8
Government bonds	2.8	10.6	3.1	10.5	4.4	10.3
Corporate bonds	3.8	11.4	3.7	13.3	5.1	12.3
Cash	0.9	3.4	1.8	3.8	1.5	2.3
Total market value	6.6	100.0	6.7	100.0	7.4	100.0

Finance Wales plc employs a building block approach in determining the rate of return on fund assets. Historical markets are studied and assets with higher volatility are assumed to generate higher returns consistent with widely accepted capital market principles. The assumed rate of return on each asset class is set out within this note. The overall expected rate of return on assets is then derived by aggregating the expected return for each asset class over the actual asset allocation for the fund at 31 March 2013.

The funding position in respect of Finance Wales plc is as follows:

	2013 £'000	2012 £'000	2011 £'000
Share of scheme assets	4,080	3,150	2,670
Share of scheme liabilities	(5,600)	(4,900)	(4,020)
Deficit	(1,520)	(1,750)	(1,350)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

21. RETIREMENT BENEFIT SCHEMES (continued)

Analysis of amount charged to operating loss:

	2013 £'000	2012 £'000
Current service cost	220	220
Past service cost	-	-
Total operating charge	220	220

Analysis of the amounts which are credited to interest paid and received:

	2013 £'000	2012 £'000
Expected return on pension scheme assets	220	210
Interest on pension scheme liabilities	(240)	(220)
Net return	(20)	(10)

Analysis of the actuarial profit/(loss) in the statement of comprehensive income:

	2013 £'000	2012 £'000
Actual return less expected return on scheme liabilities	320	(130)
Net increase in liabilities from disposals and acquisitions	-	-
Changes in assumptions underlying the present value of scheme liabilities	(170)	(380)
Past service cost		-
Total actuarial gain/(loss)	150	(510)

Analysis of movement in deficit during the year:

	2013 £'000	2012 £'000
Deficit in scheme at the beginning of the year	(1,750)	(1,350)
Current service cost	(220)	(220)
Contributions	320	340
Net finance costs	(20)	(10)
Net increase in liabilities from disposals and acquisitions	-	-
Total actuarial gain/(loss)	150	(510)
Deficit in the scheme at the end of the year	(1,520)	(1,750)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

21. RETIREMENT BENEFIT SCHEMES (continued)

History of experience gains and losses:

	2013 £'000	2012 £'000	2011 £'000	2010 £'000
Fair value of scheme assets	4,080	3,150	2,670	2,210
Present value of defined benefit obligations	(5,600)	(4,900)	(4,020)	(3,710)
Deficit in the scheme	(1,520)	(1,750)	(1,350)	(1,500)
Experience adjustments on scheme assets	320	(130)	-	470
Percentage of scheme assets (%)	7.8%	(4.1%)	-	21.3%
Experience adjustments on scheme liabilities (*)	-	-	(320)	-
Percentage of scheme liabilities (%)	-	-	(8.0%)	-

(*) This item consists of gains/(losses) in respect of liability experience only and excludes any change in liabilities in respect of changes to the actuarial assumptions used.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

21. RETIREMENT BENEFIT SCHEMES (continued)

Finance Wales Investments Limited

IAS 19 information

A full actuarial valuation was carried out at 31 March 2012 by a qualified actuary using revised assumptions that are consistent with the requirements of IAS 19. These assumptions have been updated to 31 March 2013. The information presented below relates to the employees of Finance Wales Investments Limited only. Investments have been valued, for this purpose, at fair value.

The major assumptions used for the actuarial valuation were:

	2013	2012	2011
Rate of increases in salaries	4.7%	5.1%	5.3%
Rate of increases in pensions in payment	2.8%	2.6%	2.9%
Rate of increase to deferred pensions	2.8%	2.6%	2.9%
Discount rate	4.8%	4.8%	5.3%
Inflation assumption RPI	3.7%	3.6%	3.8%
Inflation assumption CPI	2.8%	2.6%	2.9%

Post retirement mortality assumptions are as follows:

	31 March 2013	31 March 2012
Males		
Base table	SAPS	SAPS
Scaling to above table rates	90%	90%
Cohort improvement factors (from 2007)	CMI2009	CMI2009
Minimum underpin to improvement factors	1.25%	1.25%
Future lifetime from age 65 (currently aged 65)	23.3	23.2
Future lifetime from age 65 (currently aged 45)	25.2	25.1
Females		
Base table	SAPS	SAPS
Scaling to above table rates	100%	100%
Cohort improvement factors (from 2007)	CMI2009	CMI2009
Minimum underpin to improvement factors	1.25%	1.25%
Future lifetime from age 65 (currently aged 65)	24.7	24.5
Future lifetime from age 65 (currently aged 45)	26.6	26.5

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

21. RETIREMENT BENEFIT SCHEMES (continued).

The market value of the assets in the scheme and the expected rate of return at the balance sheet date for the whole of the Rhondda Cynon Taff County Borough Council Pension Fund were as follows.

	Long-term rate of return expected 2013 % pa	Asset split 2013 %	Long-term rate of return expected 2012 % pa	Asset split 2012 %	Long-term rate of return expected 2011 % pa	Asset split 2011 %
Equities	7.8	68.7	8.1	65.6	8.4	68.3
Property	7.3	5.9	7.6	6.8	7.9	6.8
Government bonds	2.8	10.6	3.1	10.5	4.4	10.3
Corporate bonds	3.8	11.4	3.7	13.3	5.1	12.3
Cash	0.9	3.4	1.8	3.8	1.5	2.3
Total	6.6	100.0	6.7	100.0	7.4	100.0

Finance Wales Investments Limited employs a building block approach in determining the rate of return on fund assets. Historical markets are studied and assets with higher volatility are assumed to generate higher returns consistent with widely accepted capital market principles. The assumed rate of return on each asset class is set out within this note. The overall expected rate of return on assets is then derived by aggregating the expected return for each asset class over the actual asset allocation for the fund at 31 March 2013.

The funding position in respect of Finance Wales Investments Limited is as follows:

	2013 £'000	2012 £'000	2011 £'000
Share of scheme assets	6,280	4,920	4,250
Share of scheme liabilities	(6,700)	(5,860)	(4,810)
Deficit	(420)	(940)	(560)

Analysis of amount charged to operating loss:

	2013 £'000	2012 £'000
Current service cost	340	310

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

21. RETIREMENT BENEFIT SCHEMES (continued)

Analysis of the amounts which would be credited to interest paid and received:

	2013 £'000	2012 £'000
Expected return on pension scheme assets	340	330
Interest on pension scheme liabilities	(290)	(270)
Net return	50	60

Analysis of the actuarial gain/(loss) in the statement of comprehensive income:

	2013 £'000	2012 £'000
Actual return less expected return on scheme assets	490	(210)
Net increase in assets from disposals and acquisitions	-	-
Changes in assumptions underlying the present value of scheme liabilities	(80)	(330)
Past service cost		-
Total actuarial gain/(loss)	410	(540)

Analysis of movement in deficit during the year:

	2013 £'000	2012 £'000
Deficit in scheme at the beginning of the year	(940)	(560)
Current service cost	(340)	(310)
Contributions	400	410
Net finance costs	50	60
Net increase in assets from disposals and acquisitions	-	-
Total actuarial gain/(loss)	410	(540)
Deficit in the scheme at the end of the year	(420)	(940)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

21. RETIREMENT BENEFIT SCHEMES (continued)

History of experience gains and losses:

	2013 £'000	2012 £'000	2011 £'000	2010 £'000	2009 £'000
Fair value of scheme assets	6,280	4,920	4,250	3,190	1,430
Present value of defined benefit obligations	(6,700)	(5,860)	(4,810)	(4,600)	(2,370)
Deficit in the scheme	(420)	(940)	(560)	(1,410)	(940)
Experience adjustments on scheme assets					
Amount (£)	490	(210)	330	670	(460)
Percentage of scheme assets (%)	7.8%	(4.3%)	7.8%	21.0%	(32.2%)
Experience adjustments on scheme liabilities(*)	-	-	(90)	-	-
Percentage of scheme liabilities (%)	-	-	(1.9%)	-	-

(*) This item consists of gains/(losses) in respect of liability experience only and excludes any change in liabilities in respect of changes to the actuarial assumptions used.

Analysis of movement in deficit during the year:

	2013 £'000	2012 £'000	2011 £'000	2010 £'000	2009 £'000
Deficit in scheme at the beginning of the year	(940)	(560)	(1,410)	(940)	(60)
Current service cost	(340)	(310)	(320)	(270)	(140)
Past service cost	-	-	790	-	-
Contributions	400	410	260	240	170
Net finance costs	50	60	(10)	(80)	-
Net increase in assets from disposals and acquisitions	-	-	-	10	-
Total actuarial gain/(loss)	410	(540)	130	(370)	(910)
Deficit in the scheme at the end of the year	(420)	(940)	(560)	(1,410)	(940)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

22. DEFERRED INCOME

	2013 £	2012 £
Balance at 1 April	17,565,026	18,941,481
Grant received in the year	6,031,463	7,614,748
Grant released to income statement in the year	(10,778,332)	(8,991,203)
Balance at 31 March	12,818,157	17,565,026

	Current			Non-current		
	2013 £	2012 £	2011 £	2013 £	2012 £	2011 £
Deferred income	8,702,108	7,129,536	8,048,252	4,116,049	10,435,490	10,893,229

The deferred revenue above relates to grants received by Finance Wales plc from the ERDF and the Welsh Government which Finance Wales plc has passed onto its subsidiaries - Finance Wales Investments Limited, Finance Wales Investments (2) Limited, and Finance Wales Investments (6) Limited - to invest within the criteria of the grants. The creditors recognise Finance Wales plc's liability to repay to the ERDF and the Welsh Government any grant received not properly invested within the prescribed time limit. The creditors are matched by corresponding debtors due from Finance Wales Investments Limited, Finance Wales Investments (2) Limited and Finance Wales Investments (6) Limited (see note 33) for the uninvested grant income. Both the creditors and debtors are reduced when Finance Wales Investments Limited, Finance Wales Investments (2) Limited or Finance Wales Investments (6) Limited make a qualifying investment.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

23. FINANCIAL INSTRUMENTS

Significant accounting policies

Details of the significant accounting policies and methods adopted, including the criteria for recognition, the basis of measurement and the basis on which income and expenses are recognised, in respect of each class of financial asset, financial liability and equity instrument are disclosed in note 2 to the financial statements.

Capital risk management

The capital structure of the group consists of debt, which includes the borrowings disclosed in note 19, cash and cash equivalents and equity directly attributable to equity holders of the parent, comprising issued capital, public equity, reserves and retained earnings as disclosed in the statement of changes in equity.

Gearing ratio

The gearing ratio at the year-end is as follows:

	2013 £	2012 £	2011 £
Debt	57,600,000	73,300,000	86,205,000
Cash and cash equivalents	(133,681,099)	(146,331,669)	(87,161,162)
Net funds	(76,081,099)	(73,031,669)	(956,162)
Equity	135,360,666	126,950,828	50,531,691
Net debt to equity ratio	(0.56)	(0.58)	(0.02)

Debt is defined as long-term and short-term borrowings as detailed in note 19. Equity includes all capital and reserves of the group attributable to equity holders of the parent.

Categories of financial instruments

The group's financial instruments comprise bank loans, investments in SMEs in the form of either loans or equity, derivative financial instruments, and trade receivables and payables arising from its operations. The purpose of the instruments is to raise finance for the group, and to invest in SMEs in Wales.

The group seeks to minimise the effects of financial risks by using derivative financial instruments to hedge known exposures. The interest rates on bank loans are managed through the use of interest rate swaps. The use of financial derivatives is governed by the group's policies approved by the Board of directors, which provide written principles on interest rate risk, credit risk, the use of financial derivatives and non-derivative financial instruments, and the investment of excess liquidity. The group does not enter into or trade financial instruments, including derivative financial instruments, for speculative purposes.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

23. FINANCIAL INSTRUMENTS (continued)

The accounting policy note describes how the classes of financial instrument are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the financial assets and liabilities in the balance sheet by class of financial instrument to which they are assigned and by the measurement basis.

Carrying value as at 31 March 2013 £	Note	Financial assets and liabilities at amortised cost	Loans and receivables	Financial assets available-for-sale	Financial assets and liabilities designated at fair value	Derivative financial instruments	Total
Assets							
Cash and cash equivalents		133,681,099	-	-	-	-	133,681,099
Investments in associates							
Measured at fair value using other methods	ii	-	-	-	4,773,311	-	4,773,311
Other investments							
Measured at market price	i	-	-	-	-	-	-
Measured at fair value using other methods	ii	-	-	3,632,586	-	-	3,632,586
Measured at cost less credit risk adjustment	iii	-	-	16,019,526	-	-	16,019,526
Loans to customers	iv	-	50,782,610	-	-	-	50,782,610
Other receivables	iv	-	1,184,423	-	-	-	1,184,423
Total financial assets		133,681,099	51,967,033	19,652,112	4,773,311	-	210,073,555
Non-financial assets							102,223
Total assets							210,175,778
Liabilities							
Interest-bearing loans and borrowings	v	57,600,000	-	-	-	-	57,600,000
Trade and other payables	v	2,099,012	-	-	-	-	2,099,012
Deferred revenue	v	12,818,157	-	-	-	-	12,818,157
Retirement benefit obligations	v	1,940,000	-	-	-	-	1,940,000
Interest rates swaps	vi	-	-	-	-	357,942	357,942
Total financial liabilities		74,457,169	-	-	-	357,942	74,815,111
Reserves							135,360,667
Total reserves and liabilities							210,175,778

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

23. FINANCIAL INSTRUMENTS (continued)

Carrying value as at 31 March 2012 £	Note	Financial assets and liabilities at amortised cost	Loans and receivables	Financial assets available-for-sale	Financial assets and liabilities designated at fair value	Derivative financial instruments	Total
Assets							
Cash and cash equivalents		146,331,669	-	-	-	-	146,331,669
Investments in associates							
Measured at fair value using other methods	ii	-	-	-	6,087,518	-	6,087,518
Other investments							
Measured at market price	i	-	-	-	-	-	-
Measured at fair value using other methods	ii	-	-	3,372,057	-	-	3,372,057
Measured at cost less credit risk adjustment	iii	-	-	13,067,466	-	-	13,067,466
Loans to customers	iv	-	53,054,220	-	-	-	53,054,220
Other receivables	iv	-	625,619	-	-	-	625,619
Total financial assets		146,331,669	53,679,839	16,439,523	6,087,518	-	222,538,549
Non-financial assets							113,116
Total assets							222,651,665
Liabilities							
Interest-bearing loans and borrowings	v	73,300,000	-	-	-	-	73,300,000
Trade and other payables	v	1,486,707	-	-	-	-	1,486,707
Deferred revenue	v	17,565,026	-	-	-	-	17,565,026
Retirement benefit obligations	v	2,690,000	-	-	-	-	2,690,000
Interest rates swaps	vi	-	-	-	-	659,105	659,105
Total financial liabilities		95,041,733	-	-	-	659,105	95,700,838
Reserves							126,950,827
Total reserves and liabilities							222,651,665

During the year, available-for-sale investments measured at a fair value of £nil (2012 – fair value of £615,286) were transferred from 'measured at market price' to 'measured at fair value using other methods' as the investment's shares were delisted from the Alternative Investment Market (AIM).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

23. FINANCIAL INSTRUMENTS (continued)

Carrying value as at 31 March 2011 £	Note	Financial assets and liabilities at amortised cost	Loans and receivables	Financial assets available-for-sale	Financial assets and liabilities designated at fair value	Derivative financial instruments	Total
Assets							
Cash and cash equivalents							
Investments in associates		87,161,162	-	-	-	-	87,161,162
Measured at fair value using other methods	ii	-	-	-	4,886,277	-	4,886,277
Other investments							
Measured at market price	i	-	-	332,718	-	-	332,718
Measured at fair value using other methods	ii	-	-	7,180,238	-	-	7,180,238
Measured at cost less credit risk adjustment	iii	-	-	9,691,717	-	-	9,691,717
Loans to customers	iv	-	50,607,120	-	-	-	50,607,120
Other receivables	iv	-	326,949	-	-	-	326,949
Total financial assets		87,161,162	50,934,069	17,204,673	4,886,277	-	160,186,181
Non-financial assets							84,485
Total assets							160,270,666
Liabilities							
Interest-bearing loans and borrowings	v	86,205,000	-	-	-	-	86,205,000
Trade and other payables	v	1,903,726	-	-	-	-	1,903,726
Deferred revenue	v	18,941,481	-	-	-	-	18,941,481
Retirement benefit obligations	v	1,910,000	-	-	-	-	1,910,000
Interest rate swaps	vi	-	-	-	-	778,768	778,768
Total financial liabilities		108,960,207	-	-	-	778,768	109,738,975
Reserves							50,531,691
Total reserves and liabilities							160,270,666

The carrying value of the group's financial instruments is considered to approximate fair value and hence a separate disclosure of carrying value versus fair value is not presented. The method of valuation of each financial instrument is described overleaf.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

23. FINANCIAL INSTRUMENTS (continued)

The following methods and assumptions have been applied in determining fair values.

Note:

i) The fair value of investments in quoted securities in an active market is the market price on the balance sheet date (level 1 hierarchy as defined below).

ii) For investments in non-quoted securities, other methods are used to determine fair value, following a recent transactional event, where these are considered reliable. These methods include using a recent valuation of the business for a funding round, using a recent offer from a prospective purchaser, or using a discounted PE valuation (level 2 hierarchy as defined below).

iii) Where the fair value of a financial asset cannot be reliably estimated, the fair value of the financial asset is approximated at cost adjusted for credit risk (the method for such an adjustment is described below).

iv) The fair value of loans to customers and other receivables is approximated to their carrying value calculated using the effective interest rate method in accordance with IAS 39.

v) The fair value of amounts owed to our ultimate parent, other third parties, share capital and public equity are assumed to approximate to their carrying amount at the balance sheet date.

vi) The fair value of interest rate swaps is calculated using discounted future cash flows and is obtained from external counterparties (level 2 hierarchy as defined below).

The group hierarchy for measuring at fair value disclosures is as follows:

Level	Hierarchy for fair value disclosures
1.	Quoted prices (unadjusted) in active markets for identical assets or liabilities.
2.	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly or indirectly. For investments in non-quoted securities, the observable inputs are derived from recent transactional events, where these are considered reliable. These methods include using a recent valuation of the business for a funding round, using a recent offer from a prospective purchaser, or using a discounted PE valuation.
3.	Inputs for the asset or liability that are not based on observable market data.

Other price risks

The group is exposed to equity price risks arising from equity investments. The shares included above represent investments in listed equity securities that present the group with opportunity for return through dividend income and trading gains. Equity investments designated as available-for-sale are held for strategic rather than trading purposes. The group does not actively trade these investments.

Market risk

The group's activities expose it primarily to the financial risks of changes in interest rates, and credit risks.

Interest rate risk management

The group is exposed to interest rate risk as entities in the group borrow funds at floating interest rates. The risk is managed by the group by the use of interest rate swap contracts to fix the interest rate on the floating rate loans.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

23. FINANCIAL INSTRUMENTS (continued)

Interest rate swap contracts

Under interest rate swap contracts, the group agrees to exchange the difference between fixed and floating rate interest amounts calculated on agreed notional principal amounts. Such contracts enable the group to mitigate the risk of higher interest rates on the fair value of issued fixed rate debt held and the cash flow exposures on the issued variable rate debt held. The fair value of interest rate swaps at the reporting date is determined by discounting the future cash flows using the curves at the reporting date and the credit risk inherent in the contract, and is disclosed below. The average interest rate is based on the outstanding balances at the end of the financial year.

The group has entered into interest rate swap agreements in respect of the bank loans. The following table details the notional principal amounts and remaining terms of interest rate swap contracts outstanding as at the reporting date:

Outstanding amounts receive floating pay fixed contracts	Average contract fixed interest rate			Notional principal amount			Fair value		
	2013	2012	2011	2013	2012	2011	2013	2012	2011
	%	%	%	£	£	£	£	£	£
Less than 1 year	2.73%	-	-	3,750,000	-	-	(48,820)	-	-
1 to 2 years	-	2.73%	-	-	3,750,000	-	-	(138,725)	-
2 to 5 years	3.64%	3.64%	3.19%	3,750,000	3,750,000	7,500,000	(309,123)	(520,380)	(778,768)
5 years +		-	-		-	-	-	-	-
				7,500,000	7,500,000	7,500,000	(357,943)	(659,105)	(778,768)

At 31 March 2013, the group has two interest rate swap agreements under which it pays fixed rates of between 2.73% and 3.64% per annum in respect of amounts drawn under the facilities. The swaps expire between 26 February 2014 and 1 April 2015.

The fair value of the interest rate swaps at 31 March 2013 was a liability of £357,943 (2012 – liability of £659,105).

The interest rate swaps settle on a quarterly basis. The floating rate on the interest rate swaps is three months LIBOR. The group will settle the difference between the fixed and floating interest rate on a net basis.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

23. FINANCIAL INSTRUMENTS (continued)

Interest rate sensitivity analysis

The group's interest rate risk arises due to commercial lending being made on fixed rate contracts, whereas borrowings are all at a variable rate. There is a natural hedge in so far as uninvested cash is invested in variable rate treasury deposits, but a risk arises, outside this natural hedge, when borrowings exceed the uninvested cash on treasury deposit. This risk is covered by interest rate swaps. However, where borrowings are to support our investments in equity instruments, any exposure here is not covered by swaps due to the uncertain cash flows. At 31 March 2013 the cash on treasury deposit exceeded borrowings by £76,081,099 therefore there was no exposure (2012 net exposure £nil). The following table details the group's sensitivity to a 1% increase in interest rates for the year to 31 March.

	2013 £	2012 £
Increase in interest payable	(502,000)	(547,000)
Increase in interest receivable	1,400,000	1,167,000
Increase in profit	898,000	620,000

Credit risk management

The group's credit risk is primarily attributable to its loan receivables, and the valuation of its equity investments. As noted in the fair value of financial instrument section above, financial assets may be measured at cost less an allowance for impairment. An allowance for impairment is made where there is an identified loss event which, based on previous experience, is evidence of a reduction in the recoverability of the cash flows.

The credit risk on derivative financial instruments is limited because the counterparties are banks with high credit-ratings assigned by international credit-rating agencies.

The group has no significant concentration of credit risk as its exposure is spread over a large number of counterparties and companies.

The following table details the group's sensitivity to a 1% reduction in the valuation of all financial assets, excluding cash and cash equivalents, at the year-end.

	2013 £	2012 £
Reduction in profit	770,000	762,000

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

23. FINANCIAL INSTRUMENTS (continued)

Liquidity risk management

Ultimate responsibility for liquidity risk management rests with the Board of directors, which has built an appropriate liquidity risk management framework for the management of the group's short, medium and long-term funding and liquidity management requirements. The group manages liquidity risk by maintaining adequate reserves and banking facilities by continuously monitoring forecast and actual cash flows and matching the maturity profiles of financial assets and liabilities.

The deterioration in the group result is not seen as a risk but as part of the normal pattern for businesses involved in making long-term investments.

Liquidity and interest risk tables

The following tables detail the group's remaining contractual maturity for its non-derivative financial liabilities. The tables have been drawn up based on the undiscounted cash flows of financial liabilities based on the earliest date on which the group can be required to pay. The table includes both interest and principal cash flows.

	Weighted average effective interest rate	Less than 6 months £'000	6 months - 1 year £'000	1 – 2 years £'000	2 – 5 years £'000	5+ years £'000	Total £'000
2012							
Variable interest rate instruments	3.37%	1,100	10,801	11,671	57,382	-	80,954
		1,100	10,801	11,671	57,382	-	80,954
2013							
Variable interest rate instruments	2.68%	681	4,862	20,086	36,000		61,629
		681	4,862	20,086	36,000		61,629

With the exception of financial assets as disclosed in note 16, financial assets are current and are non-interest bearing.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

24. CALLED UP SHARE CAPITAL

	2013 £	2012 £	2011 £
Authorised and allotted			
50,000 ordinary shares of £1 each	50,000	50,000	50,000
Called up, allotted and part paid			
50,000 ordinary shares, 25p part paid	12,500	12,500	12,500

25. OPERATING LEASE ARRANGEMENTS

	2013 £	2012 £	2011 £
Minimum lease payments under operating leases recognised as an expense in the year	338,058	299,567	289,656

At the balance sheet date, the group had outstanding commitments for future minimum lease payments under non-cancellable operating leases in respect of office properties which fall due as follows:

	2013 £	2012 £	2011 £
Within one year	277,528	298,143	300,380
In the second to fifth years inclusive	221,995	538,177	794,407
After five years	-	47,762	82,568
	449,523	884,082	1,177,355

The operating lease payments represent rentals payable by the group for its office properties. None of the figures in the above table has been discounted to present value.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

26. NOTES TO THE CONSOLIDATED CASH FLOW STATEMENT

	2013 £	2012 £
Loss for the year	(8,641,300)	(8,954,976)
Adjustments for:		
Investment revenues	(1,501,154)	(820,771)
Other gains and losses	1,035,495	(1,499,127)
Finance costs	2,058,895	2,782,535
Depreciation of property, plant and equipment	56,680	48,502
Profit on sale of available-for-sale financial assets	(457,484)	1,089,345
Proceeds on disposal of available-for-sale investments	1,538,680	498,175
Acquisition of investment in available-for-sale financial asset	(11,401,589)	(4,353,529)
Net loans made	(3,508,577)	(10,435,923)
Release of deferred income	(7,630,881)	(4,768,739)
Impairments against loans receivable	6,581,264	7,983,060
Impairments against financial assets classified as available-for-sale	5,358,631	4,943,891
Impairments against financial assets classified as fair value through profit or loss	1,431,896	689,586
Operating cash flows before movements in working capital	(15,079,444)	(12,797,971)
Increase in receivables	(573,944)	(292,920)
Increase in payables	3,496,317	2,975,265
Cash consumed during operations	(12,157,071)	(10,115,626)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
Year ended 31 March 2013

27. RELATED PARTY TRANSACTIONS

Transactions between the company and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note.

Trading transactions

Transactions between the group and its associates, who are not members of the group, during the year are as follows:

Sale of services			Loans to related parties			Equity investments in related parties		
2013	2012	2011	2013	2012	2011	2013	2012	2011
£	£	£	£	£	£	£	£	£
360,326	717,013	331,560	5,945,167	12,022,177	7,191,256	4,773,311	6,483,273	4,920,707

Sales of services to related parties were made at the group's usual prices. The amounts outstanding are unsecured and will be settled in cash. No guarantees have been given or received. No provisions have been made for doubtful debts in respect of the amounts owed by related parties.

28. ULTIMATE CONTROLLING PARTY

Finance Wales plc regards the Welsh Ministers, acting through the Welsh Government, as the ultimate controlling party. A management arrangement sets out the accountability and reporting arrangements between Finance Wales plc and its parent organisation.

COMPANY BALANCE SHEET
As at 31 March 2013

	Note	2013 £	2012 £
FIXED ASSETS			
Tangible assets		102,223	113,116
Investments	32	162,011,735	180,411,734
		162,113,958	180,524,850
CURRENT ASSETS			
Debtors: due within one year	33	587,690	164,990
Debtors: due after one year	33	12,122,465	16,691,874
Cash at bank and in hand		24,862,309	8,703,246
		37,572,464	25,560,110
CREDITORS: amounts falling due within one year	34	(6,004,763)	(1,791,350)
NET CURRENT ASSETS		31,567,701	23,768,760
TOTAL ASSETS LESS CURRENT LIABILITIES		193,681,659	204,293,610
CREDITORS: amounts falling due after more than one year	35	(53,500,000)	(72,450,000)
ACCRUALS AND DEFERRED INCOME		(12,646,819)	(17,260,204)
NET ASSETS EXCLUDING PENSION LIABILITY		127,534,840	114,583,406
Pension liability	21	(1,520,000)	(1,750,000)
NET ASSETS INCLUDING PENSION LIABILITY		126,014,840	112,833,406
CAPITAL AND RESERVES			
Public equity		150,556,334	134,556,334
Called up share capital	37	12,500	12,500
Capital reserve		10,100	10,100
Profit and loss account		(24,564,094)	(21,745,528)
SHAREHOLDERS' FUNDS		126,014,840	112,833,406

The financial statements of Finance Wales plc, registered number 4055414, were approved by the Board of Directors and authorised for issue on 22 July 2013.

Signed on its behalf by

S Lloyd-Jones
Director

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 March 2013

29. ACCOUNTING POLICIES

Basis of accounting

The separate financial statements of the company are presented as required by the Companies Act 2006 and have been prepared in accordance with applicable United Kingdom Accounting Standards and law. They have been prepared under the historical cost convention and under the going concern assumption. Further details of the directors' considerations in relation to going concern are included in the Directors' report on page 3.

The principal accounting policies are summarised below. These have been applied consistently throughout the year and the preceding year.

Tangible fixed assets

Tangible fixed assets are stated at cost, net of depreciation and any provision for impairment.

Tangible fixed assets are depreciated on a straight-line basis over their expected useful economic lives. The rates of depreciation are as follows:

Fixtures and fittings	3 to 4 years

Investments

Equity investments are treated as fixed assets and stated in the balance sheet at cost less any provision for impairment. Accounts identified as being in difficulty are specifically provided and a general provision is made on all other accounts.

Loans are held as current assets and are valued at the lower of cost and net realisable value.

Although the company may hold more than 20% of the equity of certain companies, the directors consider that, in view of the current investment objectives of the company and Finance Wales having no significant influence over the day-to-day operations of those companies, it would not be appropriate to treat these holdings as investments in associated undertakings.

Financial instruments

The company is exposed to interest rate risk arising from borrowing at a margin over London Inter Bank Offered Rate (LIBOR) and lending to SMEs at a fixed rate. The group holds interest rate swap contracts to hedge their exposure to movements in LIBOR. Details of the interest rate swaps held are given in note 18.

The use of financial derivatives is governed by the company's policies approved by the Board of directors, which provide written principles on the use of financial derivatives to manage these risks. The company does not use derivative financial instruments for speculative purposes.

Taxation

Current tax is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantively enacted at the balance sheet date.

Deferred tax is provided in full on timing differences that result in an obligation at the balance sheet date to pay more tax, or a right to pay less tax, at a future date, at rates expected to apply when they crystallise based on current tax rates and law. Timing differences arise from the inclusion of items of income and expenditure in taxation computations in periods different from those in which they are included in the financial statements. Deferred tax is not provided on timing differences arising from the revaluation of fixed assets where there is no commitment to sell the asset, or on unremitted earnings of subsidiaries and associates where there is no commitment to remit these earnings.

Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered. Deferred tax assets and liabilities are not discounted.

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 March 2013

29. ACCOUNTING POLICIES (continued)

Public equity

The Welsh Ministers, acting through the Welsh Government, have from time to time provided funds for investment purposes. These funds have largely been accounted for within Finance Wales Investments Limited (Small Loans Fund), Finance Wales Investments (3) Limited (Rescue and Restructuring Finance), Finance Wales Investments (4) Limited (the Creative Industries Fund), Finance Wales Investments (5) Limited (the Interim Fund) and Finance Wales Investments (6) Limited (the JEREMIE Fund). Some of this Welsh Government funding was originally made as Public Dividend Capital (PDC) whilst the remainder was classified as Grant in Aid or Core Funding for Investment purposes.

The funding was to invest in the long-term sustainability of Finance Wales and within the Welsh Government's own accounting arrangements the funds were regarded as being an investment. Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences residual interest in the assets of the group after deducting all of its liabilities. Equity instruments issued by the group are recorded at the proceeds received, net of direct issue costs.

Related party transactions

The company has taken advantage of the exemption conferred by paragraph 17 of Financial Reporting Standard Number 8 "Related party disclosures" and has not disclosed transactions with its wholly-owned subsidiaries.

Pensions

The company operates a defined benefit pension scheme which is administered by Rhondda Cynon Taff County Borough Council. The company accounts for its share of the surplus or deficit and administration costs of this scheme.

The level of contributions made to the scheme and the cost of contributions included in the financial statements are based on the recommendations of independent actuaries.

The scheme assets are an estimate of the company's notional share of the total fund assets measured at market value at each balance sheet date and liabilities are measured using the projected unit method, discounted using a corporate bond rate. The company's notional share of assets is assumed to be invested in the same proportion as the fund as a whole in the different asset classes. The resulting pension scheme surplus or deficit is recognised immediately on the balance sheet, net of deferred tax where applicable, and any resulting actuarial gains and losses are recognised immediately in the statement of comprehensive income.

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 March 2013

30. INFORMATION REGARDING DIRECTORS AND EMPLOYEES

	2013	2012
	£	£
Directors' emoluments		
Emoluments	448,350	421,968

	£	£
Remuneration of highest paid director	210,334	207,246

Two directors of the company and two directors of subsidiary companies were members of the defined benefit pension scheme (2012 - one and two).

	£	£
Aggregate payroll costs (excluding directors)		
Wages and salaries	1,317,053	1,417,997
Social security costs	120,654	129,026
Pension costs (see note 21)	201,673	213,116
	1,639,380	1,760,139

	No.	No.
Average number of persons employed (excluding directors) – administration	38	38

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 March 2013

31. LOSS FOR THE YEAR

As permitted by section 408 of the Companies Act 2006, the profit and loss account of the parent company is not presented as part of these financial statements. The parent company's loss for the financial year amounted to £2,968,566 (2012 – loss of £2,063,409), Auditor's remuneration for audit services for the company was £27,021 (2012 - £25,046). Auditor's remuneration for non-audit services for the company was £5,000 (2012 - £5,000).

32. INVESTMENTS

	Shares in joint venture £	Shares in subsidiary undertaking £	Investments in and loans to subsidiary undertakings and joint venture £	Investment in HSBC Enterprise Fund £	Total 2013 £	Total 2012 £
At 1 April	100	155,010	180,073,291	183,333	180,411,734	112,161,730
Additions	-	1	-	-	1	77,600,004
Disposals	-	-	(18,400,000)	-	(18,400,000)	(9,350,000)
At 31 March	100	155,011	161,673,291	183,333	162,011,735	180,411,734

The company's investments in group companies relate to:

Subsidiaries

Finance Wales Investments Limited	United Kingdom	100%	£1 ordinary shares	
Finance Wales Investments (2) Limited	United Kingdom	100%	£1 ordinary shares	
Finance Wales Investments (3) Limited	United Kingdom	100%	£1 ordinary shares	
Finance Wales Investments (4) Limited	United Kingdom	100%	£1 ordinary shares	
Finance Wales Investments (5) Limited	United Kingdom	100%	£1 ordinary shares	
Finance Wales Investments (6) Limited	United Kingdom	100%	£1 ordinary shares	
Finance Wales Investments (8) Limited	United Kingdom	100%	£1 ordinary shares	
Finance Wales Investments (9) Limited	United Kingdom	100%	£1 ordinary shares	
Finance Wales Investments (10) Limited	United Kingdom	100%	£1 ordinary shares	
FW Capital Limited	United Kingdom	100%	£1 ordinary shares	
NE Growth 500 LP Limited	United Kingdom	100%	£1 ordinary shares	
FW Development Capital (North West) GP Ltd	United Kingdom	100%	£1 ordinary shares	Incorporated 10 Jan 2013
xènos – The Wales Business Angel Network Limited	United Kingdom	100%	£1 ordinary shares	

The activities of the subsidiaries consist of the provision of financial services to small and medium sized enterprises and fund management activities.

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 March 2013

33. DEBTORS

	2013	2012	2011
	£	£	£
Debtors due within one year:			
Loans receivable within one year	849	2,663	62,502
Trade debtors	(4,872)	-	603
Amount owed by group undertakings	16,620	8,595	7,501,793
Other debtors	476,764	53,956	80,881
Prepayments and accrued income	98,329	99,776	103,024
	587,690	164,990	7,748,803

	£	£	£
Debtors due after one year:			
Loans receivable after one year	6,856	6,384	(20,657)
Amount owed by group undertakings	12,115,609	16,685,490	10,893,229
	12,122,465	16,691,874	10,872,572

34. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	2013	2012	2011
	£	£	£
Trade creditors	173,610	107,203	133,558
Amount owed to group undertakings	1,663,559	1,687,001	866,958
Bank loans	4,100,000	-	2,050,000
Other creditors	67,594	(2,854)	11,457
	6,004,763	1,791,350	3,061,973

35. CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR

	2013	2012	2011
	£	£	£
Bank loans	53,500,000	72,450,000	72,700,000

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 March 2013

36. BORROWINGS

	2013 £	2012 £	2011 £
Unsecured borrowings are repayable as follows:			
Within one year		-	2,050,000
In the second year	900,000	2,322,000	-
In the third year	2,000,000	1,428,000	3,022,000
In the fourth to fifth years inclusive	-	2,000,000	3,428,000
More than five years	-	-	-
	2,900,000	5,750,000	8,500,000
Secured borrowings are repayable as follows:			
Within one year	4,100,000	9,500,000	3,900,000
In the second year	17,900,000	6,600,000	11,600,000
In the third year	17,100,000	17,900,000	6,600,000
In the fourth to fifth years inclusive	15,600,000	32,700,000	35,000,000
More than five years		-	15,600,000
	54,700,000	66,700,000	72,700,000
Total borrowings	57,600,000	72,450,000	81,200,000

Loans received for making investments within Finance Wales Investments (5) Limited and Finance Wales Investments (6) Limited are repayable in line with the original repayment schedule over a remaining period of three and four years respectively. All other loans will either be repayable when there is surplus cash or at the end of ten years from inception. Repayments of £14,850,000 (2012 - £8,750,000) were made in the year. Interest is paid annually based on the outstanding daily capital balance at rates between 0.85% and 2.55% above LIBOR rate.

At 31 March 2013, the company has two interest rate swap agreements under which it pays fixed rates of between 2.73% and 3.64% per annum in respect of amounts drawn under the facilities. The effective notional amount outstanding at 31 March 2013 was £7,500,000 (2012 - £7,500,000). The swaps expire between 26 February 2014 and 1 April 2015.

The fair value of the interest rate swaps at 31 March 2013 was a liability of £357,942 (2012 – liability of £659,105).

The interest rate swaps settle on a quarterly basis. The floating rate on the interest rate swaps is three months LIBOR. The company will settle the difference between the fixed and floating interest rate on a net basis.

NOTES TO THE COMPANY FINANCIAL STATEMENTS
Year ended 31 March 2013

37. CALLED UP SHARE CAPITAL

	2013 £	2012 £	2011 £
Authorised and allotted			
50,000 ordinary shares of £1 each	50,000	50,000	50,000
Called up, allotted and part paid			
50,000 ordinary shares, 25p part paid	12,500	12,500	12,500

38. COMBINED RECONCILIATION OF MOVEMENT IN SHAREHOLDERS' FUNDS AND STATEMENT OF MOVEMENTS ON RESERVES

	Public equity £	Share capital £	Capital reserve £	Profit and loss account £	Total 2013 £	Total 2012 £
Balance at 1 April	134,556,334	12,500	10,100	(21,745,528)	112,833,406	30,906,815
Loss for the financial year	-	-	-	(2,968,566)	(2,968,566)	(2,063,409)
Actuarial gain/(loss) for the year	-	-	-	150,000	150,000	(510,000)
Additional public equity	16,000,000	-	-	-	16,000,000	84,500,000
Balance at 31 March	150,556,334	12,500	10,100	(24,564,094)	126,014,840	112,833,406

Extracted from Finance Wales' Management Arrangement. This is the document which governs the relationship between Finance Wales plc and the Welsh Ministers acting by the Welsh Government.

Background

1.4.1 In October 1999 the NAW resolved to establish a development fund "to provide SME's with flexible and sustained finance for development". The National Assembly for Wales' Economic Development Committee approved the establishment of the Company on 12 April 2000. Approval from Ministers acting on behalf of the NAW was given by letter dated 22 May 2000 (Annex 3 to this Management Arrangement).

1.4.2 The Company was incorporated and established on 18 August 2000.

Legislation

1.3.1 The Company was established and operates pursuant to the powers and functions provided by section 1(3) (b) (d) and 1 (7) (a), (b) and (d) of the Welsh Development Agency Act 1975 (as amended). The said powers and functions were transferred to the National Assembly for Wales ("the NAW") under the Welsh Development Agency (Transfer of Functions to the National Assembly for Wales and Abolition) Order 2005, with effect from 1st April 2006. These powers and functions were subsequently transferred to the Welsh Ministers pursuant to paragraph 30 of Schedule 11 of the Government of Wales Act 2006 ('GOWA 2006') such transfer being effected at the end of the 'initial period' as defined by GOWA 2006 namely 26th May 2007.

ANNEX 6

Cynulliad Cenedlaethol Cymru
The National Assembly for Wales

Parc Cathays / Cathays Park
Caerdydd / Cardiff
CF10 3NQ

Brian Willott Esq CB
Chief Executive
Welsh Development Agency
Principality House
The Friary
CARDIFF
CF1 4AE

Eich cyf / Your Ref

Ein cyf / Our Ref

22 May 2000

Dear Brian,

FINANCE WALES

Following consideration by the First Secretary and discussion at the Economic Development Committee 12 April, approval has been given for the formation of a new, wholly owned subsidiary company with the title Finance Wales to act as a development fund for small and medium sized enterprises in Wales. There are a number of issues which we need to take forward with the Agency and other partners. These are listed in the annex to this letter and there may be others. I think it would be helpful if we could arrange an early meeting to discuss them and we will be contacting Alan Morgan and Alistair Denton to make the arrangements.

This programme is in furtherance of the Agency's purpose set out in section 1(2)(a) of the Welsh Development Act 1975 as amended ('the Act') and its functions set out in section 1(3)(b) and (d) of the Act 1975. The project exercises the Agency's powers as set out in section 1(7)(a), (b) and (d) of the Act.

The Assembly Secretary for Economic Development's consent to the carrying out of this programme by the Agency is given in accordance with section 1(15) of the Act.

The Assembly Secretary's consent is limited to the programme described and neither constitutes consent, approval or authorisation under any other section of the Act nor a consent, approval or authorisation which may be necessary under any other statute; and is without prejudice to any other consent or approval given or to be given under any other statute.

A copy of this letter goes to both Alan and Alistair.

Yours sincerely,

STEVEN PHILLIPS
Head of Economic Policy Division

Tel: 029 2082 3634
GTN: 1208 3634
Ffacs / Fax: 029 2082 3797
E-bost / E-mail: Steven.Phillips@Wales.gsi.gov.uk

The Agency's existing Finance Programmes activities and their associated assets and liabilities will be transferred into Finance Wales. Finance Wales will be required to comply with the State Aid rules and the Agency, with the assistance of Assembly officials, should prepare a State Aid notification for the European Commission covering the new fund.

A Memorandum and Articles of Association should be prepared for the new subsidiary company to be submitted for our comments.

Operational guidelines for Finance Wales, incorporating a Code of Practice and criteria for the appraisal of applications for support should also be prepared.

Assembly officials will prepare a Financial Memorandum for the new company, which will set out the relationship between the Assembly, the Agency and Finance Wales and will define the framework within which Finance Wales will operate.

The Agency will be responsible for appointing the Directors and Chair of Finance Wales but, as stated in the Economic Development Committee paper (EDC-08-00 p4), the views of the Partnership should be sought before determining the composition of the Board.

Fund	Sub-Fund	Loan Range	No of Loans	Avg Loan Size	TOTAL INVESTED
JEREMIE	Loans	£25,001 - £2m	270	180,036	48,609,785
JEREMIE	Micro	£5,000 - £25,000	155	20,058	3,108,937
Wales Micro Business	Loans	£1,000 - £50,000	78	20,612	1,607,764
Wales SME	Loans	£50,001 - £2m	25	193,462	4,836,550
Wales Property	Loans	£250,000 - £1m	5	415,276	2,076,379
			533		**60,239,415**

Mae cyfyngiadau ar y ddogfen hon

Eitem 6

Yn rhinwedd paragraff(au) ix o Reol Sefydlog 17.42

Mae cyfyngiadau ar y ddogfen hon