Russel George
National Assembly for Wales
Economy and Infrastructure Committee
Cardiff Bay
Cardiff
CF99 1NA

December 2nd 2016

Dear Mr George

Thank you for your letter dated 28th November 2016. Our responses are given below.

Capital Funding

Mr Thorley described Welsh Government funding as "the anchor" in terms of future capital funding sources.
We would welcome greater clarity, in due course, on what this will mean.

At present Finance Wales receives its fund monies from ERDF and Welsh Government. In light of Brexit, we feel that it may be necessary to investigate what other sources of funding could be available, while at the same time working closely with Welsh Government to assist in the delivery of their key economic objectives.

Risk Management

Given the greater capacity to lending envisaged for the Development Bank, there would also be a greater exposure to risk for the Welsh Government.
While normal prudential requirements do not apply to Finance Wales, we would welcome further information on what consideration is being given to managing the exposure to risk. E.g. would bad debt be underwritten by the Welsh Government, or would some form of capital requirement to foster enhanced risk management be applied?

The increased investment and lending activity envisaged by the Development Bank will be undertaken through a number of distinct funds targeted to address specific areas of market failure. A key consideration when developing new funds is defining their risk appetite. For example, investments in early stage, technology businesses inherently carry a higher risk than does lending to established businesses to fund their growth aspirations.

Like Finance Wales before it, the Development Bank will agree in advance individual fund parameters including risk appetite, and hence forecast losses and returns, with Welsh Government. Thereafter, individual investments will be closely monitored through robust portfolio management procedures and will be summarised in a comprehensive suite of monthly management information reported to the Development Bank Board. Inter alia, this will include comparison of actual bad debts with those originally envisaged. The performance of each fund will also be reported quarterly to Welsh Government. Proactive tracking of fund performance will, with Welsh Government agreement, enable fund parameters to be varied during the life of the fund. Such variations may be appropriate where fund performance is off plan, or in response to changing macro-economic circumstances. The business plan for the Development Bank includes provision for modest recruitment activity to ensure that portfolio management is resourced effectively.

Accordingly, whilst bad debts will impact fund performance and, therefore, returns to Welsh Government, this will be factored in to the development of new funds.

Help to Buy Scheme

This scheme is underpinned by a repayable loan (to HM Treasury). A loan, we assume, that is ultimately underwritten by the Welsh Government. We would welcome a note on the terms of this loan, and an annual update on progress to repay it.

The HTBW scheme has two financial transaction reserve loans as follows:

HTBW Fund I – total loan £174.5m (fully drawn) Investment start date Jan 2014. Investment end date approx. Dec 2016
HTBW Fund II – total loan £290.0m (£26.3m drawn) Investment start date Oct 2016. Investment end date approx. Dec 2021.

The HTBW shared equity loan investments made by the HTBW funds are interest free for the first 5 years. The term is up to 25 years and capital is only returned on a sale of the property or a refinance. Each loan can be up to a maximum of 20% of the purchase price (called HTBW's equity percentage), capped at £60,000. The amount of capital received back is equal to HTBW's original equity percentage times the sales price/valuation at the time of repayment. So the success of the scheme will depend on how the property market moves over the period of the scheme.

The Fund I loan is due to start being repaid from 2018/19 with the final repayment in 2040/41. The loan is interest free and only the original capital is to be repaid. The ramp up of repayment is end loaded and starts to ramp up from 2033. To date HTBW has received 51 repayments totalling some £1.5m with a net profit of £50k. The positive news is that this amount of repayments already received from borrowers nearly covers the first 3 years of repayments of FTR to 2021.

The Fund II loan is due to start being repaid from 2018/19 with the final repayment in 2043/44. The loan is interest free and only the original capital is to be repaid. The ramp up of repayment is end loaded and starts to ramp up from 2036. HTBW has just started investing this fund with c. £200k invested to date.

The FTR repayment risk is the liability of WG not HTBW.

The scheme is operating well, based on stakeholder feedback, and is tracking slightly ahead of the forecast investment run rate.

Pensions

We noted that the rise in the remuneration of the highest paid director in 2015-16 was inflated by pension contributions; and that 30% of the current Finance Wales staff are in the same scheme. Can you assure us that the business case for the Development Bank has considered this actuarial risk?

The significant cost shown in the 2015/16 accounts are reflective of a combination of several factors:

a) Which pension scheme the individual is contributing to
b) Length of service
c) Age
d) Salary
e) Circumstance where the individual leaves the organisation as part of a restructuring.

Detailed consideration has been given to any individuals who might have more than one of these characteristics.

None would trigger any liability of anything approaching this size. The six individuals, who are of or are approaching the age where a reorganisation might trigger access to pension, do not have significant service and/or salary to create a significant cost.

In the committee hearing I promised to revert on a specific question posed by Vikki Howells AM in relation to equity investments exited by Finance Wales in the last financial year.

Of the 4 equity exits in 2105/16, 2 were loss-making which resulted in an average multiple of 0.58 or a loss of £454,850. Taken in isolation, the performance of these assets could be viewed as a cause for concern however this highlights the difficulty of viewing the performance of an equity fund in light of a single asset or as part of an annual Profit and Loss account. To understand fund performance, taking a longer term view is appropriate in order to avoid the issue of limited data misrepresenting realisations as either negative or positive.

Finance Wales equity funds follow a 5 year investment period followed by a realisation period with fund performance monitored over the same timeframe. In the last 3 years Finance Wales equity investments have performed as follows:

Year	Multiple	Profit/Loss
14/15	1.58	£4,616,120
15/16	0.51	(454,850)
16/17 YTD	2.20	£3,174,956

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In relation to the other comments in your letter where you wish to be updated in due course, we appreciate the interest of the Committee and will keep you informed of our progress.

With kind regards,

Giles Thorley

Chief Executive