STOCK OF FINANCE FACILITATED

METHOD OF MEASUREMENT

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BACKGROUND

One of the British Business Bank's agreed strategic objectives is "*To increase the supply of finance available to smaller businesses in areas where markets do not work effectively*"

Derived from this, the British Business Bank ("the Bank") has as one of its four strategic key performance indicators (KPIs) the stock of finance facilitated ("Stock") by its programmes.

What is Stock?

Stock is a snapshot of the amount of finance being provided to businesses via one of the Bank's programmes.

Of the finance received by businesses, Stock is the portion of that original investment still sitting in a business at a point in time. In general, our programmes are designed to attract in private sector investors so Stock is defined to include the value of this additional funding.

Stock = British Business Bank Investment + Private Sector Investment

Investing alongside private funds is a key feature of the Bank's programmes, although each one is different in the way it achieves this. In general, the Bank's programmes attract in private finance several times greater than the amount invested by the Bank.

Stock is one measure of how well the Bank is meeting its mission to correct market failures in the provision of finance to smaller businesses. It is also one of the few measures which the Bank's diverse range of programmes ought to have in common. While they adopt quite different approaches, the Bank's programmes are all intended to result in businesses receiving finance: that being the case it *ought* to be possible to measure how much of the finance created is still present in businesses at any given time.

How is Stock Measured?

When a business receives finance, initially the Stock is simply the monetary amount provided. In successful businesses, loan finance will eventually be repaid and equity finance will be sold at a profit (e.g. through a stock market flotation). Similarly, investments in unsuccessful businesses will eventually lose their value and be written off.

So the Stock of finance supported by the Bank changes as a result of three factors:

1. New finance provided to businesses, known within the Bank as the "flow" of finance facilitated
2. Capital repayments, which reduce Stock
3. Write-offs, which also reduce Stock

Note that Stock is entirely measured at cost, which allows it to be used as a measure of how much of the flow of finance is still "out there" in businesses. Stock does not change when the value of the amount invested changes (unless it is written-off).

Issues to be Addressed

1. Fundamental Differences Between Programmes

The inclusion of other investors' money introduces complexity to the measurement of Stock. Many of the Bank's programmes are fundamentally different in nature (compare guarantees with investment funds, for example) and even within a programme there can be radically different operating models among delivery partners (such as peer-to-peer lenders and investment funds). This means that the way in which the Bank's resources translate into finance for businesses is neither **simple** nor **uniform** across programmes.

2. Changes Within Programmes Over Time

The Bank's delivery partners raise finance from private sector sources and in many cases this happens continually during the Bank's involvement. As a result the quantity of finance provided by a delivery partner can increase as a result of additional external capital being raised (for example) without the Bank's investment changing.

Examples

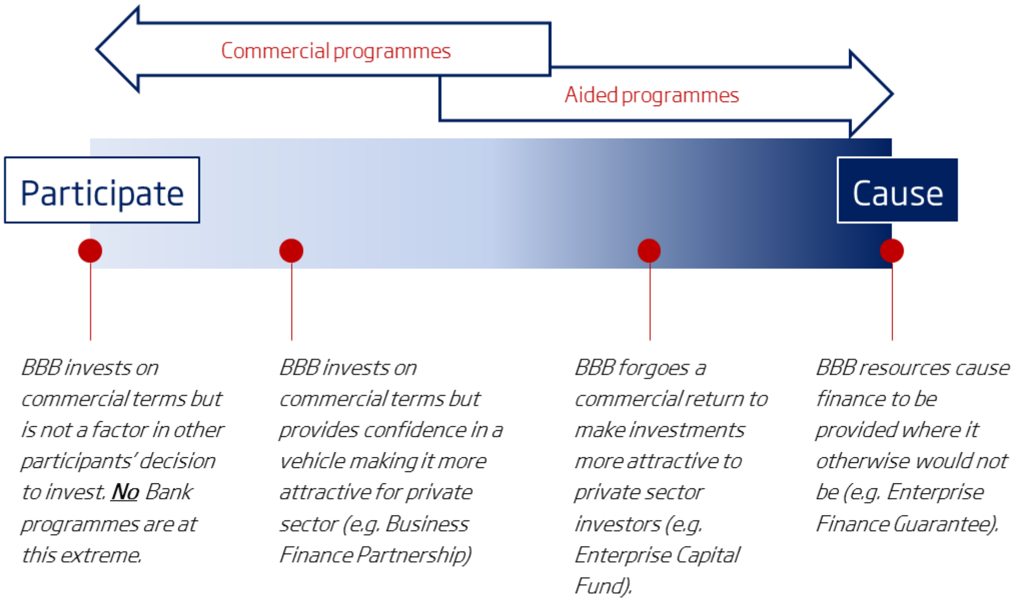
Enable Funding: the Bank finances a special purpose vehicle (SPV) which purchases loans made by smaller lenders. At a later date, the SPV issues securities, of which the Bank retains a portion. The quantity of loans underpinning the securities is the same pre- and post-securitisation, but the quantity of Bank resources consumed decreases significantly, as securitisation proceeds flow back into the Bank. The leverage of the programme therefore depends on where in the purchase-securitisation cycle the Bank is at a given time.

Funding Circle: the Bank initially took a 20% share of loans issued by the peer to peer lender. This proportion reduced to 10% for new loans from a particular date, meaning that the Bank's blended average share of the loans has gradually reduced over time. This makes the Stock of finance facilitated increase over time.

3. Causality Versus Participation

A key difference between programmes is the extent to which they can claim to be a direct cause of the finance that they facilitate.

The Bank's programmes can be viewed as sitting on a spectrum *(below)*, from those where the programme is pivotal in causing finance to be provided, to those where the Bank participates in the supply of finance but is not central to other investors' decisions to invest. Differences between programmes along this spectrum make it virtually impossible to arrive at a single measure of the impact of Bank programmes.



Causality Spectrum *The different aims and structures of the Bank's programmes mean that the link between a programme and the stock of finance facilitated is more direct in some cases than others.*

Several of the Bank's programmes are explicitly causal in nature, either because they operate in segments where there is an absence of supply (e.g. the Enterprise Finance Guarantee programme, Start-Up Loans Company) or because the Bank's involvement explicitly invokes private sector investment (e.g. VC Catalyst Fund, Angel Co-fund).

In addition to increasing Stock, the Bank also has an objective to increase the diversity of supply of smaller business finance and several programmes are designed with this aim in mind. In certain cases the Bank intentionally "cornerstones" a vehicle or finance platform in order to provide credibility to it in raising further finance: for these there is a case for the Bank having caused the stock of finance which results. In other cases, the Bank's involvement encourages participation from those that might not otherwise have invested. In instances like this, the case for causality weakens as the stock of finance grows, but it is not obvious at what point causality ends and passive participation begins.

Note that claiming causality is not the same as claiming additionality; that the finance would not have been provided at all, via any route, without the Bank's intervention. However, additionality is an important consideration and the Bank assesses potential programmes and products for additionality and to guard against crowding out productive private investment. The Bank also has an evaluation programme to assess the impact of its interventions, including the level of additionality.

PREVIOUS METHOD OF STOCK MEASUREMENT

Summary of Method: Ad Hoc Adjustment

At the time of the Bank's creation the actual stock of investments made was adjusted downwards for a number of delivery partners. This was done to adjust for private finance investing alongside certain Bank programmes, in which the Bank did not claim to have directly caused the private finance.

Adjustments were made where there was additional private sector investment after the Bank made its investment (e.g. where there have been second and third funding rounds in which the Bank has not participated). Adjustments could also be made where private sector resources have been put into vehicles in which the Bank is only indirectly investing (e.g. where the Bank has invested in a fund-of-funds, but additional private sector resources have been added to the underlying investment funds).

Where these effects were material, individual adjustments were applied at the programme level to calculate the Stock figure that best reflects the amount of finance which arose alongside the Bank's involvement.

Advantages of the Previous Method

- Works well for investment funds, which have well-defined funding rounds and portfolios of investments
- Based on a principle of reasonableness, which can be justified and explained although it is hard to verify.

Disadvantages of the Previous Method

- Auditability and analysis. The adjusted Stock does not correspond to a real set of whole investments. Scaling of Stock leads to distortions in average investment size, as well as requiring care when interpreting breakdowns by region, sector, parliamentary constituency and so on.
- Crude adjustments. The Bank's programmes occupy a spectrum from those which cause finance to be provided where it otherwise would not, to others where the Bank is participating alongside commercial investors. While the aim of making adjustments is to limit the quantity of finance for which the Bank is claiming credit, it is not possible to calculate the precise amount of finance which the Bank caused to be provided. Given the fundamental differences in causality between programmes, the post-adjustment Stock numbers are still not on a common basis across programmes.
- Subjectivity. There is a degree of judgement applied to determine what proportion of external finance is included, which reduces verification/auditability. This is particularly true for BFP Mid Cap, which has the largest adjustment applied, since its delivery partners are not conventional investment funds and lack the well-defined boundaries of such entities with respect to both quantum and timing.
- Inconsistency. BFP Mid Cap's Stock was adjusted because the amount of additional external finance had increased, but in the investment in Funding Circle was not adjusted even though the Bank's share of that partner's lending has declined due to additional external finance. The Bank's share of Funding Circle's Stock is expected to fall further over time meaning that any adjustment factor would need to be continually updated, further emphasising the difficulty of producing an adjusted measure of Stock.
- A further point of inconsistency is the inclusion of non-UK businesses in the portfolios of certain investment funds. Programmes affected by this are structured so that a minimum level of investment is made in UK businesses and the pan-European nature of the funds was understood up front, but it introduces an additional complexity.

NEW SIMPLIFIED APPROACH

To remove the drawbacks of the previous method of adjusting Stock, the measure has been simplified as much as possible to include the full amount of external investors' money in the Stock of finance facilitated.

The Stock measure becomes simply the total amount of finance sitting in UK businesses, to which the Bank has contributed. For comparability and to ensure appropriate incentivisation, the Bank's Stock targets used to set its KPIs have been re-stated (upwards) on the new basis, but the Bank's underlying business plan and operational activity is unchanged.

Changes Which Increase the Reported Stock

- Inclusion of all private funding in BFP Mid Cap vehicles
- Inclusion of all private funding in the UKIIF programme.

Changes Which Decrease the Reported Stock

- Exclusion of non-UK businesses (principally UKIIF and VC Catalyst programmes)
- Removal of Ex-RDA* Stock

**Regional Development Agency. These investments fall within Venture Capital Solutions and include a range of legacy equity and debt investments established under the now-defunct Regional Development Agencies. The Bank provides oversight and represents HM Government's interests as part-owner of the vehicles through which investments are made. The degree of control and discretion which the Bank has in respect of the ex-RDA investments is considerably less than for other programmes.*

Given the Bank's different role in respect of these investments, the limited control it possesses over them and the quality of information it receives, the ex-RDA programmes have been removed from the definition of Stock.

Advantages

- Simple; easy to understand and communicate.
- The reported Stock figure corresponds to a real set of financing transactions which can be easily listed for verification; this is not the case currently where an adjustment factor is applied.
- Analysis by region, sector, etc. is more straightforward and meaningful when based on a set of whole, unadjusted investments
- Average investment sizes are not distorted by adjustments to total Stock
- Actuals and Targets are perfectly comparable, both being re-stated on the new basis

- Absence of subjective adjustments removes the risk of manipulation/gaming to achieve a target

Disadvantages

- Movements in stock might be dominated by the entrance/exit of external investors: these movements could determine the overall Bank position against its Stock target.
- Movements in Stock are less foreseeable by the Bank, making planning more difficult.
- Does not distinguish between Stock which the Bank has invoked (caused to happen) and Stock in which the Bank has participated but does not claim to have caused. Note that the previous method also had this disadvantage, which highlights the fundamental difficulty of measuring causality, particularly where the Bank is operating in markets with many participants.

However, the Bank already distinguishes in its publications between mid-cap and smaller business stock. In future the Bank would describe its role as “participating” in mid cap finance and “supporting” smaller business finance, which more accurately portrays the level of causality in its involvement.

Implications of the New Method

The net effect of the change in methodology is to increase the value of Stock currently reported.

	March 2015 ACTUAL	
	Old Stock £m	New Stock £m
Venture Capital Solutions		
UK High Technology Fund	0.0	0.0
Regional Venture Capital Fund	51.1	53.1
Early Growth Fund	7.4	8.0
Bridges Ventures Fund	2.3	3.1
Enterprise Capital Fund	225.5	219.2 ↓
Aspire Fund	15.8	15.8
Capital for Enterprise Fund	10.2	14.2
UK Innovation Investment Fund	112.8	445.3 ↑
Angel Co-Investment Fund	110.4	110.4
VC Catalyst Fund	57.1	13.9 ↓
Ex-RDA	209.0	0.0 ↓
Investment Programme		
BFP Small Cap & IP	425.0	460.8 ↑
BFP Mid Cap	1,411.8	2,879.9 ↑
Lending Solutions		
EFG	845.1	845.1
Help to Grow	0.0	0.0
Start Up Loans	94.3	94.3
Wholesale Solutions		
Enable Guarantees	0.0	0.0
Enable Funding	0.0	0.0
	3,577.8	5,163.1
BFP Mid Cap	1,411.8	2,879.9
Other	2,166.0	2,283.3

Note *Final year-end data has been used for the New figures, rather than the preliminary results used at March 2015. This causes some minor differences between Old and New which are not related to the methodology change and are not highlighted above.*

Including all the finance in which the Bank has participated increases the Bank's reported total in the near term, with the effect most pronounced in the BFP Mid Cap programme (March 2015 Stock increases from £1.4bn to £2.9bn when restated – *see table*) and as a result, BFP Mid Cap's Stock becomes the largest component of the total.

Given that the Bank should not, and does not, claim credit for having created all the Mid Cap finance provided to businesses, the Bank will need to continue to be precise in how Stock is presented and described to stakeholders.

Simplification of the measure, then, requires care and sophistication in interpreting Bank-level Stock figures, since the mix of Stock is an important part of judging the Bank's success. The Bank's Remuneration Committee will take these factors into account when accessing the performance of the senior team.

The increases caused by the broader definition of Stock are tempered by the exclusion of non-UK businesses and the removal of ex-RDA investments from the reported total.

Excluding non-UK investments from Stock is expected to prevent in the region of £1.5bn of investments from being counted as Stock in future years, principally in the UKIIF and VC Catalyst programmes within Venture Capital Solutions.

The net effect of the methodology changes is to increase reported Stock in the near term, but for this effect to moderate so that in five years, the old and new methodologies produce Stock levels that differ by around £200m. This is driven by the de-emphasis of the BFP mid-cap programme and the exclusion of non-UK investments as described above.

CONCLUSION

The new methodology provides a simple, auditable measure of the quantity of finance associated with the Bank's programmes. It avoids the difficulties of interpreting adjusted Stock figures, which are necessarily notional values not corresponding to concrete financing transactions. The new method ensures the Bank does not claim excessive credit for the Stock associated with some of its programmes, as it makes more explicit the level of its involvement. The Bank's programmes are diverse in nature and differ in the extent to which they directly add to the supply of finance. It is therefore preferable to report Stock on a robust, unambiguous basis and interpret the measure intelligently, than to apply well-intentioned adjustments which risk creating as many problems as they solve.

For these reasons, the board of the Bank has agreed to move to measuring Stock using the simplified methodology and has re-stated its Stock targets (including any targets used for remuneration) on a comparable basis.

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