

Select Committee on the European Union

EU Financial Affairs Sub-Committee

Oral evidence: Brexit: the European Investment Bank

Wednesday 14 November 2018

10.20 am

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Members present: Baroness Falkner of Margravine (The Chairman); Lord Bruce of Bennachie; Lord Butler of Brockwell; Lord Cavendish of Furness; Lord De Mauley; Lord Desai; Lord Giddens; Baroness Liddell of Coatdyke; The Earl of Lindsay; Lord Thomas of Cwmgiedd; Lord Vaux of Harrowden.

Evidence Session No. 5

Heard in Public

Questions 55 - 64

Witnesses

Catherine Lewis La Torre, Chief Executive Officer, BBB Patient Capital Holdings and Keith Morgan, CEO of the British Business Bank

Examination of witnesses

Catherine Lewis La Torre and Keith Morgan.

Q55 **The Chairman:** Good morning, Mr Keith Morgan, CEO of the British Business Bank, and Ms Catherine Lewis La Torre, Chief Executive of BBB Patient Capital Holdings. Welcome to the EU Financial Affairs Sub-Committee inquiry into the European Investment Bank and Brexit.

You have before you a declaration of members' interests. The session is being broadcast on parliamentlive.tv. A full transcript is being taken and will be made available shortly after the session for you to make any corrections.

I will kick off with a fairly direct question to you, Mr Morgan. We are coming to the closing stages of our inquiry so we are quite familiar with what the British Business Bank does, and its mandate, but we are also

looking at what might replace it if the United Kingdom does not remain a member, by some methodology, of the European Investment Bank. We have been looking at other models. One that strikes us as fairly significant in delivering very well is the German KfW bank. I assume you are familiar with that model.

I am aware that the Government, should they not get a deal to remain a member of the EIB, have committed to work with you as some form of replacement for the functionality of the EIB in the United Kingdom. Perhaps you can tell us your ask of government to be able to fill in the hole that will be left in the kind of support that the EIB gives the United Kingdom. What will you do to help Britain cope with the loss of that funding?

Keith Morgan: I am very happy to answer. I know you are aware of the distinction between the EIB and the European Investment Fund.

The Chairman: Yes.

Keith Morgan: The EIB is principally an infrastructure funding organisation. The EIF is somewhat different and is focused on providing financial support—lending, investment and guarantees—to small and medium-sized enterprises. The remit of the British Business Bank covers small and medium-sized enterprises and smaller mid-cap, so it does not currently extend to the infrastructure element that is in a sense part of your question.

I would like first of all to set the infrastructure piece to one side, because the focal points of our expertise are clearly SME and small mid-cap lending, and we do not have the skills or expertise at this point in time to conduct infrastructure lending. There are other focal points of expertise in government around infrastructure lending, and they currently reside in the Infrastructure and Projects Authority, which, if I have the topology right, is within the remit of the Treasury. For example, it runs a £40 billion UK guarantee scheme.

On the first part of your question, I would like to talk about how we could assume a role around SME and smaller mid-cap. The model we currently operate is very similar structurally to the one that the European Investment Fund operates. We both make investments into venture capital, growth capital and private lending; we both offer guarantees to share risk with the banking sector, so the model of operation is very similar. We are both predominantly wholesalers. We do not make direct investments in small businesses; we operate through delivery partners. In our case, we operate through more than 120 delivery partners, ranging from big banks and small banks all the way down to venture capital funds and angel syndicates.

In set-up and model, we are quite well placed to assume activity that may or may not be done by the EIF going forward. You might want to compare some of the characteristics of the two organisations. I was reading some of the testimony of my good friend Mr Hames and his comparison of the organisations. We are four years old and have just

celebrated our fourth birthday. At the end of this year, we will have 350 people and right now the EIF has approximately 420 people. Our balance sheet is of the order of £1.8 billion; the EIF balance sheet is of the order of €2.5 billion. So, the first thing is that the stage of development of the bank is quite significant given that we are only four years old.

It is fair to say that we are already on the journey of accepting additional roles and scale for the future. After the referendum, it became clear that the EIF was not playing the same role in the marketplace as it had. We started discussions with HM Treasury about how we could respond to that situation. The Chancellor announced that we would be able to bring forward some existing funding to play a larger role in the marketplace. We increased the percentage of investment we would be prepared to make in individual funds to 50%, which allowed us to increase our existing cornerstoning role.

That was followed one year ago by the announcement of the patient capital review, which granted us additional funds of £2.5 billion, and in the very recent Budget there was the announcement of additional one-year funding of £200 million conditional on the outcome of the actual Brexit deal. If you look at the situation before the referendum and the activities of the EIF, which are equity and debt investment, we had the capacity before then to invest £300 million a year. If you look at where our resources sit now, and include the £200 million, which is contingent, it has increased to £930 million a year, which is a threefold increase. As regards the difference between the £300 million and £930 million, the information published about the EIF is not fantastic, but our estimation of its activities on average over the last five years in similar areas is £460 million in this country.

There has been a significant increase over the last three years in the amount of funding available to the bank, so I feel the organisation is quite well placed to step into any gaps identified as a result of a reduced level of activity by the EIF. The infrastructure is in place; there are good finance and risk frameworks and capabilities. Obviously, that is absolutely key. Expertise has been brought on board. Catherine, on my right, has more than 30 years' experience in the venture, private equity and institutional investment market, and we are already operating at a level of engagement in the market that gives us the confidence to move forward.

Q56 Lord Desai: When I look at the document I have here, it looks like a genealogy chart: So-and-so begat So-and-so. The British Business Bank has spawned a number of entities. You are not that large an organisation. Do you need nine subsidiaries? I should say in parenthesis that I am very concerned about the title "Patient Capital". It looks like it needs to be hospitalised.

Keith Morgan: We do not invest in the NHS. There is an explanation for the subsidiary structure on which I can give some background. It originates from the state aid agreement that we secured in 2014.

The Chairman: The state aid agreement with the EU.

Keith Morgan: Yes. The European Commission was very keen that our activities were segregated. Principally, at the top level, there are three subsidiaries. One arm is reserved for all our commercial activity, where we are operating *pari passu* in line with what is happening in the marketplace and earning a commercial return, but obviously with a strategic purpose.

The second subsidiary is reserved for all our activities that are subsidised and on our balance sheet. That is where we have previously been to the European Commission to agree a programme of activity that offers a subsidy in the marketplace, or we operate under some of the safe harbours, as they are called, of rules of state aid. The third subsidiary is designed for us to offer services to BEIS, our shareholder, or elsewhere in government, so it is where they can ask us to conduct activity. We agreed those three subsidiary groups at the very beginning.

With the announcement on patient capital, we were awarded £2.5 billion extra funding and that was captured in a distinct subsidiary on the commercial side of the organisation. That is because we have a view, which we agreed with HMT, that over time we would like to see much more private activity in that marketplace, and the way we would seek to do that would be to move the subsidiary into private ownership. We imagined that we would list it, or accept private institutional investment into it, and that dictated the need for a separate subsidiary. Those are the principal reasons for the subsidiary structure.

Lord Desai: Does it help?

Keith Morgan: In the subsidiary structure, particularly the segregation between commercial and subsidised and service, the commercial break does create some frictions because it dictates our organisational structure. There are various other rules we have agreed to abide by that separate our marketing activity between those two organisations. We have undertaken to the European Commission as part of the state aid agreement that there would be a board of the commercial subsidiary that would have independent characteristics, so that creates an additional governance element to the business that would not otherwise be there.

Lord De Mauley: Which subsidiary does which of the activities you have just explained?

Catherine Lewis La Torre: The commercial arm is under BBB Patient Capital Holdings, which is the entity of which I am CEO. There are two commercial subsidiaries: British Patient Capital, which invests primarily in venture and growth capital funds, and British Business Investments, which has more of a lending strategy, so we are engaged in private debt investments through that subsidiary. You can look at it mainly as debt-related lending services and investments and then private equity, venture capital and growth capital in British Patient Capital.

Lord De Mauley: Which is the one that you contemplate, over time, moving into private ownership?

Catherine Lewis La Torre: That would be British Patient Capital.

Lord Butler of Brockwell: Can you tell us why you chose the title "Patient Capital"? Lord Desai made a joke about it, but it does sound as if it is ailing.

Lord De Mauley: It is exercising patience, Robin.

Lord Butler of Brockwell: You are waiting for them to flourish; they are long-term loans.

Catherine Lewis La Torre: What it really means is long-term, primarily equity, investment. You have to be patient to have a return on your capital, so that is where the patience comes from.

Lord Desai: When was it invented? In all my life in economics I have never encountered patient capital.

Catherine Lewis La Torre: I have been in the private equity and venture capital world for 30 years. There is always a new label. We have had development capital, expansion capital, private equity and private capital, so it is the latest in the series. I think it is helpful because, taking that segment of investment in the equity world where generally you have less risk appetite within the institutional community, and you have to invest over a very long timeframe to get your rate of return, it is important to shine the light on that type of equity investment.

Lord Desai: Surely, that is what pension funds and sovereign wealth funds do.

Catherine Lewis La Torre: Partly, yes, they do.

Lord De Mauley: What I really wanted to get was the subsidised activity. Where is that? Is it in British Business Finance?

Keith Morgan: Yes. We call it BBFL.

Lord De Mauley: Can I explore how you ensure that you jump through the state aid hoops, or how you avoid breaching them?

Keith Morgan: In this sense, the segregation of activities helps because all the commercial activities are grouped together. There is some independent governance where the boards of the commercial arm are focused very much on upholding the commercial requirements of the business. That is enshrined in the articles of association of those businesses, so it is quite strong.

Elsewhere, we are subject to observing the rules we have agreed on particular programmes or observing some of the underlying safe harbour rules. We have a programme of evaluation conducted by independent academic evaluators that looks at how our programmes are developing.

Once again, we have a board. The board of BBB plc has a responsibility, passed to it by the Government, to ensure that we observe state aid rules, but principally, because the rules of state aid are then translated into the underlying documentation and rules of the programme, as long as we are observing those rules, we are observing the state aid requirement. That is the sort of compliance and checking we do to be sure we are observing the rules.

Lord De Mauley: Can you give me the broad categories of the rules?

Keith Morgan: Some rules are specific to programmes where we have agreed various parameters. To give an example, we have a state aid-approved programme in venture capital that operates at the earliest stage of venture capital. It has a particular focus on encouraging emerging fund managers to keep the talent pool developing in that area. There are rules; for example, we cannot invest more than £5 million in one underlying company. There would be a rule similar to that.

Elsewhere, there are rules governed by the title global block exemption, designed to ensure that we are focusing our activities on early-stage companies. There tends to be a parameter that restricts the application of lending and support of investment to companies below a certain age. There is another group of rules associated with the size of the investment, so you can appeal to a group of rules called *de minimis*. As the name implies, that is about a maximum scale. For example, in one of our programmes we can offer the programme, but not above a certain level of lending, which in that particular case is close to £1 million.

Lord De Mauley: Do you contemplate that during the transition period you will require new authorisations from the Commission?

Keith Morgan: Yes. When we secured our state aid at the back end of 2014 it was for a five-year period, and the renewal formally comes up in December 2019, so we will have to seek a renewal at that point.

Lord De Mauley: Have you assessed the probability of obtaining it?

Keith Morgan: Yes. As you can imagine, with one year to go and the current situation, we have been very keen to have that discussion with our shareholder, BEIS. Our default position is that during the implementation period state aid will continue as is and the European Commission will continue to operate in the same way. In those circumstances, I see no reason why we should have an underlying problem, because we have operated our model in the way that was expected.

The uncertainty comes if there is no implementation period with the same commitment to state aid rules. We understand that after the implementation period the Government will position the CMA to be the authority that would oversee such activities.

Our position is quite straightforward. We are preparing the documentation that we know we will have to prepare, which is a review of

our activities and a forward look as to what we intend to do next. The default position is that the documentation will go to the European Commission. If there is a different system in place, it will go to a different authority.

The Chairman: If all other variables were not in play, would you like more flexibility on those rules?

Keith Morgan: Yes. To go back to the discussion on the subsidiary structure, there is some detail in the current rules, which creates additional frictions in how we operate. As an example, it is clear that we want to ensure that we operate commercially in some areas, and we segregate those activities from subsidised activities, so there is no blending of activities, which would be inappropriate, but maybe some of the detailed rules around the construction of our board and the legal structure of the subsidiaries would not be necessary.

The Chairman: I am mindful of time, so I will be brief, and I would appreciate a brief answer, Mr Morgan. How do the others do it? How does KfW get away with that process not applying to it?

Keith Morgan: I might be brief because I do not know the exact answer. The European Commission grants state aid. It is very clear that we have to observe the rules we are given at the end of that discussion. KfW itself will have been through the same process. It has a long history.

The Chairman: We know; we are taking evidence from it in a short while.

Keith Morgan: Some aspects of its state aid decision are different from ours, so I can only suggest that you ask them that question when they come in.

Lord Thomas of Cwmgiedd: Are those documents published, and do you study what other countries have when you negotiate with the Commission?

Keith Morgan: Yes. At the time we went for our original state aid approval we were very conscious of all the other arrangements. They did not, however, necessarily set a precedent for our decision, so we were faced with an individual discussion with the Commission.

Q57 **Lord Cavendish of Furness:** My question is rather more about nuance than the technical position as it has been. It falls into three parts. What is your current relationship with the European Investment Bank and the European Investment Fund, and how important are those relationships in supporting the work of the BBB? Have there been any changes in the relationships since the referendum, or consequences for SMEs in accessing finance?

Keith Morgan: Yes. In the specific activities of the BBB, our reliance upon European funding is limited. Three elements of European funding are important or have been part of our programmes. Two fall into our

regional programmes. The Northern Powerhouse Investment Fund, the Midlands Engine Investment Fund and the Cornwall & Isles of Scilly Investment Fund are all built on European funding. Roughly speaking, the largest part of that is a loan from the European Investment Bank, and a similar, but slightly smaller, amount, which is a grant, comes from the European Regional Development Fund. The combination of that funding with our own funding led to the creation of those funds.

We were very careful to explore any vulnerability around that at the time the funds were created. We got assurance in the following ways. The first is that the EIB loan is a contract, so that loan will withstand any change in the relationship between the UK and the EU. The second relates to the European Regional Development Fund. HM Treasury explained at the time that it would be prepared to underwrite that funding until 2020 in the event that it was not forthcoming, so in that respect the current structure of these funds is secure. The third area is that we have some quite small relationships with the EIF on a counter-guarantee structure; we offer guarantees or lending and it has a small guarantee behind. It is not material to our business.

Lord Cavendish of Furness: To press you a bit on before and after the referendum, have things changed in the relationship as far as the BBB is concerned?

Catherine Lewis La Torre: We see that probably more in the commercial arm, because we have often been limited partners in fund structures alongside the EIF on both the venture capital side and the direct lending side. Over the last year to 18 months, we have found that, when we look at opportunities that have more of a UK focus, there is potentially less appetite for the EIF to take those forward, because, quite understandably, it also wants to make sure that roughly two-thirds is invested in EU countries; that is the number we seem to hear most often.

Venture funds normally have pan-European strategies, if not global ones, so we can co-exist. The UK represents between 30% and 40% of the venture market in Europe, so you can envisage a pan-European VC fund where both the EIF and the British Business Bank, through our commercial arm, would be investing. Where there is a more domestic strategy, we have noticed less appetite from the EIF.

Baroness Liddell of Coatdyke: You talked about some of your big projects, such as the Northern Powerhouse, Isles of Scilly and Midlands Engine funds. It looks as if you have it covered for those existing projects, but if you lose access to ERDF and EIB funding, how will you fill the gap, given the pressures on public funding? If you put together, say, a commercially-based venture capital fund, its attitude to risk is very different from government's attitude to risk, in the nature of the investments. How are you going to fill the gap?

Keith Morgan: It is a very good point. It is important to say that the regional funds do not operate in a purely commercial way. They are prepared to take more risk and encourage more lending and investment

in the regions. If you want to make a change in the regional allocation of lending and investment in key areas, you will have to offer, effectively, a subsidy in that area, certainly in the first instance.

The areas we are interested to explore further with government are around the workings of the expected UK shared prosperity fund, which has been positioned as a fund that would occupy, or replace in some way, the European Regional Development Fund. We are expecting that the Government will open a consultation on that and that there will be a decision by Ministers about how they want to structure it, but we would like to see funds of that nature being made available for regional access to finance.

Baroness Liddell of Coatdyke: Have you any indication that that might happen?

Keith Morgan: It is hard to say yes, because a consultation is about to start, but we have been making the case very clearly that those funds will be required.

Q58 **Lord Vaux of Harrowden:** You have covered some of this already. In your 2018 annual report, you referred to losing access to the EIF as a "strategic risk". Does that refer to any other risks you have not already covered? Secondly, could you talk a little about BBB filling the gap from the withdrawal of the EIF?

Keith Morgan: I have covered some of that. The strategic risk we were referring to is that there are certain areas of the marketplace where it currently has the resources to play a role, and until the latest Budget announcement we had fewer resources. There still happens to be a risk because those resources are not guaranteed in any event. They are not guaranteed beyond a year and will be subject to the spending review that government will conduct thereafter. That is perhaps a further explanation of the risk as we see it with respect to EIF participation in the market.

Lord Vaux of Harrowden: You talked about financial resources. Is there a knowledge resource, expertise or any other sort of gap that would also apply?

Catherine Lewis La Torre: That is a good point. It is about being ready with capital but also having the expertise in-house to take a more active role in the market. We have been moving in that direction over the last year to 18 months in any event.

We are the largest institutional UK-based investor in venture capital today. We have a team that has been active in this market for many years, not just through the bank; it had experience in a predecessor organisation called Capital for Enterprise. Other people on the team come from a VC investment background or, like me, broadly from an investment management background. We have a very strong core team in place that is able to respond. We are thinking about how we can scale efficiently. Because we have a core team in place, we will have potentially

more capital to invest. The programmes are in place, so we think we are able to respond to that ask, should it be required.

Lord Vaux of Harrowden: Are there any particular areas where you think there might be greater risk of a gap?

Catherine Lewis La Torre: Patient capital is an obvious place where the EIF has played. We can do our bit. As Mr Morgan said, we can invest up to 50% of any fund, but the fund manager has to find the rest of the capital from the private sector. That might be a broader issue than EIF replacement; it is about the general risk appetite in the institutional community for patient and other long-term investments that carry a higher risk. We can influence that part of the market by showing the way, but we cannot plug the entire gap; we need the private sector to come in alongside us to do that.

Keith Morgan: That is a point to emphasise. Although we are very keen that we have the resources to replace the EIF, we believe that public funding of that marketplace is not the only answer. If we compare our marketplace to more advanced marketplaces such as the US, it is very clear that there is a much greater level of institutional private investment into these higher-risk asset classes. We would like to see more of that, which means that we have to work quite closely upstream with potential institutional investors to build their confidence to work in the market.

We are doing that in probably three ways. One is British Patient Capital itself, which is being positioned as a transparent organisation that will report on its progress. Future investors will understand its performance and, ultimately, will have the opportunity to invest in it if we list it. Secondly, we have created what we call the managed fund programme, which means that we will work with private sector fund of funds managers who will themselves be bringing institutional investors into this area of the market.

The third thing, which was announced in the Budget, is that we will be working with a group of direct contribution pension funds to explore the feasibility of creating a joint investment platform. That joint investment platform would give them the capability and greater expertise to invest in venture, growth and the area we are talking about. Those are three activities that we are pushing forward to increase the probability of institutional investment.

Lord Cavendish of Furness: You talked about the role of the private sector. We are constantly told that there are almost limitless funds lurking in the private sector. I have never understood why they are not released. Is it because traditional lenders have been impatient as opposed to patient? What is the culture that has locked in that money?

Catherine Lewis La Torre: You are right. In general, in financial markets fundraising is robust and has been increasing because a lot of institutions want to allocate in that market, but they tend to focus on certain areas of the market that are considered lower risk. Although you

can have higher returns in parts of the market where we are very active in venture and growth capital, of course that carries additional risk. It is all about setting the risk appetite, and the pension community is a good example. Does it really have the risk appetite to move into the market where we are currently playing a more significant role? There is plenty of capital, but it does not filter through into every sub-segment of the financial market.

Lord Butler of Brockwell: Several times, you have referred to being on a journey to replace the role played by the EIF. Can you put a figure on the extra money and time that will be necessary for you to complete that journey?

Keith Morgan: As regards the extra money, I explained earlier that in our annual commitments capacity has increased threefold. That increase in capacity allows us to occupy space that the EIF occupied before. Moving from £300 million to over £900 million capacity means an increase in capacity of £600 million, which I think is greater than the average activity of the EIF over the past five years.

Lord Butler of Brockwell: In that case, why has the Chancellor given you only £200 million for one year? What happens when that £200 million is exhausted?

Keith Morgan: My assumption is that a spending review will be conducted by government next year. In another completely unrelated area, we also got one year's funding, and our expectation is that the longer-term funding will be discussed as part of the spending review.

Lord Butler of Brockwell: How much time will it take before you are fulfilling the role of the EIF, or do you think you are already there?

Keith Morgan: In relative scale, we are close in size to the EIF. We have been growing very quickly. We are only four years old. It will take us a little time to recruit additional people, particularly at the front end of the business, which will be interfacing with potential counterparties and clients, but I would measure that in 12 to 18 months, rather than a longer period.

Q59 **Lord Giddens:** Thank you so much for your lucid answers so far. They are so lucid that they have partly blocked off the questions I am going to ask. To put one generic question, how do you see your activities in the future folding into the Government's industrial strategy? Do you have a strategy within that strategy, and do you have financing options? Would they go beyond just state money, and how would that be organised?

The second question concerns me a lot, but you may not be able to answer it. The EIB and EIF have lent or allocated £2.1 billion to higher education, and to universities. Having spent my whole life in universities, I am deeply worried about the leverage that universities take on and what will happen if access to the EIB and EIF is suddenly cut off. For example, UCL has a vast programme of expansion. I think it borrowed £20 million.

Keith Morgan: I think that was from the EIB.

Lord Giddens: Yes. It has a new campus in east London, and it bought all these bloody buildings in Bloomsbury that cost it a fortune. I do not know whether you are able to comment on that, but I think the position of HE is pretty precarious.

Keith Morgan: I will take the industrial strategy point first. We have a very close relationship with policymakers in Government—in BEIS—and have been part of the discussions on creating the industrial strategy, in particular the access-to-finance elements. The initiatives we rolled out recently to create a regional presence for the bank, and implementing a new digital information hub for small businesses to understand better what their options are, are all completely aligned with the industrial strategy.

With respect to sector-type activities, we are also active in that area. For example, we have an existing sector-based fund in creative industries. We are working closely with the Department for Digital, Culture, Media and Sport on the creative industries deal, in particular ensuring that our regional angel programme will match up with the investment-readiness spending that they are contemplating.

We have some other specific sector initiatives—for example, the space and satellite venture capital fund we established, where we are the cornerstone investors. Very recently, we established the National Security Strategic Investment Fund. That is quite innovative in the way we are working with the country's security services to bring together fund managers and companies that have access to and are developing dual-use technology, which can then be utilised by the security services. There is a commitment to work very closely with government on policy, and we have a good ongoing dialogue to do that.

Lord Giddens: Would you like wider access to markets to be able to do that and fold in more risk capital?

Keith Morgan: Do you mean access to the capital markets to raise our own money?

Lord Giddens: Yes.

Keith Morgan: That is an interesting question. If you raise money on the capital markets as a government institution, even if you have a guarantee from the Government, you will be raising it at a fraction above what it costs the Government to raise gilts. From the very beginning, there is a value-for-money question: why would you seek to do that? You then have to ask yourself whether there are any other reasons why you would seek to have that in place. One issue that is often raised is whether or not the new source of funding would be on the government balance sheet. Would it be recorded under public sector net debt?

The Chairman: We will be coming to that question, so perhaps we can park that thought. You mentioned the digital sector. I think Lord Giddens

was referring to housebuilding, housing associations and universities. Do you have plans to fill that gap?

Keith Morgan: On housebuilding, it was announced in the Budget that we are working with the Ministry for Housing, Communities and Local Government and Homes England on a programme of up to £1 billion of guarantees. The guarantees would work through the banking sector and allow the banks to issue more lending to small housebuilders, so that is the principal focus in that area.

The Chairman: You are not doing that with universities.

Keith Morgan: Not in respect of infrastructure. We have a very strong interest in the way technology is commercialised by universities.

Lord Giddens: I was including all of that. I gave examples of the amount of money that the higher education sector has got from European funding. I gave property only as an example because it has lots of other support for directly academic things, including digital infrastructure.

Keith Morgan: We are currently looking very closely at how the work we are doing in British Patient Capital and elsewhere could reinforce the commercialisation of technology in universities.

Q60 **The Earl of Lindsay:** I have two or three questions. The first stems from your reference to your regional presence and the regional investment programmes. I note that KfW has an ownership structure and a governance structure that reflects a central and a devolved scenario, with 80% being held by the Republic and 20% by the States. Might there be any benefit or merit in considering a similar structure in either the ownership or governance of the BBB, given that in the UK we have both a central and a devolved structure?

Keith Morgan: I have not given much thought to that, but it is an interesting question. If you were to go down that line, it would be because you felt you would bind more stakeholders into the future of the bank and its participation across the UK.

The ownership of the bank is not an issue for me; it is for the shareholder, BEIS. The question would be whether there were other methods whereby you could secure stakeholder buy-in. We spend a lot of time working with the local enterprise partnerships in England and the devolved authorities in Scotland, Wales and Northern Ireland. For example, currently we are talking with the Scottish Government about the evolving and emerging plans for their own institution and how we could work in a complementary way.

The Earl of Lindsay: Are you encouraged by the direction of that discussion? Do you think there will be a collaborative and synergistic relationship between what you are doing and what the Scottish Government are planning to do?

Keith Morgan: I think so. That is certainly the message we have been given by the Scottish Government. It also reflects capability. We do certain things where we have established a UK-wide capability, certainly in issuing guarantees and operating in the venture capital markets. There are other areas where they may wish to expand that are not in those two segments.

The Earl of Lindsay: My second question is this: beyond your headline objective to support SMEs, how would you describe your funding priorities?

Keith Morgan: Every year, we conduct significant empirical research to understand what the market needs. As we think that through, three areas emerge. One is the patient capital area we have just been discussing. We believe that there are gaps in the market where government can help at this point in time to encourage greater investment, with a view to demonstrating that it is an attractive area for the private sector and the institutions to become more involved with.

The second focal point is around regional activity. Particularly in the area of growth finance and equity finance, there are some apparent imbalances between the regions of the UK. London and the south-east get a disproportionate share of the investment resources for small businesses. There are the same number of high-growth businesses in the north as there are in London, but London gets a huge share of the investment resources that are used to grow those companies. The work we are doing through Northern Powerhouse, Midlands Engine and Cornwall & Isles of Scilly is important, as is understanding through our network regionally where some of the obstacles and information deficiencies are.

The third area is information. What holds companies back from growing is sometimes not lack of supply of finance but insufficient understanding of what types of finance will be appropriate for them and where they can find routes to that finance. That points us in the direction of the finance hub we have established to create greater information resources.

Q61 **The Earl of Lindsay:** Can I ask about the nature of the discussions between you and the Treasury on how much funding you receive? Is there a fairly open and positive relationship, with you setting out your pitch and the Treasury understanding what you require to deliver your remit, or do you simply wait for decisions made elsewhere to which you have not been party?

Keith Morgan: The best example of that is the process and outcome of the patient capital review that led to the £2.5 billion extra funding last year. We work very closely with our shareholder, BEIS, and HMT. The patient capital review was launched by the Treasury and the Chancellor. We participated in that from a very early stage. I was a member of the steering group on the review. We seconded people to the team conducting the review, and we were party to the discussions through the steering group about appropriate recommendations. It led to a very

sensible outcome with a well-understood and clear role for the BBB. That is a good example of how well that process works.

The Earl of Lindsay: For my last question, I want to pick up the discussion that started in response to a question put by Lord Giddens about whether or not you should be able to borrow money on the commercial markets. Do you want to complete the story, to the extent to which you have discussed it with Treasury and how it might change the way you can do things?

Keith Morgan: As I mentioned, the first question is one on value for money, as to whether the Government are prepared to raise money at a more expensive rate than they would through the Debt Management Office and gilts. The second consideration on which I have had some thoughts is whether having access to capital markets means that a portion of our funding would not be recorded on the government balance sheet. The advice I received previously is that such issues are governed by the Office for National Statistics. We operate with our specific definition of public sector net debt, and the advice I have received is that, if we raised money from capital markets, it would be consolidated on public sector net debt.

The third consideration would be whether it granted the BBB any further freedoms. Whether you raise money on capital markets or through government, we are subject to the approval of our business plan by the shareholder; that would operate, no matter which course of funding we took. My conclusion is that the source of funding will not deliver a different BBB, and there must be a value-for-money question as to whether it would be appropriate to go down that route.

Q62 **Lord Bruce of Bennachie:** You said that you have trebled your engagement, but if the EIB withdraws or substantially diminishes, you would have to double it again, would you not, to be able to absorb that? Then there is a cultural difference. A lot of our witnesses have pointed out that, when the EIF gets involved, it comes in early and does due diligence. As a result, when other investors look at a project, they can say that it has the seal of approval from the EIF and they are going in. They tell us that the BBB comes in at the end, after all that has been done, and, although that may be useful, it is not really a door-opener for other investors.

Do you need to change the culture towards the EIF? How quickly could you do it, given that you will not benefit from its credit performance and that, at the same time, you may have to expand substantially to absorb EIF funding, if it disappears?

Catherine Lewis La Torre: That view probably reflects how we were operating two years ago, under the VC catalyst programme; it does not reflect what we do today. We have been a cornerstone investor in all the VC fund investments where we have made a commitment. I think that is the role you are referring to; it is engaging early with the general partner and fund manager and making sure that we do detailed due diligence

that other investors may rely on to come in alongside us. We are already performing that role. It may not be widely known in external markets.

Lord Bruce of Bennachie: It is certainly not the view of witnesses we have heard.

Catherine Lewis La Torre: Yes, but they are not investing directly in venture capital funds. If you talked to institutions in that market, they would recognise the cornerstone role that the BBB has been playing.

Lord Bruce of Bennachie: Do you feel that you have the capacity to expand in that area? I suppose you are one of the beneficiaries of Brexit, as I suspect that the direction of the BBB would have been different if the referendum had gone in another direction. The fact is that, nevertheless, a lot is being expected of you both in volume and scale of build-up and in being able to unlock other capital. In spite of the big figures, it is still a very tiny proportion of our economy, and there is a danger that people are looking to you as a magic box that will compensate for other things that are not happening. How quickly and substantially can you fill that bill? Some people have said that it will take you five or 10 years.

Catherine Lewis La Torre: Earlier, we talked about the journey, and we have had an incredible journey over the last 18 months, because we have had additional capacity to invest. We have already taken on that cornerstone role more significantly. In fact, there was a landmark transaction, and we split our analysis, pre and post that transaction, as to what percentage we were a cornerstone investor.

Lord Bruce of Bennachie: Can you tell us what the transaction was?

Catherine Lewis La Torre: It was Seedcamp, where the EIF had been a supporter, and we came in to take on the cornerstone role. That sent a message to the market that the BBB could take a cornerstone role. It coincided with a change in the rules that said we could invest up to 50% of the fund as opposed to 33%, which was the rule we had under the older VC catalyst programme. We have moved de facto into that space.

It is generally known within the VC fund manager community that we are ready to be a cornerstone investor. We have an incredible pipeline, so people are definitely knocking on our door with a wish for us to take on the cornerstone role. Of course, we are also a commercial investor, so we do not invest in everything that comes through the door; we have a very selective process for the types of funds and underlying investment strategies we want to support. We will not do everything, but we will certainly do the most interesting, ambitious and potentially catalytic things for the UK economy.

Lord Vaux of Harrowden: You said earlier that you regularly co-invest with the EIF. In those situations, who has led the due diligence? Who is relying on whom?

Catherine Lewis La Torre: We operate totally independently and have our own due diligence process, as does the EIF. There will be lots of

similarities, because we both operate as professional limited partners in that space. If you look at the investment criteria, and the things that we are trying to understand about a manager, the processes would probably look quite similar. We have never relied on EIF due diligence to decide whether we would engage; we have always conducted our own due diligence.

Q63 Lord Thomas of Cwmgiedd: You have spoken about the three English regional funds, but, as you are a British bank, could you be a bit more precise about what you do for Wales, Scotland and Northern Ireland? How do you engage in increasing their prosperity?

Keith Morgan: We operate across the whole of the UK, particularly in the area of guarantees and debt lending. The activity is broadly spread, so, if Wales represents 3% or 4% of the GDP of the country, it has 3% or 4% of our activities in debt lending in those areas. In the area of equity ownership, there is a natural force in the country to draw activity to London and the south-east, and we are taking measures to try to counter that. For example, we work with all four venture capital groups in Scotland and are investors in their funds.

Lord Thomas of Cwmgiedd: Why is there not something equivalent to the three English regional funds in the extent to which you are working with the Scottish and Welsh development banks? Surely, some of the problems that have to be tackled are the ones you have indicated, which are about trying to move stuff away from London and the south-east, not merely to the other English regions but to the rest of the United Kingdom.

Keith Morgan: The best explanation is that the current allocations of the European Regional Development Fund go directly to Scotland, Wales and Northern Ireland, so they can take their own measures based around those.

Lord Thomas of Cwmgiedd: But for the future?

Keith Morgan: That would come down to how the UK shared prosperity fund operates.

Lord Thomas of Cwmgiedd: That leads me to my last question. We have had a look at what happens in Germany, as no doubt have you, and there is a sort of equivalent. Well, it is not an equivalent, really; it is a body that looks at matters such as how you invest in developing countries and deal with export guarantees and infrastructure, so that you have a coherent national policy. How does that work here, so that all the investments are co-ordinated for the greatest prosperity of the United Kingdom?

Keith Morgan: That is a big question, but I shall do my best to answer it.

Lord Thomas of Cwmgiedd: How do we replicate the prosperity and wealth of Germany?

Keith Morgan: First, the question is whether it is correlated or not to that particular thing, and I do not know the answer. You are quite right that there are many independent institutions in the UK. We are focused on SMEs and small mid-cap. If you put us together with the Student Loans Company and the Commonwealth Development Corporation in what is formally agreed, you would get something of the scope of KfW.

My own thinking on it is that the strategic question is how policy is organised. At the moment, those policy decisions are taken at the governmental level, around allocations of resources, rather than at the institutional level. We allocate within our own remit, but not more broadly. Then there are questions about the underlying rationale. If you have a balance sheet like KfW, and we know, of course, that KfW goes into the market to raise money, there is a very strong synergy across those different businesses. One treasury is raising that money for use across the whole group.

Then there are questions about the degree of co-ordination benefit. For example, for us it is important that we understand the small business and smaller end of the spectrum. There is a distinction between marketing and understanding customer need and infrastructure spending. There are choices to be made. I cannot make a recommendation, but there are choices as to the degree to which you want to develop strategic synergies, financial synergies and the connection with the market itself.

Lord Thomas of Cwmgiedd: That gives rise to a lot of questions, but I shall not ask any more.

Q64 **The Chairman:** We have a few minutes left. A thought came out of what you said. You described earlier how the Infrastructure and Projects Authority, run by the Treasury, does most of the large infrastructure lending. If a rethink was on the cards, would you wish to take over some or all of that work? Would you like to move into large-scale infrastructure funding, leaving aside the guarantees but finding the finance for infrastructure funding? Could there be something there, where the two of you might work better together?

Keith Morgan: I would have to look very closely at the detail before answering the question; we would have to look at the underlying synergies between infrastructure lending and the focus on small and medium-sized enterprises. I am afraid that I do not have an answer to the question.

The Chairman: That takes me back to another of your earlier questions. Do you have an ambition to go beyond just being an SME lender?

Keith Morgan: To be clear, we go beyond SMEs.

The Chairman: Yes, I know, you do mid-caps as well, and other stuff. I am conscious that you have a formal role in advising the Government. If the Chancellor and Mr Clark were jointly to call you in and say, "Here is an opportunity. What would you like to do?", what would your answer be? What is your vision for how we move forward, if you assume that Brexit

is going to happen?

Keith Morgan: The Government have created an institution in the BBB that is flexible to change and can be scaled. The basic components are the ability to manage finance and risk, and to interface effectively with government as a shareholder. We have a very well-established model, and I would be eager for it to be built on. There would then be some considerations about whether that was the right thing to do from a business or policy point of view, but we have the culture and capabilities to extend our remit, if government wanted us to do it.

The Chairman: Thank you very much.

Lord Butler of Brockwell: Taking the big picture, and looking at the other institutions you have mentioned, such as the Infrastructure and Projects Authority, can the gap left by access to the European Investment Bank be filled—not just the fund but the bank?

Keith Morgan: I would look very closely at where the market gap is and whether there is a market failure. There is a stronger case for saying that there is a more fluid and functioning market in infrastructure lending than in some of the areas of SME lending I am familiar with. There will be a question, in looking at the EIB's range of activities, as to whether they are all genuinely required. That would be my personal view. I can even see some activities that the EIF is involved in, to do with larger-scale private equity, where my conclusion would be that it was not an area where public money needs to be invested.

The Chairman: If you could take that question away and have a think, would you be prepared to write to us, giving us further thoughts about where you do not think that there are gaps in the market, along those lines?

Keith Morgan: I will certainly consider the question again.

The Chairman: Thank you very much, and thank you for your time, Mr Morgan and Ms Lewis La Torre. If there are any other thoughts, do send them in, as we still have some time.