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Rt Hon Alok Sharma MP
Secretary of State
Department of Business, Energy and Industrial Strategy
1 Victoria Street
London
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Dear Secretary of State

FUTURE FUND – RESERVATION NOTICE

Over the last four weeks, we have been working with your officials and with HMT to prepare for the launch of the Future Fund following its announcement on 20th April. This has been a period of intense work in which British Business Bank, BEIS and HMT colleagues have worked very closely together on a variety of fronts in response to the situation the UK economy faces. We are all aware of the imperative to act quickly to facilitate a swift economic recovery.

As you may know, the Bank has received a series of instructions to first assess the feasibility of the potential Future Fund, to then continue the development work by appointing an agent, working with them to develop the necessary operations and systems, undertaking an assessment of the feasibility and State aid risks, and finalising the design. Most recently, the Bank received an instruction from Sam Beckett this morning to deliver the Future Fund.

You will be aware from my letter of 17th April that the Board Risk Committee has had a number of concerns about the overall design of the scheme since its inception. As I set out at the time, these concerns included: that the policy objectives were not clearly articulated, leading to a risk that the scheme would not be well-targeted and that companies may be supported which did not need the intervention; the risk of perverse incentives, resulting in the substitution of private sector capital and moral hazard in the behaviour of any match-funders given the programme design; that the design and implementation of the scheme would need to be undertaken at pace and outside the usual processes and controls that the Bank would ordinarily follow; and that, ultimately, Government would be required to manage a sizeable portfolio of direct equity investments and that additional resources and capability would be required for this.

In responding to the instructions we have received we have striven to work with your officials and those in HMT to shape the design of the Future Fund in a way that optimises the outcomes of the scheme and addresses the concerns set out above as far as possible. We have done so in our role as the centre of expertise for Government on smaller business finance markets, and in a concerted attempt to minimise the likelihood of our Board feeling obliged to issue a notice such as this.

In light of the concerns we have raised previously, the Bank's Board Risk Committee met on Monday 11th May and the full Board met on Thursday 14th May and again on Friday 15th May to discuss the launch of the Future Fund, the progress that has been made on scheme design since announcement and the Board's potential response to any instruction received, as well as to provide an opportunity to identify any further mitigations that could be implemented. We provided feedback on the outstanding matters to your officials after all of these discussions. I appreciate the sustained work they have undertaken with HMT officials to try to address the Board's concerns.

However, the changes made over the period since my letter of 17th April have not been sufficient to allay all of the Board's concerns. The Board has therefore requested that I raise a formal Reservation Notice to you in response to the instruction we received earlier today. As you are aware, a Reservation Notice is a mechanism in the Bank's constitution through which we may raise concerns on particular grounds. Having considered the grounds set out in our Company Operational Independence Undertaking, the primary basis on which we are sending you this notice concerns value for money.

The overriding fact is that the value for money outcome from this scheme is highly uncertain. Based on the industry experience around the Board table, the central scenario upon which our value for money assessment has been based yields a negative Benefit Cost Ratio (BCR). That view was driven by concerns that the best companies will not use this funding route, as investors will fund those companies without HMG support. This will result in HMG investment going to the second tier of companies, which will likely result in higher associated loss rates. The distribution of returns in venture capital is not a normal distribution and therefore the impact of investors not putting forward their best investments could reduce very considerably the average expected return from the investments made into companies. While the automatic conversion in most cases should ensure that HMG has exposure to any unexpected outperformers, it does not remedy the fact that the best investment prospects are unlikely to come through the platform, affecting the expected average growth rates and the distributions to paid-in capital post-conversion.

These impacts have been captured in the Bank's economic model and have resulted in a central case with an expected BCR of -0.13, with a distribution of probable outcomes that is skewed negatively. This value is highly sensitive to assumptions and very difficult to model, as the assumptions attempt to capture the expected impact of the behavioural effects inherent in the scheme design as described above. We cannot, therefore, be confident that the Future Fund provides good value for money for the Exchequer. It is also possible that other alternatives may yield better value for money for the Exchequer, although we have not been able to evaluate those alternatives as a full options analysis was not conducted prior to the broad parameters and standardised nature of the scheme being decided.

While the Board's overarching concern is value for money, there are two further criteria that raise concerns, although they would not, by themselves, trigger this course of action. However, for completeness, I set them out below.

On the matter of propriety, the difficulty arises in reconciling the Chancellor's announcement of a fixed budget (an initial £250m allocation) with a rules-based scheme. The Future Fund will not be making individual assessments of investment viability and there is no other mechanism for managing to the specified quantum of funding within the announced timeframe. Whilst I note the recognition of this issue in your instruction and your assurances that additional allocation decisions will be made promptly, it remains the case that with an application period open until the end of September there is a high risk that delivery will need to be halted before the end date, with reputational and market consequences, if further budget cover cannot be provided in advance. In addition, the Board raised concerns about the lack of funding available to allow for Government to make follow-on investments in subsequent funding rounds and therefore avoid the risk of its stakes being diluted, impacting on its returns.

On the interaction with the Bank's overarching objectives, the scheme arguably runs counter to both the Bank's objectives on regionality[1], as recipients are more likely to be based in London and the South East, and on operating within a robust risk management framework[2].

As you know, we had previously expressed concerns about the feasibility of delivering the scheme in the time available. We have worked intensively with officials and our appointed agent to operationalise the scheme to be ready for a launch during May and good progress has been made. Whilst we believe delivery to be feasible, I should draw to your attention that it has not been possible within the short timeframe available to conduct the breadth of testing that would normally underpin the launch of a substantial new programme and automated platform for its delivery.

While we recognise that you have already provided a direction to the Permanent Secretary as Principal Accounting Officer in relation to the scheme, the Board have concluded that it is appropriate that we raise a Reservation Notice with you directly. While refinements to eligibility parameters have been made in recent weeks and there have been useful clarifications, it has not been possible to resolve the scheme design in a manner which would satisfactorily address all of the Board's concerns. As I have communicated previously, however, we do also fully understand the considerable difficulty in assessing risk in these unusual times and also that Ministerial objectives and considerations may in these circumstances be broader than ours.

Given the concerns of the Board, and under our established constitution, in order to ensure the scheme can be launched as planned it will be necessary for you to respond to this letter by instructing the Bank directly. The Board have requested that this wording be unambiguous, and that it should acknowledge the limitations on the Bank's ability to mitigate and control risks which are inherent in the design of the scheme.

I look forward to your response. Our implementation efforts continue at pace, and should you direct us accordingly, we stand ready to deliver this programme to the very best of our ability.

You should be aware that I will be required to copy your reply to the Comptroller and Auditor General and the Treasury Officer of Accounts. I am further required to arrange for the existence of your letter of direction to be published unless you direct me to keep the matter confidential. Given the potential impact that making the existence of your direction public might have on the confidence in, and take-up of, the scheme you may alternatively choose to ask me to delay publication of its existence until a later date.

Yours sincerely

Keith Morgan CBE
Chief Executive Officer & Accounting Officer

[1] Objective: to identify and help reduce regional imbalances in access to finance for smaller businesses across the UK.
[2] Objective: to achieve the Bank's other objectives whilst managing taxpayers' money efficiently within a robust risk management framework.