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EUROPEAN COMMUNITY LENDING AND THE STRUCTURAL FUNDS

Patrick Honohan



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*EUROPEAN COMMUNITY LENDING
AND THE STRUCTURAL FUNDS*

Patrick Honohan

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ACRONYMS USED:

ACP	Africa, Caribbean and Pacific
CLI	Community Loan Instrument
CSF	Community Support Framework
DG	Directorate General
EC	European Communities
ECSC	European Coal and Steel Community
EMU	Economic and Monetary Union
ERDF	European Regional Development Fund
EIB	European Investment Bank
GDP	Gross Domestic Product
GNP	Gross National Product
IBRD	International Bank for Reconstruction and Development
IMPS	Integrated Mediterranean Programmes
LDC	Less Developed Country
NC	New Community Instrument
OECD	Organisation for Economic Co-operation and Development
SME	Small or medium-scale enterprise

GENERAL SUMMARY

For many years the European Investment Bank (EIB) has, together with the European Coal and Steel Community (ECSC) and other Community loan instruments, played an important part in the financing of infrastructural and other capital investment in Europe. At the time of the major increase in the Structural Funds, it was envisaged that this Community lending would be linked in an important way with projects that were being part-financed by grant aid from the Structural Funds. This paper reviews the operation of the Community loan instruments to see whether this expectation was justified and to explore the likely role of the instruments in the 1990s.

Having disbursed 15.5b ECU in loans during 1991 alone, the EIB is a very important provider of long-term funds. The growth in its activities has indeed been rapid over the last several years to the point where, in order to fund these activities, it has become one of the largest single issuers of debt on the international capital markets.

As the efficiency of financial markets in Member States improves, a process that will be accelerated by the completion of the Internal Market and progress towards EMU, the role of the EIB in achieving Community objectives will tend to become less central.

Financial markets in most member states have grown a lot since the EIB was set up in the late 1950s, and now many of its borrowers have alternative possible sources of funds at similar interest rates and even at similar maturities. In lagging regions, however, the EIB remains a force for promoting cohesion through enhanced competition and efficiency. This function is probably more important than that of actually co-financing Structural Fund projects and programmes.

Over three-fifths of EIB lending is for Regional Development (8.5b ECU in 1991), most of it in the areas designated for the reform of the Structural Funds. About two-thirds of this relates to operations complying with specific objectives under Community Support Frameworks (CSFs). However, although the EIB collaborated in drawing up the indicative financing plans for the CSFs, and in preparing operational programmes, and although it is entitled to a seat on the monitoring and oversight committees, comparatively little of the EIB's regional development lending was provided in tandem with Community grant-aid.

The European Coal and Steel Community (ECSC) is the other main institution concerned with Community lending as considered here. While EIB loans are mostly unsubsidised, interest rate subsidies are an important element in generating demand for ECSC loans, especially for job-creating "conversion loans" in areas where the coal and steel industries have declined. As with the EIB, and probably to an even greater extent, the links between the CSFs and ECSC conversion loans appear to be comparatively slender.

We consider several suggestions which have been made to get the EIB to do more to help promote the objectives of the Structural Funds. We begin by considering the respective role of debt and grant finance at a theoretical level. Drawing on the theory of financial structure, we stress the risk-sharing and discipline or incentive effects of various forms of financing.

Some superficially attractive ideas are found wanting on closer inspection. In particular there is no need for, and considerable arguments of principle against, an expansion in the use of subsidised loans in tandem with grant-aid for the Structural Funds. Interest subsidies have in general proved to be more prone to implementation difficulties than capital grants: they are much less likely to achieve the envisaged goals. An additional specific objection would arise if interest subsidies were tied to having the loans come from the EIB as that would distort the competition between financial institutions in the Community, discouraging private intermediaries from developing long-term lending by locking-in many borrowers into the EIB.

Much has been made of the dichotomy between the programme approach, adopted by the Structural Funds, and the project approach to lending traditionally used by the EIB. Critics of the EIB blame the lack of a closer involvement with the Structural Funds on this dichotomy; and the EIB appear to accept this argument, responding that their mission as a financial institution requires them to be project lenders. We argue that the dichotomy as presented is not as relevant as it might seem, and that the idea of opening a programme window at the EIB need not be ruled out. In favour of the idea is the political requirement to have a closer tie-in between Community loans and grants. Properly designed, programme lending would not damage the other operations of the EIB. In some instances programme lending could provide a better discipline on lead agencies for the supported programmes, though there would tend to be some loss of discipline *vis-a-vis* final borrowers.

In considering future initiatives, the EIB should build on existing strengths, among which are its strong balance sheet and its experienced

staff. Thus there is scope for greater involvement of the EIB in risk finance, a field with the largest remaining gaps in the private financial market. Preliminary ideas in the direction of using EIB funds more adventurously are to be welcomed.

Likewise the EIB's strengths in economic and technical appraisal and the accumulated expertise of their staff in industrial and especially infrastructural investment in Europe should be better harnessed in support of the objectives of the Structural Funds.

Ireland's interest in the EIB is twofold. In the first place as a shareholder, Ireland has an interest to ensure that the substantial funds deployed by the Bank are wisely spent. Second, as a borrower, Ireland has drawn heavily on the EIB over the years, especially when it was the conduit for interest subsidies associated with the start of EMS. More recently Irish demand for EIB funds has been lower, partly reflecting depressed loan demand generally, and also the ability of large borrowers to tap alternative funding sources. As the Irish financial system becomes increasingly integrated into the Community, it is very much in the interest of all peripheral countries to ensure that their financial systems remain efficient and competitive, and that cohesion is not blocked by deficiencies of finance. The EIB is a key catalyst in achieving this result.

INTRODUCTION

For many years the European Investment Bank (EIB), the European Coal and Steel Community (ECSC) and other Community Loan Instruments (CLIs) have played an important part in the financing of infrastructural and other capital investment in Europe. At the time of the major increase in the Structural Funds, it was envisaged that this Community lending would be linked in an important way with projects that were being part-financed by grant aid from the Structural Funds. This paper reviews the operation of the Community loan instruments to see whether this expectation was justified and to explore the likely role of the instruments in the 1990s.

The paper is in five parts. It begins with a succinct overview of Community lending, focusing in particular on what distinguishes this lending from other financial intermediation in Europe and asking why borrowers use these facilities. While the country mix of borrowers suggests that local demand and supply conditions for long-investible funds are an important consideration, it appears that one of the important contributions of the EIB to cohesion is in providing competitive pressure on intermediaries in the less efficient banking markets of the Community. At the same time, the EIB's insistence on top-quality security amounts to a decision not to involve itself in the evaluation and pricing of credit risks, often thought to be the hallmark of financial intermediation. The need for diversification into this area, especially in the less efficient banking markets, is discussed in the concluding subsection.

Chapter 2 describes policy with regard to the integration of Community lending activities with grant aid under the Structural Funds and highlights the discrepancy between the original vision of how that policy might operate and the reality after more than 2 years of the reform.

Chapter 3 is largely analytical in character. It presents a brief synthesis of current academic thinking on the incentive and risk-sharing role of different financial instruments. Some lessons are drawn for how one should rephrase the much discussed question of the optimal mix of loans and grants. The real question should be: what financial structure offers the best risk-sharing and incentive effects? Some concrete suggestions are made: the practical implementation of these would require further study. The section also addresses the issue of interest rate subsidies and

concludes with some comments on the attitude of bankers to risk.

Chapter 4 presents an account of project appraisal by the Community lending institutions. The potential usefulness of applying EIB-type project appraisal to the CSF process is considered.

Chapter 5 reviews the pros and cons of some seven possible initiatives to improve the functioning of loan finance in the context of the Structural Funds.

Chapter 1

WHAT DISTINGUISHES COMMUNITY LOAN INSTRUMENTS?

This section looks at Community lending with a view to identifying its distinguishing characteristics. We begin with an overview of the EIB's activities and discuss some of the cost and pricing considerations as well as its attitude to risk and guarantees, all of which make its lending so distinctive. Brief reference is also made to the ECSC, highlighting contrasts with the EIB. We then turn to the borrowers: who are they, and what makes them choose to borrow from the Community? Finally we draw conclusions about the public policy role of the EIB in promoting cohesion among the regions of the Community and look at how it and the ECSC can be expected to perform in the changing environment induced by the moves towards the Internal Market and EMU, with specific reference to CSF project needs.

In order to place the discussion in perspective, Table 1 sets out the standard statement of Community lending to borrowers both within and outside the Community during the past three years. So far as lending within the Community is concerned, the CLIs have comprised:

- Lending by the EIB out of its own resources,
- The New Community Instrument (NCI), also granted and managed by the EIB from funds borrowed by the Commission and for projects whose eligibility is decided by the Commission;
- Euratom loans granted by the Commission but managed by the EIB;
- ECSC loans; and
- Balance of payments loans. (There were none of these within the Community in 1988-90. The balance of payments loan included in the table was to Hungary. A balance of payments loan for Greece was approved in February 1991.)

Table 1: *European Community: Lending Operations*

<i>in millions of ECUs</i>	1988	1989	1990	1990
				<i>Per Cent</i>
New Community Instrument (NCI)*	356.5	78.3	23.6	0.2
EC Balance of Payments*	0.0	0.0	350.0	2.4
ECSC*	907.8	700.1	993.8	6.8
Euratom*	0.0	0.0	0.0	0.0
EIB (own resources)	9,638.4	12,041.8	13,325.9	90.7
of which:				
Within Community	9,118.3	11,555.9	12,656.9	86.1
ACP and Overseas Territories	129.1	155.1	117.5	0.8
Mediterranean Countries*	391.0	330.8	336.5	2.3
Eastern Europe	0.0	0.0	215.0	1.5
Total	10,902.7	12,820.2	14,693.3	100.0

* Guaranteed in part or in whole from general Community budget.

Source: EC Commission: *24th Annual Report on the Activities of the European Communities, 1990*.

Table 1 shows that own resource EIB lending has been by far the most important, followed by that of the ECSC. NCI loans have tapered away as the NCI IV funds approached exhaustion, while there have been no Euratom loans in recent years because of the depressed state of the nuclear power industry. Despite the variety of instruments, only 2 institutions need to be considered, namely the EIB which administers not only its own funds but also those of the NCI and Euratom, and the ECSC, administered by the services of the Commission (DGXVIII). Both institutions are based in Luxembourg.

1.1 The EIB and its Activities

The EIB is the premier long-term credit bank in Europe; its focus has traditionally been on infrastructural and other fixed capital formation within the Community.¹ The volumes of lending are large: 15.5b ECU in gross disbursements in 1991; (about 11b ECU after netting out

¹The statutory and operational objectives of this lending are discussed briefly below and extensively in EIB documentation.

repayments). The typical EIB loan is at long-term, with maturity of between 7 and 12 years for industrial borrowers and – notably – up to 20 years for infrastructural projects. Interest rates are typically fixed for the maturity of the loan, but there has been an increase in the share of variable rate loans². The interest rates charged are calculated by reference to the Bank's own marginal cost of funds plus a small spread to cover administrative costs. Lending rates are not differentiated by borrower. The Bank requires each loan to be backed by adequate security, typically a government guarantee or that of a first class private name.

An important component, especially of EIB's regional development lending, is the "global loan" where the EIB lends to local financial intermediaries for on-lending to smaller borrowers. Global loans are primarily focused on small and medium-scale enterprises (SMEs).³ The typical loan agreement with the intermediary governs, among others, the ceiling on individual loan size (e.g. 10m ECU), the eligible regions and the type of project.⁴ The on-lending interest rate is usually governed by local market conditions, though the EIB ensures that unreasonable margins are not imposed.

Global loans have accounted for as much as 30 per cent of EIB lending recently, and it is envisaged that the share will remain in the 25-30 per cent range for the future. This heavy reliance on global loans has allowed EIB to direct funds towards SMEs and for regional development without greatly enlarging its staff and operating expenses. The EIB reserves the right to examine sub-borrower performance; but in practice this is done on a very limited scale, especially after a relationship has been established with the intermediary.

EIB regional lending is a large component of the total, and is large in relation to regional GNP and capital formation. Approximate calculations show lending in Objective 1 regions varying up to about 0.8 per cent of regional GDP (cf. Table 2).

²The variety of financial instruments now being offered by the EIB is much greater than in the past, though the Bank is not a full service commercial bank and does not aspire to offer a full range of financial engineering products.

³Fewer than 500 employees and less than 75m ECU in net fixed assets.

⁴Especially in regard to items governed by the EIB's negative list.

Table 2: *EIB Lending to Objective 1 Regions 1989-90*

	<i>m ECU</i>	<i>% GDP</i>
Greece	262	0.22
Spain	718	0.20
France	0	0.00
Ireland	192	0.27
Italy	1,500	0.34
Portugal	720	0.77
United Kingdom	2	0.01

Source: EIB; GDP estimates are estimated from data in "The Regions in 1985-90" (European Commission, DG18, 1991).

Profitability and Subsidisation

The EIB borrows wholesale long-term funds at very keen rates and on-lends these to borrowers at a small margin over marginal cost. The Bank is precluded by its statute from overtly subsidising loans,⁵ but the rapid growth in its business in recent years has led to suggestions that there might be some hidden subsidy involved. We have found no evidence for any such hidden subsidy.

The most likely source of any hidden subsidy would be the substantial unremunerated capital subscriptions made over the years by the Member States as shareholders. We examined the financial statements of the Bank with a view to seeing if subsidy from this or some other source could be detected. Comparison of the Bank's financial statements with the aggregated financial statements of large commercial banks in industrial countries (cf. the Annex) does not provide any reason to believe that there might be any hidden subsidies. It is true that the shareholder governments do not receive dividends on their investment in the Bank. Furthermore, far from being "non-profit-making", as is sometimes suggested, it is in fact one of the more profitable large banks in the world, with 1991 net profits of 1.1b ECU on a balance sheet of some 74b ECU. But the non-payment of dividends from these profits has chiefly resulted in an accumulation of reserves. Interest rates to borrowers have not benefited. In particular, a

⁵This wise statutory provision prevents the EIB from competing on an unfair basis with local financial intermediaries.

comparison of the profit and loss account with that of major banks worldwide reveals that the profitability of the EIB is broadly commensurate with its high capitalisation. Thus, even if the shareholders receive no dividends, nevertheless their funds are being used profitably.

The accumulation of reserves over the years has been very considerable. Total capital and reserves have recently amounted to 15 per cent of the total balance sheet, or 17 per cent of the loan portfolio.⁶

The other most striking feature of the EIB's accounts is the extremely low operating costs, given the size of the balance sheet. The lower costs by comparison with commercial banks reflect the fact that the EIB is a wholesale concern and that it does not provide significant fee-based services compared with the typical large bank. As a result, the lower costs do not lead to lower on-lending rates as compared with the average bank.

Risk and Guarantees

The EIB has always required guarantees from first rate guarantors for all lending. Traditionally, these guarantees have been mainly from Member States, but the actual situation has changed rather rapidly in the last several years. As recently as 1985, less than 25 per cent of all loans outstanding⁷ (amounting to about 7.3b ECU) were not guaranteed by Member States. By end-1991 this percentage had jumped to 50 per cent, and to 34b ECU. Guarantees from financial institutions took up much of the shortfall in government guarantees, jumping from 3 per cent of the total outstanding to over 18 per cent. In addition there were more guarantees from non-bank private enterprises (e.g. parent company guarantees) – up 7 percentage points to over 10 per cent. Guarantees from Public Institutions also accounted for a greater share. (See Table 3).

The percentages given reflect the evolving stock of loans. The shift in practice is more evident when one considers that during 1989-91 almost three-fifths of new business did not carry government guarantees. Almost 70 per cent of 1991 lending did not carry a government guarantee,⁸ and close to a third of 1991 lending relied on financial institution guarantees.

At a time when the international credit-rating of many banks has been downgraded, it is natural to interpret the Bank's move in the direction of accepting a rapidly increasing proportion of financial institution

⁶These figures refer to the total of paid-up capital and the various reserve funds plus the unallocated balance of the profit and loss account at end-1991.

⁷Within the Community.

⁸But some of these were guaranteed by Public Institutions. In this context, the accounting treatment of state-owned financial institutions has recently been revised.

guarantees as quite a significant move in the direction of a lower quality of guarantee. However it should be noted that the Bank's management insist that the quality of the guarantor bank is scrutinised, and that no significant deterioration is involved.

Inevitably, the quality of parent company guarantees can be variable and will generally be lower than that of government guarantees. The Bank points out in this connection that non-bank guarantors are selected on the basis of their exposure to risk having a low correlation with that of the borrowing company; the Bank's assumption is that this low correlation will mean a very low risk that borrower and guarantor are both unable to perform.

Table 3: *EIB Reliance on Guarantees*
Loans within the Community

<i>(a) Percent of outstandings</i>									
	1983	1984	1985	1986	1987	1988	1989	1990	1991
Governments	75.9	76.2	75.1	73.3	70.7	66.6	61.0	55.5	50.2
Public Institutions	14.7	15.3	15.9	26.9	18.0	18.2	18.6	18.0	17.6
Financial Institutions	3.5	3.1	3.3	3.8	4.7	7.2	10.6	14.0	18.0
Nonbank Pub. Ent.	0.9	0.8	0.8	0.8	0.6	1.5	1.7	1.9	1.3
Mortgages (real estate)	0.5	0.6	0.6	0.7	0.6	0.5	0.5	0.4	0.4
Nonbank Private	2.9	2.5	2.4	2.4	3.2	3.7	5.3	7.8	10.3
Other	1.6	1.6	1.9	2.1	2.2	2.2	2.4	2.3	2.3
<i>(b) Per cent of new loans</i>									
	1986-88		1989-91		1991				
Governments	59		38		31				
Public Institutions	20		17		16				
Financial Inst.	11		26		33				
Nonbank Pub. Ent.	2		1		0				
Mortgages (real estate)	0		0		0				
Nonbank Private	5		15		19				
Other	3		2		2				

Source: Derived from *EIB Annual Reports* (some figures estimated by extrapolation)

Although the quality of guarantees required has been lowered, it is still a firm benchmark of EIB lending practice to seek guarantees that are virtually certain. Most other banks price loans to take account of default risk; that is how they make profits even on a portfolio experiencing some non-negligible percentage of loan-losses. Such behaviour is contrary to the philosophy adopted by EIB. Its on-lending rate builds in essentially no margin for loan-losses, and its actual loan-loss experience to date has been altogether negligible.

Two important conclusions may be drawn concerning guarantees. First, since financial institutions make a charge for providing guarantees, the total cost of servicing to the EIB borrower is often higher than the interest charged by the EIB. To the extent that the guarantee is granted by a bank which is well-informed about the borrower's prospects, and in a competitive market, this price charged will reflect objective risks. Second, one of the important functions of most financial intermediaries is evaluating and pricing risk. Because it insists on what it regards as absolutely first-rate guarantees and essentially no risk the EIB has abdicated this function.

Treasury and Borrowing: the EIB's Credit Rating

Although almost 17 per cent of EIB lending is funded by the paid-up capital and reserves of the Bank, the borrowing activities of the Bank remain the most important determinant of its long-term competitiveness. Its market niche as a borrower in the capital markets is clear. It is one of the most important issuers of straight long-term bonds with its issues approaching 5 per cent of the world total in recent years. As a percentage of total foreign and international bond issues, the Bank's issues have also approached 5 per cent. (See Tables 4a and 4b).

The Bank's credit rating is impeccable and the size of its issues makes for a high degree of liquidity in the secondary markets.⁹

The Bank's high credit rating can be attributed to 4 factors, in ascending order of their importance to bond-holders. First, the quality of the project selection, which has been sufficiently good to result in a very small rate of recourse to guarantors.¹⁰ Second, the guarantees, from

⁹The Court of Auditors, in its 1990 special report (3/90) on lending and borrowing, raises some questions about the passing on of savings from treasury operations to borrowers. An examination of this and other aspects of the efficiency of the treasury operations of the Bank would be beyond the scope of this study. It seems unlikely that they could be more than a marginal factor in the present context.

¹⁰Only 4 loans have resulted in such recourse.

Table 4a: *Funds Raised on International Markets 1989-90*

<i>in billions of US dollars</i>	<i>1989</i>	<i>1990</i>
International bonds	212.8	181.9
Foreign bonds	42.9	46.9
International bank loans	114.5	115.8
Foreign bank loans	6.6	2.5
Other international funds	8.4	6.3
Total	385.3	353.2
<i>of which:-</i>		
ECSC	0.6	1.0
EC	0.6	0.4
EIB	8.4	10.5
BNI	0.5	1.1
IBRD	9.0	11.0
IFC	0.5	0.7
Other Int. Dev. Inst.	3.4	3.3

Source: OECD Financial Statistics

Table 4b: *International Bond Issues 1989-90*

<i>in billions of US dollars</i>	<i>1989</i>	<i>1990</i>
International bonds	212.8	181.9
<i>of which:</i>		
ECSC	0.5	0.6
EC	0.4	0.1
EIB	5.2	7.0
BNI	0.5	0.5
IBRD	5.2	9.1
Other Int. Dev. Inst.	1.0	1.7
Traditional foreign bonds	42.9	46.9
<i>of which:-</i>		
ECSC	0.1	0.3
EC	0.2	0.0
EIB	3.2	3.5
BNI		0.6
IBRD	1.5	1.6

Source: OECD Financial Statistics.

governments and other sources, which back each loan. Third, the paid-up capital and reserves. Fourth, the callable capital. Any one of these, with the possible exception of the first, would be enough to copperfasten the high credit rating.

Critics sometimes suggest that there is no need for the first and second levels of protection, given that the third and fourth are of greater comfort to bondholders. However, it should be noted that the first and second provide comfort to the shareholders as well. Not only do they reduce the likelihood of a call on the subscribed but unpaid capital, but they also improve the quality of investment in the Community.

Nevertheless, it is hard to avoid the conclusion that caution has prevailed to an extent that is not strictly necessitated by the risks of the business. It would be hard to refute, on the grounds of a threat to the Bank's credit rating, worthwhile proposals which might involve a modest reduction in the margin of safety. Indeed, this has been recognised in a very limited way by the Bank's management in recent initiatives, discussed below, relating to risk capital.

1.2 The ECSC

The origin of the ECSC lending operations is quite different from that of the EIB: these operations are governed by the ECSC Treaty and date back to 1954. Though considerably smaller than the EIB's activities, ECSC lending is by no means insignificant, totalling just under 1b ECU in 1990. ECSC lending can be divided into 3 categories, (a) loans to benefit the coal and steel industries, (b) industrial conversion loans to promote job creation in the areas hit by decline in the coal and steel industries and (c) a small volume of loans to finance housing for coal and steel workers.

While conversion loans are provided to designated areas which are mostly included in the Objective 2 regions of the Structural Funds¹¹, this is not generally the case for the loans designed to benefit the coal and steel industries. Some of these ("Article 54") loans are made directly to enterprises in the coal and steel industries, some to other undertakings with a view to promoting the consumption of Community coal or steel.

¹¹ The Objectives of the Structural Funds relate to priority areas and priority fields. The priority areas are those lagging (Objective 1 - Greece, Portugal, Ireland, Southern Italy, Corsica and Parts of Spain), declining (2) and rural areas needing development (5(b)). The priority fields are long-term unemployment (Objective 3), young job-seekers (4), agriculture and forestry(5(a)).

A key difference as compared with the EIB is that some ECSC loans carry interest subsidies. In the case of conversion loans the rate of subsidy is calculated by reference to an estimate of the amount of employment to be created (or maintained) from the project being financed. The maximum interest subsidy is 300 basis points per annum for 5 years; to receive this maximum the project would have to create 75 jobs per 1m ECU of loan (or about 100 jobs per £1 million). The subsidy per job created thus comes to (an undiscounted) 2,000 ECU (or about £1,500) per job. The annual value of subsidies paid for conversion loans during the past 5 years (1985-89) was 57.3m ECU.

Loans for promoting the use of Community coal are also eligible for an interest subsidy for 5 years, but such subsidies have not normally been provided for loans promoting the use of Community steel. Most of the housing loans are granted at very low interest rates.

Conversion loans may be – and indeed mostly are – made through financial intermediaries in the form of a global loan; the intermediary's margin in such cases is normally said to be limited to 100 basis points.

Though there has been steady growth in the ECU value of conversion loans over the past few years, from 0.30b ECU in 1987 to 0.58b ECU in 1990, other ECSC loans have been much more variable. As a result, the share of conversion loans in the total has fluctuated rather widely with an average over the past 4 years of 50 per cent (Table 5). Of total ECSC lending 1987-90 of 3.6b ECU, over one third went in direct loans for investment in the coal and steel industries; the greater part being unsubsidised loans to steel.¹² About 0.5b ECU went in other loans to promote the use of Community coal and steel. Lending for workers' housing has declined in importance over the years – it came to only 10m ECU in 1990 – and it is not further discussed here.

New guidelines for the granting of conversion loans, published by the Commission in July 1990 provide (among other things) for combining of ECSC loans with grant-aid under the Structural Funds. Specifically, interest rebates provided out of ERDF funds may now be granted for ECSC loans supporting investments coming under a CSF programme. The objective of granting loans under a programme is said to improve the flexibility of Community assistance. Though the Commission hopes that loans to projects under CSF programmes will become the predominant form of conversion loan, it is not clear how quickly this objective is likely to be realised.

¹²These financed about one-tenth of Community steel industry investment in the period.

Table 5a: *European Coal and Steel Community Loans*

<i>m ECU</i>	1987	1988	1989	1990	1987-90
Total	969	908	700	994	3571
A.54(1)	393	389	195	243	1220
<i>of which:</i>					
Steel	110	389	152	213	864
Coal*	283	0	43	30	356
A.54(2) Sectoral	247	46	30	155	478
<i>of which:</i>					
Thermal Power	123	9	0	0	132
Iron Ore Mines	20	0	0		
Coal Use*	43	22	2	0	67
A.56 Conversion	304	452	458	585	1799
(% of total)	(31%)	(50%)	(65%)	(59%)	(50%)
<i>of which</i>					
Individual	55	26	49		
Global	249	426	409		
Workers' housing	25	21	16	10	72

* Interest rebates or subsidies may apply.

Source: ECSC Financial Report, various years.

Table 5b: *Interest Subsidy Payments on ECSC Loans*

<i>m ECU</i>	1987	1988	1989
A.54 (1)	-	-	-
A.54 (2)	8.0	7.0	-
A.56	40.3	55.3	60.7
Total	48.3	62.3	60.7

Source: Court of Auditors Special Report (3/90).

1.3 The Borrowers

Reasons for Borrowing from EIB

In order to obtain some feel for the experience of EIB borrowers, a very small number of borrowers were interviewed. These included private sector firms in Belgium and France, intermediary banks in Belgium and Ireland, and public enterprises in Ireland. In order to obtain a representative sample, it would be necessary to mount a more extensive programme of interviews, especially including regional authorities in Italy and Spain, for example. However, the interviews that were conducted are suggestive of the range of differing experiences which exist across the Community. Even based on this very small sample, the reasons given by borrowers for using the funds of the EIB in preference to other sources are varied.

Some borrowers have used EIB funds because this allowed them to access foreign currency funds. A particular reason for favouring foreign exchange for some borrowers in high interest rate countries was the fact that they were also able to avail of underpriced government exchange rate guarantees, thereby offering a lower overall cost of funds. Such exchange rate guarantee schemes have been especially important in Italy, and probably contribute to explaining the dominance of Italy in the EIB's portfolio for many years (as mentioned below). Though curtailed, such exchange rate guarantees still exist in parts of Italy and in Portugal.

Some borrowers have preferred EIB funds on straight interest rate grounds. One private sector borrower with whom we spoke was offered funds of comparable maturity by several banks, but found the EIB's offer to have the lowest interest cost, even taking account of the need to pay for another bank's guarantee.¹³ This kind of "shopping around" approach to bank finance has been increasingly common in the last decade, though some reaction is now setting in and a return to greater reliance on relationship banking seems likely.¹⁴

Other borrowers find that the long maturity of EIB loans make them especially attractive. It is often costly, especially for a small borrower, to obtain long-term funds even though the existence of interest rate swap markets make it possible for local banks in most Community countries to provide long-term funds. The improvements in the efficiency of financial

¹³It is noteworthy that the same borrower had chosen another lender for a similar long-term borrowing just a few months before borrowing from the EIB, illustrating the competitive nature of the market for qualified borrowers.

¹⁴See Chapter 3, Section 3.1 below.

markets still leave them far short of the textbook perfection where funds of any maturity and in any size or currency are always available. The EIB has generally been found ready to fill gaps in the availability of long-term funds.

Some borrowers find it attractive to have the EIB's seal of approval on their project. One argued that it was easier to sell the project to his shareholders on the basis that EIB finance was approved. It may very well be that this kind of synergetic relationship between the Bank and its borrowers also exists *vis-a-vis* potential guarantors. Thus a local or regional authority whose infrastructural project is acceptable to the EIB may also find it easier to obtain approval – and the necessary guarantee – from the State or a public institution. We have no direct evidence of this, but the possibility should be explored further: it could be that EIB involvement induces in this manner subsidised guarantees for its own borrowers.

Finally, the energy of the EIB loan officers in seeking out likely clients and putting together realistic financing packages has also played a part in inducing borrowers to access EIB funds.

Table 6: *EIB Lending by Country 1985-91*

	<i>Lending 1985-90</i>		<i>Lending 1991</i>	<i>National Economic Data for Reference</i>				
				<i>% Share in EC</i>		<i>Interest Rates</i>		<i>Unemployment %</i>
	<i>m ECU</i>	<i>%</i>	<i>%</i>	<i>Pop</i>	<i>GDP</i>	<i>Govt Bond</i>	<i>Lending</i>	
Belgium	314	0.6	1.7	3.0	3.1	8.6	10.5	11.0
Denmark	2462	4.7	4.1	1.6	2.3	11.1	13.5	6.7
Germany	2789	5.3	5.6	18.9	25.2	6.4	9.0	6.4
Greece	1424	2.7	1.2	3.1	1.1	21.8	21.8	8.3
Spain	5078	9.7	17.5	12.0	7.1	12.6	14.1	20.0
France	6231	11.9	13.3	17.2	19.9	9.3	16.3	10.2
IRELAND	1157	2.2	1.8	1.1	0.7	10.7	10.7	18.0
Italy	20416	39.1	28.0	17.7	17.4	10.8	14.1	10.4
Luxembourg	32	0.1	0.2	0.1	0.1	8.6	10.5	2.5
The Netherlands	938	1.8	1.4	4.6	4.8	6.7	8.9	9.9
Portugal	2535	4.9	7.0	3.2	0.9	16.0	20.6	6.9
UK	8036	15.4	15.8	17.6	17.3	9.8	11.4	9.7
Other	859	1.6	2.2					
Total	52270	100.0	100.0					

Source: EIB Annual Reports; International Financial Statistics; SOEC.

Distribution by Country

Table 6 presents the distribution of EIB lending in the period 1985-90 by country together with each country's share in EC population and GDP. The table clearly demonstrates Italy's disproportionate share of EIB funds – fully two-fifths in recent years, compared with a share of about 17-18 per cent in EC population and GDP. At the other end of the scale Germany, with a comparable share of EC population and one quarter of EC GDP, has accounted for only 5 per cent of EIB lending in this period. Of course, the objectives of the EIB do not imply any proportionality in the distribution of its lending across Community countries: rather the contrary. To the extent that the regional difficulties and financing gaps are unevenly distributed, it is reasonable to expect that some regions will receive greater emphasis than others. It is nevertheless necessary to adopt some scale of reference in order to interpret the regional distribution of EIB lending, and that is why reference is made to population and GDP.

Table 7: ECSC: Country Breakdown

<i>Loans Ever Granted to 1989</i>			
	<i>m ECU</i>	<i>%</i>	<i>%</i>
Belgium	399	2.5	2.6
Denmark	80	0.5	0.5
Germany	4,856	30.5	31.2
Greece	13	0.1	0.1
Spain	183	1.1	1.2
France	2,859	17.9	18.4
IRELAND	34	0.2	0.2
Italy	2,418	15.2	15.6
Luxembourg	277	1.7	1.8
The Netherlands	494	3.1	3.2
Portugal	41	0.3	0.3
United Kingdom	3,895	24.4	25.0
Other	388	2.4	
Total	15,937	100.0	100.0

Source: ECSC.

Apart from the heavy weight of Italy, and the light emphasis on Germany, other generalisations may be made. Like Germany, Belgium and The Netherlands have not availed themselves of EIB lending to a great

extent: their share in EIB lending is about one-third of their share in EC GDP. France is also under-represented by the same measure, but to a lesser extent. Denmark and Ireland are over-represented, with shares in EIB lending over twice their share in EC GDP or population. Portugal and Greece are over-represented by reference to GDP, but not by reference to population. The UK's share of EIB lending is not far short of its share in EC GDP.

Among the various factors which are likely to have contributed to the actual distribution across countries of EIB borrowing, most can be grouped under 2 headings. Thus, (A) countries with investment opportunities going beyond the financing capacity of domestic savings, and (B) countries suffering inefficiencies or other difficulties in the domestic financial system would be more likely to have recourse to the EIB. In this context we examined a couple of quantitative indicators for each of these two headings to see to what extent they are consistent with one or other of these factors.

(A) Under the heading of investment opportunities outstripping domestic savings, a low level of *per capita GDP* is an indicator which may suggest the potential for high-yielding productive and infrastructural investment.¹⁵ Likewise, a high *Government deficit*, tending to crowd out non-government borrowers from domestic sources of finance, and causing the government itself to have recourse for project finance to the EIB.

(B) Among financial market difficulties, high nominal *interest rates* might induce borrowers to prefer foreign-currency denominated loans, especially where the foreign exchange risk is covered by some government scheme. Furthermore, *institutional inefficiency* or lack of competition in the domestic banking systems might induce borrowers to turn to the EIB for better terms and conditions.

While, as is evident from Figure 1, there is a negative correlation between per capita GDP and EIB borrowing,¹⁶ this is not a systematic relationship (as witness the relatively heavy borrowing by Denmark).¹⁷ So far as crowding out is concerned, simple measures of government deficit

¹⁵Besides the fact that the EIB's mission calls for special attention to lagging regions.

¹⁶We took the logarithmic difference between the shares of lending and of GDP as a measure of intensity of lending; this has a correlation of -0.73 with per capita GDP.

¹⁷The Danish experience may be attributed to the crowding out factor: the private sector was encouraged to borrow from abroad during the 1980s.

again indicate that the relationship is not a systematic one: though the high government deficits in Italy, Greece, Ireland and Portugal could explain the high intensity of borrowing from the EIB, the deficit of Belgium and surplus in Denmark are not accompanied by the appropriate level of borrowing intensity.

There is also (Figure 2) a correlation between nominal interest rates and lending.¹⁸ However, the relationship is not systematic here either: high bank lending rates in France have not induced a high intensity of recourse to the EIB.¹⁹ The high mutual correlation between nominal interest rates and per capita GDP (-0.80) shows that this kind of evidence can only be suggestive.

Recent studies of the efficiency and competitiveness of the banking systems in Europe²⁰ conclude that there are wide differences across the Community. Unambiguous quantitative indicators are hard to come by, but qualitative conclusions may be drawn. For instance, drawing on a variety of indicators, Neven asserts that Germany, The Netherlands and possibly the UK have the most competitive banking systems. In Belgium, France and The Netherlands competition has resulted in relatively low bank profits, but prices of bank services may be less keen because of higher labour costs. At the other extreme, Spain and Italy are highly profitable banking systems, with high labour costs: these presumably provide the highest cost banking.²¹ The same can be said, though to a lesser extent, for Denmark and, though it is not covered by Neven, Ireland. In addition, though this too does not emerge so clearly from Neven's data, the banking systems of Greece and Portugal are widely regarded as costly and inefficient.

¹⁸Using the same measure of intensity of lending, the correlation is +0.72 for bond rates and +0.68 for bank lending rates.

¹⁹Ireland is another outlier in this comparison.

²⁰Price Waterhouse, "The Cost of Non-Europe in Financial Services", Volume 9 of *Research on the Cost of Non-Europe*, (Brussels: EC Commission), 1988. D.J. Neven, "Structural Adjustment in Retail Banking", in J. Dermine, ed., *European Banking in the 1990s*, (Oxford: Basil Blackwell), 1990. W.H. Branson, "Financial Market Integration, Macroeconomic Policy and the EMS", *CEPR Discussion Paper*, No. 385, March 1990.

²¹The local monopoly power of regional banks in Southern Italy is documented in detail by R. Faini, G.P. Galli and C. Giannini, "Finance and Development: The Case of Southern Italy", in A. Giovannini, ed., *Finance and Development in Europe*, Proceedings of CEPR Conference, forthcoming 1992. Their paper both shows the regionally specific character of banking inefficiencies, and proposes an explanation in terms of locally specific information.

Figure 1: *Correlation between intensity of EIB lending and per capita GDP.*

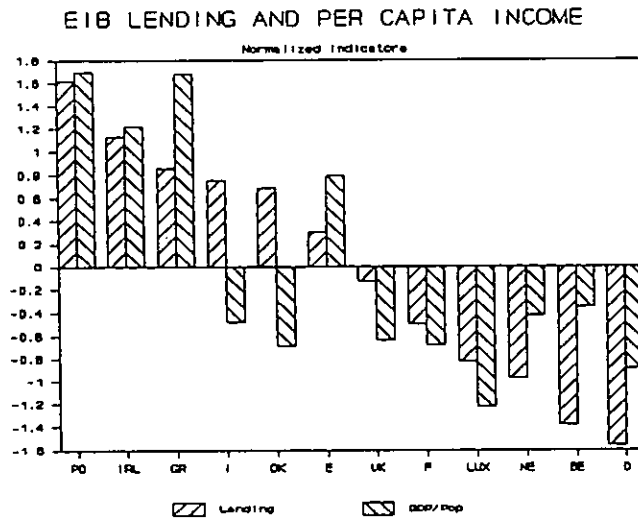
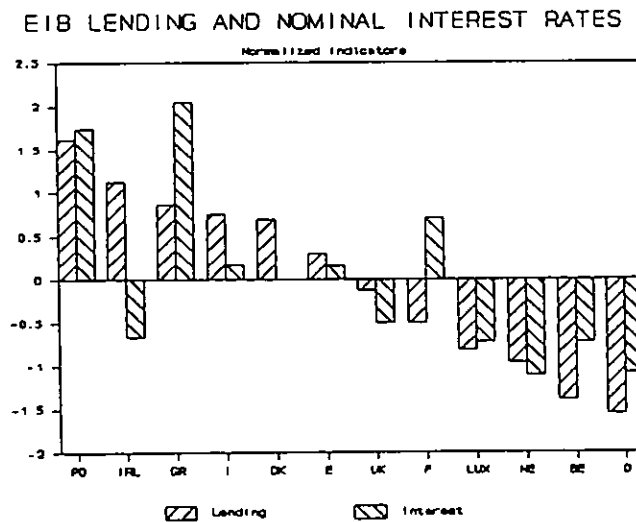


Figure 2: *Correlation between intensity of EIB lending and commercial bank lending rates*



Note: Intensity of lending is measured by logarithmic difference between national shares in lending (1985-90) and the GDP. Bank lending rates are averages for 1985-89, source IFS

Conclusive statistical relationships cannot be expected in this kind of analysis, and the correlations obtained are, as noted, subject to various reservations. Nevertheless, the evidence does not argue against either of the main headings proposed: the investment-savings gap and financial market imperfections. The correlation between EIB borrowing intensity and the perceived inefficiency or costliness of the domestic financial system is striking. The important role of the EIB in providing finance where the domestic financial system is deficient seems to be confirmed.

Distribution by Objective

In implementation of the EIB's remit under the Treaty, the Bank has established 6 objectives under which any given project receiving financial assistance from the Bank must fall. This positive list, together with the volume of associated lending in 1990 may be summarized as follows (cf Table 8): Regional development (7.4b ECU in 1990), Transport and telecommunications infrastructure (3.1b ECU), Protection of the environment, etc. (2.2b ECU), small and medium scale enterprises (SMEs), (2.0b ECU), international competitiveness of industry and its integration on a Community basis (1.8b ECU), and energy (1.5b ECU). With such a wide range of rather general objectives it is not surprising that some lending is categorised under more than one heading (the total of the sums listed above comes to almost half as much again as the total of lending in 1990).

Table 8: *EIB: Lending by Sector*

<i>in billions of ECUs</i>	1987	1988	1989	1990
1 Regional	3.8	4.9	7.0	7.4
2 Transport & Telecom	0.7	1.7	2.7	3.1
3 Environment, etc.	1.3	1.2	1.7	2.2
4 SMEs	1.4	1.6	2.0	2.0
5 Competitiveness	0.8	0.8	1.0	1.8
6 Energy	2.0	1.8	1.7	1.5

- 1 Regional development.
- 2 Transport and telecommunications infrastructure.
- 3 Protection of the environment, improvement of the quality of life and urban development.
- 4 Ventures promoted by small and medium-sized enterprises.
- 5 International competitiveness of industry and its integration on a Community basis.
- 6 Energy.

Source: *EIB Annual Reports* and *EIB Information* No. 67.

One is immediately struck by the comprehensiveness of the range of objectives. Indeed, it would be hard to imagine a project that could not be squeezed into one or other of these categories as stated. Furthermore, borrowers report that the Bank adopts a flexible approach in determining whether a project can be accepted as falling into the categories. For instance, many people are surprised to learn that EIB finances the purchase of long-range passenger aircraft: but this obviously falls under the category of transport infrastructure. It must be concluded that these positive objectives do not provide a very selective or focused target for the EIB's lending activities.

However, the Bank does have a negative list of areas where it either will not or is unlikely to lend, for reasons of Community policy. Even this negative list can and has been challenged in certain respects, as in regard to the reluctance to lend in support of R&D.

The list of objectives cannot help to explain in detail how the present pattern of lending has come about. Virtually any bankable project not specifically on the negative list could have been accommodated within the broad criteria chosen. A more realistic way of explaining the present pattern of lending is to recognize that the Bank's client base has been built up over the years and its present sectoral distribution is more a function of the Bank's response to opportunities as they arose (and probably also of historical accident) than the result of a consistent and explicit targeted sectoral approach.

1.4 Community Lending in the 1990s: Needs and Opportunities

The EIB and Cohesion

The general mission of the EIB is clearly stated in Article 130 of the Treaty of Rome which calls for the EIB to make loans on a not-for-profit basis for projects promoting regional development, adaptation to the common market and projects of common interest to several Member States which by their size or nature cannot be fully covered by existing financial institutions. Within this general mission, the Bank has defined a mode of operation and a number of market niches which have allowed it to operate successfully without reliance on public subsidies, and in a manner that has won it general acclaim for efficiency and professional competence.

In public documents and internal reporting, the EIB presents a wide range of evidence concerning its contribution to the Community. Typically this involves a sectoral classification as already discussed above. But the contribution of the EIB to Community interest is not to be measured

simply by a list of the sectors receiving loans or by adherence to a negative list ruling out lending that conflicts with Community policy. After all, the lending of most private banks could be (and indeed often is) presented in much the same manner. The special Community interest served by the EIB, which justifies its being considered as a public entity and an instrument of EC policy, must be measured by reference to the net contribution it makes to cohesion over and above what would be done by a profit-oriented private bank. In short, we must ask: "What does the EIB do that other banks do not?" This is not an easy question to answer comprehensively; certainly it is all but impossible to quantify.

When the EIB was established over 30 years ago, the scope of banking was quite restricted, national capital markets were much less developed and international capital flows an order of magnitude smaller than they are today. While it would be a gross oversimplification to state that the market imperfections which led the founding fathers to create the EIB have disappeared, it is certainly true that they have been very much reduced. As a result, when a large and profitable commercial entity borrows from the EIB, both parties enter into the contract with the awareness that alternative lenders exist. The interest rates and terms of the loan are typically comparable to what would be offered by the alternative lender; the borrowers' choice of the EIB being made on the basis either of some slight cost saving, or the interest of maintaining a relationship with more than one source of long-term credit, or some such second-order consideration. Smaller borrowers usually receive EIB loans from an intermediary for whom the availability of EIB funds (through a global loan) is again a matter of second-order convenience.

These general points do not, however, apply uniformly across Europe. The 1988 Price Waterhouse study for the "Costs of Non-Europe" project revealed wide differences in the costs of banking services between different Member States.²² The reported cost ratio between the highest and lowest cost locations was as high as 5 to 1 for some of the products. These cost differences have already been referred to above as one of the contributory explanations for the geographical pattern of EIB lending: it lends where the local banking system is a high cost one. This is an important public service and may be one of the most effective ways in which the Bank contributes to cohesion. Not only does it lower the cost of funds to the final borrower but the competition should also stimulate the domestic banking system to respond with improved efficiency.

²²Cf. European Commission: "The Economics of 1992", *European Economy*, Vol 35, 1988.

There is also the extensively discussed issue of large-scale projects, where even the streamlined financial markets of the 1990s may hesitate, and the related issue of Community interest in certain large infrastructural projects. The role of the EIB in helping finance the Channel Tunnel is an illustration of its public policy role in both of these areas which, however, are not of central importance in the context of the present study.

We argue therefore that, the large-scale projects aside, the central public policy and cohesion promoting role of the EIB is its readiness to fund sound projects at competitive prices where the local financial market displays inefficiency. Without such a role one would begin to wonder whether the EIB should be privatised. But the role identified here is an important one, and one which should be constantly borne in mind in considering policy initiatives for the Bank. We return to this point below.

Growth and Niches

Looking to the future, it is clear that the EIB will not have things all its own way. Some of the sources of growth in the past will no longer present themselves. For one thing the progressive reduction in Community interest differentials makes the foreign currency option less attractive for borrowers even with an exchange risk cover. The move to Stage 3 of EMU will eliminate exchange rate risk, so that at the end all or most EIB lending will presumably be in the common currency.²³

Continued development in the sophistication of domestic capital markets will allow more and more first-rate borrowers direct access to capital markets, making it unnecessary for them to resort to banks including the EIB. Cross-border competition in banking is negligible at present, but it will become more important as the Internal Market nears completion. Experience in Australia and Canada where entry to the banking system has been liberalised in recent years shows that, even if foreign banks do not dramatically increase their market share, the threat of foreign competition will induce a response by the domestic bankers in the direction of improved efficiency and lower margins. Domestic banks will become more attuned to local borrower needs for long-term capital and they will be able to provide strong competition for the EIB.

These improvements in banking efficiency across Europe, spearheaded by the completion of the Internal Market and the elimination of exchange risk, could ultimately result in a situation where the public policy functions of the EIB were no longer relevant. At that stage, the Bank would indeed

²³Exchange risk may persist for some Member States to the extent that they do not become full members of EMU stage 3 at the outset.

be merely one player among many. (And the question of it contributing to the financing of CSF projects would be altogether moot). But that day is still some distance away. For the present, the client base built up over the years, combined with the potential for expansion into the Southern periphery countries will mean that the EIB is far from facing a crisis of survival. Even in the longer run and even if the financial sector in these countries had become much more efficient, the tight control it has, as discussed, always maintained over costs means that the EIB could continue to function adequately.

This perspective suggests that the financing possibilities for CSF for projects that are bankable (after receipt of grant-aid) will steadily improve also. Nevertheless there are clearly gaps at present which will probably be slow to fill. The cost of borrowing was identified as the highest priority area for improvement in competitiveness by companies in Objective 1 areas responding to a recent sample survey,²⁴ while it was ranked much lower in other parts of the Community. In another recent survey,²⁵ focusing on gaps in the financial market, cost of credit also topped the list of financial market shortcomings. Note that cost more than availability of term credit was identified in both studies.²⁶ No doubt these complaints tended to be louder in countries whose macroeconomic condition resulted in high nominal interest rates all round; but it was argued that assisted regions suffered more than other regions, even within the same country, so far as cost of credit was concerned. The same was true for SMEs relative to other borrowers. This all tends to reinforce the notion that improving efficiency and competition in banking is an important objective.²⁷

Cost deficiencies, though severe, are identified only in some countries, while the other, less severe, financial market gap identified by most observers²⁸ affects Objective 1 and 2 regions in all countries, namely a

²⁴IFO, "An Empirical Assessment of Factors Shaping Regional Competitiveness in Problem Regions". Study financed by the European Commission, Luxembourg, 1990.

²⁵Ernst & Young, "Financing of Small and Medium-Sized Enterprises in Assisted Regions". Study financed by the European Commission, 1990.

²⁶In the IFO study, availability of risk capital ranked 20 out of 37 mostly non-financial items offered to the respondents. In the Ernst and Young study more than 3 out of every 4 enterprises named cost of credit, while fewer than 1 in 4 named a lack of medium and long-term finance.

²⁷Note also that cost of credit was not seen as a major problem in Belgium, Germany, The Netherlands and Luxembourg, precisely the countries in which EIB is under-represented.

²⁸Including the above mentioned study by Ernst & Young, *op. cit.*

shortage of risk capital of various types for SMEs. Both borrowers and financial institutions agree that some of this type of funding is scarce. Terminology is somewhat flexible in this area, but the risk capital that is seen as being in short supply includes:

- Seed capital: This is finance provided essentially for an idea. For example funds might be provided to finance the product development stage for a small industry in its start-up phase.
- Venture capital, to finance a somewhat later stage in the process of bringing the product to market and expanding productive capacity. This typically involves an equity claim and for various reasons is usually confined to medium-scale enterprises promising rapid growth: it is a high-risk, high return type of activity for the investor, and the lender usually becomes involved in management support.
- Mezzanine finance is somewhat less risky finance provided to enterprises whose prospects are less unstable than those of the beneficiary of venture capital, but whose proposals are not fully bankable often because there is not enough unpledged collateral or guarantees. Mezzanine finance, which often takes the form of subordinated debt at high interest rates, will in any case offer higher rewards to the investor than the normal rate of interest on bank borrowing.

All of these forms of finance provide possible niches, albeit small-scale ones, into which the EIB could consider moving.²⁹ The EIB has recently addressed the question of how to contribute to the financing of venture capital. Because of statutory requirements (the loan on equity financing by the Bank itself), the arrangement considered would necessarily involve a loan to, rather than equity participation in, a venture capital company. The Bank would presumably be assuming risk mainly by virtue of the absence of the sort of guarantees which it customarily requires, rather than through a direct share in fluctuating profits. The equity holders of the venture capital company would likely be assuming the greater part of the risk. Though a modest initiative along these lines would be welcome, it is arguable that standard venture capital is the least urgent of the risk capital needs in

²⁹That is not to neglect Commission initiatives already in place designed to address some of these niches.

European financial markets, and one which has already received a good deal of attention, in view of its spectacular success in the United States some years ago.

The question of risk capital is taken up at a more abstract level in Chapter 3.

Chapter 2

COMMUNITY LENDING AND THE STRUCTURAL FUNDS: VISION AND REALITY

Policy with regard to the operation of Community lending in its relation to the Structural Funds was set out at the time of the reform of the Structural Funds. As elaborated below, the reform envisaged a major role for the EIB and the other CLIs in helping to finance projects under the CSFs. The reality has, however, differed from what was expected to happen.

While the various institutions concerned have responded to the policy changes enunciated at the time of the reform of the Structural Funds, this response has been somewhat limited. The vision of collaboration between loan and grant agencies foreshadowed in the documents adopted at the time of the reform of the Structural Funds has not been fully realised. There are several reasons for this: for one thing, the vision would have required a more drastic change in the way the lending agencies operated than was, perhaps, envisaged. Second, the vision was not sufficiently precise; different interpretations were possible. This suggests that a more precise specification of how a closer collaboration might realistically be achieved is needed.

We begin by reviewing the vision of co-operation and an integrated approach to Community grants and loans as adumbrated in the documents defining the reform of the Structural Funds. The Single Act called for reinforcement of economic and social cohesion through not only the Structural Funds, but also through the EIB and the other existing CLIs. A review of the legislation, mainly adopted during 1988, governing the reform of the Structural Funds suggests that there was the expectation that the CLIs would be very centrally involved, and in a new way in a co-ordinated effort with the Structural Funds.

Thus both the "reglement cadre" (2052/88) and the "reglement d'application" of the Structural Funds stress the importance of assistance provided by the loan instruments to projects being part-financed by the

Funds.³⁰ A further key document, and one which spells out the close co-operation between the CLIs and the Structural Funds is the Commission Communication of 23 December 1988 on "the EIB and the other CLIs in the reinforcement of economic and social cohesion". After reviewing the past function of the CLIs in assisting cohesion, this document calls for a "new approach" to be characterised by an emphasis on concentration, programming and efficiency. Concentration involves a reinforcement of the priority given to regional development, and within that a new emphasis by the EIB on the regions identified for Objective 1, 2 and 5(b) lending. Programming means that only a limited number of large individual projects would be considered on a case-by-case: the remainder of Community lending would be based on a clear quantified financing programme agreed in advance and explicitly included in the CSF. Disbursement would be effected in a decentralised manner on the "global loan" model.³¹ Efficiency calls for more follow-up and *ex post* evaluation.

More than any other aspect of the new relationship, the matter of finding the best mix of loans and grants illustrates the Commission's *ex ante* vision of the new relationship between the Structural Funds and the CLIs. A mix of Community grants (subsidies) and loans which was "both

³⁰The "reglement cadre" (2052/88), though primarily concerned with the activities of the Structural Funds itself, treats financial assistance from the Funds on essentially the same terms as financial assistance by the EIB and the other existing CLIs. While it recognises explicitly that the EIB must operate in accordance with its Statute, and the other existing financial instruments in accordance with the specific provisions governing their operations, the drafting of this key document conveys the impression that, so far as their regional development lending is concerned, the activities of the EIB and the other loan instruments would henceforth be essentially determined by a joint and co-operative process with the Structural Funds. The repeated references to the CLIs in this regulation (the EIB is mentioned 16 times) reinforce this impression.

The "reglement d'application" (4253/88) is more specific. Co-ordination and consistency is to be assured between assistance from the funds and assistance provided by the loan instruments (A.3(1)). The EIB is to be associated in the use of the Funds with a view to the part-financing of investments (A.3(2)). The EIB is also to be involved in the preparation of the CSFs, and the indicative financing plan of each CSF is to specify allocations from the EIB and the other CLIs (A.8(1), A.8(3)). The appropriate combination of Community grants and loans is to be determined for each CSF in conjunction with the EIB (A.18). There is provision for EIB representation on the 3 key Community-wide committees established by the regulation, notably the Advisory Committee on the Development and Conversion of Regions and on the Monitoring Committees (A.25(3), A.27).

³¹As explained later, new guidelines and operational rules for the ECSC giving effect to this intention were published in July 1990.

judicious and economical in terms of budgetary resources" is to be sought. In practice, attention has been confined to 2 dimensions, first, the degree to which a project was likely to generate revenue, second, the region in which the project was located. Subject to the regional consideration, the idea was to limit grant aid where the project was likely to yield a financial return. The Operating Guidelines³² establish maximum grant percentages by class of project and by location. These have the explicit objective of ensuring "efficient utilisation of a combined instrument consisting of loans from EIB and [other CLIs] and subsidies from the Structural Funds".³³

More recently, the Maastricht Treaty (December 1991) echoes the same concerns, and the revised Article 130 enjoins the EIB to "facilitate the financing of investment programmes in conjunction with assistance from the structural Funds and other Community financial instruments".

While the legislation has been complied with, it does appear that the reality of CLI involvement in regional development departs significantly from the picture conveyed from this reading of the likely intent of the legislators. It is true that EIB and ECSC lending is heavily concentrated in the assisted regions covered by Objectives 1, 2 and 5(b) (cf. Table 9). To take the EIB, of over 23b ECU in 1989-90 lending, some 63 per cent was for regional development. Five-sixths of this was in Objective 1, 2 and 5(b) regions, and about two-thirds of this in turn related, according to EIB estimates, to operations "complying with specific CSF objectives". On the one hand, this last figure (which comes to 8.2b ECU) is about the same as the 8.4b ECU planned for ERDF commitments in the 2 years. But on the other hand it means that almost two-thirds of total EIB financing within the community, and over 43 per cent of EIB regional development lending went for operations *not* falling under specific CSF objectives.³⁴

³²The guidelines are summarised in DGXXII's Guide to the Structural Funds, pp.19-20.

³³Despite this objective (and although additional ceilings governed the total of grant plus CLI assistance to any given project), there is no presumption in the Guidelines that CLI assistance will be forthcoming at all: the ceilings on grants are not accompanied by floors on CLI assistance. As is made clear below, we think that this omission was a wise one, but it does mean that the Guidelines do not ensure the emergence of a truly "combined instrument".

³⁴Note that not all of EIB regional development lending goes to the regions identified for Objectives 1, 2 and 5(b) of the reform of the Structural Funds, even when this is augmented by the additional areas (mainly in Greece) covered under the Integrated Mediterranean Programmes. The EIB counts lending to an area about one-tenth as large again as eligible for its regional development; the extra area being that which benefits from national incentives.

Table 9: EIB: Regional Financing 1989-90

<i>in billions of ECUs</i>		<i>% Regional Development</i>	<i>% Total Financing</i>
<i>(a) Individual and global loans</i>			
Total regional development	14.5	100	63
<i>By Objective</i>			
Objective 1	6.8	47	30
Objectives 2 and 5b	5.4	37	23
IMPs	0.7	5	3
Other regional development	1.6	11	7
<i>Relation to CSF</i>			
Responding to specific CSF objectives	8.2	56	35
In tandem with grant-aid	1.3	9	6
Total Financing	23.1		100
<i>(b) Individual loans only</i>			
Total regional development	11.2	100	
Objectives 1, 2 and 5b	9.3	83	
Responding to specific CSF objectives	5.5	49	
In tandem with grant-aid	1.5	13	

Source: Calculated from EIB data.

About three-fifths (and more than 1b ECU) of ECSC lending in the same period was for "conversion" loans – for the most part in Objective 2 regions, and some of the remaining loans would also have been in Structural Fund regions.

It is clear that this quantitative link between CLI operations and the various CSFs has not come about through close co-ordination between the EIB and the CSF process. Even where projects are part loan-financed, subsidies are granted without associated EIB loans, the promoters securing their funding independently. Only 1.5b ECU of EIB individual loans was provided "in tandem with" Community grant-aid.

Indeed, far from being intimately tied in with the CSFs, the EIB has been careful to attach a disclaimer from the financing envelopes included in each CSF. The disclaimer states that the envelopes represent estimates

only, the actual amounts being contingent on the submission of satisfactory projects. It appears that EIB participation in the design of the CSFs was largely confined to arriving at this financing envelope: EIB representatives did not tend to remove their narrowly institutional hat in these deliberations. Furthermore, as the programmes have moved from the design to the implementation stage, it is noteworthy that, though it has a seat on each monitoring committee, the EIB is said in practice to be rarely present.

Why this discrepancy between vision and reality? One reason is the fact that the EIB and the ECSC have previously operated in an essentially independent manner. Despite rather small staffs, both lending instruments are active and expanding and their loans are in ready demand. Each has an established clientele and procedures for identifying new business. Their natural mode of operation is geared to making loans for bankable projects. It was perhaps too much to expect that they would change their mode of operation to become full participants in what is essentially the administration of public expenditure. The working of the Structural Funds is a complex administrative and political operation involving subtle interaction between many layers of government, and calling for wide-ranging policy judgments. It differs substantially from the normal activity of the EIB or the ECSC; staff participation in it is certainly not the type of activity most likely to generate new lending. To divert significant staff resources to focus on an area of uncertain loan demand would have involved a wrenching decision calling for either a considerable expansion of staff or abandonment of some of their existing niches.

Another reason may have been the fact that the nature of the change in activity that was being called for was somewhat vague. Was it intended that the CLIs should enter as a lender of first resort for grant-aided projects? If so were they to be given first refusal on the lending needs of such projects? Were there to be large programme loans made to the lead agency for operational programmes under the CSFs, loans that could then be on-lent to final beneficiaries? To what extent was it the experience and expertise of the CLIs as much as their financial resources that was being called upon? In Chapter 5 below we turn to consideration of just how closer co-operation between the CLIs and CSFs could best be defined. Before that, it is necessary to look in some greater detail at the merits of linking grant-aid and debt finance, which we do at a largely conceptual level in the next section. Chapter 4 discusses some of the institutional strengths of the EIB on which the proposals of Chapter 5 are built.

Chapter 3

THE NATURE AND ROLE OF DEBT FINANCING

This section steps back from the immediate concerns of CSFs and CLIs to look at the basic role of debt financing with a view to asking: when is debt financing appropriate and what particular function does it serve? The discussion is abstract, but leads to some practical conclusions for action. The question of subsidising the interest cost of loans is also treated in this section, which concludes with some remarks about the assumption of risk by banks.

3.1 The Analytical Background

The role of debt financing, as seen in modern finance theory, centres on its ability to cope with deficiencies or asymmetries of information, and on the incentives or disciplines required to ensure that borrowers will perform adequately despite these informational deficiencies.

When a borrower seeks external finance for his operations there is a variety of types of contract or financial instrument which can be considered. These instruments differ mainly in terms of the time-path of intended service payments and in their risk-sharing characteristics. Even for projects that bear fruit over a long-period, each type of instrument has advantages and disadvantages. Some examples:

The equity contract, where the lender gets a share of the profits, is useful for a project whose returns are very uncertain before the event. The reason is that the lender can acquire a portfolio of several such contracts, benefitting from risk pooling to obtain a potentially high average return even if some of the underlying projects fail. The disadvantage here is that the lender may not be able to verify the financial success of each project. The promoter certainly has an incentive to understate the true returns and short-change the lenders. Only when returns are easily verified will the equity contract come into its own. That is why we observe a correlation between the development of equity markets and the effectiveness of accounting practices across countries.

The debt contract, e.g. a fixed interest loan, has the advantage, when combined with penalties or costs of bankruptcy, of inducing good performance by the borrower, even when the true returns are not readily verifiable.³⁵ On the other hand, a portfolio of loans does not offer as good an averaging in that highly successful projects will still only return the contracted interest rates to the lender while failed projects will yield little or nothing. Accordingly, for projects with highly uncertain returns, a fixed interest loan is usually unattractive: to form part of a reasonable portfolio for the lender, it must carry a high contractual interest rate, possibly too high to make it of interest to the borrower.³⁶

Bankruptcy and information problems aside, debt-holders tend to receive a less uncertain return than equity-holders, because equity holders obtain the residual value and debt holders a pre-determined contractual value. This is the basis of the traditional approach to thinking about debt as a means of finance. In the presence of an efficient secondary market for both debt and equity it leads to the well-known Modigliani-Miller conclusion that the debt-equity mix chosen by an enterprise might have no consequence for it or for its stakeholders. According to this theory, any increased risk imposed on a shareholder by the decision to move to a higher debt-equity mix could be fully offset by the shareholder through an adjustment of his own portfolio of debt and equity in the enterprise. In reality tax considerations, especially the fact that in most countries debt interest is allowable as a deduction before computation of corporation tax liability, are important in overturning this notion that the choice of debt-equity mix in an enterprise's financing is of no consequence.

³⁵Cf. D.W. Diamond, "Financial Intermediaries and Delegated Monitoring", *Review of Economic Studies*, July 1984.

³⁶This problem has been widely discussed since the well-known paper by J.E. Stiglitz and A. Weiss, "Credit Rationing in Markets with Imperfect Information", *American Economic Review*, June 1981. It is probably an important reason for the emergence of venture capital as a more secure route through which financial intermediaries can become involved in the provision of risk capital. By taking an equity share in a high-risk high-potential enterprise the bank can share in better than average successes as well as in failures. A portfolio of venture capital investments can diversify much of the risk and result in a satisfactory overall risk-return mix for the bank (though the bank's management costs are usually heavy in venture capital). Cf. the discussion of banks' attitudes to risk in Section 3.4 below.

Deeper consideration of the role of equity finance and of dividend payments has brought incentive and signalling issues to the fore.³⁷ Noting that, even when they could use the internally generated funds for new investment, companies often pay out dividends and recourse to the new issue market or to borrowing, observers have suggested that this behaviour may be interpreted as a signal being given by managers to shareholders that all is well and that they are able to expose their operations to the scrutiny that will be involved in bank or bond-market borrowing, or in the new issue market.³⁸

A similar type of consideration has been advanced as one explanation of the preference which many banks have for lending at short-term, even if the lending is continuously rolled over (evergreen). The short maturity of each loan allows the bank to monitor the general performance of the borrower frequently, and to decline further accommodation (or take other corrective action) as soon as warning signs are seen. A long-term loan contract would leave the bank relatively helpless even in the face of an evidently deteriorating condition of the borrower provided the contractual obligations of the loan (e.g. interest payments) were being met.

Interest rates do fluctuate, both in response to varying expected inflation rates and in response to monetary policy initiatives and other changing economic circumstances. The risk entailed for the holders of financial contracts depend not only on the terms of the contract, but on the holder's remaining exposure to interest rate fluctuations. Either variable or fixed interest contracts can be better for a borrower or a lender, depending on these other exposures. A financial intermediary whose liabilities are all at variable interest will reduce the shareholder's risks by lending at variable interest rates. On the other hand, a borrower whose own receivables are unlikely to fluctuate in response to interest rate changes will prefer a fixed interest obligation. Although these may be the typical cases, there will be borrowers whose position leads them to prefer

³⁸A related aspect is that the managers can be seen as incurring costs in order to overcome what are known as agency problems, i.e. the problem that the interests of the managers and the shareholders need not coincide. Further arguments in this vein are presented for example by M.C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers", *American Economic Review*, May 1986.

³⁷Much of the discussion of these issues stem from the paper by M.C. Jensen and W.H. Meckling, "Theory of the Firm: Management Behaviour, Agency Costs and Ownership Structure", *Journal of Financial Economics*, October 1976. Another seminal paper in the area is S.C. Myers and N.S. Majluf, "Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have", *Journal of Financial Economics*, 1984.

variable rates and lenders who prefer fixed rates. Thus even borrowers and lenders whose expectations as to the likely future trend and variability of interest rates coincide may find a mutually beneficial contract which reduces the exposures of both so far as interest rate fluctuations are concerned.

The variations on the basic debt or equity contract are innumerable. Some are relatively straightforward mixtures of the basic instruments, as where a debt-contract carries a warrant entitling the holder to acquire equity under certain circumstances. In the international context the choice of exchange rate in the contract is the source of many other variations. Other contracts bring in new factors, such as indexing repayments to external indicators such as the price of specific commodity, or a general price index. The purpose of these innovations is generally to distribute risk among the parties concerned in a mutually attractive way, and in many cases to ensure adequate performance.

In important respects, the lending relationship between a commercial bank and its business borrowers go beyond the simple contract. The fact that the borrower will have a continuing need for a variety of banking services means that the decisions of both parties will be made with a view to this continuing relationship.³⁹ The bank that processes the payments transactions of a business has better information concerning that business at its disposal than many other potential lenders and will be better able to judge to which businesses and to what extent it can safely and profitably lend.⁴⁰ In countries where this is permitted, commercial banks may be in a good position to take equity shares in some of its customers, but even without this explicit profit-sharing link, the value of the continuing business as well as the early warning system allowing the bank to reduce its exposure before other lenders are aware of the problem mean that this type of bank's investment is in a different category from the investment held by an unconnected bondholder. In this context, the lack of a continuing relationship means that the position of the EIB is probably

³⁹The banking relationship is discussed, among others, by D.W. Diamond, "Reputation Acquisition in Debt Markets", *Journal of Political Economy*, August 1989, and by M. Hellwig, "Banking, Financial Intermediation and Corporate Finance", in A. Giovannini and C. Mayer, eds. *European Financial Integration*, Cambridge University Press, 1991.

⁴⁰This view is expressed in E.F. Fama, "What's Different About Banks?", *Journal of Monetary Economics*, January 1985. The bank may also be in a better position to recover its claims to the extent that the receipts of the borrower are paid into its account with the bank. This kind of relationship is said to be exemplified by the banking business of local authorities in Belgium with the Communal credit bank.

more analogous to the distant bondholder than to the continually involved commercial bank, though for some borrowers the tranching of loans and the repeat business does provide some continuity of information.

One form of external finance is the grant. Not considered much in this context in the academic literature, it nevertheless represents an important element of capital finance in European countries, and is central to this study. Even if the provider of grant-aid does not actually expect a monetary return, nevertheless he typically hopes for a return in other forms -the provision of services such as roads or sanitation. Similar information, incentive and risk issues apply. In certain respects the grant is like an equity contract: the return is not prespecified, and if no monitoring is possible, the entity receiving the grant will have little incentive to provide any return.⁴¹ It is interesting to consider the grant-debt mix in the light of this analogy, imperfect though it is.

These introductory remarks suggest a framework for thinking about when grants are appropriate, and when loans. But there is also the consideration that both grants and loans may come from different sources. National governments may grant-assist projects; financial institutions other than those of the Community make the bulk of loans in the Member States. Choosing a grant-debt mix for a project is not the same as choosing the appropriate involvement of Community instruments. Depending on other grant elements provided, grants from the Structural Funds may need to be reduced, in order to maintain the optimal grant-debt mix for each project (or borrower). Likewise, because of the elasticity of financial markets there is no necessary involvement of the EIB or other loan instruments in financing the debt component of the mix. Who should provide the loan finance will depend on the competitive situation of the local financial market and the comparative advantage of different lenders.

3.2 Practical Implications for Financing Programmes and Projects Under the CSFs.

The above discussion suggests two general guidelines for the choice of financing structure in CSF projects. First, and obviously, the Commission should seek to minimise the grant component: from the viewpoint of the Structural Funds the minimum grant that will ensure the desired result is the optimum size of grant. Second, use the financial structure to maximise

⁴¹The analogy is not perfect (for example the grant confers no ownership rights) but seems most appropriate in the present context. One could alternatively consider the grant as a special case of a loan, with zero interest and no redemption date; but thinking of it in that way would neglect the concern which the grant agency has in ensuring a good outcome.

the performance of the grant recipient and to share in unexpected financial success. But how are these guidelines to be implemented? Some concrete suggestions in this regard are made below.

In considering how this general theory can be applied in practice to the financing decisions involved in operations and projects under CSFs, account must be taken of the very different types of beneficiary that can be involved. The effectiveness of financial leverage as a discipline will be greater for recipients that are either in the private sector or, if they are in the public sector, have a degree of financial autonomy and responsibility for their financial performance. Some of the investments and activities under operational programmes are actually carried out by government agencies, some by private enterprises. Probably most operational programmes have a mix of public and private involvement with central or regional government agencies acting as a lead agency, but with actual implementation contracted out to other agencies public and private. Among the government agencies there are varying degrees of financial autonomy.

When a grant is made from the Structural Funds for a programme or project, the remainder of the cost may be secured at any of a variety of levels. At one extreme, the remainder of the cost is provided by national or regional government in the form of grant-aid also. At the other extreme, the Structural Fund grant may be passed to a private enterprise which secures the remaining funding from borrowing or from its own resources. Unless financial structure can be used to improve the pattern of risk-sharing in the project, or to place better financial discipline on the recipient, we suggest that it is of little economic consequence where this funding comes from.

Tying Loan Facilities to Grants

Generally speaking, exposing a grant recipient to the rigours of the financial market for securing complementary loan-finance will have the advantage of introducing an additional scrutiny, from an independent source (the financial institution) of the likely financial viability of the project being undertaken by the grant recipient. This would argue against any special availability or privileged tie-in of a Community loan for the grant recipient.

As against this, however, it can be argued that another way in which financial discipline could be imposed, in this case on the grant administrator, would be to ensure that the grant administrator – say the lead agency for the particular operational programme – was normally making matching loans in parallel with the grants. In that case the grant

administrator, worried about the risk of non-recuperation of the loan, might be induced to scrutinise the whole project more carefully than if he were simply making a grant.⁴² The "programme loan" concept, explored below in Chapter 5, could yield this kind of discipline. However, as is often the case, tightening financial discipline in one area may cause it to be relaxed in another. Specifically, if loan finance is channelled through a grant administrator, then the lending is not being subjected to the professional assessment of a disinterested financial institution.

Another case in which special availability of a Community loan facility might not weaken financial discipline might be in the case of a grant recipient that was a public body not financially autonomous. Private financial institutions lending to such a public body (with a government guarantee) are unlikely to scrutinise its policies very closely. After all, the national government has authorised these policies and will in any event cover any financial shortfall that arises. It is largely a matter of indifference whether the loan finance comes from the market, or from some earmarked Community loan facility as in a programme loan.

A private grant beneficiary or a financially autonomous public enterprise is more subject to financial discipline. Providing it with a loan requires a definite decision concerning creditworthiness. This argues for using Community loan instruments only with the normal banking practice and prudential safeguards. That means that CLIs will be in competition with other financial institutions for this lending business, and will sometimes not be chosen by the borrower. There should be no special pressure on CLIs to make direct loans in such cases on the grounds that the project has been approved under a CSF. The requirement to repay the loan will place a discipline on the performance of the recipient, and the need to be repaid places a financial discipline on the lending financial institution to make an adequate *ex ante* creditworthiness evaluation.

This discussion points up the complex balance of incentive considerations which arise. We return to this issue in Chapter 5 when considering the advisability of programme lending. But these ideas have the potential for wider application, to which we now turn.

Applying Financial Theory Ideas to Grant-Aid

Standing back from the question of loans, it is worth considering whether this financial theory reasoning has any practical implications for

⁴²It is reported that, because of this greater accountability that is placed on them - described as the "sleepless nights" problem - grant administrators generally prefer to avoid loan schemes.

the grant-aid process. We argue that it has, especially in order to minimise the incidence of grants that were unnecessarily generous. The ideas advanced here are somewhat theoretical, but elements of them could be implementable.

First, where there is uncertainty about the likely future receipts of a revenue-generating project (but where the revenue will be verifiable after the event), a revenue-sharing formula or equity contract should be considered.⁴³ Instead of simply being given a grant, the recipient would undertake to repay an amount which would depend on the revenue or success of the project. If the project was no more successful than expected, no claw-back or return to the grant-giver need arise (thus the scheme would differ sharply from a loan in this respect). But if the project proved to be much more successful than expected, a proportion of the revenues or the profits⁴⁴ would go to the grant-giving agency. This would allow unexpectedly large revenues to be partly clawed-back. That would, in turn, provide more funds for grant-aid for other projects in the operational programme. In this way grant-aid which proves to have been excessive can be partially recovered.

While such a scheme would not be feasible in many cases both because of the difficulty of assessing the revenues, and possibly because of perceived political obstacles, there are other cases in which it could work well.

A second idea from the theoretical perspective might also be worth exploring, though here the practicality of the scheme might be questioned. According to this idea, and again with a view to minimising grant-aid, an attempt could be made to employ competitive bidding between projects or promoters for grants. The idea here is to ensure that the minimum grant necessary to "get the job done" should be required. That is to say, a social need for a certain set of schemes, each not privately profitable, having been identified, the task is to ration scarce grant resources among alternative schemes. If two schemes are of equivalent social merit, then first preference for grant-aid should lie with the scheme which can be put in place for the minimum grant cost.

But how to obtain the information necessary to decide what this minimum is? By introducing some notion of competitive bidding for the grant component of EC aid can one move in the direction of solving the

⁴³Some Member States have begun to experiment with "repayable grants" or "conditional grants" having some of these characteristics.

⁴⁴In practice, the difficulty of measuring profits argues for a simple rule for the clawback, such as a fraction of the revenues in excess of some pre-arranged total.

information problem? This is a tentative suggestion which would be infeasible in many cases, but could be valuable in some. The most natural type of application would be where there are *two possible providers of the same service* (for instance a sanitary service or the building and operating of a toll bridge). More complicated to implement would be competition between *different projects within a given operational programme*. Rival promoters (which could be different local authorities) would contract to provide measurable improvements in the relevant service in different localities for a given sum in grants. The promoters who credibly⁴⁵ offer the best improvements for the lowest grants win the contracts. The idea of competition for grants could even be extended to competition between *different operational programmes* in the next round of CSFs.

While this idea emerges from consideration of the question of grant-loan mix, an assessment of its practicality and the possible scope of its implementation would require further work. In particular, this approach would have to be implemented in a decentralised manner if it were not to compromise the shift from project to programme finance which has been central to the reform of the Structural Funds.

3.3 Interest Rate Subsidies

This subsection reviews, at the general level of principles, the pros and cons of interest rate subsidies. Special considerations relating to the linking of interest subsidies with CLIs are discussed in Chapter 5 below.

Making Interest Rate Subsidies Effective

Interest rate subsidies have been used as a means of favouring certain sectors in many countries. Their operation takes a variety of forms but usually falls into one of the following 3 categories. First, arrangements where bank lending in the favoured category is refinanced at below-market rates by the central bank or another special public financial institution. Second, interest rate ceilings for credit in the favoured categories, sometimes accompanied by a requirement to provide a minimum quantity of credit to these categories. Third, subsidies provided by a fiscal entity to the interest costs of favoured borrowing secured in the open market.

The favoured category of borrowing can be defined by the purpose of the borrowing, or by some characteristic of the borrower, such as geographic location, economic sector or social group. The objective of the

⁴⁵It would, of course, be essential to verify the credibility of the bids, both on technical grounds, to ensure that the proposal met the desired specifications, and on financial grounds, to make sure that the promoter had the capacity to fulfil the contract.

scheme may include income distribution (as with subsidised schemes directed to worker housing – cf. the ECSC scheme), but it often relates to the desirability of capital formation to encourage technology transfer and development of a certain type or in a certain region.

The manner in which interest rates subsidies are generally intended to work is by altering relative prices in respect of the favoured categories. Thus, any borrowing that can qualify for admission to the category faces a different, lower, interest rate than non-favoured borrowing. That is to say, the subsidy typically has an open-ended character, where the individual borrowers or projects are not specified precisely; eligibility for the subsidy is established by reference to preset criteria.

Making sure the subsidy reaches the target group is problematical. To the extent that the scheme is coherent and applied without a lot of administrative discretion, the categories must be defined in fairly broad terms. Thus the declared categories will not correspond to the truly intended targets. Furthermore, it will not be possible to screen out infra-marginal borrowing: i.e. borrowing that would have taken place without the subsidy. The lack of discretion also means that the rate of subsidy will be the same across broad categories. In other words, the problem of deadweight is an acute one for interest subsidies.

Presented with a subsidy scheme defined in a broad manner, the financial intermediary will generally choose borrowers which, while falling within the announced categories, are (a) large (in order to minimise processing costs) and (b) creditworthy (in order to minimise loan-losses). But many of these are likely to be borrowers who could obtain credit anyway, and who could afford to service the credit at market interest rates.

Because of the open-ended subsidy that is involved, various protections always have to be built-in if there is to be any hope that the objective of the subsidy is to be achieved. Frequently there is a *ceiling on the size of loan* which may be eligible. A ceiling provides some protection against gross abuses, where large corporations might contrive to establish sham borrowers ostensibly satisfying the criteria, but in reality channelling the borrowed funds for normal purposes of the corporation. Furthermore, if the banking system is not very competitive, there needs to be a *limit on the allowable interest margin*; otherwise, the bank will capture much of the subsidy by continuing to charge what the market will bear for the loan. If the allowable interest margin is too low, banks will not voluntarily lend, especially to the higher risk borrowers within the target category. Accordingly, unless there is a compulsory minimum lending quota, the allowable interest margin will generally leave some rent to be captured by the banks.

When refinanced by the central bank or another public institution, interest subsidy schemes present problems of monetary policy. The injection of central bank funds resulting from the refinancing may need to be offset by restrictive monetary action elsewhere. Refinancing usually leaves the credit risk in the first instance with the initiating bank, as the refinancing agency usually retains recourse to the initiating bank. In some cases, however, the public institution assumes or shares the credit risk.

In the European context, especially post-92 and even more so in the EMU, the only form of interest subsidy that can really be considered is that in which the subsidy is paid out of budgetary funds.

Another, more subtle, type of difficulty with subsidised interest schemes is the psychological effect on financial discipline. The fact that interest has been subsidised can, for example, give the borrower a false sense that some special tolerance may also be exercised if he has difficulties in repaying. Studies show default rates ranging from 30 to 95 per cent for subsidised agricultural credit programmes in LDCs. In industrial countries too, there have been unfavourable recoveries: almost one-quarter of the loan portfolio of the Farmers' Home Administration in the US⁴⁶ was delinquent by 1985; the loan loss rate in federally subsidised student and small business loan schemes is estimated at between 9 and 13 per cent.⁴⁷

For the financial intermediary too, the element of subsidy can change its perception of its role as intermediary. The government agency paying for the scheme sees the intermediary as its agent. But the intermediary may well see its role as acting for the borrower in securing the loan. This conflict of perspective is potentially disastrous, particularly when compounded by the possibility for corruption of the individual loan officers belonging to the staff of the intermediary.

If there is a minimum lending quota, the quality of the bank's portfolio can be severely worsened. Effectively, the bank is being required to take on its books loans that it would not voluntarily make at the interest rates allowed (or perhaps at all). A worsening of the bank's loan-loss experience will inevitably follow.⁴⁸

⁴⁶This agency provided a large volume of low-interest loans involving relief of about one-fifth of interest costs.

⁴⁷A recent review of US Federal interest subsidy programmes argues that this and related problems have been so severe as to have cost that country the equivalent of one-third of a per cent of GNP per annum (cf. W.G. Gale, "Economic Effects of Federal Credit Programs", *American Economic Review*, March 1991).

⁴⁸In some countries, the bank's position is safeguarded in effect by converting the subsidy into a cross-subsidy financed through higher interest charges on other borrowers, and lower interest paid to depositors. In an open financial system, below-market interest ceilings cannot survive, because the non-favoured borrowers and depositors will migrate to alternative sources or homes. After 1992, this will be the situation throughout the EC.

Practical experience on these points is discouraging. Much of the recently documented experience relates to developing countries, where subsidised and directed credit has been most widely used. The experience was recently summarised as follows:

Subsidised credit often failed to reach its intended beneficiaries. Lenders misclassified loans in order to comply with central bank directives. Within priority sectors, larger and more influential borrowers benefited most. Much was at stake: acquiring subsidised credit could sometimes add more to profits than producing goods. A review of ten small and medium scale industry projects showed that the distribution of loans was skewed in favour of larger firms. Studies of agricultural and housing programmes show similar results. Directed credit programmes do redistribute income, but not necessarily in favour of the poor.⁴⁹ Furthermore, when rates of return in targeted activities were lower than elsewhere, borrowers did not use directed credit as intended. A study of an agricultural scheme in Colombia found that nearly half the funds had been diverted to other uses. Korea had an active curb market in which those with access to subsidised credit at times lent to others without.⁵⁰

This poor record has resulted in a re-evaluation of the desirability of subsidised credit programmes, and they are being dismantled in many countries. Admittedly, serious administrative deficiencies are more widespread in developing countries, but who would claim that none of these problems could and indeed do arise with interest subsidy schemes in the EC?⁵¹

⁴⁹The cited source included a box describing an agricultural credit scheme in Costa Rica, where the distribution of loans was actually more skewed than the distribution of land, and where the subsidy value of the larger loans would be sufficient in itself to put a family into the top 10 per cent of the income distribution.

⁵⁰Extracted from *World Development Report*, (The World Bank, Washington, D.C., 1989), p.59.

⁵¹A recent paper prepared for the Commission by Douglas Yuill and Kevin Allen ("Capital Grants versus Loan-related Subsidies as an Instrument of Regional Incentive Policy", European Policies Research Centre, Strathclyde, May, 1991) provides particulars of schemes still in operation in Member States. Yuill and Allen note that, while several Member States still have some form of interest subsidy in their battery of national incentives for regional development, "the last decade has witnessed a notably reduced emphasis on loan-related subsidies...with the demise of important loan-related regional assistance in Britain, Denmark, Portugal and Spain". They also remark that "in no country do the interest-related subsidies currently on offer play other than a secondary role to the mainstream capital grants within the regional incentive scheme".

Interest Subsidies vs. Capital Grants

Many of the problems of interest subsidies are also echoed in the analysis of capital grants. But we argue that even well-designed interest subsidy schemes, by operating in a less discretionary manner, are more prone to these problems than the typical scheme for capital grants.⁵² The reasons are threefold.

First, the fact that the interest subsidies are dependent on the use of financial intermediaries as agents introduces an additional layer of problems that does not exist where grants are being awarded directly by the grant-giving agency.

Second, as mentioned, interest subsidy schemes are essentially open-ended in nature; capital grant schemes can build in much more discretion. If a lot of discretion is built into an interest subsidy scheme, it loses its automaticity and becomes tantamount to a discretionary capital grant⁵³ with a complicated entry screen.

Third, by altering relative prices, the interest subsidy scheme induces an over-use of debt-financing relative to other sources and weakens the capital structure of beneficiary firms.⁵⁴

Overall, the fungibility of money combined with the weak control and perverse incentives of the interest subsidy approach is likely to result in greater deadweight than capital grants schemes.

While these criticisms seem persuasive, they could, in principle, be outweighed by special advantages seen for interest subsidy schemes. However, a review of such advantages shows them to be rather weak.

- It may be argued that there is some gain from the fact that a beneficiary has been subjected to the financial discipline of an independent appraisal carried out by the financial intermediary. But the financial intermediary's appraisal is geared to ensuring that it can recover the loan, not that the objectives of the subsidy scheme will actually be accomplished.

⁵²Of course, a badly conceived system of capital grants can be as bad as a badly conceived interest subsidy scheme.

⁵³The fact that the payment may be spread over a number of years is of minor importance in this comparison.

⁵⁴It also increases the relative cost of labour. In order to avoid this particular problem, well-designed capital grant schemes should not take the form of a fixed proportion of capital costs.

- It may be argued that the cost of capital is high especially for SMEs and other entities that are perceived as high risk by banks. However it has been pointed out that within any announced category, the intermediaries will select low risk borrowers, so the objective of lowering the cost of credit is unlikely to be achieved precisely for those borrowers most in need of it.
- It may seem that more projects can be covered by an interest subsidy scheme for the same cost, presumably on the grounds that interest subsidies seem low-cost per project, while capital grants seem high-cost. But this is surely a fallacy: if projects are decided upon on the basis of their net present value to the promoter, it would be hard to see how more projects can be swung into being by simply changing the form of subsidy from a lump sum to an annual subsidy. Only if the capital grants were much greater than needed to swing the project – and that to a greater extent than the interest subsidies – would a saving be made.
- The fact that interest subsidies are spread over time might seem to give more control. But capital grants can also be tranching, and the optimal tranching plan for a capital project is unlikely to be an equal monthly or 6-monthly amount over the duration of the loan. (Nevertheless it is acknowledged that, in the case where a project fails, there might be some budgetary saving in the fact that unpaid interest subsidies could be cancelled whereas a capital grant would have been wholly lost.)
- The existence of financial market imperfections arising from deficiencies of information (as documented in recent research on the influence of liquidity constraints on investments)⁵⁵ may indicate the social desirability of government intervention to promote credit to firms who are liquidity-constrained. The problem is that, as mentioned, even carefully targeted interest subsidy schemes are not likely to be successful in channelling much credit to firms to whom the banks are not already willing to lend.
- Even small interest subsidies could be used to achieve policy objectives if linked to covenants insisting that the borrower satisfy criteria (e.g. environmental considerations). However, it seems likely that this would be rarely the optimal form of subsidy to achieve such objectives.

⁵⁵Cf. Calomiris, C.W. and R.G. Hubbard, "Firm Heterogeneity, Internal Finance and 'Credit Rationing'", *Economic Journal*, March 1990, and references therein.

3.4 Banks and Risk Capital

The conservative banking stance adopted by the EIB has resulted in its accepting practically no risk for the account of its shareholders or bondholders. Accordingly, though not all of the projects financed by the Bank are risk-free, the financial risks involved have been assumed by others, notably the guarantors. Should the Bank be prepared to accept more risk, and thereby contribute to the amount of risk capital available in the Community? This section notes two different attitudes to bank risk that exist in the literature.

Differing views have traditionally been held as to the proper role to be played by banks in providing risk capital. One view, which may be termed the British view,⁵⁶ is that the structure of banks' funding does not permit them safely to take risky positions. They are liable to pay depositors or bondholders in full and with interest; little of their own funding comes from risk capital. The risk of a deposit run adds to this conservative line of reasoning for deposit banks. An alternative ("Continental") view asserts that the fact that the banks absorb such a high proportion of available savings means that they are the inevitable source of most investment funding. This privileged position means that they can assume a dominant role in the provision even of risk capital, and can be adequately rewarded for the risk in doing so.

While adherence to the "British view" by British bankers may have held back industrial progress in Britain in the first half of the century, the events of recent years tend to bring that view back into more favour. On the one hand the costs of unwise and excessively risky bank lending strategies have been highlighted by widespread banking failure, notably in the US. On the other, the rapid development of securities markets in Europe (as elsewhere) means that borrowers now have recourse to other sources of risk capital.

Nevertheless, with specific respect to the EIB, it should be noted that two of the reasons given for caution in bank lending – low capitalisation and dependence on a potentially volatile deposit base – are not applicable to the EIB.

Closely related to the question of risk-taking by banks is the issue of whether banks should be allowed to take equity positions in non-financial companies. Again there is a wide international difference of practice and law here. Some argue that equity holdings by banks in non-financial

⁵⁶Cf. Kennedy, W.P., *Industrial Structure, Capital Markets and the Origins of British Economic Decline*. Cambridge University Press, 1987.

companies is incompatible with prudent banking practice: some believe it can foster a resilient banking relationship. The fact that in practice countries which allow equity holdings of non-financial companies have not obviously suffered suggests that a dogmatic opposition to this freedom may not be appropriate.

The EIB is inhibited by its statutes from taking equity positions in non-financial companies, and this has proved to be a barrier preventing the Bank from making certain interventions in the direction of promoting venture capital.

A balanced view would conclude that, while imprudence is worse, an excess of banking caution can also damage the economy, and that sound banking is possible even without blanket rules against equity holdings. From this perspective, the EIB's policy and statutes may need to be reconsidered.

Chapter 4

PROJECT EVALUATION

This chapter examines the question of loan and project evaluation with a view to how it relates to projects benefiting from the Structural Funds, and more generally how it fits with the objective of economic and social cohesion as a whole.

4.1 The EIB: Project Selection and Project Appraisal

EIB is a project-driven bank. It is not happy to lend to a borrower unless there is a project which is sound from the technical, financial and economic viewpoint, even if the loan is otherwise adequately guaranteed. To this end the Bank maintains a small, but well respected, technical department to carry out *technical appraisal* of each project that is funded. The Bank's *economic appraisal* includes not only an evaluation of the financial viability of the project, but also of its overall economic (cost-benefit) rationale, thereby taking account of externalities and other public good aspects of the project. The technical department of the EIB comprises about 40 specialists, mostly engineers; the research department has 22 economists.

Typically, a project will be appraised by a mission in the field consisting of the loan officer or rapporteur, an engineer and an economist. Their mission will be preceded by a detailed questionnaire (the source of many small complaints by borrowers of the heavy bureaucracy involved in obtaining EIB loans).

The technical appraisal has two objectives, to find out whether the project meets a real need and whether it will be implemented adequately under known conditions. The small team of technical specialists cannot expect to be expert in every project; but their experience allows them to ask the right questions and assess the soundness of the answers. Their purpose is not to identify technical solutions, but to approve (or otherwise) solutions that have already been arrived at by the project promoter.

Briefly, the economic appraisal consists of answering three questions. First, is the project in line with the mission of the Bank? Specifically, can it be classified under the bank's objectives and is it free of the negative list of

projects that are not supported by the Bank? Second, is the project commercially viable? The answer to this question involves assessing whether such parameters as traffic projections contained in the project proposal are realistic and attainable. Market information on this is sought in a variety of ways including the purchase of outside market studies and interviews with market experts. Third, is the project economically beneficial? Criteria here include assessment of non-commercial costs and benefits of the project such as time saved and improved safety on non-toll roads, and possible environmental effects.

There is no fully standardised methodology for these non-commercial calculations, and there may be some divergences between the EIB's procedures and those of some member countries. The Bank has not attempted to have its approach adopted as a Europe-wide standard, and indeed does not even publish its manual specifying the appraisal criteria. There are other non-commercial factors which could be taken into account (including for example adjustments to wages to take account of unemployment) but which are not used by the Bank. In general, the Bank's approach is simplified relative to the elaborate all-embracing formulations of cost-benefit analysis which were proposed by the OECD and others in the 1970s. Instead its slimmed-down version serves to provide an approximate relative rating of different projects of the same general class. The third stage is not fully carried out for loans to commercial enterprises.

There are several consequences of this project appraisal approach. First, there are benefits to the bank's shareholders, who can be assured that the Bank is not likely to be funding projects that are unsound from an engineering or technical viewpoint, and thus that it is fulfilling its statutory mission. The fact that shareholder governments are also guaranteeing the borrowings of public enterprises or local authorities gives them an additional reason for wishing to ensure that such borrowing is for technically sound projects.⁵⁷

Second, borrowers whose activities and financial position are not primarily project driven are likely to find the Bank's insistence on project appraisal irrelevant and costly in terms of management time. This would apply, for example to public authorities and to financial institutions. The timing and magnitude of the borrowing needs of governments are driven

⁵⁷It is probably in this sense that the Bank's management see government guarantees as "the worst type that you can have", because if the project goes wrong, the guarantor is both a shareholder and likely to be called on again in the future as a guarantor.

by a great variety of factors, including the state of the macroeconomy, and the maturity structure of their existing debt. Debt management activities of these governments are largely concerned with balancing interest cost with maturities and exchange risks. Because of the need to prepare for it a dossier containing sufficient projects to back the borrowing, the EIB is not likely to be taken seriously as a funding source by the central debt management experts of a country which itself has a good credit-rating internationally.

Third, the appraisal procedure can serve as a useful external discipline on public agencies in ranking their development projects. The Bank is the only agency which conducts such appraisals across the Community on a consistent basis, and thereby it has the ability to become aware of international discrepancies in the rate of return on investment in different sectors.

Fourth, the Bank has the technical capacity to take the lead finance role in infrastructural or industrial projects of a large or novel kind. While this lead financier role is also driven by the political consideration that the Bank's approval implies a political commitment by the shareholding countries, the Bank's technical appraisal can also play a part in establishing credibility for the project.

The Bank has been involved in some programme-type lending. Cases in point related to the IMPs, and also to what are known as "framework loans". The latter have been introduced for Portugal and Ireland. They involve establishing a simplified approval framework for a sequence of broadly similar project loans. Reliance is being placed to some extent on the local appraisal capability. The Bank hopes that rigorous implementation of the simplified approval process (a 5-page application form is enough, but it must satisfy pre-set criteria) will result in there being no fall-off in average project quality in the framework loans.

It should be noted that the Bank's technical and economic appraisal functions are more vigorously exercised in its lending outside the Community, where the Bank takes a more active role in influencing the technical aspects of a project. In this case, the Bank is performing more of a developmental role than it does within the Community, though still not as much as the World Bank, whose project officers and technical staff take the lead in promoting and designing many of the projects which it finances.

4.2 The ECSC

Without having conducted an in-depth evaluation of ECSC procedures a few general remarks must suffice. The ECSC appears to place less reliance than the EIB does on project appraisal for conversion loans;

probably this is because the vast majority of these loans are channelled through intermediaries as "global loans". Yet, in so far as they are subsidised loans, it is arguable that they should receive a greater economic cost-benefit scrutiny than unsubsidised lending. Indeed, the Court of Auditors, in its Special Report (3/90) raised doubts as to the effectiveness of the ECSC's procedures for ensuring that intermediaries verify that job creation objectives have been realised.

The importance of carrying out formal cost-benefit analysis should not be minimised. In theory loan subsidies could be provided for schemes which do not have a net social benefit if such factors as spillover effects⁵⁸ are not taken into account. Were it not for the interest subsidy, the need for such analysis would be less: after all if the ECSC refused to accommodate the developer, another bank would probably come forward. But the subsidised funds introduce a distortion in the market, and it is important to ensure that the distortion arising should offset other distortions (such as those generated in the course of industrial decline) rather than exacerbating them.

Up to now, sufficient ECSC budgetary funds have been available to finance the associated interest subsidies, coming to over 50m ECU per annum. Some pressure on these resources has been foreseen and is likely to be alleviated by the recent decision to permit the use of ERDF funds for subsidising the interest costs of borrowing for projects under CSFs in the ECSC regions.

4.3 The Role of the Commission in the CSFs and the Operational Programmes

The scope of the present study does not extend to an analysis of the role of the Commission in the process of developing the CSFs and the Operational Programmes. Nevertheless, understanding this role and how it might evolve becomes relevant to judging what the role of the EIB might be in a new round of CSFs. A key element in the reform of the Structural Funds was the shift from a project-based approach to intervening through multi-annual programmes "in order to ensure better coherence and effectiveness in the actions taken". In practice an important aspect of the objective here was to streamline the decision and approval procedure so that the services of the Commission would not become overloaded with detailed assessment of a multitude of individual projects. This also entailed a degree of delegation of the design as well as the implementation of programmes to the regions.

⁵⁸Such as might occur when a developer creates employment in a new supermarket development at the eventual cost of the closure of old-established but less well-equipped or located retail outlets.

In evolving the appropriate manner of assessing regional submissions, whether inputs into CSFs or draft operational programmes, there remain unresolved issues. Should there be a more formal use of cost-benefit techniques; can these techniques be decentralised in such a way as to allow a greater control by the Commission without a commensurate increase in the workload, effectively nullifying the trend towards programme financing that has been established?

When it comes to the complex range of policy issues that arise in deciding a package of public spending it is never sufficient to rely solely on formal cost-benefit analysis. Political and strategic considerations inevitably come into play. This is especially true at the level of generality in which CSFs and even Operational Programmes under the Structural Funds are formulated. Cost-benefit analysis comes into its own in quantifying a number of well-understood market imperfections.

We may distinguish between narrow and broad uses of cost-benefit analysis. In its narrow use, such a quantification can be used to rank alternative policy initiatives of a generally similar kind: these could be mutually exclusive alternatives such as arise in determining the location of an airport, or the alignment of a road, or they could involve establishing priorities within a class of projects as with deciding the order in which road improvements are to be carried out. Cost-benefit analysis is much less reliable in choosing between broad priorities in substantially different fields of policy, (as between sanitary improvements and vocational training for example). But it can provide some useful indications even for such broad decisions.

Applying this narrow-broad distinction to Structural Fund categories we may say that cost-benefit analysis is more reliable in choosing between projects than in choosing between programmes. To the extent that the former choice is now being substantially delegated to regional and national authorities under the reform of the Structural Funds, it is natural that the Commission's use of formal economic appraisal techniques (cost-benefit analysis) should be rather limited - much more limited than that of the EIB. But it is worth considering whether the Commission should not pay more attention to this area if only to establish and maintain guidelines for the implementation of cost-benefit analysis in order to allow it to be satisfied that the regional authorities are in fact implementing an adequate ranking of projects.

Chapter 5

SCOPE FOR SYNERGY

5.1 Building on What Exists

The natural starting point for any policy initiatives must be the identified strengths of the organisation. The EIB is a financial institution. Its strengths are those of a well-capitalised long-term project-oriented credit bank. The options for change must respect and build on these strengths. Proposed reforms will not work unless the institutions and individuals involved in achieving them are motivated to do so. Among the strengths of the EIB may be mentioned:

First, a small but valuable staff which is experienced (a) in mobilising long-term wholesale funds in a professional manner; (b) in providing technical and economic appraisal of investment projects, especially those of an infrastructural nature; (c) in identifying and working with potential borrowers, especially those in the parapublic sector.

Second, the AAA credit rating which the EIB enjoys: high intermediary credit ratings are less common than they used to be, and accordingly must be more highly valued. The sources of this credit rating have been discussed above.

Third, the substantial reserves over and above what would be needed for normal prudent operation of the Bank represent an important resource which is at present being used to make profits and thus to generate growth in the reserves.

Fourth, as with most Banks, its client base, especially among borrowers, is a valuable resource.

The possible directions for reform must be assessed with these strengths in mind.

5.2 Seven Possible Directions for Policy Initiatives

This subsection reviews seven possible directions in which policy initiatives might be seriously considered. There are pros and cons for each and, while none can be absolutely ruled out, some of these directions do not seem very promising on balance. Although much of the CSFs relate to public sector projects, many of the initiatives mentioned here relate more to support for financing needs of the private sector, as it is in this area that market failures and deficiencies of finance are likely to be most acute.

Programme Lending

Since the reform of the Structural Funds involved a shift from project-based grant-aid to programme based assistance, it is natural to inquire whether the same shift should be adopted for EIB and ECSC lending. What would be involved? A programme loan typically means one granted to (or against the guarantee of) a sovereign borrower to finance a prescribed programme, the quality of which has been pre-assessed. The most straightforward type of programme lending, in the context of the CSFs, would involve (a) the selection of a suitable operational programme; (b) determination of an appropriate scale of loan financing; (c) the extension, on a quasi-automatic basis, of a line of credit from the EIB to the lead agency of the operational programme in the amounts specified. This credit would be guaranteed by the national government.

Much has been made of the dichotomy between the programme approach, now adopted by the Structural Funds, and the project approach to lending traditionally used by the EIB. Critics of the EIB blame the lack of a closer involvement with the Structural Funds on this dichotomy; and the EIB management appears to accept this argument, responding that its mission as a financial institution requires it to be a project lender. But this dichotomy as presented appears to us to be overlaid. Though the EIB certainly goes through all the motions of a project-based approach, and understands itself to be project-driven, its lending decisions are also strongly determined by the requirement of a first-class guarantee. Continuing relationships with public authorities or public enterprises, notably in infrastructural activity in Community countries, has allowed the EIB to relax its project appraisal scrutiny in many cases of repeat lending, thereby merging into programme lending. It would admittedly be a different matter to lend quasi-automatically to new borrowers against a programme drawn up without close EIB involvement, but not so much different (provided the loan was guaranteed by government) as to rule it out of court.

Among the changes *vis-a-vis* the present situation would be the fact that the scale of EIB financing established for a programme would be a firm one, and not simply the indicative envelope at present included in CSFs. Furthermore, the EIB would not be required to assess individual projects or to evaluate the progress of the operational programme on its own account. This evaluation would continue to be carried out by the monitoring committees, on which the EIB would continue to be represented, but the responsibility for repayment of the loan would be entirely borne by the lead agency and the national government.

Establishment of a programme loan facility would have certain advantages. For one thing, it could ease the financing problems faced by

individual project promoters. They would in effect be able to obtain matching loan finance from the lead agency as soon as their project was approved for grant aid. The need to service and repay the loan to the EIB would, at the same time, impose a certain financial discipline on the lead agency in giving grants and loans (see Chapter 3 above); there is no comparable discipline in the present grants-only approach.

Programme lending of this type need not involve a curtailment of the other lending activities of the EIB. The capacity of the international capital markets to absorb further EIB paper would not be a material constraint at present. Nor would there be any great need for an expansion of EIB staff given the nature of the programme loan. In particular, the programmes being financed would require no more appraisal than would already have been carried out for the purpose of deciding on grant-aid. The EIB would not have an independent responsibility to ensure that the programme was economically and technically sound. However, the Bank would contribute to the decision-making process for the CSFs and the operational programmes, thereby helping to ensure that all such programmes were sound.

Admittedly, the fact that individual projects were not being appraised would remove one of the safety nets which EIB lending, other than global loans, has at present. We have already pointed out that there is scope for a somewhat more relaxed approach without this posing any threat to the Bank's credit rating.

Any bank of the EIB's standing is reluctant to be associated with the financing of a badly planned or unsound programme or project. Even if its own lending is adequately secured, its market reputation could be tarnished by such lending. This is a consideration that needs to be borne in mind, and it means that the Bank should be able to reserve the right to stand aloof from financing certain operational programmes through a programme loan.

From the public policy point of view, there are also some drawbacks which may need to be considered. The availability of this automatic line of credit to project promoters through the lead agency would definitely reduce the role of the private financial market in financing CSFs. The long-term objective of improving the efficiency and cohesion of financial markets especially for assisted regions would be damaged. Furthermore, the discipline of submitting the project to the independent scrutiny of a private financial intermediary would be lost.⁵⁹ Finally, the need to insist on a

⁵⁹Discipline aspects are teased out more generally in Chapter 3, Section 3.2 above. That discussion implies that among the most attractive programmes for this form of lending are those where the sub-borrowers are public agencies that are not financially autonomous.

government guarantee for programme lending would mean that the implementation of such programmes would add to government or government-guaranteed borrowing at a time when governments need to cut back as much as possible on deficit finance. This last objection on broad principles of public finance discipline could prove to be the decisive one.

It must be recognised that the Bank has considerable experience in dealing with intermediaries through its global loans. Its view as to the ability of the lead agency to administer the programme loan successfully should have considerable weight with the Commission services in considering the appropriateness of a given programme loan. It is quite possible that, in certain circumstances, a lead agency which was perfectly satisfactory for grant administration might not be ideal for loan administration. At the same time, the Bank should not be so rigid as to insist on the lead agency satisfying the Bank's usual banking criteria for a global loan intermediary. Here, and in the matter of programmes with which the Bank is not happy on more general grounds, there needs to be a dialogue between the Commission services and the management of the Bank in achieving a satisfactory outcome.

The main purpose of initiating programme lending would be to meet the political requirement that the CLIs be more closely linked with the CSFs. The likely success of programme lending in achieving a large increase in the volume of CSF-related lending is unclear, though the prospects are good if only because of the convenience for a grant recipient receiving loan finance from the same source. If it is successful, however, one would need to be sure that the substantial increase in lending was not undermining budgetary discipline. At the end of the day, the decision in favour of or against this kind of lending will hinge on the balance of public policy considerations mentioned.⁶⁰

A New Approach to Risk

The role of banks in providing risk capital has been discussed in Section 3.3 above with the conclusion that, despite the risks that have become more evident in recent years, there is some scope for banks to contribute to risk capital, and that the conservative approach adopted by the EIB can be thought of as a rather extreme position. If the EIB were to develop a more active approach to risk, this would require new products and new pricing methods.

⁶⁰In its recent statement of 11 February 1992 "From the Single Act to Maastricht and Beyond: The Means to Match Our Ambitions" the Commission appears to have endorsed the idea of the EIB having credit lines to support the financing of programmes.

To take pricing first: the banker's view regarding pricing of risky loans is diametrically opposed to the development enthusiast's approach. The latter recognizes the considerable chance that any given risky project may not succeed, and looks to the bank to provide low-interest funding to give the project promoter a better incentive to continue with it. The banker, by contrast, will not share significantly in the high profits of a successful project. Accordingly he needs to charge a sufficiently high interest rate to allow for the losses incurred on unsuccessful projects which were unable to repay borrowed moneys. But interest rates cannot be set too high: otherwise too many prudent promoters will be discouraged, leaving the bank, at the limit, with a client-base of reckless or dishonest borrowers. It is not the case that for any project there is an interest rate at which the bank would be willing to lend to that borrower. The banker must find a middle path: he will pitch the interest rate on risky loans somewhat higher than that for secure loans, but in addition he will take steps to refuse the riskiest type of borrower.

Which should prevail, the banker's view or the development enthusiast's view on pricing of risky loans? Ultimately, the pricing policy adopted will be transmitted into the profit and loss account of the bank. Accordingly, if the banker's view is not to be adopted, there must be a subvention to cover losses so that the bank can remain financially independent and responsible for its own profits and loss. But as already discussed, interest subsidies raise considerable problems, and are not recommended. This report therefore sides with the banker's view: development objectives are not best served by inserting interest subsidies.

So the new products if any will require either higher interest rates, or interest subsidies from the Community. This applies to such products as start-up finance and mezzanine finance already identified above as potential risk-niches for the EIB.

An alternative is venture capital. By pooling equity investments in a number of risky projects (in the manner already described in Chapter 3, Section 3.1 above) a risk capital fund can become an acceptable investment even for a cautious bank. One reason is that the capital gains from successful equity investments made by the fund can go a long way to offsetting the losses from the failures. Another reason is that the managers of the risk capital fund will typically become involved in oversight of the strategic management and performance of the projects to a greater extent than is possible for the banker who merely provides a loan. This is obviously a potentially attractive alternative. If linked with the financing of a grant-aided project under the Structural Funds it could also meet the objective, stressed above, of sharing in the benefits of what prove *ex post* to

be over-generous grants. As already mentioned, this route is at present being explored by the EIB, but in what can only be described as a watered-down version, with comparatively little risk being assumed by the Bank. The legal obstacles to a more energetic approach need to be examined with a view to statutory amendments as necessary.

Accepting more risk requires more risk evaluation. This is costly in terms of staff resources, and uses skills that are not at present part of the EIB's tool-kit. While the additional risks may be acceptable in view of the very considerable financial reserves available to it, the Bank could reasonably argue that the administrative costs involved would change its character drastically by moving it much more into the retail lending field. It is hard to avoid the conclusion that financial resources deployed in riskier lending should be administered through one or more separately managed subsidiaries, possibly including joint ventures with the private sector.

By establishing risk capital subsidiaries in the Community's less sophisticated financial markets the Bank could materially contribute to banking know-how. This would happen not only through demonstration effects, but also as a result of the inevitable mobility throughout the banking system of staff that it trained.⁶¹

It is less clear how establishment of risk capital subsidiaries could directly contribute to links between the EIB and the Structural Funds. No doubt some of the beneficiaries of the risk finance would be contributing to the objectives of the CSFs, and some would be benefiting from grant-aid, but the links would tend to be incidental, as at present.

Interest Subsidies

The EIB has in the past, and the ECSC does at present, provide loans carrying interest subsidies for some borrowers. These interest subsidies have not been funded by cross-subsidisation from other borrowers, or out of the capital resources of the institutions, but from budgetary subventions. It would be possible on an administrative and legal basis to envisage an expansion of such subsidies.⁶² The question is: would this be a good idea?

The merits and drawbacks of subsidised interest rates have been discussed above in Chapter 3, Section 3.3. Traditionally seen as an important development instrument, interest subsidies have fallen foul of a

⁶¹The establishment of risk subsidiaries also appears to be endorsed in the Commission's statement of 11 February, 1992.

⁶²And interest subsidies would obviously be welcomed by borrowers, as stressed in the recent study by Ernst and Young, *op. cit.*

sharp shift of opinion in most countries. Many arguments and experiences have been adduced against the idea, and few solid arguments brought forward in its favour.

In the present context a special argument in favour of interest subsidies for CSF-related loans would be the potential to achieve the political objective of a higher volume of CSF-related projects co-financed through Community loans, in accordance with what was hoped for at the time of the Reform of the Structural Funds. Effectively, by transferring a relatively small portion of the Structural Funds for use as interest subsidies, an artificial demand for Community loans would be created.⁶³ There is no doubt that this strategy would be successful in achieving a greater volume of Community lending to CSF-related projects⁶⁴. But it would have unfortunate byproducts of the type discussed in Chapter 3, Section 3.3 including a worsening of rent-seeking, heavier deadweight costs and a distortion of company financial structures.

It is true that promoters of long-term capital investment have been badly hit by high nominal interest rates impinging on their cash-flow before their project was in full production. Lower nominal interest rates in most EC countries in recent years, and even more prospectively as the EMU takes shape, reduce this problem, as do the availability of more sophisticated lending instruments including early years' moratoriums. High nominal interest rates attributable to high inflation were never a good argument for interest subsidy, but only for a restructuring of the time-pattern of debt service payments.

Interest rate subsidies funded by subvention are attractive to the lending banker because they provide him with a ready market for the subsidised loans. The willingness of the EIB to operate an interest subsidy scheme should not be taken in itself as a strong reason for going down this route. The banker who is faced with competition from subsidised interest rates is less enthusiastic about the idea. By giving the EIB a special privileged position, interest subsidies selectively granted to it would nullify its role in promoting improved financial sector efficiency through fair competition.

⁶³A hundred million ECU per annum of budgetary cost would be associated with 3b ECU or more of loans. The transparently cosmetic nature of this leverage must raise some doubts as to its ability to have a lasting political impact.

⁶⁴The exception would be in ECSC regions, where subsidies not tied to CSFs already exist. But see the recommendations for the CSF in Chapter 5, Section 5.3 below.

An EC Loan Guarantee Scheme

Borrowers who are unable to secure adequate guarantees can benefit neither from individual nor global EIB loans. Inability to provide adequate guarantees or other security is a barrier to SME investment and may hold back projects that would otherwise be in line with operational programmes under CSFs. Could there be a case for a Community-sponsored loan guarantee scheme?

The case for and against here contains many echoes of the discussion of risk-finance and interest subsidies above. It is true that lending to SMEs is an area prone to market failure. It might seem that, by pooling a large number of risks the government or another central body could, for relatively little cost, overcome the reluctance of financial intermediaries to lend to individually risky borrowers. But the intervention may be worse than the cure. Centrally administered loan guarantee schemes generally prove to be underpriced in that claims on the scheme outweigh the cost of guarantee charged to the borrower. Because they involve no immediate outlay, such schemes tend to be popular with governments at first. But by removing or reducing the financial intermediary's incentive to screen the borrower, adverse selection sets in and the average quality of loan applicant tends to be low. In short, the loan guarantee scheme usually involves a hidden subsidy.

Recent types of partial loan guarantee in development finance have involved the guarantor taking responsibility for the later interest or amortisation payments⁶⁵. Evaluating the degree of risk involved here is difficult, but it is certainly much higher than a guarantee of a flat proportion of all the servicing.

With loan guarantees, the less financially successful the project is, the higher the subsidy that is eventually paid. Accordingly, a loan guarantee scheme could be targeted at projects falling within the scope of the CSFs would represent a significant breach of the ceilings adopted for the percentage of project cost to be grant-aided.

"Development Banking"

The achievement of economic cohesion requires many of the same types of improvements as have been sought in respect of the Third World for many years by development institutions. Spearheaded by the activities of the World Bank, "development banking" has become a well-known, though somewhat loosely defined, concept. In the present context we understand it to mean an approach to lending which goes beyond the

⁶⁵Cf. Richard Kitchen, "Some Experiences from Developing Countries", paper prepared for EC Commission Seminar, May 1991.

traditional functions of the banker to include the identification of promising projects or programme areas – even going so far as to become effectively a co-promoter - and close preparatory work with promoters to ensure appropriate technical specification.

This kind of activity is of course very expensive in terms of staff time. For example, the World Bank's staff is much larger than that of the EIB⁶⁶ even though it lends roughly the same amount. The correspondingly higher interest margins charged by the World Bank make it unattractive as a source of funds to the more successful of the developing countries. For non-sovereign borrowers in the less-developed parts of the EC, however, higher interest margins could be envisaged for loans which were supported by this kind of intensive preparatory and pre-appraisal work.

In its activities in non-EC countries, the Bank's staff already have some experience of this kind of work. That experience could be built upon and applied in Objective 1 regions where project development has been a bottleneck in bringing projects under the CSFs to completion, or even to the stage where they could be appraised in the normal way for an EIB or other loan.

Admittedly, the principle of subsidiarity requires that project identification and pre-evaluation be carried out generally at the national or regional level. It would appear to rule out heavy involvement of the EIB in this work across the Community. But there are said to be parts of Greece, Portugal and perhaps other countries where the administrative capabilities are not sufficient to push the needed projects forward.

Perhaps the best approach on this front would be to target regions of special need and place a task force in operation to work in the context of the CSFs to identify and develop projects under the CSFs. In the first instance two task forces could be set to work, one in Greece and one in, say, Portugal. Each task force would be led by EIB staff, in consultation with the Services of the Commission. It would be assigned a particular sectoral focus and the members of the task force chosen for their relevant experience. The EIB has occasionally made special efforts in the past to generate loan business in target areas. This initiative would differ from previous efforts in the amount of preparatory work budgeted: this task force would have the resources to work on projects that were much less advanced than is the norm for the Bank. Furthermore their task would be defined, not by the objective of generating loan activity, but by reference to the objectives of the Structural Funds. The projects identified would have to be eligible for Structural Fund financing.

⁶⁶More than 6,000 compared with just about 750 at the EIB.

The objection may be made to this proposal that the difficulty of getting projects under way in certain regions is often political as much as technical in nature, and that a task force would be of little avail against political problems. The capacity of an EIB task force to overcome the barriers, whether administrative, technical or political, should not be overestimated; nevertheless it would not be negligible.

Better Institutional Links with the Structural Funds

At present, the EIB may be represented on each of the CSF organising committees. In practice, it is absent more often than not. The ECSC is kept informed of CSF activities, but it too is rarely physically present at organising committee meetings. In fact, neither organisation could possibly cover the enormous number of committee meetings that are involved in the CSF process, given staff resources, and given the relatively small results which they would anticipate in terms of loan activity. How could this impasse be resolved. Is there some practical way of establishing stronger organisational or institutional links between the CSFs, on the one hand, and the EIB and the ECSC on the other?

One suggestion is that targets could be set for both the EIB and the ECSC for their co-financing of projects being grant-aided under the CSFs. This would have the merit of focusing the attention of EIB loan officers on CSF projects and presumably this might make it easier for promoters who have not been able to obtain loan finance to get the attention of EIB or ECSC staff. Some project promoters may not be sufficiently aware of the EIB and ECSC loan facilities, some will not have the ability to present their project proposal in a manner which would normally be required to meet EIB and ECSC demands. However, bearing in mind that these would be small-scale borrowers and that EIB and ECSC assistance to small borrowers is exclusively through global loans, this idea could be effective only to the extent that the CLIs started to make individual loans to small promoters. This target or quota approach would be strongly resisted by the EIB management as interfering materially with the independence of their banking judgments. On the whole it does not seem a very promising route.

An entirely different type of institutional link could come through greater integration of appraisal techniques. We do not recommend using EIB project appraisal abilities directly in evaluating projects for grant-aid. This would be a major diversion of EIB resources into supporting the Commission in a function which should be substantially devolved according to the principle of subsidiarity. But we do think the EIB's experience with project appraisal could be used on a one-off basis to make an intensive effort to improve project appraisal procedures built-in to the new round of CSFs.

This would also divert some staff resources from normal EIB work, but would potentially be of very considerable longer-term value. It would call for a more structured and active participation of the EIB economic appraisal services in helping to build-up an appraisal capability for the Structural Funds. As already indicated in Chapter 4, Section 4.3 above there seems to be a need for better appraisal procedures both of the "broad" type, designed to judge which are the most advantageous areas for policy initiatives under CSFs (e.g. ranking operational programmes) and the "narrow" type (choosing among projects within an operational programme). In the latter case the need is for decentralised procedures which can be readily checked by the Commission.

As the most experienced organisation in carrying out appraisals of infrastructural projects on EC-wide basis, the EIB is well-placed to help the Commission to design procedures of both types for the coming round of CSFs. EIB experts could help design procedures to help the Commission and the national and regional authorities in choosing between programmes at the design stage of the CSFs. They could also design semi-formal procedures to be applied by lead agencies in choosing between potential projects under the programmes. Formal appraisal procedures will certainly never take over the business of policy-making entirely, but they can simplify and organise it.

In helping in this design effort and in its early implementation, the EIB staff would inevitably become more involved in the Structural Fund area and more aware of the financing needs and opportunities, and of the EIB's ability to supply these. A useful synergy could result.

Business Advisory Services

Financing gaps for viable projects in assisted regions are partly attributable to lack of business and financial skills in SMEs wishing to prepare financing proposals. Local banks may also lack the necessary skills for evaluating longer-term loan proposals. Consideration should be given to assisting, with grant-aid from the Structural Funds, business advisory services and banker training facilities in regions where this is a problem.⁶⁷

One of the functions of the business advisory service would be to provide an improved flow of information between CSF projects and the EIB and ECSC lending facilities to ensure *inter alia* that eligible projects did not forgo needed loan assistance through ignorance of its availability.

⁶⁷Some practical recommendations for this have already been provided by Ernst & Young (*op. cit.* pp. xxxi-xxxii).

5.3 The ECSC

ECSC lending activities were not examined in detail: they are driven by the special mandate of the ECSC and are hard to categorise within overall Community policy, though the conversion loans which account for one-half or more of the lending and the bulk of the interest subsidies are designed to create employment in depressed areas just like other lending and grants in Objective 2 regions. Some of the considerations already advanced against the use of interest subsidies seem to apply with considerable force to the ECSC conversion loan subsidies. In particular, it is unlikely that the ECSC interest subsidies, totalling in most cases no more than about 6-7 per cent of the present value of the loan, really make the difference between a project going ahead and not, especially when one notes that intermediaries interviewed for the Court of Auditors' study declared that they would not have allowed the existence of the subsidy to influence their judgement as to the creditworthiness of borrowers.

It has been argued that the ECSC is like a club, narrower in focus than the Community in general, raising levies on its members and spending the proceeds for their benefit. From that perspective, the ECSC interest subsidies are not something which should be integrated into overall Community policy. Whatever about that, it has to be acknowledged that the new regulations allow ERDF funds to be used for some of these interest subsidies now. Furthermore, the benefits (if any) of the subsidies hardly go to this club in any narrow sense: only 1 in 15 of the jobs said to be created through ECSC loans went to former ECSC workers.

So far as unsubsidised conversion loans are concerned, they should continue to be further integrated into the CSF process as foreseen by the 1990 operational rules. But the inevitable corollary of previous discussion is that the extension of interest subsidies, foreshadowed in the operational rules, to be financed out of the Structural Funds is inadvisable. This provision should therefore be reconsidered. It is desirable that there should be ready access to ECSC loans for qualified CSF projects. However, as with the EIB, it seems difficult to justify restricting the use of global loans to CSF-supported projects, and the emphasis should instead be on an information campaign to ensure that the existence of ECSC financing through global loans is available. In addition, the use of lead agencies as intermediaries for programme loans, as already described for the EIB above, and as also provided for - at least in outline - in the operational rules, could be considered more actively by the ECSC.

Given that the general function of unsubsidised ECSC conversion loans is almost identical to that of other regional development lending to Objective 2 regions, it is natural to ask whether a separate administration

of these loans is warranted. The duplication of effort is hardly significant so long as the subsidised loans remain in place under ECSC funding. If and when interest subsidies are phased out in the ECSC, it will seem natural to transfer responsibility for this type of global loan to the EIB. The suggestion that these loans should thereafter be administered by the EIB need not imply any change in respect to Article 54 loans, the policy for which is not being reviewed here.

5.4 Conclusion

In contrast to the situation which prevailed when it was founded, the EIB is now only one of a variety of alternative providers. This is clearly the case for large borrowers, whether in the public sector or not, and is also true of most small beneficiaries in that they access EIB funds only through intermediaries in the "global loans". Many of its borrowers have alternative possible sources of funds at similar interest rates and even at similar maturities. As the efficiency of financial markets in Member States improves, a process that will be accelerated by the completion of the Internal Market and progress towards EMU, the role of the EIB in achieving Community objectives will tend to become less central. For the immediate future, however, the EIB remains a force for promoting cohesion through enhanced competition and efficiency in the lagging financial markets.

Closer links can be forged between the lending institutions and the Structural Funds, and that this can best be done by building on existing institutional strengths as well as by promoting certain types of co-operation between institutions so that each can benefit from the strengths of the others.

Guiding our attempt to achieve a closer link between Community loans and the Structural Funds has been a methodological framework setting out the respective functions of loan and grant finance. This framework, drawing on the theory of financial structure points to the risk-sharing and discipline or incentive effects of various forms of financing. Previous approaches to the grant-loan mix for Structural Funds have taken no cognisance of these aspects.

The question: "In what proportion should loan and grant finance be provided for development projects?" has already been addressed by the Commission and the EIB. A schedule of maximum rates of grant assistance has been established limiting Community grant aid, with the ceilings being established according to the location of the project and its potential to generate revenue. This schedule was mainly designed to ensure that limited grant finance was spread as widely as possible, and was not greater than necessary to ensure that the project went ahead.

The grant-loan mix schedule does not dictate a minimum amount of matching Community loans. Nor should it. Our proposal is that this question of grant-loan mix be rephrased to ask: what financial structure offers the best risk-sharing and incentive effects? The feasibility of two concrete though radical suggestions in this field should be explored. First, a procedure of auctioning grant-aid among rivals' projects and programmes could be instituted, perhaps in association with the loan appraisal abilities of the EIB. Second, revenue-sharing or similar arrangements could be put in place to allow the Funds to benefit from unexpectedly good returns in revenue-generating projects.

We have considered possible initiatives under a number of headings. These include the introduction of programme lending to complement the Bank's traditional emphasis on project lending, a more aggressive approach to evaluating, pricing and accepting risk, subsidised lending, the idea of an EC loan guarantee scheme, greater use of EIB's human resources in project identification and project promotion, closer institutional involvement by the EIB in the preparation and implementation of the next round of CSFs, and the subsidisation of business advisory services designed to ensure that small project promoters can benefit from available loan finance.

Despite the rapid development in financial markets in all Community countries, there are still gaps and the exercise of monopoly power. By providing long-term funds and competitive rates even in the less competitive markets the EIB promotes cohesion by maintaining a degree of pressure on private intermediaries. This pressure has, however, been confined to the segment of the market relating to long-term guaranteed borrowing.

There is no need for, and considerable arguments of principle against, an expansion in the use of subsidised loans in tandem with grant-aid for the Structural Funds. Interest subsidies have in general proved to be more prone to implementation difficulties than capital grants: they are much less likely to achieve the envisaged goals. An additional specific objection would arise if interest subsidies were tied to EIB or other CLI loans as that would distort the competition between financial institutions in the Community, discouraging private intermediaries from developing long-term lending by locking-in many borrowers into the EIB and the other CLIs. The establishment of an EC loan guarantee scheme would be subject to similar criticisms.

Much has been made of the dichotomy between the programme approach, adopted by the Structural Funds, and the project approach to lending traditionally used by the EIB. Critics of the EIB blame the lack of a

closer involvement with the Structural Funds on this dichotomy; and the EIB appear to accept this argument, responding that their mission as a financial institution requires them to be project lenders. We argue that the dichotomy as presented is not as relevant as it might seem.

In fact the idea of opening a programme window at the EIB deserves serious consideration. This would involve the lead agencies of selected Operational Programmes (under CSFs) being accorded a block loan by the EIB (subject as usual to government guarantee) for onlending to projects within the Operational Programme. Arguments have been presented on both sides here. In favour of the idea is the political requirement to have a closer tie-in between Community loans and grants. Properly designed, programme lending would not damage the other operations of the EIB, and in some instances would not be too different from project lending, especially if closer EIB involvement in the preparation of the next round of CSFs (and the operational programmes) allows them to approve loans under these programmes more readily than was the case in the first round. The strongest arguments against programme loans draw attention to the fact that they could become essentially a new EIB facility lending to Member States or regional authorities for general purposes. These arguments raise wide questions concerning fiscal discipline which seem to go beyond the scope of this study.

Preliminary ideas in the direction of using EIB funds more adventurously are to be welcomed. The size of EIB's reserves are ample to absorb even considerable risks, and modest allocations for risk-capital would not begin to exhaust the financial resources available in the Bank's balance sheet. Unfortunately, initial ideas here have had to be watered-down considerably to satisfy statutory requirements: it appears that a change in the statutes of the EIB will be necessary if it is to make a more worthwhile contribution to risk-finance. Among the market niches which the EIB could explore in the context of a more adventurous approach to risk would be the provision of second-tier, subordinated or mezzanine debt, of a riskiness appreciably greater than its existing portfolio. Even though it should bear a higher rate of interest, to compensate the Bank for the higher risk, such lending could be of considerable development assistance in the backward regions, as these are also the regions where the private financial system is at present unable or unwilling to provide such assistance. Support for business advisory services could also help project promoters to benefit from available sources of loan finance.

ECSC lending activities were not examined in detail: they are driven by the special mandate of the ECSC and are hard to categorise within overall Community policy. Their key component, subsidised lending for

conversion, is mainly administered through global loans, and is thus necessarily not subjected to a very detailed or rigorous economic appraisal despite the fact that interest subsidies are payable. These loans do not necessarily fit into CSFs, even though they absorb subsidies. Clearly, larger issues - going beyond the terms of reference of this study - are involved in the ECSC operations and they should not be used as a model for the EIB. Furthermore we question the use of ERDF funds for these subsidies, as is now allowed. In attempting to ensure access to (unsubsidised) ECSC global loan funds for qualified CSF projects, the emphasis should be on an information campaign in the relevant areas. The ECSC could also explore the possibility of using lead agencies of selected Operational Programmes under CSFs as intermediaries for programme lending as discussed above for the EIB, and as already provided for in the operational rules.

The EIB's strengths in economic and technical appraisal and the accumulated expertise of their staff in industrial and especially infrastructural investment in Europe should be used as the basis for a two-pronged initiative. First, the development of the next round of CSFs should include a more rigorous and considered ranking of priorities. The role of the EIB in assisting in this activity should not be confined to identifying possible demand for its loan facilities. Instead EIB officials should be full members of the CSF teams and have as their special remit ensuring that these plans are drawn up in a manner which allows specific projects to be easily assessed for consistency with criteria of economic efficiency. Second, in order to overcome bottlenecks in project identification and project development in backward regions, the EIB should form one or more task forces to be sent to work in co-operation with national and regional authorities in targeted regions (Greece would be a priority) in attempting to get projects off the ground. (There is a parallel here with the EIB's own proposals to have earlier and closer involvement in certain infrastructure projects of European interest.) Meeting these new tasks will involve more work for EIB staff, and presumably will call for a modest and progressive increase in staffing to allow for this. However, inasmuch as the intention is to build on existing expertise, such an increase would have to be a gradual one only.

Annex

OBSERVATIONS ON THE FINANCIAL STATEMENTS OF THE EIB.

A.1 Balance Sheet

The EIB had a total balance sheet size of 74.3b ECU at end-1991. A summary of the 1991 balance sheet is given in Table 10. Of the total assets some 66b ECU represented loans. There is a further 6b ECU in off-balance sheet loans – the so-called Special Section – managed by the EIB for the account of the Community and of others under the NCI and Euratom as well as for various loans outside the Community. These totals clearly indicate the large size of the EIB as a long-term credit bank. It is, however worth bearing in mind that these sums are dwarfed by the balance sheet sizes of the world's largest commercial banks. The largest of these, the DKB of Japan, had an end-1989 balance sheet of \$415 billion, compared with just \$60 billion for the EIB. Indeed, the largest banks in each of the UK, France, Germany, The Netherlands, Italy and Belgium have bigger total balance sheets than the EIB.

The rapid recent growth of the EIB is also noteworthy, with the balance sheet total jumping by almost one half in the 3 years from end-1987, when the balance sheet total was less than 43b ECU. The potential for further growth has been put in place through the doubling of the subscribed capital as from the first day of 1991. According to the EIB's statute, the total of loans and guarantees must not exceed 2.5 times the subscribed capital; the new capital lifts this ceiling to 144b ECU, allowing a headroom of over 82b ECU over the existing stock of loans and guarantees. The Bank itself anticipates further rapid growth sufficient to exhaust this by 1995.

The growth has been achieved with the assistance of 15.5b ECU of new loans in 1991. Although widely employed as the "headline" figure for measuring EIB activity, these gross new lending figures must be interpreted with care. For instance the 15.5b shrinks to 11b ECU when loan repayments are taken into account.⁶⁸ Still, even the smaller figure is appreciable.

⁶⁸Commercial banks do not use figures for new loans granted because of the predominantly revolving nature of their funds; the practice is meaningful at all only for long-term credit banks such as the EIB.

Community borrowers are predominant in the loan portfolio: almost 95 per cent by value at end-1989 for the on-balance sheet loans and 80 per cent for the Special Section.

Table 10a: *EIB Summary Balance Sheet at End-1989*

<i>Assets</i>		<i>Liabilities</i>	
Receivable from member states (1)	686	Paid-in capital	2,596
Cash	2,090	Statutory Reserve (5)	2,880
Investments	1,206	Additional Reserves	2,221
Borrowing proceeds to be Received	496	Other Provisions (6)	175
Loans Outstanding (net)	47,672	Payable to member states (1)	19
(total outstanding) 53,288		Short-term Notes	988
(less undisbursed) 5,616		Medium and long-term borrowings	41,332
Accrued Interest	1,319	Accrued Interest	1,537
Special Deposits (2)	781	Bonds and Coupons Due	781
Interest Subsidies (3)	164	Interest Subsidies (3)	573
Land and Buildings	36	Balance of P & L Account 1989	808
Other (4)	560	Other (including sundry creditors)	1,090
Total	55,010	Total	55,010

(1) On account of called capital or adjustment of capital contributions

(2) Held against bonds and coupons due and not yet paid.

(3) Receivables for interest subsidies paid in advance and liability for interest subsidies received in advance.

(4) Including unamortised issuing charges.

(5) 10 per cent of subscribed capital.

(6) Fund for Staff Pensions and for ECU rate adjustments.

Source: *EIB Annual Report*.

Table 10b: *EIB: Summary Balance Sheet at end-1991*

<i>Assets</i>	<i>1991</i>	<i>Liabilities</i>	<i>1991</i>
Receivable from Member States	829	Paid-in-capital	4321
Cash and deposits	2968	Statutory reserve	5635
Investments	2163	Additional reserves	0
		Other provisions	155
Loans outstanding (net)	65715	Payable to member states	4
(total outstanding) 72343		Owed to credit institutions	220
(less undisbursed) 6628		Debts evidenced by certificates	58893
Prepayments and accrued income	1911	Accruals and deferred income	2598
Interest subsidies	118	Interest subsidies	404
Tangible assets	35	Balance of P&L account	1083
Other	552	Other (incl sundry creditors)	978
Total	74291	Total	74291

Source: EIB Annual Report

A.2 Profit and Loss Account

The EIB borrows wholesale long-term funds at very keen rates and on-lends these to borrowers at a small margin (15 basis points) over marginal cost. The shareholder governments do not receive dividends on their investment in the Bank; as a result a considerable reserve has built up over the years - amounting at end-1991 to 14.9 per cent of the total balance sheet, or 16.8 per cent of the loan portfolio. Far from being "non-profit-making", as the Bank's publicity material suggests, it is in fact one of the more profitable large banks in the world, with 1991 net profits of 1.5b ECU, or almost 1.5 per cent of total assets at end-year.

The profit and loss account of the EIB may be analysed by comparison with that of large commercial banks to see in what way its financial position differs from the norm. Following conventional practice, and drawing on the studies published by the OECD,⁶⁹ we consider in turn the net interest income, other (non-interest) income, operating costs (including staff costs), and provisions against loan-losses and for depreciation. These are the elements contributing to net profit, which in turn may be assigned to taxation, distributions and retained earnings. This kind of comparison

⁶⁹OECD: *Profitability of Banks*, Paris: 1987.

involves using an aggregate of data from many countries where different accounting and banking conventions and practices apply.⁷⁰ Despite the potential difficulties of interpretation that this presents, a coherent and reasonably reliable picture emerges.

The results of our calculations are presented in Table 11. The net interest income of the EIB, at about 1.67 per cent of total assets, is rather less than the average for large banks in the industrial countries (2.42 per cent). The difference is explained in terms of three different factors affecting the cost of resources and rates of interest charged. First, all of the large banks against which the comparison is being made have low-interest sources of deposits (such as current accounts). Second, commercial banks can and do charge higher interest rates to less-than-prime borrowers to take account *inter alia* of the risk of loan-losses. These two factors tend to result in their net interest income being rather high. Note, however that low-interest deposits may not be low-cost overall to a bank, as they generally necessitate the provision of costly services such as branches and money-transfer facilities. Furthermore, as will be seen below, higher interest earnings attributable from riskier borrowers are largely offset by the need to make provisions against loan-losses. Third, a partially offsetting factor for the EIB is the fact that it benefits from its high capitalisation.

Non-interest income for the EIB is rather small, reflecting the fact that it does a comparatively small amount of business not related to the earning of interest. Thus, this item averages 0.07 per cent of total assets for the EIB compared with 1.12 per cent for the sample of commercial banks.

The apparent advantage of commercial banks in both net interest and non-interest income is, however more than completely eroded by the much higher operating expenses and loan-loss provision which they incur. Thus, compared with operating expenses of about 0.16 per cent for the EIB, the average commercial bank incurs 2.33. The EIB's operating costs are thus extremely low, given the size of the balance sheet. These lower costs reflect the fact that the EIB is a wholesale concern and that it does not provide significant fee-based services compared with the typical large commercial bank. Conversely, the higher operating costs incurred by the commercial bank reflects the costs of its activities in collecting low-interest deposits and in earning non-interest income.⁷¹

⁷⁰There is also the point that nominal interest rates differ substantially from one currency to another: the use of net interest should minimise this difficulty.

⁷¹The fact that EIB is not liable for VAT in certain respects cannot materially affect the comparisons being made here as the VAT would relate chiefly to these very small operating costs.

Table 11: *Components of Profit and Loss Account: EIB and Large Commercial Banks*

Percentage of Total Assets	Commercial Banks			EIB			
	A	B	EIB Average 1986-89	1986	1987	1988	1989
Interest income	8.03	8.59	8.70	8.95	8.55	8.59	8.70
Interest expense	5.51	6.31	7.03	7.34	6.97	6.91	6.89
Net interest	2.52	2.42	1.67	1.61	1.58	1.68	1.80
Non-interest income	1.39	1.12	0.07	0.10	0.08	0.07	0.03
Operating expenses	2.41	2.33	0.16	0.17	0.16	0.16	0.15
Provisions (net)	0.70	0.58	0.01	0.01	0.01	0.01	0.01
Profit before tax	0.80	0.63	1.57	1.53	1.49	1.58	1.67
Income tax	0.29	0.23	0	0	0	0	0
Profit after tax	0.50	0.36	1.57	1.53	1.49	1.58	1.67
Distributed profit	0.21	0.17	0	0	0	0	0
Staff costs	1.52	1.35	0.14	0.14	0.14	0.13	0.13

Commercial banks figures are drawn from the OECD study for 1986.

The data are for large banks where these are available separately.

"A" refers to 16, "B" to the 7 largest countries; simple average across countries.

The EIB makes no explicit loan-loss provisions. This may be justified by the guaranteed nature and essentially unblemished performance of its portfolio. Lacking a branch network, depreciation on the EIB's assets comes to only 0.01 per cent. In contrast, the average commercial bank needs to set aside 0.58 per cent for these items.

The net result is a higher rate of profit (share of total assets) for the EIB at 1.57 per cent than for the average commercial bank at 0.63 per cent. Considering the fact that EIB's capitalisation is probably between 2 and 3 times as high (share of total assets) as that of the average commercial bank, this probably reflects a rate of profit on paid-up capital and reserves which is no higher than that for the average bank. To help interpret this, suppose an additional sum equivalent to, say, 9 per cent of total assets had to be borrowed at about 10 per cent (instead of being available from accumulated reserves). In such circumstances the EIB's profit would fall to about the same share of total assets as the average bank. It seems fair to say that the profitability of the EIB is broadly commensurate with its high capitalisation.

The EIB's profit is not subject to income tax (the average bank pays 0.23 per cent of total assets), and the total profit is added to reserves. No distribution of profit is made, resulting in the large accumulation of reserves that has been noted.

The main differences between the EIB and the average bank can thus be described as follows:

- Higher capitalisation means higher profits as a per cent of total assets but not necessarily as a per cent of shareholders' funds employed.
- Very low operating expenses for EIB are associated with and offset by its higher average cost of borrowed funds and low non-interest earnings.
- There is little evidence of subsidisation coming either from tax exemptions or the failure to pay dividends; VAT would only apply to the very low amount of operating expenses, and any subsidy from absence of income tax and dividends should show up in the form of reduced profits as a per cent of shareholders' funds employed.

Thus, we conclude that the various positive factors contributing to EIB cash flow (no distributions despite very high capitalisation, low operating costs, low provisions) are not obviously passed on in lower lending rates. Indeed, this is confirmed by the general observation that, abstracting from risk-premia and handling costs for small borrowers, EIB lending rates are not materially different to that of large commercial banks.

A.3 The Reserves

The size of the capital and reserves of the EIB has already been alluded to. Part of this represents paid-up capital and an approximately equal part the statutory reserve fund which, in accordance with statute, is built up to 10 per cent of the subscribed (i.e. paid up and callable) capital. There is also an "additional reserve" amounting to almost 1b ECU at end 1992. Finally, the unallocated balance of the profit and loss account can be included in a global figure for capital and reserves which will exceed 12b ECU at end- 1992. Total capital and reserves are thus more than ample in banking terms to allow for the risks involved in the Bank's present lending strategy.

Table 12: *EIB Growth in Reserves*

<i>End-year in m ECUs</i>	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992 ^p
Paid in capital	1,466	1,466	1,466	1,466	2,596	2,596	2,596	2,596	2,596	4,321	4,321
Statutory reserves	1,250	1,440	1,440	1,440	2,880	2,880	2,880	2,880	2,880	5,635	5,760
Additional reserves	0	173	561	1,001	332	911	1,544	2,221	3,086	0	959
Prov for ECU rate adj	11	15	20	15	16	13	30	57	0	0	0
Total reserves	1,261	1,628	2,021	2,456	3,228	3,804	4,454	5,158	5,966	5,635	6,719
Operating surplus	363	393	440	487	579	633	727	871	894	1,083	1,100
Exceptional profits	0	-5	0	39	0	0	-50	0	0	0	0
Added to next reserves	363	388	440	560*	579	633	678	864	894	1,083	1,100
Total capital and reserves	3,090	3,482	3,927	4,482	6,403	7,033	7,728	8,618	9,456	11,039	12,140

* Includes 45m in contributions by new member states to the 1985 p&l balance;

In addition the new members paid 212m to reserves and provisions.

1991 paid-in-capital includes transfer from reserves of 1225m.

p = projection

Source: *EIB Annual Reports*; own calculations.

Could these reserves be used to greater benefit than simply to the generation of further profits and ultimately to the accumulation of even larger reserves? Apart from financing even more rapid asset growth, a number of alternatives are possible.⁷² They could, for example, be returned to the shareholders by way of dividend,⁷³ or passed to form the nucleus of a Community-wide fund for some quasi-budgetary purposes. Finally,⁷⁴ a portion of the reserves could be invested in one or more risk capital funds, as discussed in the body of the report.

⁷²There are two ways of looking at this, one is the statutory point of view, and here, following the capital increase of 1991, and the use of the additional reserve to augment the paid-in portion, reserves at end-1991 were slightly below the statutory 10 per cent of subscribed capital target. However, this still leaves ample scope in pure banking terms for greater acceptance of risk than is the case at present (assuming statutory changes where necessary).

⁷³The use of the additional reserves to constitute the greater part of the latest capital increase was somewhat analogous to a dividend distribution.

⁷⁴And more in keeping with the mission of the Bank.

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