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Article

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Jorge Núñez Ferrer*

Financial Instruments and Promotional Banking in the EU are Growing – But is this Justified?

Institutions and the European Investment Bank are at the forefront of EU investment policy. Their role is expanding and it is now a widely-held position that an improvement in the economy will not eliminate the need for their intervention. The proposals for the 2021-2027 MFF launch more financial instruments and present 'InvestEU' as a larger more powerful version of the European Fund for Strategic Investments (EFSI). However, promotional banking is often misunderstood and so is the actual size of promotional banking in Europe in which InvestEU will operate.

This article brings together the research by the author in a forthcoming research study for the European Investment Bank (EIB)¹ and for the European Parliament² focusing on the role of the EIB and promotional banking at the national level. The literature on public promotional banks and institutions is surprisingly scant and the EIB is by far not the only relevant or major player. With the creation of the European Fund for Strategic Investment (EFSI) and the recent proposal of InvestEU for the next Multiannual Financial Framework (MFF) aiming at mobilising 650 billion euro with a stronger role for national promotional banks and institutions (NPBI),³ it is important to better understand the landscape of promotional banking in Europe as well as its strengths and limitations.

* This represents solely the opinion of the author and does not necessarily represent the views of CEPS or any other institution.

- 1 J. Núñez Ferrer: The role and coordination of investments by the European Investment Bank and National Promotional Banks and Institutions in the European Union – An efficient governance model for EU financial instruments, forthcoming CEPS Research Report, 2018.
- 2 J. Núñez Ferrer, D. Rinaldi, A. Thomadakis, R. Musmeci, M. Nesbit, K. Paquel, A. Illes, K. Ehrhart: Financial Instruments: defining the rationale for triggering their use, Study for the Policy Department on Budgetary Affairs, European Parliament, 2017.
- 3 European Commission: Proposal for a Regulation of the European Parliament and of the Council establishing the InvestEU programme, COM (2018) 439 final, 2018.

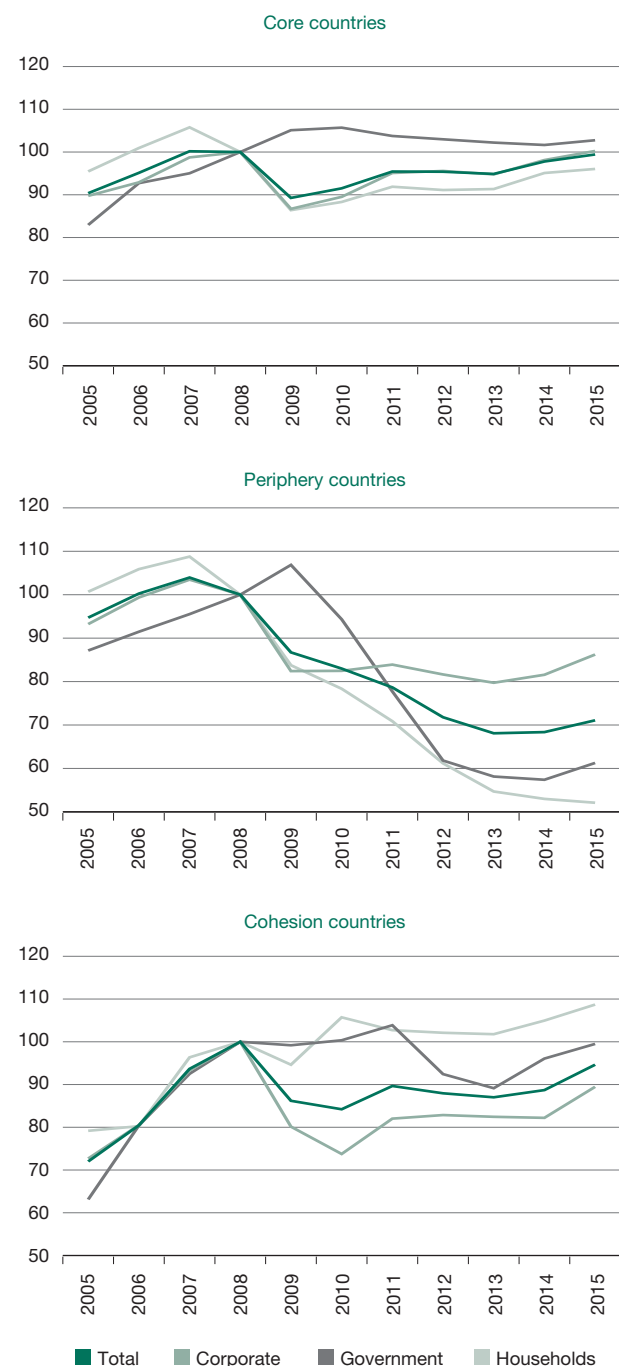
The financial crisis which hit the EU in 2007 led to a rapid reduction in private and public investments, in particular in infrastructure, small and medium-sized enterprise (SME) finance and innovation. This is clearly illustrated in Figure 1, which shows the level of investment across sectors by type of investor and Figure 2 on the evolution of the investment rate for infrastructure in the EU. The drop in investment has varied between country groups, being particularly strong in the periphery and 'cohesion' countries, whereas more developed member states did not see such strong declines and were able to quickly reverse the negative trend.⁴

The economic and financial crisis added to the more restrictive Basel III banking supervision rules and have led member states to seek support from national promotional banks and institutions (NPBIs) and the EU institutions from the EIB. The former was partially driven by the need to reduce spending and the ability of member states to use promotional banking as a means to promote investment but spread the costs to the exchequer over time. It does not reduce the budget deficit and it affects debt as it becomes a state liability, but it avoids having the actual expenditure undertaken on the specific year. There was a perceived need for a pan-European stimulus package, and the EU budget was too small to provide it. The Commission extended the EU budget equity and guaranteed increasing the size of the financial instruments. It

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4 European Investment Bank (EIB): Investment and Investment Finance in Europe. Financing productivity growth, 2016.

Figure 1
Gross fixed capital formation (GFCF) by institutional sector, index (2008 = 100)



Note: GFCF is reported in current prices in the sector accounts. A GFCF-specific deflator is used to compute the series in 2010 prices.

Sources: European Investment Bank: Investment and Investment Finance in Europe. Financing productivity growth, 2016. J. Núñez Ferrer: The role and coordination of investments by the European Investment Bank and National Promotional Banks and Institutions in the European Union – An efficient governance model for EU financial instruments, forthcoming CEPS Research Report, 2018.

ultimately created the EFSI and recently extended it.⁵ The expectation is to leverage funding from the EIB Group, the European Investment Fund (EIF) and other public or private financial institutions to 500 billion euro by 2020. The EU proposes to continue with the new InvestEU instrument in the next MFF, aiming to leverage 650 billion euro.

It seems that the countercyclical intervention in response to the crisis is not the only driver of investment activity, nor is it the key motivator for the InvestEU proposal. The argument is that some of the underlying weaknesses in investment in several of the economy's key areas predated it. The economic downturn exposed accumulated and well-documented investment gaps. Shortcomings were already prevalent in several areas including the SME sector, public infrastructure, research and innovation as well as in the areas of climate mitigation and adaptation.

There seems to be a case for continued involvement of publicly supported financial solutions. The operations of the EIB Group and NPBIs are thus unlikely to go back to a pre-crisis level. But is this expectation based on solid rationale? The debate revolving around EU-supported financial instruments and the NPBIs often lacks a solid analysis and understanding of the institutional and economic rationale.

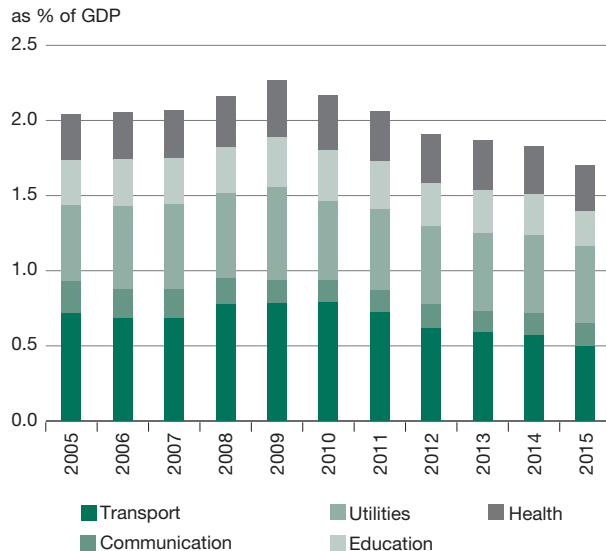
The Statute of the EIB defines its core objective which is to “grant finance, in particular in the form of loans and guarantees to its members or to private or public undertakings for investments to be carried out in the territories of member states, to the extent that funds are not available from other sources on reasonable terms”.⁶ In other words, the EIB Group's role is to support bankable projects aligned with the objectives of the European Union that would not have been possible to the same extent without public support.

The NPBIs do not have a single and clear role, and their mandates and operations are very heterogeneous. The European Commission defines NPBIs in the European Fund for Strategic Investments (EFSI) regulation as “legal entities carrying out financial activities on a professional basis which are given a mandate by a member state or a

⁵ Regulation (EU) 2017/2396 of the European Parliament and of the Council of 13 December 2017 amending Regulations (EU) No. 1316/2013 and (EU) 2015/1017 as regards the extension of the duration of the European Fund for Strategic Investments as well as the introduction of technical enhancements for that Fund and the European Investment Advisory Hub, in: Official Journal of the European Union, L 345, 27 December 2017, pp. 34-52.

⁶ Statute of the European Investment Bank, Article 16, 2013, pp. 15-17.

Figure 2
Infrastructure investment in the EU



Note: Belgium, Croatia, France, Greece, Lithuania, Poland and Romania are excluded from the analysis due to missing datas.

Sources: European Investment Bank: Investment and Investment Finance in Europe. Financing productivity growth, 2016. J. Núñez Ferrer: The role and coordination of investments by the European Investment Bank and National Promotional Banks and Institutions in the European Union – An efficient governance model for EU financial instruments, forthcoming CEPS Research Report, 2018.

member state's entity at central, regional or local level, to carry out development or promotional activities".⁷

The expansion of the EIB Group's operations with assistance from the EU budget has brought more of these operations under EU budgetary control, as well as into closer contact with the policy and governance procedures of the EU. This raises the spectrum of a stronger politicisation of both EIB operations and NBPI operations.

This article presents the landscape of promotional banking in the EU and focuses on the future rationale of the EU-level financial instruments supported by the EU budget.

A review of public promotional banking

As mentioned in the introduction, the emergence of a stronger public banking sector is not only the result of a need to respond countercyclically to an economic slump.

⁷ Regulation (EU) 2017/2396 of the European Parliament and of the Council ..., op. cit.

Surprisingly, despite their size, the NPBI are rarely analysed in academic literature. Research is available on the EIB operations in the context of recent studies financed for the EU institutions due to its increasing operations backed by the EU budget.⁸

Extensive research points out that the NPBI and EIB Group are moving beyond 'fixing market failures' to fostering market creation.⁹ However, not all of the papers see this behaviour and the rise of public banking positively.

Mazzucato and Penna as well as Griffith-Jones and Cozzi present the rise of sustained public investment as a necessary response to the realisation that private markets cannot provide a socially optimal outcome.¹⁰ The private sector will not cater to the long-term investment and public goods needs of society by itself. Public support for infrastructure or research with a high public goods value is essential to the private sector. Valla et al. produce evidence for the positive impact of public investment on growth, demonstrating that the higher the level of public investment, the larger the long-lasting positive GDP impact compared to other fiscal instruments.¹¹ Table 1 shows the fiscal multiplier estimations for the euro area in the long run: the fiscal multiplier for public investment amounts to 1.46 for each euro invested, compared to 1.38 for government consumption and 0.89 for social transfers. Public financial institutions are particularly promising for crowding in private investors to cover the

⁸ Such as M. Whittle, J. Malan, D. Bianchini: New Financial Instruments and the Role of National Promotional Banks, Study for the Policy Department on Budgetary Affairs, European Parliament, 2016; J. Núñez Ferrer, C. Egenhofer, A. Behrens: Innovative Approaches to EU Blending Mechanisms for Development Finance, CEPS Special Report, May 2011; D. Rinaldi, J. Núñez Ferrer: The European Fund for Strategic Investments as a New Type of Budgetary Instrument, In-depth Analysis for the Policy Department on Budgetary Affairs, European Parliament, reprinted as CEPS Research Report No. 2017/07, 2017; J. Núñez Ferrer, D. Rinaldi, A. Thomadakis, R. Musmeci, M. Nesbit, K. Paquel, A. Illes, K. Ehrhart: Financial instruments, op. cit.

⁹ M. Mazzucato, C.C.R. Penna: Beyond Market Failures: The Market Creating and Shaping Roles of State Investment Banks, Working Paper No. 831, Levy Economics Institute, 2015; S. Griffith-Jones, G. Cozzi: Investment-led Growth: A Solution to the European Crisis, in: M. Jackobs, M. Mazzucato (eds.): Rethinking Capitalism: Economic Policies for Equitable and Sustainable Growth, London 2016, Wiley-Blackwell; N. Valla, T. Brand, S. Doisy: A New Architecture for Public Investment in Europe: The Eurosystem of Investment Banks and the Fede Fund, Policy Brief No. 4, CEPII, 2014; D. Mertens, M. Thiemann: Building a hidden investment state? The European Investment Bank, national development banks and European economic governance, in: Journal of European Public Policy, Vol. 26, No. 1, 2019, published online 2 October 2017; P. Volberding: National Development Banks and the Rise of Market-Based Protectionism in Europe, Paper presented at the CEEISA-ISA 2016 Joint International Conference at Ljubljana, Slovenia, 23 June 2016.

¹⁰ M. Mazzucato, C.C.R. Penna, op. cit.; and S. Griffith-Jones, G. Cozzi, op. cit.

¹¹ N. Valla et al., op. cit.

Table 1
Fiscal multipliers by specific instrument for the euro area

	Immediate	One year later	Two years later	Five years later
Government investment	1.42	1.53	1.57	1.46
Government consumption	1.38	1.4	1.41	1.38
Targeted social transfers	0.92	1	1.03	0.89
Taxes on consumption	0.55	0.8	0.87	0.71
Social contributions of employees	0.37	0.45	0.46	0.25

Note: The numbers shown in the table represent cumulative, net present value multipliers, i.e. the sum of output variations up to the indicated year, divided by the sum of fiscal variations up to the indicated year, both discounted at the risk-free short-term interest rate in the neo-Keynesian model presented by the authors.

Source: N. Valla, T. Brand, S. Doisy: A New Architecture for Public Investment in Europe: The Eurosystem of Investment Banks and the Fede Fund, Policy Brief No. 4, CEPIL, 2014, p. 6.

investment gap. Based on their empirical analysis, there is sufficient complementarity to limit crowding out, particularly in times of recession.

The assessment that these banks are brought into action to address market failures and underinvestment is not fully shared by other analysts. According to Mertens and Thiemann, this is just a reaction to the weakening ability of governments to influence the real economy. They believe this trend is leading to the emergence of a 'hidden European investment state' and point out the difficulties of monitoring the promotional banks' activities which have their own technocratic and relatively opaque procedures and decision-making processes.¹² The impact is difficult to monitor as the outcome of the investment often lies beyond the lifetime of the equity or debt instrument provided. Volberding even considers the rise in national NPBI as a sign of growing national protectionism.¹³

A study for the European Parliament identifies 35 promotional banks at the supranational or supra regional national level and 26 subnational promotional financial institutions – most of them in Germany with its Länder promotional institutions.¹⁴ Some have been created recently as a response to the impact of the financial crisis on the ability of public administrations, such as municipalities, to raise capital and to support the business sector (particularly SMEs). The latest addition (not included in the report) is the development bank of Malta in 2017; Greece is setting up its national development bank that will be operational this year.

¹² D. Mertens, M. Thiemann, op. cit.

¹³ P. Volberding, op. cit.

¹⁴ M. Whittle et al., op. cit.

Valla et al. collected information on the key size indicators of the most important public financial institutions (Table 2).¹⁵ The data is for 2012 and the balance sheets for all institutions have expanded since, but the figures nevertheless reflect their importance. The balance sheets have increased considerably.

The most recent balance sheets (2017 or 2016) of the main NPBI and the EIB indicate a further expansion with the exception of KfW, which has seen a slight fall from 497 billion euro to 472 billion euro. The EIB's balance sheet has increased to 550 billion euro.¹⁶

The EIB Group has seen its total assets double in 10 years (from 299 billion euro in 2006 to 573 billion euro in 2016)¹⁷ – an increase in real terms of close to 80%. NPBI have also seen a considerable increase in double digit percentages or even beyond 100%. KfW saw its assets grow by roughly 40% between 2007 and 2014. For Cassa di Risparmio di Roma (CR) it was 80%, while Finnish Finnvera grew by 275%.¹⁸

The economic firepower they possess is significant: the largest balance sheet hovering at around 20% of national GDP and significant loans-to-GDP ratios.

At EU level operations, the debt and equity activities of the EIB and EIF are substantial and therefore have a potentially important impact on the economy. The 2017 activity report lists the EIB Group financing level of 78.16

¹⁵ N. Valla et al., op. cit.

¹⁶ Information from EIB and NPBI balance sheets.

¹⁷ From EIB balance sheets in annual financial reports.

¹⁸ D. Mertens, M. Thiemann, op. cit.

Table 2
Size of selected public investors

	KfW	CDC	BPI Finance- ment	Cassa Depositi e Prestiti	ICO	European Invest- ment Bank	Total
Euro bn (2012)							
Balance sheet total (total assets, 2012)	497.5	393.7	29.9	305.4	115.2	508.1	1 850.0
Total loans	118.5	155.6	15.6	100.5	88.8	293.4	772.3
Country	Germany	France		Italy	Spain	European Union 1/	
Long-term credit rating	AAA/Aaa/AAA	AA/AA1/AA+		BBB/Baa2/BBB+	BBB/Baa2/BBB+	AAA/Aaa/AAA	
Memo							
Nominal GDP (2012)	€2 666	€2 032		€1 567	€1 029	€12 960	
MFI Loans to NFC	€909	€876		€875	€729	€4 674	
Balance sheet/GDP	19%	21%		19%	11%	4%	14%
Total loans/GDP	4%	8%		6%	9%	2%	6%
Total loans/MFI Loans to NFC	13%	20%		11%	12%	6%	17%

Source: N. Valla, T. Brand, S. Doisy: A New Architecture for Public Investment in Europe: The Eurosystem of Investment Banks and the Fede Fund, Policy Brief No. 4, CEPII, 2014, p. 8.

billion euro (29.6 billion euro for SMEs, 18 billion euro for infrastructure, 16.7 billion euro for the environment and 13.8 billion euro for innovation) and supporting a total investment of 250 billion euro in 901 approved projects. Of the amounts above, EFSI backed operations¹⁹ amounted to 51.3 billion euro (of which 37.6 billion euro were signed), for a total investment related to EFSI of 257 billion euro at the end of 2017.²⁰ In addition, there are debt and equity instruments under Horizon 2020, COSME, EaSI, CCSGF, Erasmus and CEF in the 2014-2020 MFF backed by seven billion euro from the EU budget.

The main counterparts of the EIB Group (particularly in the areas of infrastructure investment) at the national level are those in the European Association of Long-Term Investors (ELTI) of private and public financial institutions. ELTI represents a combined balance sheet of 1.5 trillion euro, and its institutions are significant payers.

For EFSI, approximately 25% of the funds were co-financed by NPBIs at the EIB Group level. The role of NPBIs in project financing and implementation is mainly that of co-financier. The EFSI guarantee supports the operations of the EIB and the EIF. The EIB takes the first loss in projects, while lending by the EIB above the guarantee will operate as the second loss. The co-financiers benefit from the reduced risk of this structured financing.

19 Following the revision of the EFSI Regulation, the EFSI guarantee amounts to 33.5 billion euro (26 billion euro from the EU budget and 7.5 billion euro from EIB own resources).

20 Overall figures for the EIB and EFSI share originate from the 2017 EIB annual report.

The exception is in the case of European Structural and Investment (ESI) Funds under shared management instruments, where managing authorities can set up financial instruments handled by themselves or through intermediaries, which may be NPBIs or private banks.

Together, financial instruments and normal promotional banking are significant investment tools with considerable power to create additional investment or, if abused, distort the markets. This means that bigger is not always better.

Conclusion on an efficient use of promotional banking

Increasingly, the EU and its member states are expanding the mandates of the EIB Group and their respective NPBIs to focus on specific objectives, such as investing in renewable energy or improving broadband access. However, in today's atmosphere of budget restrictions, it is very tempting for the EU and many member states to use the promotional banks as a substitute for state expenditures. Promotional banks are increasingly under pressure to achieve political goals in many areas previously not covered by promotional funding.

There seems to be a lack of clarity and understanding about the role of promotional banking. The usual narrative – that the purpose of public financial instruments is to finance risky projects and correct market failures – is partially misleading and misunderstood. The role of promotional banking is quite simply a means to mobilise pri-

vate finance for projects with high public good value added when the private sector is unwilling to finance them. Limiting their intervention to a response to higher risks or a market failure is too reductionist.

The return may be low compared to other investments, even in times of economic boom with high return options, and therefore their intervention may still be required to support public objectives. An investment with a sound profile may not attract financing because it competes with others that offer quicker or higher rewards, i.e. projects that are profitable may not attract funding because there are greener and easier pastures available elsewhere.

At the political level the role of promotional debt and equity instruments are also often misinterpreted as public funds for investment in public goods. This is concerning as there is a lack of understanding that the risk-return trade-off needs to be correct. The level of risk needs to be proportional to the design of the instrument and also to the amount of risk it can take on. The return must also be sufficient enough to cover the debt. Risks taken also need to be proportional to the risk-bearing capacity of the financial institutions. If the operations of the promotional banks become excessively risky in proportion to the public capital base, the financial markets will not offer the banks the same low financing rates, defeating the purpose of lowering the cost of capital to leverage private investments and make the projects more bankable.

Also contrary to many claims, grants and financial instruments are or should – if efficiently deployed – not be interchangeable. If pure grants are used when financial instruments can be used, the financial instrument has to be the preferred choice. If a grant is used, the risk distribution between the public and private sector is incorrect and will therefore unduly pass the bill on to the taxpayer. In fact, grants and financial instruments should be complements, not substitutes. Some of the policy discussions attempting to determine which projects should receive grants from financial instruments and what criteria should be used are heading in the wrong direction from a technical perspective. The efficient size and type of financial assistance in a project should be based on an overall risk assessment and bankability. The use of ‘grant rules’ in projects combining grants and financial instruments is never the right approach, regardless of the grant size.

An important point to remember is that financial instruments are not a substitute for good governance and structural reforms. When the private sector does not invest because the economy is sluggish due to lacking

structural reforms and proper governance, financial instruments do not work. Attempting to fight policy distortions with other distortions is a risky strategy. It is also risky and counterproductive to use financial instruments to avoid or postpone reforms as sound policies are central for any investment to contribute to economic growth.

Mandates and targets for InvestEU and any public financial institutions should follow appropriate implementation principles:

1. The operations should be additional, i.e. investments should only take place if they were not going to be undertaken by the private sector.
2. The operations of the promotional banks should be responsive to market conditions. The areas in which promotional banking is required needs to be reviewed over time, or the banks need to have automatic response parameters to ensure it is used where needed.
3. Support from the EIB or national public promotional banks should not create expectations for automatic pre-allocation of their support in the future.
4. Their operations should never be used as or replace needed structural reforms in member states.
5. Their rollout should be based on identified market failures and address market gaps proportionally.
6. Fragmented and overlapping financial instruments should be avoided; large funds with a broad portfolio are more efficient.
7. In the case of the EIB Group, it should not replace national investments that would have been undertaken with the same or better results in the absence of EU support. Of course, it can complement NPBIs or other private financial institutions where collaboration ensures better results.

It is also recommended that the goal of higher leverage and bigger roles for the EIB and promotional banks be better justified and further analysed. If promotional banking has a countercyclical role, there is no rationale to pre-determine what the desired size of operations should be. Ultimately, a very well-functioning and growing economy should not need large amounts of support from the EIB or other NPBIs. From the point of view of an economist, the InvestEU proposals are a signal that the EU does not expect to do well for a long time and that the risk of market distortions is not taken seriously.