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BOARD OF DIRECTORS

DEVELOPMENT OF THE BANK AND ITS FINANCES

C O N F I D E N T I A L

For

BOARD OF DIRECTORS

The Development of the Bank and its finances

1. Introduction

When the Board of Directors examined the balance sheet and profit and loss accounts for 1988, at its meeting on 14 March 1989, a number of general issues relating to the Bank's overall financial situation and prospects were raised. The purpose of this note is to provide a somewhat fuller analysis which might serve as a background for a discussion of some of these issues. The analysis is essentially preliminary and illustrative, and is intended simply to provide the background for a general discussion by the Board. It does not require decisions, which indeed would only be appropriate at a later stage. This note therefore looks at prospects for the Bank's future lending and financial results against the background of the surge in EIB lending which is currently taking place, the increasing integration within the Community as the 1992 programme gathers momentum and the likelihood that an increase in the Bank's subscribed capital will become necessary within the next few years. The current growth of lending constitutes a convenient starting point.

2. The current surge in EIB lending

2.1. In 1988 EIB lending in the Community (including NCI lending) was above a year earlier by 27.4 % at current prices (and 23.5 % at constant 1988 prices) ; and growth at about this rate has continued into the early part of 1989. This rapid rate of increase follows three years during which the Bank's loans increased relatively slowly : the volume of EIB lending in the Community was above a year earlier by 4 % in 1987, 8.4 % in 1986 and 0.1 % in 1985. It is natural, therefore, to ask how the recent surge in lending can be accounted for, and how it fits with Community policy generally.

2.2. The main cause of the recent sharp increase in the growth rate was a surge in the demand for EIB loans. One factor underlying this increase in demand was an accelerating rate of growth of investment in the Community. Gross fixed capital formation was above a year earlier by 7.1 % in 1988, as compared with 4.6 % in 1987, 3.1 % in 1986 and 2.1 % in 1985. This trend applied throughout the Community and it was particularly marked in manufacturing industry. Another factor was interest rate expectations : much of the demand for loans in 1988 and early 1989 was in anticipation of increased interest rates. The stock market crash of 1987 did not result in reduced output, as some had feared, but by temporarily increasing the cost and difficulty of raising new equity finance in 1988, it favoured debt financing such as the EIB provides. It has not proved possible to quantify

the exact effect of these and other factors on the EIB's aggregate lending, or to determine the relative importance of temporary and more permanent influences. Nevertheless it is clear that the interaction of factors external to the Bank triggered an increase in the demand for EIB loans. In responding to this surge in demand, the Bank has maintained a pattern of lending which reflects Community priorities, while remaining selective in terms of quality. This has been made possible by the policy of pragmatic and continuous adaptation followed by the governing bodies of the Bank.

2.3. A more disaggregated approach is illuminating in that it enables this link between lending growth and Community objectives to be more clearly seen (all figures in current prices) :

- regional development has remained the main objective of the Bank's lending, accounting for almost 60 % of loans from the Bank's own resources in 1988. The case of Portugal and Spain, respectively eligible in total and in large part in terms of regional development, is particularly striking in this context. EIB loans in these two countries increased by 44 % between 1987 and 1988 to reach ECU 1 578.9 million ;

- support for small and medium enterprises has also been a dynamic element. Total global loan allocations to such enterprises increased from a low of ECU 985.3 million in 1987, to ECU 1 611.4 million in 1988. Some 62 per cent of allocations in 1988 were in assisted areas ;

- loans to finance transport and communications projects of Community interest increased from ECU 680.8 million in 1987 to ECU 1 727.6 million in 1988. This growth incorporates the first signature in respect of Eurotunnel (ECU 213 million). It reflects very rapid increases in investment in transport and communications throughout the Community ;

- lending for environmental projects remained high in 1988 (ECU 1 231.1 million) though not quite as high as in the peak year of 1987 (1 315.3 million). In 1988 it accounted for some 14 % of total lending ;

- lending to industry increased strongly from ECU 1 922.3 million in 1987 to ECU 2 912.7 million in 1988. Most of this was to small and medium enterprises through global loan allocations. Individual loans increased from ECU 937.1 million in 1987 to ECU 1 094.5 million in 1988. Within this there has been some decline in loans to finance advanced technology outside assisted areas from ECU 375.0 million in 1987 to ECU 256.6 million in 1988.

2.4. A tentative assessment of the effects on the Bank's activity of past adaptations aimed at keeping its action consistent, along the lines previously described, with Community objectives and market evolutions, leads to two conclusions :

- their effects may take several years to become evident, and their scale and timing are somewhat uncertain,

- they do not by themselves trigger quantitative jumps in the level of the Bank's activity ; rather they increase its qualitative capacity for flexibility in responding to demand.

2.5. These two conclusions can be illustrated by the adaptations introduced in 1984 in favour of the environment and advanced technology. As to the first conclusion, it is notable that financing for environmental projects went through a build-up period which lasted until about 1987 and that, contrary to expectations, the finance of advanced technology projects in manufacturing industry is still running at a rather low level. As to the second conclusion, the adaptations of 1984 did not result in any net additional surge in the Bank's activity. This second point is perhaps worth developing a little.

2.6. One way to do so is to consider, as a mechanical exercise, the development of the loan categories not affected by the 1984 adaptations. If all loans for environmental and advanced technology projects outside assisted areas are taken out of the figures for EIB lending in the Community, and also all loans in Spain and Portugal, since these two countries were not members of the Community in 1984, the remainder shows a steady decline from 1984, in constant (1988) prices, to end in 1987 at about the 1982/1983 level (the decline is from ECU 6 726 millions in 1984 to ECU 5 786 millions in 1987). Altogether, the adaptations introduced gave room for the Bank, in the 84-87 period, to maintain a (moderate) rate of growth and action consistent with Community objectives. They did not result in a sharp quantitative extension.

2.7. These figures are illustrative only. But they suggest that the effect of extending eligibility to new areas is not to add to the lending that would have taken place in any case. The main effect is rather to enable the Bank to respond more flexibly to a changing environment while maintaining its traditional insistence on the high quality of the projects which it finances.

### 3. The evolution of the Bank's lending and of its financial accounts to 1994

3.1. The recent growth in lending has continued to be associated with a strong balance sheet and increasing annual surpluses of revenue over expenditure. The strength of the Bank's financial position has underpinned its lending growth in that it has enabled the Bank to borrow and lend on triple A terms and conditions. At the same time the soundness of the Bank's loan portfolio has contributed to its continuing to be assessed as triple A by the rating agencies. Two major questions arise in this context :

- when is a further increase in the Bank's subscribed capital likely to be necessary ; and

- how far are the Bank's surpluses likely to be sufficiently big and reliable that when the subscribed capital is next increased, there will be no need for any substantial fraction of the newly subscribed capital to be paid in ?

3.2. These questions raise many difficult issues and a two-stage approach will be adopted to try to provide some tentative answers. In the first stage the financial model of the Bank will be used to simulate the Bank's accounts from 1989 to 1994. These simulations should not be seen as

forecasts or strategic alternatives. They illustrate possible outcomes associated with given technical assumptions, whose actual validity can be strongly affected by the course of events outside the Bank's control (evolution of market interest rates or exchange rates in particular). It is obviously a somewhat naive and mechanistic approach and in the second stage an attempt will be made to consider how the outcome may be affected by the cumulating effects of the 1992 programme for the internal market of the Community.

### The simulations

3.3. In order to simulate the development of the Bank's accounts, assumptions have to be made about a number of macroeconomic and other variables external to the Bank. The future course of interest rates is an example. The assumptions that have been made are outlined in Annex I.

3.4. Figures are also required for the future growth of the Bank's aggregate lending. Here two alternative hypothetical scenarios have been explored for lending within the Community on own resources.

#### Percentage increase from previous year in loans signed

	<u>Scenario I</u>	<u>Scenario II</u>
1989	25	25
1990	15	20
1991 onwards	10	15

The increase of 25 % in 1989 is the upper limit to the range given in Document 89/013 which was considered by the Board of Directors at its meeting in January 1989.

### The timing of the next capital increase

3.5. The subscribed capital of the Bank will have to be increased when the total of loans and guarantees outstanding reaches ECU 72 billion, which is 250 per cent of the Bank's subscribed capital. The key figures which are relevant to this in the two scenarios are as follows :

#### Loans and guarantees outstanding (and absolute increases from a year earlier)

(figures in billions of ECU)

	<u>Scenario I</u>	<u>Scenario II</u>
end 1988	47.6	47.6
end 1989	55.5 ( 7.9)	56.7 ( 9.1)
end 1990	64.2 ( 8.7)	67.2 (10.5)
end 1991	74.6 (10.4)	80.2 (13.0)

3.6. On these figures, the ECU 72 billion loan ceiling would be approached by the end of the third quarter of 1991 if the assumptions of Scenario I apply. This was the timing foreseen on the occasion of the 1986 capital increase. On the other hand if the assumptions of scenario II apply, the ceiling would be reached some 5 or 6 months earlier than this. In any case, it looks as if a capital increase would be necessary some time during 1991.

#### The financial position of the Bank

3.7. Simply for purposes of illustration it has been assumed for the two alternative scenarios that the next capital increase will have a nil paid-in ratio. Payments of capital from the 1986 capital increase are scheduled to continue from 1988 to 1993. This assumption has been taken only in order to examine the potential effect on the bank's financial ratios and without prejudice to whatever may be agreed when the time comes. It should be seen as a very extreme test of the potential represented by the present and possible future surpluses of the Bank for its development. It should not preclude the consideration of financial requirements associated with an eventual diversification of the Bank's activity or with the actual evolution of markets. One should also take into account possible market reactions with respect to the rating of the Bank, which can be triggered by less palpable, more qualitative, factors.

3.8. The projections for scenario I (Annex II) show that while the operating surplus and own funds increase impressively between 1988 and 1994, the ratio of own funds to loans outstanding declines from 14.6% to 13.3% over that period. Such a decline, however, should be seen in perspective; this ratio was standing at around 11% as recently as 1983/84. Comparisons with institutions such as the IBRD or the KfW are hazardous since each such institution has its special features. But in the light of such comparisons too, the EIB figures seem fully adequate.

3.9. All the EIB's ratios relating to the relative level of earnings (ratios E,F,G in Annex II) show declines between 1988 and 1994, but it appears that these declines slow or stabilise in the later years in scenario I. The EIB's return-on-earning-assets ratio, at 1.7% at present and 1.3% in 1994, will be declining towards the level which the World Bank plans to achieve in the early 1990's. Likewise, the interest-coverage ratios of the EIB and the World Bank are not too dissimilar over the period of the late 1980's and early 1990's.

3.10. On the face of it then, on scenario I, the EIB could be financially self-sufficient in the 1990s. The main indicators of the financial well-being of the Bank would slim somewhat nevertheless.

3.11. Under scenario II, the high growth hypothesis (Annex III), total loans and guarantees would grow above 120 billion ECUs by 1994 compared to 106 billion ECUs in scenario I. As a consequence, the ratio of own funds to loans outstanding would reach 11.6% in 1994 compared to 13.3% in scenario I. The earnings quality ratios show declines. The interest coverage ratio at 1.17 in 1994 would be lower than in scenario I. The same would be also broadly true of the return on earning assets over the same period. In

contrast, the return on equity by 1994 is higher under the high growth hypothesis, the reason being that, when the growth of lending is faster, the Bank's debt is higher relative to its equity and the higher gearing causes higher returns on equity.

3.12. Both scenarios I and II illustrate the evolution of the financial ratios of the Bank associated with given technical assumptions. It should be stated again that the results obtained are entirely dependent upon the assumptions made. Should the course of events deviate from the extrapolative hypothesis retained, the previous conclusions could be substantially affected.

3.13. Finally, it is perhaps worth trying to compare the EIB's rate of return on equity with the average interest rate on government bonds which might be taken as an indicator of opportunity cost.

	<u>EIB return on own funds (1)</u>	<u>Average interest rate on government bonds (2)</u>
	%	%
1986	12.6	9.3
1987	11.5	9.2
1988	11.3	9.1

(1) Based on an average of own funds at end year and at end of previous year.

(2) Average yield on government bonds in Community countries weighted by their contributions to the capital of the Bank.

This rather approximate comparison indicates that the return on the EIB's own funds has exceeded the opportunity cost of these funds by two or three percentage points in nominal terms.

#### 4. Looking ahead : a qualitative view

4.1. Looking beyond these simulations, there are a number of immediate operational considerations and some more speculative reflections which they do not capture but which are relevant in the present context.

4.2. The lending policy of the Bank can be heavily influenced by the reform of the structural funds, and the completion of the internal market. The implications of these programmes have already been discussed by the Board, most recently in January 1989 (documents 89/014, 89/015 and 89/016). The present analysis can therefore be brief, recapitulating some of the main points.

4.3. As to the reform of the structural funds, the Bank is fully committed to play its part alongside the Commission. It is already involved at an early stage in the procedures envisaged in the Framework Regulation and the Implementing Regulations ; and an agreement with the Commission on the financing of infrastructure investment by a combination of loans and grants is being finalised.

4.4. The question of infrastructure investment in general will be brought back to the Board when the agreement with the Commission has been finalised ; and there may be Community programmes for special categories of infrastructure to be brought to the Board later. Meanwhile, however, it may be worth dwelling for a moment on the important issue of the Bank's role with regard to financing of industrial investment.

4.5. The new background to this is the objective set out in the Single Act of strengthening the scientific and technological basis of European industry, and developing its international competitiveness (Article 130 F) as part of the means of completing the single market.

4.6. In this perspective, the Bank will continue to finance industrial investment in the assisted areas (Article 130 point a)), and in other areas for modernisation and conversion (Article 130 point b) in the case of Spain and Portugal) and energy saving and the protection of the environment (Article 130 point c)). Much industrial investment is by SMEs and the Bank will continue to support it under the arrangements established by the Board of Directors at their meeting on 14 December 1988 pursuant to the Board of Governors' resolution of 25 February 1987. As regards large industrial projects outside assisted areas, it is the Management Committee's intention to select them by appropriate reference to the Board of Governors' guidelines (Doc. CG 84/4), focusing on international competitiveness and European integration under Article 130 point c).

4.7. The full impact of the 1992 programme on the EIB's activity can go considerably beyond the immediately operational considerations just outlined, and to complete the picture it will be necessary to touch on some of the wider repercussions which will affect the Bank as they work through the financial services sector as a whole.

4.8. Recent and prospective changes in European and national banking legislations could induce European banks to adopt a universal banking model (already well-established in a few Member Countries, but not in several others). As a consequence, capital market activities (including share and bond underwriting and, above all, long-term finance) could come to be increasingly performed by European commercial banks, while Long-term Credit Institutions might become more active in retail banking and in the investment service areas. An intermingling of so-far well-defined and separated functions could take place and broaden the range of activities where there will be a potential overlap between the Bank's operations and ordinary banking activities, and the boundaries of the Bank's business could change.

4.9. Direct investor-borrower links, without the interposition of financial institutions as providers of funds, could characterize a growing proportion of financial transactions. This is so because a larger number of these operations could be more efficiently performed by capital markets themselves and because, on account of their modest profitability, they hardly justify committing the banks' capital to the required extent. By end-1992, the BIS capital adequacy rules and the EEC's directive on solvency ratios will put a premium on the availability of capital and its most efficient application. If this is the case then the Bank could, as other financial institutions, be drawn towards less standardized and more



sophisticated financial operations possibly involving higher costs. All of this will require adequate financial resources. On the other hand, should the Bank concentrate on its traditional business as a long-term lender of fixed-rate funds, it could find itself under increased competition from capital markets.

4.10. Finally, the creation of the single European market is attracting new participants in the areas of infrastructure financing and of industrial restructuring - not just other European banks, but also non-European intermediaries.

4.11. As a consequence, though business opportunities will probably keep growing in line with increased investment needs created by the approaching 1992 deadline, promoters, facing a more diversified offer of financial packages, will probably expect to be offered lending conditions characterized by tighter terms and more innovative contents. This could mean that in the years ahead the Bank's revenues and operating surpluses may grow at a rate lower than foreseen in the projections described above being, as they are, based on the assumption of a largely unchanged external environment. In the face of changing circumstances, the Bank's financial self-sufficiency will increasingly rest on the availability of adequate capital resources, on a continuing commitment to operational flexibility and on its ability to detect and meet evolving client needs.

## 5. CONCLUSIONS

5.1. The Bank's lending policy must continue to follow Community priorities as the 1992 programme causes fundamental changes in

- industry, and hence in the Bank's customers ;
- the financial services sector, and hence in the financial institutions which are the Bank's co-financiers and global loan intermediaries as well as in those which are the source of its borrowed funds ; and
- the structural funds, which will be providing increased grant finance alongside the Bank's loans, particularly in the regions.

To achieve this, and remain in the mainstream of Community action, the Bank must continue the policy of pragmatic adaptation that has been consistently followed by its governing bodies over the years. This policy, together with the Bank's traditional insistence that the investment which it finances should be of high quality, is the best assurance that the Bank will continue to play its full part in the balanced development of the Community.

5.2. It is impossible to forecast how the volume of lending is likely to develop in the medium term, and the evolution of interest rates and other factors affecting the evolution of the Bank's operating surplus are equally uncertain. However, two conclusions appear to follow from the foregoing analysis. First, it looks as if a capital increase will be needed some time in 1991, which means that the necessary preparatory work will have to be

done during 1990. Second, and more tentatively at this stage, it looks as if on these assumptions such a capital increase should not require a paid-in ratio which would involve a significant contribution from the Bank's shareholders. However, the evolution of the Bank's activity will depend on a wide variety of factors which cannot be quantified at this stage, and any decision as to an appropriate paid-in ratio will have to be taken in the light of the circumstances ruling at the time.

**Annexes : 3**

Macro-economic assumptions used in the simulations

The acceleration of new fixed capital investment in the Community in 1988, following on the relatively slack period for much of the 1980's, is expected to continue in 1989 and into 1990. New fixed investment could, however, tend to level off as the Community approaches 1992. The surge of new fixed investment in Spain and Portugal in 1987-90 could enter a more mature phase in the 1990s. Inflation is not expected to be a major factor in the early 1990's, but some moderate increases in inflation in certain European countries during 1989 will raise concern. The authorities have reacted strongly to these inflationary pressures, which are however likely to prove temporary, by increasing short-term rates during early 1989. Subsequently a moderate overall decline in rates can be expected. It is assumed that no new oil crisis impinges on world economies. Two hypotheses have been retained for the projections - Scenario I comprising a moderate loan growth assumption, and Scenario II a high loan-growth hypothesis.

In Scenario I, growth of EIB lending on own resources in the Community is expected to reach 11 400 M. ECUs in 1989, representing a 25% rise over the 1988 figure (itself 30% higher than a year earlier). In 1990 EIB lending in the Community, under this scenario, may rise by 15%. In subsequent years (1991-94) an average loan growth rate of 10% is assumed. Over the whole period 1989-1994, average loan growth within the Community would be 13.8% p.a. compound. Lending to PA countries would average around 650 M. ECUs per year during the 1989-94 period.

Under Scenario II, lending within the Community would rise by 25% in 1989 (as in Scenario I), but the rate of expansion would slacken only to 20% in 1990 and to 15% p.a. up until the projection horizon in 1994. PA lending, under this hypothesis, would rise quickly to 900 M. ECUs per year by 1990 and remain at that level.

EIB average lending rates will reflect the trend of international long-term rates while the return on the treasury portfolio holdings will tend to reflect short-term international rates. EIB loan rates average under the scenario will rise moderately from the 8.0% average for 1988 to 8.8% in 1989, subsequently declining slowly. The yield curves in main markets, at present flat or negatively sloped as short-term interest rates have moderately risen in response to the adoption by the monetary authorities of a tighter policy stance, will from 1990 onwards return to more normal configurations.

%	1988	1989	1990	1991	1992	1993	1994
EIB, loan rate, average	8.0	8.8	8.6	8.4	8.2	8.0	7.8
Return on Treasury	7.6	9.2	8.6	8.2	7.8	7.4	7.0

Given this pattern of moderately rising interest rates in 1989 , early repayments of EIB borrowings are likely to be reduced compared to the 1 344 M. ECUs recorded in 1988. The hypothesis is for early repayments of borrowings of 900 M. ECUs in 1989, 600 M. ECUs in 1990/91 and nil thereafter. Early loan repayments, usually about 200 M. ECUs per year, will jump in 1989 and 1990 to about 1 000 M ECUs and 1 300 M. ECUs respectively due to exceptional factors.

Under Scenario I exchange differences on loans, resulting from the movement of exchange rates vis-à-vis the ecu accounting unit, are assumed to be zero; under Scenario II, it is assumed there will be 1 000 M. ECUs positive exchange differences on loans in the years 1989-91.

SCENARIO I

EIB ratios 1988-1994

M. ECUs	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>
1. Total loans & guarantees outstanding	47 627	55 500	64 150	74 600	84 100	94 350	105 500
2. Subscribed capital	28 800	28 800	28 800	60 000	60 000	60 000	60 000
3. Borrowings outstanding (including short-term)	37 701	43 700	50 900	59 350	67 130	75 900	85 600
4. Own funds (1)	6 932	7 960	9 040	10 190	11 410	12 730	13 980
5. Operating surplus	727	860	920	980	1 060	1 150	1 250

Ratios

A. Total loans outstanding/ subscribed capital	1.65	1.93	2.23	1.24	1.40	1.57	1.76
B. Borrowings outstanding/ subscribed capital	1.31	1.52	1.77	0.99	1.12	1.27	1.43
C. Own funds/total loans outstanding	0.146	0.143	0.141	0.137	0.136	0.135	0.133
D. Own funds/borrowings outstanding	0.184	0.182	0.178	0.172	0.170	0.168	0.163
E. Return on equity *	11.3%	11.5%	10.8%	10.2%	9.8%	9.5%	9.4%
F. Return on earning assets **	1.7%	1.7%	1.6%	1.5%	1.4%	1.3%	1.3%
G. Interest coverage ratio ***	1.23	1.24	1.22	1.21	1.21	1.20	1.19

(1) Own funds are the sum of paid-in capital, the reserve fund, additional reserves, provision for ECU conversion adjustments and the annual surplus.

\* Average of two year-ends.

\*\* Operating surplus in relation to disbursed loans and Treasury (average of two year-ends).

\*\*\* Operating surplus plus cost of borrowings in relation to cost of borrowings.

SCENARIO II

EIB ratios 1988-1994

M. ECUs	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>
1. Total loans & guarantees outstanding	47 627	56 750	67 000	80 200	92 100	105 800	121 600
2. Subscribed capital	28 800	28 800	28 800	60 000	60 000	60 000	60 000
3. Borrowings outstanding (including short-term)	37 701	44 760	53 590	64 600	74 450	86 420	100 600
4. Own funds <sup>(1)</sup>	6 932	7 960	9 045	10 205	11 435	12 775	14 050
5. Operating surplus	727	860	925	990	1 070	1 170	1 275

Ratios

A. Total loans outstanding/ subscribed capital	1.65	1.97	2.32	1.34	1.54	1.76	2.03
B. Borrowings outstanding/ subscribed capital	1.31	1.55	1.86	1.08	1.24	1.44	1.68
C. Own funds/total loans outstanding	0.146	0.140	0.135	0.127	0.124	0.121	0.116
D. Own funds/borrowings outstanding	0.184	0.178	0.169	0.158	0.154	0.148	0.140
E. Return on equity *	11.3%	11.5%	10.9%	10.3%	9.9%	9.7%	9.5%
F. Return on earning assets **	1.7%	1.7%	1.6%	1.4%	1.3%	1.2%	1.2%
G. Interest coverage ratio ***	1.23	1.24	1.22	1.20	1.19	1.17	1.17

(1) Own funds are the sum of paid-in capital, the reserve fund, additional reserves, provision for ECU conversion adjustments and the annual surplus.

\* Average of two year-ends.

\*\* Operating surplus in relation to disbursed loans and Treasury (average of two year-ends).

\*\*\* Operating surplus plus cost of borrowings in relation to cost of borrowings.