European
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FOR DISCUSSION AT THE CD AWAY DAY

AWAY-DAY AGENDA
DOCUMENT 3c

Note to the Management Committee A. Riess/R. Wagenvoort/C. Hurst

Subject: **Public Banks and EU Competition Policy**
– possible implications of the agreement between the German authorities and the Commission concerning the German public banks

As requested, please find attached a paper on public banks and EU competition policy for discussion at the Away-Day of 4 September, 2001. The paper supplements two earlier CED papers that dealt with strategic issues facing the Bank and, in this context, touched upon the controversy surrounding Germany's public banks.[1] This discussion has centered on the claim that public banks enjoy unfair advantages and, therefore, crowd out private competitors. In July, the European Commission and the German authorities reached an agreement concerning the state guarantees for public banks. The thrust of this agreement is to ensure that public banks operate on a level playing field when they compete with private banks.

This is a watershed event that could have important implications for the Bank. Against this background, this paper outlines (i) the link between the institutional advantages of public banks and state aid; (ii) the July agreement concerning the German public banks; (iii) the economic rationale that could justify state aid under EU competition policy; and (iv) issues for the Bank.

The paper is based upon the economic logic of competition policy. It does not address the host of political and legal issues that such a topic could raise, nor more specific operational questions.

C. Hurst
ff A. Steinherr

[1] *Life began at 40?* (EI/CED/2000-0310 of November 20, 2000) and *Life began at 40? Report 2* (EI/CED/2001-026 of February 1, 2001).

EXECUTIVE SUMMARY

A. The EU Commission and German Public Banks

1. The European Commission regards **foregone government revenues as state aid** that is subject to EU competition policy. Foregone revenues include an **inadequate remuneration of state guarantees and equity**.

2. **State aid can be approved if it serves a public task**. But it is objectionable if it does not – or if it unduly distorts competition in the Common Market.

3. Applying these principles to **Germany's public banks, the Commission found that the system of state guarantees constitutes state aid that distorts competition**. The Commission has also decided that a recent capital injection for *WestLB* – one of the public banks – is distorting because it is not adequately remunerated (though this case is yet to be concluded).

4. After initial resistance, **the German authorities have accepted the essence of the Commission's position**. An agreement reached in July of this year is meant to clarify the role of Germany's public banks.

5. According to the agreement, **the current system of state guarantees will be replaced by a normal owner-bank relationship**. This will limit the liability of the state to its equity stake. Although not specified in the agreement, one would presume that a normal owner-bank relationship implies the obligation to earn an adequate return on equity for activities where public banks compete with private banks.

6. The agreement also stipulates that the state will continue to have the right to support public banks provided that such support is compatible with EU state aid policy. To be compatible, it must be **demonstrated that state aid addresses market failures**, i.e. a sub-optimal allocation of resources.

B. Current EIB lending and competition issues

7. **The market failure test is quite stringent**. If applied to the Bank, the Bank would have to demonstrate that its lending (i) addresses a market failure, (ii) ensures that the benefit passed on to beneficiaries is not excessive, and (iii) helps an investment that would not have happened without the Bank. In addition, competitive distortions among firms and the crowding out of private finance would have to be reduced as far as possible, though subsidized loans are recognized as a suitable policy instrument.

8. Bank lending in **support of investments in non-competitive sectors** (e.g. public infrastructure, health, and education) **should take these hurdles with relative ease**. This should be the case whether or not these investments are undertaken by the state or by the private sector via PPPs. Likewise, lending to the **competitive sector in assisted areas** is easily defendable **if** the Bank can convincingly argue that **its action brings about additional investment in assisted areas** (permitted under EU competition rules) rather than providing general support to the beneficiary (which is not).

9. Lending to **competitive sectors outside assisted areas is a more complex question**. For the Bank, the key issue is that the test of market failure is more stringent that the concept of supporting EU policies *per se*. For example, state funding of R&D is permissible under competition rules as a failure is thought to exist in the private sector's provision of research. On the other hand, it is not acceptable to support investment in a particular high-tech company simply because the sector in question is thought to be important part of the Union's industrial fabric.

C. Potential consequences for the EIB – adapting to the new environment

10. Thus, **close scrutiny according to EU competition rules would most likely require modifications to the Bank's current mode of operation.** Most importantly, the Bank would need to step into the project cycle much earlier than at present to show that the investment in question would not have happened without Bank support. Eligibility criteria outside of regional development would also have to be carefully honed to ensure that they cover only clearly defined market failures.

11. The recent decision concerning the German public banks makes one thing clear. In the event that **a loan from a public bank is not compatible with the criteria** we have discussed, **then it is the financial intermediary that is seen to benefit from the state aid** – which it uses to fund balance sheet growth and an increasing market share at the expense of private competitors. Such business will **either have to cease, or be placed in a structure where the benefits of state ownership are eliminated**.

12. In a nutshell, the issue boils down to:

    Acceptable – If the borrower merits state aid and this does not distort competition in the borrower's own market, then Bank lending is permissible even if commercial banks lose business as a result. However, the Bank should make its best effort to ensure that state aid is not wasted (in other words, not fund investment would have happened anyway) and to minimize unnecessary crowding-out of private finance.

    Unacceptable – If the borrower does not merit state aid then Bank lending is an anti-competitive practice and an unfair use of state resources. The criterion to be used is that the private market is not functioning properly without state involvement. Government industrial policies in general (e.g. going under the titles of "competitiveness", "employment" and the like) are not sufficient in themselves, even if they appear to reflect the wishes of the EU Council.

13. A logical next step would be for the Bank **to categorize its lending activity** according to whether it falls clearly in the safe area for public banking, whether it is in the danger area, and border line cases. As a first step, it is likely that this would require re-assessing lending criteria and the "eligibility" of borrowers. Based upon this assessment an attempt could be made **to move EIB activity progressively into the safe zone over a number of years**.

14. This could be seen as a defensive response to an increasingly hostile environment. However, it could also be seen in a more positive light as **making concrete the goal of being a policy-driven institution.**

Public banks and EU competition policy

The times they are a-changin'
Bob Dylan

1. Introduction

There is broad consensus that the role of the state in providing goods and services ought to be the exception rather than the rule. In banking, the most obvious manifestation of this consensus is the privatization wave that has swept across Europe, establishing a banking industry dominated by private ownership.

One notable exception to this process has so far been Germany, reflecting the important role of state-owned *Landesbanken* and *Sparkassen* (henceforth called public banks unless a distinction needs to made between the two). But even in Germany – where public banks denied the need for change less than a year ago – fundamental changes are in the making.

On July 17, 2001, the European Commission and the German authorities reached an agreement concerning the state guarantees for Germany's public banks. The thrust of this agreement is to ensure that public banks operate on a level playing field when they compete with private banks.

The German authorities will now have to translate the July agreement into legislation. In this process, important details of the relationship between the state and its public banks will have to be clarified. A possible bone of contention could be the remuneration of state equity.

Both issues – i.e. state guarantees and the remuneration of state equity – are clearly relevant for the Bank. In addition, in implementing EU state aid policy, the Commission has emphasized time and again that state aid needs justification, notably the presence of market failures and the demonstrated contribution of aid to EU policies.

Against this background, the next section reviews the type of state aid that is at the heart of the controversy about public banks in Germany. Section 3 examines the background, content, and the implications of the July agreement. Section 4 takes a look at a case concerning the remuneration of state equity in the *Landesbanken* that is currently before the European Court of Justice. Section 5 sketches a variety of market failures that could underpin the policy function of public banks. Following up on this, **section 6 notes that the Bank is not immune to the changes that are affecting the Germany's public banks and it suggest how the Bank could embrace and cope with such changes**.

2. Foregone state revenue and the distortion of competition in banking

An important pillar of the common market is open and free competition. A potential impediment to this type of competition is state aid, defined as

> "... *any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens competition* ...".[2]

In its recent survey on state aid, the Commission emphasized that the

> "... *notion of State [aid] is very wide and covers not only the central budget of the State but all the resources of the State including those foregone by way of State aid*...".[3]

Private banks have repeatedly complained that Germany's public banks benefit from state aid, giving them an unfair advantage in lines of businesses where they compete with private banks. In essence, it is argued that state aid takes the form of forgone state revenue. Two variants of foregone revenue have received particular attention.

First, state guarantees for public banks and their creditors result in lower funding costs for public banks. All other things being equal, lower funding costs could result in lower prices and so in a higher market share. There would be no funding advantage and, thus, no unfair competition if the guarantees, which are unlimited and unconditional, were properly priced. But as they are not, the state is implicitly providing state aid to public banks.

In 1999, the European Banking Federation (FBE) – representing the private banks – lodged a complaint with the Commission concerning these guarantees with the objective of having them abolished. In January 2001, the Commission stated in its preliminary opinion that the guarantee system constitutes state aid that is not compatible with the common market. After initial resistance, the German authorities and public banks reached the agreement with the Commission that we have mentioned in the introduction. We will get back to this topic in section 3.

Second, compared to private banks, public banks do not have to earn a return on equity that a private investor would expect. As a result, public banks can intermediate funds at a lower margin than private competitors, enhancing the competitive advantage arising from lower funding costs. Again, aid takes the form of state revenue foregone. In this case, however, it is an inadequate remuneration of state equity rather than an unremunerated provision of guarantees. To address this issue the German Bankers Association lodged a complaint with the Commission in 1994. We look at this case and its wider implications in more detail in section 4.

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[2] Art 87 (1) of the EC Treaty.

[3] Commission of the European Communities, *Ninth Survey on State Aid in the European Union*, Brussels, July 18, 2001.

3. State guarantees: the agreement of July 17, 2001 [4]

3.1 The current guarantee system for public banks

The controversy has been about two types of state guarantees: the *Anstaltslast* (often translated as "maintenance obligation") and the *Gewährträgerhaftung* ("guarantee obligation"). The practical result of these guarantees is that the public banks have credit ratings that that are much better than their inherent financial strength.

The "maintenance obligation" means that the public owners of an institution are responsible for securing the economic basis of the institution and its functioning for the entire duration of its existence. In essence, this requires the owner of a public bank to ensure its solvency at all times. The "guarantee obligation" stipulates that the guarantor will meet all liabilities of the bank that cannot be satisfied from its assets. Both guarantees are neither limited in time nor in amount and they are provided free of charge.

As the "maintenance obligation" requires owners to keep the bank solvent, bank creditors will normally not have to rely on the "guarantee obligation". It follows that abolishing the "guarantee obligation" without dismantling the "maintenance obligation" would leave the funding advantage of public banks largely unchanged.

3.2 Content of the agreement

The key elements of the agreement can be summarized as follows:

1. With effect of July 19, 2005, the "guarantee obligation" will be abolished.[5]

2. With effect of July 19, 2005, the "maintenance obligation" will be replaced by a normal relationship between the owner and the public financial institution concerned. More specifically,

    a) the financial relationship must be the same as that between a private bank and its owners;

    b) there must be no automatic obligation of public owners to support their institution and the responsibility of public owners for the institution's liabilities must be limited to the owners' equity contribution;

    c) the bankruptcy of public financial institutions and private must be governed by the same rules;

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[4] This section is based on the Commission's press statement of July 17, 2001, press releases of the Association of German Public Sector Banks and of *WestLB*, and on CED staff communication with representatives of Germany's public banks and the Federal Association of German Banks, the latter representing Germany's private banks.

[5] Liabilities incurred in the period July 19, 2001 to July 18, 2005 will continue to be covered by the "guarantee obligation" provided that their maturity does not go beyond December 31, 2015.

d) a possible state intervention in favor of public financial institutions will – like interventions in favor of enterprises in general (public or private) – be governed by EU state aid policy.

3. The legislation necessary to implement (1) and (2) will be submitted to the respective parliaments by end-2001 with a view to having such legislation adopted by end-2002.

3.3 Implications of the agreement

The substitution of a "normal owner-bank relationship" for the existing "maintenance obligation" implies that public banks will have to pursue their profit-oriented activities on a level playing field with private banks. This will require changes to the legal and organizational structure of public banks. A particular concern of the German authorities in negotiating the agreement with Commission was to leave scope for individual solutions to these changes.

There is, for instance, the model contemplated for the *Bayerische Landesbank*. Under this model, profit-oriented activities and public policy functions would not be separated and the legal structure of the *Landesbank* would remain unchanged, i.e. the *Landesbank* would remain a public-law institution. However, a limited-liability financial holding company (*Finanzholding AG*) would replace the current owners of the *Landesbank*. The liability of the holding company for the obligations of the *Landesbank* would be limited to its equity stake in the *Landesbank*. The current owners of the *Landesbank*, i.e. the *Freistaat Bayern* and the Bavarian *Sparkassen*, would be shareholders of the holding company. While not envisaged for the immediate future, the holding company could include private shareholders and thereby open the way of an indirect privatization of the *Bayerische Landesbank*.

And then there is the *WestLB* model, for example, which envisages a separation of profit-oriented activities from public policy functions. A private-law bank (*WestLB AG*), owned by the current owners of *WestLB*, would pursue the profit-oriented business and a public-law institution (*WestLB öR*) would take care of public policy functions. In addition, *WestLB öR* would provide a letter of comfort in favor *WestLB AG*. A letter of comfort could be considered a soft version of the existing "guarantee obligation" but *WestLB* has stated in its comment on the July agreement that the Commission no longer opposes to such a link between the profit-oriented bank (*WestLB AG*) and the public policy institution (*WestLB öR*). Whether this is in fact the position of the Commission is debatable but will not become clear before the Commission has examined the relevant legislation.

Whatever solution will be chosen in the end, from a competition policy viewpoint the main requirement will be that state aid, if any, benefits only public policy functions and not profit-oriented activities.[6] It is clear that the Commission – and private banks – will carefully scrutinize the legislation that will be proposed and adopted and, as one observer has put it, this is when things will get exciting again. Two issues are likely to arouse particular excitement. First, whether the profit-oriented sections of public banks will effectively be sealed off from the funding advantages that the policy-oriented sections may retain and, second, whether the "normal owner-bank relationship" for profit-oriented activities will

[6] This also seems to be the position of the European Banking Federation. While publicly stating that it sees no justification for keeping the current system of state guarantees in place for another four years (and that it may ask the European Court of Justice to examine the agreement), the FBE is understood to regard the specifics of the "normal owner-bank relationship", which will replace the "maintenance obligation", as far more important than a shortening of the transition period.

require the generation of a market return on state equity and how such a requirement could be enforced in practice. We leave the first issue aside and turn directly to the second one.

4. The remuneration of state equity: a case not yet settled

This should be seen in the context of an outstanding dispute between the Commission and *WestLB* (and five other *Landesbanken*) concerning the remuneration of a specific capital injection for *WestLB*.[7] After summarizing the main points of this case, we turn to the broader question of how state equity in public banks should be remunerated.

In 1991, the state of *Nordrhein Westfalen* transferred assets from its housing promotion agency to *WestLB*. The resulting capital increase went beyond what was required to meet the EU Capital Adequacy Directive and therefore allowed *WestLB* (and other *Landesbanken* which took similar measures) to increase its level of activity. In return of this capital injection the state is receiving a fixed interest payment of 0.6 percent (after tax) a year.

In 1994, the Federal Association of German Banks filed a complaint with the European Commission, arguing that this transfer of assets and their low remuneration constitute state aid that distorts competition.

In July 1999, the Commission decided that this was indeed the case and that the transfer of assets at an interest rate of 0.6 percent was not compatible with EU state aid policy. The Commission considered a remuneration of 9.3 percent (after tax) for this particular type of capital injections as appropriate. As a result, it asked *WestLB* to remunerate the capital injection at this rate. For the period during which the capital injection was not properly remunerated the Commission asked *WestLB* to pay DEM 1.6 billion (plus interest) to the state of *Nordrhein Westfalen*, reflecting the difference between the two interest rates.

WestLB has appealed and the case is now with the European Court of Justice, which is expected to decide in 2002. Observers find it quite possible that the Court will rule in favor of the *WestLB* – not because the activities of public banks do not have to generate a return that a market investor would find acceptable but because the transfer of assets in question constitutes a surety rather than a capital injection. And a surety premium of 0.6 percent (after tax) is not considered unusual.

Even if the current case ends in favor of *WestLB* (and other *Landesbanken*), the Commission's key conclusion holds: state aid is involved if funds are made available on terms that a private investor would find unacceptable. This takes us back to the July agreement, stipulating that the financial relationship between a public financial institution and its owners must be the same as that between a private bank and its owners. It follows that the state should earn the same return on equity as private investors in banks pursuing activities similar to those of public banks.[8]

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[7] See, for instance, Commission of the European Communities, *Decision of July 8, 1999 on a measure implemented by the Federal Republic of Germany for WestLB*, Document 300D0392. Additional background to this case can be found in Sinn, H. -W., *The German State Banks*, Cheltenham, UK, 1999.

[8] For completeness we note that, in principle, compelling public banks to pay an adequate price for the guarantees could have solved the state-guarantee problem discussed above without abolishing such guarantees. The July agreement did not take this route, mainly because it would have been very difficult to determine the value of what effectively is an unlimited guarantee. At first glance, one may think that things are easier with regard to determining an adequate return on state equity. But we will see that it is not.

Determining an adequate return on state equity may seem straightforward for, say, the profit-oriented *WestLB AG*. In this case, the targeted and actual return on equity of private banks could serve as a yardstick to examine whether or not public banks try to and in fact do operate in a non-distorting manner.

In practice, things are more complicated. For one thing, choosing the right yardstick will be difficult because banks differ in their appetite for risk and, thus, aim at different returns on equity. There is thus a range of returns on equity from which to choose the target for a public bank. For another, actual returns on equity are determined by the residual claim on the surplus generated in any one year. It is a normal feature of market economies that even viable firms incur losses every now and then. Whether a lower-than-targeted return – or even a loss – in any given year has systematic causes or is only a random deviation from the mean can never be known for any individual year. In sum, it will be a challenge for competition authorities to determine what is an appropriate targeted return on state equity and whether lower-than-targeted actual returns have been due to unfair competitive behavior or just bad luck.

This challenge will be even harder if public banks pursue profit-oriented activities and public policy functions under one roof (as for instance in the model of the *Bayerische Landesbank*). In these circumstances, a low rate of return may arise because the surplus of the profit-oriented business is used to cross-subsidize public policy functions.

As an alternative to monitoring returns on state equity one could directly investigate the pricing policy of public banks. Loans with similar characteristics, maturity and risk in particular, should be priced in line with the market. It is clear, however, that adequate loan pricing cannot be taken as proof that public banks are not distorting competition. While charging the same price as the market and, thereby, maintaining their market share, public banks may fail to generate a return on equity that a reasonable private investor would expect. With this we are right back to the shortcomings of using observed returns on equity to assess the (mis)behavior of public banks.

To summarize, the July agreement together with the Commission's position that an inadequate remuneration of equity in public banks constitutes state aid can be seen as a watershed. To all intents and purposes, there seems to be only one solution that will pacify private competitors and that will not attract the attention of competition authorities: privatize the banks' profit-oriented activities and confine the role of public banks to policy functions where state aid is admissible.

As we will discuss in the last section, the key for justifying state aid – in whatever form it comes – is that it demonstrates its contribution to correcting market failures. With this in mind, we now turn to a short presentation of just what these market failures may be.

5. In search of market failures

Competition law is based upon the belief that under certain conditions market economies ensure an optimal allocation of resources and, thus, maximize the wealth of societies. Economic theory also leaves no doubt, however, that when these conditions are not fully met, markets may fail in producing this outcome. In particular, there could be an undersupply of certain goods and services and an oversupply of others.[9]

However, the presence of market failures is a necessary but not a sufficient condition for state intervention. For one thing, intervention may be unable to address the causes of market failure. For another, state intervention is justified only if the cost of correcting or mitigating market failure is lower than the cost of accepting it. In this context, two questions would have to be addressed. First, which type of intervention – taxation and spending, regulation, public production of goods and services etc. – is most appropriate to address the market failure at hand? Second, which level of government – local, regional, national, or international – should carry out the intervention?

It would certainly go far beyond the scope of this note to tackle these questions. But we need to keep them in mind when sketching the policy role of public banks. In organizing this sketch it is useful to distinguish failures in the financial market from those in other markets.

Financial market failures

Financial market failures do exist. At the risk of simplifying a bit, two variants of the story can be distinguished. In one, asymmetric information explains the lack of finance; in the other, monopolistic market structures could cause a shortage of funds.

Asymmetric information means that users of funds know more about themselves and their investments than providers of funds. Because of the risks this raises, banks may require excessively high levels of collateral or ask for a "risk premium" that overstates the uncertainties associated with the underlying investment. Both approaches result in under-investment.

Market failures could also arise from a tendency toward monopolistic market structures. For instance, in remote areas – or in banking markets where it is difficult for SMEs to establish multiple bank relationships[10] – a "natural" monopoly may arise. As a result, only one bank offers banking services – if they are provided at all – and this bank may overcharge its borrowers, thereby reducing the demand for loan finance.

In practice it seems that these problems are limited to retail banking (and thus to SMEs), while large firms appear to be well-served by banks and capital markets. But even in the case of SMEs, it needs to be demonstrated that a problem does in fact exist, that it can be

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[9] Besides these failures, markets may lead to a distribution of income and wealth that society finds unacceptable.

[10] Relationship banking could solve part of the information problems in the credit market. After several periods of unviolated track record, the cost, collateral requirements, and availability of credit may become more favourable for the small firm than the comparable conditions at the beginning of the relationship. However, relationship banking may lead to a "hold-up problem", that is, the company may find it difficult to turn to other lenders since its credit history is the private knowledge of the bank.

corrected, and that a public bank is the most suitable tool for doing this – by no means a minor challenge.[11]

Other market failures

The list of market failures in the real economy could be a long one. In general, public infrastructure, environmental externalities, and externalities in health and education as well as in research and development have been the main reason for a policy response. Regional inequalities are also recognized as justifying state intervention via regional development policies.

In theory, policy instruments such as subsidies and taxation are the obvious means for enhancing the production of goods and services that are undersupplied. In practice, loans at favorable terms can play a useful role as they encourage the recipient of financial support to use the funds wisely.

What is important here is that other sources of finance are available, and the mere presence of a public institution providing loans does change the picture. Loans from public banks are only valuable in meeting public policy goals if they transfer a subsidy to the borrower through loan terms that are more attractive than the market rate.

6. Implications for the EIB

This discussion inevitably raises the question of how the EIB fits into the picture. In particular, given the imminent changes in the German public banking system, is there a risk that the Bank (and in Germany institutions like the KfW) will come under closer scrutiny? And if yes, how could the Bank respond to this?

There are certainly similarities between Germany's public banks – in particular the *Landesbanken* – and the Bank, but there are also important differences. Like the *Landesbanken*, the Bank enjoys considerable funding advantages because of its substantial callable capital. While it is true that callable capital is not unlimited, it is large enough (currently € 94 billion, equivalent to around 38 percent of the Bank's maximum exposure of € 250 billion) to provide the Bank's creditors with considerable comfort. Moreover, the Bank's return on equity is likely to be below the level that a market investor would expect. Evidently, this is because the Bank is a non-profit institution and it would be perfectly acceptable as long as the Bank carried out only public tasks. But the Bank may also be seen to compete with private banks and then its low return on equity could become a matter of concern under state aid policy rules. Finally, the Bank has other privileges, notably exemption from income taxation.

Turning to the differences, the Bank pursues only one activity, namely the provision of loans for investment projects, whereas the *Landesbanken* offer a variety of financial services and their assets comprise not only loans and other debt instruments but also equity. It follows that there is only one line of business where the Bank potentially crowds out private banks, and this business is probably the banks' least profitable.

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[11] In this context, EI/ CED is preparing a study on the importance of SMEs for EU economies and on the possible implications of further consolidation in the EU banking sector on SME finance.

Another difference is that the Bank has been set up as an institution with the mandate to support the policy objectives of the European Union, and a regionally balanced economic development within the Union in particular. In principle, this should make the Bank less vulnerable to accusations of unfair competition. In practice, however, it will depend on how well the Bank demonstrates that its contribution to these objectives clearly sets it apart from private banks.

Overall, despite the idiosyncrasies of the Bank, the risk of being accused of unfair competition is real and, in fact, such criticism has been made.[12] Is there a way out for the Bank into a promising future?

An obvious strategy would be to strengthen the Bank's contribution to public policy functions. Given its institutional advantages, on the one hand, and the EU policy objective of ensuring free and open competition, on the other hand, the Bank is likely to face increasing demands to demonstrate that its lending is compatible with EU state aid policies.

Against the benchmark of these policies [13], Bank lending would have to (i) address market failure, (ii) ensure that the benefit passed on to the borrower does not go beyond what is necessary to compensate for the market failure, and (iii) demonstrate that the investment would not have happened – or not in the same beneficial way –without the Bank's lending. In addition to taking these hurdles, Bank lending would have to ensure that (iv) competitive distortions among firms and the (v) crowding out of private finance is reduced as far as possible. Interestingly enough, even support for regional development would have to pass these tests although the burden of proof is likely to somewhat lighter.

Looking at the Bank's areas of operation, it is fair to say that lending in support of investments in non-competitive sectors (e.g. public infrastructure, health, and education) should take these hurdles with relative ease.

Things get more complicated when it comes to market failures in competitive sectors. Take the case of renewable energy – supplied to a competitive market – as an example: the Bank would have to demonstrate that the underlying project addresses a market failure (easy given the environmental benefits), the promoter is not overcompensated for the economic benefits he creates (a bit more difficult but feasible given the modest subsidy element of Bank loans), and that the project would not have materialized without lending from the Bank (difficult given the Banks current mode of operation); at the same time, the risk of creating distortions among the suppliers of renewable energy and of crowding out other finance should be minimized.

The task becomes harder still with regard to projects of well-established firms in industry and competitive services (such as some segments of the telecom sector). Such projects seem very difficult to defend outside assisted areas, but even when they are presented as regional development projects it would be a challenge to demonstrate that they properly address market failures without unduly distorting competition. The same applies to investments that aim at fostering employment, innovation, and the competitiveness of EU industry. In sum, to operate in line with EU state aid policies, simply lending in favor of financially and

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[12] A flavor of the type of arguments that could be made is provided by the article by Friederich Heinemann in the *Handelsblatt* of 30.05.00 ("The EIB enjoys similar privileges to *WestLB* – A bad example to take forward"), or the article ("The EU Investment Bank irritates banks – a phenomenon that messes up markets completely") in the Finnish *Hensingin Sanomat* of 19.10.00.

[13] See, for instance, Commission of the European Communities, *State Aid and Risk Capital* (2001/C 235/03) Brussels, August 21, 2001 and *Ninth Survey on State Aid in the European Union*, Brussels, July 18, 2001.

economically viable projects that meet certain eligibility criteria (and come with buzzwords such as 'innovation', 'jobs', 'competitiveness') will not do the trick.

Meeting the challenges of EU state aid policies will require a departure from the Bank's current mode of operation. This is not the occasion to flesh out details. But it is obvious that the Bank would need to step into the project cycle much earlier than at present. How else could the Bank demonstrate that the investment in question would not have happened without its support? Early involvement, in turn, would have to be guided by in-depth analyses to identify market failures that warrant the intervention of a public bank.

We have stressed the crucial importance of market failures. What about EIB policies that fail to convincingly meet public policy functions? In this case, the Bank runs the risk of being increasingly seen as an unfair player, bestowed with institutional advantages that enable it to take away market share from private competitors. As we have discussed elsewhere [14], this is bound to increase calls for the Bank – like the *Landesbanken* – to be governed by a normal owner-bank relationship, requiring the Bank to generate an adequate return on equity, to pay for the guarantee implicit in the Bank's callable capital, and to become subject to income taxes.

To conclude, times are indeed changing. There is no reason to believe that the Bank could not adapt to and prosper in the new environment. But there can be little doubt that the new environment will demand much greater clarity of objectives from the public sector banking community.

[14] EI/CED/2000-0310 (Life began at 40?) and EI/CED/2001-026 (Life began at 40? Report 2).