European Investment Bank

TOWARDS A NEW STRATEGY FOR THE EIB GROUP

At its 2005 Annual Meeting held on 7 June 2005, the EIB's Board of Governors endorsed the general orientations on future strategy outlined in the attached document, while taking note of the annexes. The Board of Governors requested the EIB's Board of Directors to make proposals as appropriate and to take the necessary decisions within the framework of the Corporate Operational Plan, in particular as regards the various elements of the Profit and Loss Account, with a view to maintaining financial self-sufficiency.

June 2005

TOWARDS A NEW STRATEGY FOR THE EIB GROUP

Introduction

1. When the Board of Directors submitted its proposal for the last capital increase in June 2002, it undertook to conduct a formal review of the Bank's Strategy, including a review of risk management, at the mid-point in the ensuing five-year period. The purpose of the review was to provide assurances that the announced strategy was being effectively implemented by the Management Committee and the Board of Directors and that the capital increase would last, as decided by the Board of Governors, for at least five years. The results were to be reported to the Governors at their June 2005 meeting.

2. Since June 2002, the Board of Governors has received reports on the performance of the EIB Group in relation to the Strategic Framework notably on results, control of volume of operations, new initiatives relating to EU policies, the identification of value-added and risk management. While a further report on Risk Management is submitted separately, this report, together with its annexes, takes stock of the capital situation of the Bank and developments in activity, both within and outside the European Union. It is intended to lay the groundwork for a revised Strategy for the Bank and the EIB Group as a whole.

3. Subject to the agreement of the Governors on the orientations as outlined below and detailed in the attached annexes, the Management Committee and Board of Directors are ready to prepare for its implementation at EIB Group level. The Board of Directors requests a mandate from the Board of Governors to monitor implementation and report on developments.

Capital situation

4. According to the current Statute, the Bank requires an increase in capital when the stock of outstanding loans approaches 250% of subscribed capital. Should the stock of outstanding loans reach this limit, the smooth development of Bank lending would be disrupted. After the 2003 capital increase, and the additional increase in subscribed capital in 2004, the **capital of the Bank is now expected to be sufficient at least until 2010,** all things being equal[1]. So, with the present trend in lending and barring a significant and sustained fall in the Euro exchange rate, there should be no need for an increase in capital in 2008 as was envisaged three years ago.

5. Moreover, the financing of a future capital increase will not pose any particular difficulties, and the **principle of financial self-sufficiency should be maintained**. In the run-up to decisions about the next capital increase, it could be possible to consider devoting some of the Bank's own funds specifically to the policy objectives described below (as in the past with the ASAP reserve), as well as to the capital increase.

Added value : the cornerstone of EIB lending policy

6. It is recalled that the value-added of Bank lending rests on three Pillars, viz.:
    1) Consistency between operations and the priority objectives of the EU
    2) Quality and soundness of each project
    3) Particular financial benefits obtained by the use of EIB funds.

7. The EIB has demonstrated strong value added under the first two Pillars, through its support of EU policy, responding quickly and effectively to requests to support programmes launched by the successive EU Presidencies, and through the quality of its project selection. However, for a signifiant proportion of traditional intermediated EIB operations, developments in the financial marketplace over recent years have had an adverse effect on the Bank's financial value added (Pillar three).

[1] also taking into account the appreciation of the Euro and the increase in the subscribed capital on 1.5.2004 of € 7.7bn more than was expected at the time of the 2003 capital increase.

8. As a consequence, and mindful of the Bank's "policy-driven" mission, the Board of Directors and Management Committee have considered whether the current approach to value added provides sufficient justification for the Bank's operations in the longer term. They are of the view that the EIB Group, and in particular the Bank, must now consider making important adaptations and changes, to be introduced albeit gradually, that would lead over time to a new approach to the Bank's added value.

Europe (EU 25), Acceding and Candidate Countries

9. **The Management Committee and Board of Directors conclude that as regards activity in Europe, the EIB Group should review its key priorities, introduce new instruments, focus more on the types of operations than on volume and allow for a controlled increase in its tolerance of risk on individual operations.**

Adding SMEs to the Bank's key operational priorities

10. Currently, the Bank's key operational priorities within Europe are: 1) Economic and social cohesion (the Bank's main priority), 2) Implementation of the Innovation 2010 Initiative 3) Development of Trans-European and Access Networks, and 4) Environmental protection and improvement. The relevance of these four priorities has been continuously confirmed by Council decisions to improve growth and employment within the Union and to advance the Lisbon agenda. These themes will stay at the core of the discussions taking place at Community level in the context of the 2007-2013 EU priorities and Financial Perspectives and should therefore remain key priorities for the Bank.

11. Moreover, in a market of over 20 million SMEs, support for the small business sector in the EU, with its capacity to generate employment, is considered to be central to the mission of the EIB Group in pursuit of EU policy goals. Whilst the Bank has consistently supported this sector through its global loans, contributing to better access to finance for SMEs has been the sole focus of the European Investment Fund since its reform in 2000. Taking into account the specific characteristics of the individual markets, **it is now proposed that SMEs be added to the Bank's own key priorities, putting the combined strengths of EIB and EIF to work more efficiently through an increase in synergies.** This will result in a better identification of the most appropriate product required to improve access to finance for SMEs, reflecting the variety of situations at national and regional level but also the specificity of the financial counterpart, thereby maximising the EIB Group's value added in favour of SMEs. These new operational arrangements would clarify the respective roles of EIB and EIF and would also strengthen joint EIB-EIF product development, drawing on EIB`s extensive network of relationships with EU financial intermediaries and EIF`s specific technical expertise and operational experience in the sector.

12. The maximisation of the value added of Bank action will require strict focus on these five main objectives. Consequently, eligible operations falling outside these priorities would be given less attention, including fewer resources.

A renewed partnership with the banking sector

13. A fruitful relationship with commercial banks based on subsidiarity and complementarity will remain very important for the EIB. Without its banking partners, EIB would not be able to bring added value to a wide variety of projects both in the public and private sectors. In the New Member States, Acceding, Candidate and Partner Countries, EIB can make a significant contribution to the development and reinforcement of the banking sector.

14. Bearing in mind that EIB product offerings must remain sufficiently attractive to generate an adequate financial benefit not only for intermediaries but also for final beneficiaries, the Bank is seeking to develop alternative approaches and structures, with a view to ensuring that the final borrowers (SMEs, municipalities) really benefit from EIB intervention. There is no single solution for all countries or client groups, as the nature and scope of the partnership reflects the specific characteristics of each banking market.

15. While this process is unfolding, therefore, the Bank's role should evolve further, from its previous focus of universal provider of funding, to a role of a flexible partner acting with more tailor-made products adapted to local market circumstances and to the needs of counterparts.

Controlled increase in tolerance of risk; new financial instruments

16. Across the spectrum of the reviewed list of key operational priorities indicated above, the Management Committee and Board of Directors have reviewed the range of financial instruments offered. They believe that additional products could and should be brought to the marketplace, in order to better reflect the Bank's statutory commitment of additionality. EIB's extensive knowledge and expertise in certain sectors, high capitalisation and solid risk management systems should allow the Bank to increase its value added by expanding its actions in areas that are served insufficiently, or not at all, by the market.

17. These additional products, although more staff-intensive, are designed to address the various requirements of both public and private sector borrowers as well as potential new clients; they include taking more risk on individual operations; they will require more Risk Capital and Structured Finance. Apart from additional changes to the risk profile, they will also include modifications to the loan grading and risk pricing systems.

18. In addition to its direct financial activities, the Group proposes to increase provision of advisory services in fields where its technical expertise can support EU policies.

Enhanced cooperation

19. Co-operation with the **European Commission** at Group level will continue and will be enhanced wherever this is considered beneficial as regards the impact of the overall Community financial intervention, not least through a substantial strengthening of the Cooperation Framework with the Structural Funds. The institutional and operational **cooperation with other IFIs**, viz EBRD, NIB and Council of Europe Development Bank, that aims to maximise respective interventions, be it on the level of expertise, financial resources or policy objectives, will be pursued.

Partner Countries

20. Under the present arrangements, the Bank is entrusted with the management of a series of ad hoc political mandates rather than being in a position to develop its own approach and strategy on the basis of a broadly defined mission. Its practice is also influenced by its capital structure and by the culture of its core business in the EU and Accession Countries.

21. The Management Committee and Board of Directors consider that whilst the Bank has established a reputation as a reliable, pragmatic and efficient lending institution in many parts of the world, certain changes would improve the overall visibility and effectiveness of EU development finance.

22. Better serving the development objectives and policies of the Union would call for a more coherent and staff-intensive approach to EIB activity in Partner Countries that would put more emphasis on country and sector intervention strategies and involve more risk-taking coupled with greater availability of subsidies, and closer cooperation with all actors (the Member States who are the Bank's shareholders, the Commission, bilateral aid agencies). The relevant decisions, including those relating to the institutional set-up and staffing, can only be taken once the evaluations of FEMIP, the Investment Facility and the external mandates have been completed.

23. Without prejudice to future discussions at a political level, possible options are set out in the attached Annex II. The Board of Directors and Management Committee will, at the request of Governors, evaluate the main elements of such alternatives.

24. In the meantime, the Bank will continue to operate within the existing institutional arrangements for its lending outside the EU, while striving to make them more effective. Notably, for the ACP Cotonou Investment Facility a higher risk profile will be proposed.

Consequences of a new Strategy for the EIB Group

25. It is clear that the Bank would continue to be managed according to sound banking principles and taking into account its objective to meet Basel II standards within a reasonable time frame. On this basis, the consequences of the proposed changes in strategy would need to be evaluated in depth if they are endorsed by the Board of Governors.

26. It should be noted that taking into account the realities of individual markets, a possible consequence of the proposed innovations might be a stabilisation of lending volume within the EU.

27. Moreover, bearing in mind that the new strategy focuses on quality, it implies an increase in costs of operations that will affect the level of the surplus. It might also lead to proposals to dedicate own funds to specific initiatives. Therefore, an appropriate balance will need to be found with traditional EIB lending products in order to maintain a level of surplus that is consistent with the principle of self-sufficiency.

28. The consequences of the new strategy in terms of human resources should not be underestimated. It would require internal organisational and budgetary changes, the identification of skills needed, a redistribution of existing resources, the development of appropriate training and the recruitment of specialised staff.

Proposal

29. The Board of Governors is requested to endorse the general orientations on future strategy as outlined above, and to take note of the attached annexes. It is further requested to ask the Board of Directors to make proposals as appropriate and take the necessary decisions within the framework of the Corporate Operational Plan, in particular as regards the various elements of the Profit and Loss Account, with a view to maintaining financial self-sufficiency.

<u>Annexes</u>

ANNEXES

I EU, Acceding and Candidate Countries

II Partner Countries

III Funding Strategy

IV Capital Increase

ANNEX I

I EU, Acceding and Candidate Countries

1. From four to five operational priorities

Within the enlarged Union, the Bank targets four operational priorities in line with the 2002 capital increase proposal and the latest COP 2005-2007 approved by the Board of Directors. These four priorities are **Economic and Social Cohesion, Innovation 2010 Initiative, Trans-European Networks** and **Environmental Protection and Improvement.**

The relevance of these four priorities has been continuously confirmed by Council decisions to improve growth and employment within the Union and to advance the Lisbon agenda. These themes will remain at the core of the discussions taking place at Community level in the context of the 2007-2013 EU priorities and Financial Perspectives and should therefore remain key priorities for the Bank.

Economic and Social Cohesion will have to reflect fully the challenges resulting from enlargement but also the continuous disparities within each Member State. This is, and will remain, the Bank`s top operational priority.

Innovation 2010 Initiative with EIB and EIF using, in a complementary manner, the entire range of financing instruments available (loans, guarantees and equity through venture capital funds) i2i will remain the EIB Group's main contribution in support of the Lisbon Strategy as well as of the European Action for Growth launched by the European Council in December 2003).

Trans-European Networks is the other main component of the European Action for Growth with efficient transport, energy and information networks key to economic integration and development.

Environmental Protection and Improvement activities will continue to cover requirements for ensuring sustainable development, investments that are needed to ensure compliance with existing and new EU environmental legislation and to fulfil commitments under the Kyoto Agreement, in particular regarding reduction of greenhouse gas emissions.

Small- and medium-sized enterprises (SMEs) play an essential role in the European economy, with over 20 million SMEs accounting for around two-thirds of jobs and half of the turnover in the non-agricultural business sectors. SMEs' contribution to growth and employment as well as diffusion of innovation make them key players in the achievement of the Lisbon Strategy goals. At the same time, limited access by SMEs to external finance unduly restricts employment and growth in the Union.

Whilst there is no indication of generalised market failure across Europe for the supply of finance to SMEs, the Commission has, in a recent Communication, stressed the need for public action as a catalyst to development of markets at European, national and regional levels in three specific areas:

I. the improvement of the framework conditions for SME finance with, in particular, the development of financial markets in the New Member States suffering from a low level of equity investments and bank lending;
II. early-stage finance in particular through guarantees and microlending;
III. equity.

With an extensive network of banking partners in the Union, the availability of the full range of lending, guarantee and equity products as well as its experience in the successful implementation of mandates from the Commission, the EIB Group is in a unique position to contribute to the support of SMEs. In order to provide a clear signal of the importance of and commitment to sustained action in favour of SMEs, it is proposed that support for

SMEs be upgraded from the Bank's "other operational objectives" and added to its priority objectives.

The maximisation of the value added of Bank action in line with the decisions taken by the Board of Governors at the last capital increase will require strict focus on the five main objectives. Consequently, eligible operations falling outside these priorities would be given less attention, including fewer resources. Subject to approval by the Board of Governors, this will be reflected in the forthcoming COP.

2. Renewed partnership with the commercial banking sector

2.1 Background

The partnership with the banking sector has been particularly valuable for EIB to develop and leverage its activities. Without its banking partners, the EIB would not be able to bring added value to a wide variety of projects both in the public and private sectors and would see its remit limited to a modest number of large projects and counterparts.

The nature and scope of the partnership differs significantly from country to country, reflecting specific characteristics of each banking market and the way EIB developed tailor-made structures to adapt to particular needs and expectations of different banking partners and final beneficiaries in different geographical areas.

The partnership is based on subsidiarity and complementarity, whereby EIB takes into consideration market concerns of its banking partners in striking a balance between the advantages of co-operation with banks and direct financing alternatives. Commercial banks take into account EIB's operational priorities and accept its reporting, transparency and value added requirements, thus delivering EIB benefit to financial beneficiaries.

In mature banking markets, the partnership is not an aim in itself but a delivery mechanism for "doing more and better" for project promoters. In the New Member States, Accession and Partner Countries, EIB can make a significant contribution to the development and reinforcement of the banking sector[2].

Through its leverage effect and the high level of standardisation of credit requirements, the partnership with the banking sector has contributed to the Bank's growth in volume of lending activities at broadly constant staffing levels in its lending departments. This business model is, however, challenged by a combination of factors, both internal and external to the Bank:

Changing capital market circumstances: The continuous sophistication of capital markets has lead to a widening of its risk spectrum reaching lower-rated borrowers and a deepening of the market offering longer maturities. It also allows borrowers to tailor standard bond market offerings to their specific funding needs and reduces the relative reliance on bank debt as a source of funding. The development of the EUR market has replaced a large number of national markets that offered more opportunistic funding possibilities for blue chip names such as EIB.

Additionally, at the current point in the economic cycle, the banking system in most Member States is characterised by a high level of liquidity and modest levels of lending opportunities. These circumstances, combined with the historically low interest rates, have driven investors and banks to increase their search for higher yield, which has led to the erosion of the credit spread differentials in funding conditions between top rated counterparts such as EIB and lower rated counterparts. Compared to commercial banks that can rely on a significant low cost deposit base for their funding, EIB is particularly sensitive to these market conditions as it is confronted with tight margins in capital markets for both its funding and lending activities. Whilst it is not possible to assess how long the

2 The value added that EIB thereby provides in most of the NMS and Accession countries is particularly high as it is underpinned by three special Commission programmes under which EIB channels EU grants through dedicated global loans.

current market conditions will prevail or to what extent the changes will be of a more permanent nature, the Bank has to take into consideration the possibility that these more challenging conditions could prevail for quite some time.

This decline in the relative funding advantage of EIB resulting from present capital market circumstances has reduced the financial value added that the Bank can currently provide, in particular to some of its highly rated counterparts.

Increased focus within EIB on value added: The implementation of the value added framework based on the three pillars is an essential step to ensure that the EIB benefit is significant, taking into account the specific characteristics of the targeted markets, and reaches final beneficiaries. In this context, the EIB has to increase its transparency and reporting requirements, possibly causing higher administrative costs for the partner banks at a time when the absolute advantage of EIB funding has already been reduced. Although smaller, specialised intermediaries (particularly those without retail activities providing access to cheap funding through client deposits) might be willing to set up a dedicated and fully transparent EIB back-to-back financing mechanism, other banks might be reluctant to change the way they operate today.

2.2 Proposed new ways of co-operating with the banking sector

Bearing in mind that EIB product offerings will have to remain sufficiently attractive to generate an adequate financial benefit for both intermediaries and final beneficiaries, the Bank is seeking to develop alternative approaches and structures to maintain and further strengthen its value added, thereby diversifying the nature of the partnership over time. This process is to be managed carefully in order to maintain the win-win situation in the partnership that has been built over many years. There is no single solution for all countries or client groups to strengthen the Bank's value added given the diversity of the bank relationships and the different requirements in the respective banking markets. The approach will be based on a more individualised assessment of particular needs and expectations of different banking partners and final beneficiaries.

Through dialogue with its banking partners, EIB will identify areas or niches of common interest and broaden its product offerings with the aim to preserve and enhance its value added. While this process is still unfolding, the Bank's role should evolve further from its previous focus of universal provider of funding to **a role of a flexible partner acting with more tailor-made products**, adapted to local market circumstances and the needs of counterparts. Over time, the implementation of new products should gradually replace the more traditional provisioning of attractive wholesale funding.

The relevance of new product offerings involving banking partners will have to be measured in terms of the three pillars of the Value Added Framework in order to ensure a high level of dedication, visibility and transparency for each operation. The ways for the EIB Group to widen its bank co-operation can be clustered around the following themes:

Optimisation of capital efficiency: One of the consequences of the implementation of Basel II on the banking industry will be to further strengthen the focus on optimisation of capital efficiency. A prime avenue for product development for the Bank will therefore be to focus on the potential for **capital relief** that EIB involvement can provide to its banking partners by exploiting more structured operations. For a number of banking partners, the value of EIB involvement could be strengthened significantly by widening a "funding only" approach to the sharing of credit risk on final beneficiaries. **Risk sharing** structures will increase credit capacity of intermediaries thereby underpinning availability of and access to funding for final beneficiaries.

Several alternatives are being explored to widen EIB risk sharing product offerings, including a concerted **EIB Group approach to increase the use of securitisation** such as SME loan-backed ABS and MBS operations. Securitisation can be an adequate solution to resolve limit, capacity and, in certain cases, pricing constraints. A joint EIB-EIF approach to SME securitisation could consist of combining EIB investments in senior notes and EIF providing guarantees for (sub-) mezzanine tranches.

Other capital relief products under consideration are based upon the development of **risk sharing mechanisms.** A first approach would consist in the close scrutiny of the intermediary and its decision making process combined with its continued compliance with the Internal Rating Based (Advanced Approach) in the context of Basel II. For a limited number of medium sized projects that can be subject to a succinct individual risk assessment by EIB, the Bank could share in risk and reward on a case-by-case basis with partner banks. Complementary structures are to be worked out to take into account the nature and size of the underlying projects as well as the specific needs of intermediaries in the different markets. In the case of SME financing, bank partners could appraise and administer loans whilst the Bank could co-finance and share in risk and reward based on the performance of the underlying SME loan portfolio. Such operations have to be carefully structured, notably to mitigate the risk of adverse loan selection and to determine the adequate risk premium level. EIB Group could develop a **combined risk sharing SME loan product** whereby EIB provides the financing and EIF the risk insurance on SMEs.

Closer involvement in the market strategy of partner banks. EIB could strengthen its commercial and strategic role in banking partnerships by being more closely associated to particular marketing efforts of its banking partners for the development of niche products promoting EIB priorities (e.g. innovation facility, R&D, very small companies). In addition to funding, the Bank would contribute the EIB label, support and stamp of approval to the initiative. These arrangements will de facto involve a temporary exclusivity for the intermediary to cover a particular market niche in a given geographical area for highly visible and dedicated initiatives such as in the field of urban transport and urban renewal.

Supporting alternative investment financing structures. The Bank could explore this possibility on a case-by-case basis and, for instance, **act as a bond purchaser / underwriter**, seeking not only to pass on its funding advantage but also aiming at catalysing other financing sources through its signalling effect ("EIB stamp"). This initiative would seem particularly relevant in well-defined circumstances, e.g. in support of first-time or infrequent access to capital markets or for lesser-known borrowers.

Other areas being considered: They include **support to pilot credit schemes** (e.g. micro credit, student loans, support to priority social projects in urban areas). An EIB Group approach to **micro-credit** could be based on combining the ability of the Bank to provide attractive funding and take counterparty risk on Micro Finance Institutions, with EIF guarantee facilities to provide partial credit cover for loan portfolios.

3. More risk, and other instruments, for more value added

3.1 Increased tolerance of risk

The Bank is able and willing to accept more risk where this can enhance added value in its lending activities. Over the last years, the Bank has taken first steps to provide additional support to priority projects through the assumption of risks that it was previously unwilling to take. The Bank has now begun to take further steps to allow for a more systematic use of specific higher risk facilities such as the Structured Finance Facility (SFF), and also to increase the flexibility of its risk policy to accommodate a wider range of well understood risk profiles. These steps are accompanied by internal measures to strengthen financial monitoring.

Since the last capital increase of January 2003, the Bank implemented the following main changes to its credit policy:

- The **risk weighting** was lowered in the case of some risk mitigations, providing for more room under counterparts' exposure limits.
- The **acceptable credit quality** was lowered for corporates and banks by at least one rating notch.
- Sublimits for **unsecured lending to banks** were introduced to improve control of this exposure.

- A re-orientation of the "**Minimum Acceptable Criteria**" (MinAC), formerly called Justified Exceptions, has been introduced to allow for more flexibility in corporate lending by focusing on internal EIB credit assessment instead of on the borrower's external rating only.
- The **MinAC portfolio limit** has been increased and its criteria adjusted to accept lower rated counterparts.
- **SFF operations** were given additional room by lowering the capital allocation and the finer classification of the relevant grading category.
- **Additional Risk Pricing** was introduced in early 2003 for unsecured corporate loans and extended in July 2003 to Project Finance and corporate loans falling under MinAC, creating an incentive to diversify counterparts and avoid risk concentration.

Further changes have been introduced recently to standard lending requirements to enable more risk taking:

- in **corporate lending**: by the lowering of the minimal external rating for unsecured lending, the increase in loan maturities and the modification of loan portfolio limits on MinAC and Project Finance exposure;
- in **local authority financing**: by temporarily lowering its minimum credit rating requirements in New Member States with the intention to gradually bring them back to standard levels by the end of 2007 (decision taken in 2002); and now more recently by permanently lowering minimum requirements for all EU local authorities;
- in **Acceding and Candidate Countries** (i.e. Bulgaria, Romania, Turkey and Croatia) by now extending its assumption of Non Transfer and Convertibility of currency (NTC) risks to non-sovereign lending under the Pre-Accession Facility, thereby further promoting foreign and domestic private investments;

  under the **SFF**: It is recalled that the SFF was established in 2001 to enable the Bank to provide additional support to priority projects through the assumption of risks it was previously unable to take. Since 2003, it has been particularly focused on TENs and i2i projects in support of the EU Growth Initiative. SFF is a tool for the Bank to take risk at the lower end of the investment grade spectrum and beyond, as appropriate. Within SFF, the Bank can provide financial products such as senior debt, mezzanine and subordinated debt, project derivatives, and equity-type instruments, the credit profile of which is lower than the standard normally assumed by the Bank. SFF is designed to have a high added value, being generally used in limited amounts and with a high leverage factor.

Despite the flexibility within the existing SFF framework to enable a range of risk profiles and structures, progress in implementing SFF projects has so far been rather slow. However, based on this first experience, SFF product models that are scaleable and on which business volume can be built have now been identified. The objective now is to build a significant and sustainable SFF programme, making it into a more mainstream element of the Bank's lending activity with a continued focus on the high priority sectors of TENs and i2i projects.

The financial capacity required for a sustained SFF programme should be drawn both from internal and external resources. Total SFF reserves of EUR 750m have been authorised by the Board of Governors from internal resources, of which EUR 500m have already been released and are currently available to be deployed. The remaining EUR 250m may be required to be released for use within the next years, dependent upon the Bank's success in implementing the SFF programme. EIB is working with the Commission on the development of a risk sharing instrument for Research and Technological Development (RTD) projects which would provide significant additional resources, alongside the SFF programme, for leveraging the Bank's own resources deployed in the i2i instrument.

More adjustments will be considered to the Bank's modus operandi. In addition to a general review of pricing systems which is currently in hand, and apart from additional **changes to the risk profile**, they will also include **modifications to loan grading and risk pricing systems**.

3.2 New financial instruments

Additionally, the use of new financial instruments will be explored to enhance value added. The provision of **guarantees** should be considered as a new line of business to complement traditional bank-related lending. The foreseen 0% risk weighting of EIB under Basel II should significantly enhance the potential value added of this activity. In private sector financing, the Bank could consider the provision of **mezzanine / high yield debt** for i2i projects, thereby developing a role as a "pathfinder" in sectors where commercial bank finance is more constraint (e.g. in terms of maturity matching asset life). Additional mandates in line with the two successive **Risk Capital Mandates** could be explored using the Bank's surplus for self financed initiatives in favour of, for example, European R&D.

3.3 EIB Group approach towards SMEs: enhanced EIB-EIFcooperation

As indicated above, effective contribution to the SMEs objective requires reinforced integration and exploitation of synergies with EIF, which has SMEs as its main focus since its 2000 reform. With the aim of avoiding intra-Group competition, overlaps and possibly confusing signals to the market, EIB will reconsider the group`s overall product offering in support of SMEs as well as the market approach required for its successful implementation. Currently, the funding and guarantee instruments on Own Resources but also on mandates are marketed and implemented separately without systematic overall co-ordination at Group level. While fully respecting the tripartite nature of the EIF and its own governance structure, financial intermediaries should be presented with a **coherent EIB Group product offering** in the framework of Global Relationship Management (GRM)[3]. A systematic consultation process between EIB and EIF based on GRM will ensure effective co-ordination of common client relationships and enhance the Group's product offering to SMEs.

Co-ordination of the marketing and relationship function will result in a better identification of the most appropriate product required to improve access to finance for SMEs, reflecting the variety of situations at national and regional level but also the specificity of the financial counterpart, thereby maximising the EIB Group's value added in favour of SMEs. These new operational arrangements would also **strengthen joint product development** drawing on EIB`s extensive network of relationships with EU financial intermediaries and EIF`s specific technical expertise and operational experience in the field of SME portfolio guarantees. Finally, it would enhance the joint intervention of EIB and EIF for SME and Micro-credit finance through the combination of lending and guarantee instruments, and, in the case of SMEs, securitisation transactions.

3.4 EIB Group as Advisor

The development of advisory services enables the Group to leverage its recognised expertise in support of EU policies in addition to its direct financial activities.

Notably in the field of **transport infrastructure**, Member States and local authorities have requested the Bank on numerous occasions to play an advisory role in a formal or informal capacity for the development of new financing structures (e.g. in the context of PPPs) or for support in the development of priority Trans-European Networks (TENs).

Through staff secondments, through the use of Technical Assistance resources drawn from EIB or managed on behalf of third parties (e.g. Italian Trust Fund for the Balkans), through information on the availability of European funding as well as through the role played by its services in advising project promoters and borrowers at the various stages of the project – in particular appraisal, procurement and monitoring-, the Bank has been able to play a significant role in ensuring the development of projects to a stage where they can be successfully financed.

3 The GRM concept is well embedded in the Bank and is designed to ensure a systematic approach to increasingly complex relationships with key clients in the achievement of COP policy objectives complementary to geographic goals. GRM stimulates a culture of cross-border cooperation, fosters a sharing of skills and new products, as well as generating transparency in information flow.

In addition, the Bank is supporting the Union's priority objectives in terms of **environment** under the Kyoto Protocol, with the launch of the Climate Change Technical Assistance Facility (CCTAF) using EIB and third party contributions. This facility provides advance funding to assist project promoters in developing the carbon reduction potential of their activities and therefore maximising the benefits resulting from the generation of carbon credits, which can be recognized and used within the EU emissions trading scheme.

Cooperation with the **European Commission** for advisory services has also been strongly developed over time, ranging from the provision of technical and economic evaluations (e.g. for projects to be financed by the Structural and Cohesion Funds or by Euratom), to advisory services for the Galileo priority TEN project as well as the definition of new Community financial instruments (see for instance CGIT, SFF/RTD).

Since 2003, **EIF** has also developed advisory services drawing on its expertise in the fields of Venture Capital and Portfolio Guarantees to support regional and financial organisations in creating more favourable conditions, and enhanced access to finance, for SMEs. Until now, assignments have been undertaken for national and regional, public or private organisations and the Commission.

It is proposed that EIB Group will **increase provision of advisory services** where its technical expertise can support EU policies.

4. Enhanced cooperation

4.1 Cooperation with the Commission

Fully reflecting the nature of the Bank as a policy-driven public bank supporting policy objectives of the European Union and in line with orientations provided by the Board of Governors and the European Council, the Bank has intensified co-operation with the European Commission in order to maximise the impact of the overall Community financial intervention.

The Bank has a long tradition of co-operation and joint product development with the Commission. The main current initiatives include the SME and Municipal Finance & Infrastructure facilities, a co-operation between EIB, Commission and the banking sector which enables channelling EU grants through dedicated EIB global loans in most of the New Member States and Accession Countries.

In the context of the European Action for Growth, new initiatives would involve upstream involvement in project issues (e.g. TEN Priority projects or Quick Start Package initiatives for Research) but also **design of specific financial instruments** mobilising budget resources in the context of the new Financial Perspectives (covering identified financial needs in both TEN and research fields). The creation of the new instruments now being considered by the Commission and their possible management by the Bank would leverage EU financial action through the use of the Bank's technical and market experience:

Expanding SFF activity: Mandates from the European Commission are likely to be a further significant resource to provide additional funds for the Bank's SFF programme. Discussions are underway on the establishment of a further SFF resource dedicated to **i2i/RTD** (for an amount of EUR 1bn from the beginning of the new Financial Perspective covering the period 2007 to 2013).

In a similar way, proposals are underway with the Commission to enlarge the existing partnership and to include closer association of the Bank in the preparation and implementation of the future Cohesion Policy:

TEN-T Guarantee Instrument: The Commission has recently proposed the creation of a TEN-T Guarantee Instrument which would support major transport projects in the immediate post-construction phase. The Commission has proposed that EIB should manage the instrument.

JASPERS: (Joint Assistance in Supporting Projects for European Regions). The Commission and the Bank are considering a substantial enlargement of the current Cooperation Framework with the Structural Funds with specific priorities for the New Member States and Accession Countries covering the 2007-2013 programming period. The aim is to support the countries' implementation of the Structural and Cohesion funds through the provision of technical assistance by the Bank in the four phases of programming, project preparation, implementation and monitoring, to assure quality of projects and their implementation, and to leverage the available Funds through co-financing arrangements. In addition, JASPERS is expected to involve an "Access to Finance" initiative which would include a micro-finance facility in co-operation with EIF and specific support for financial engineering in assisted areas (notably for investment funds and guarantee schemes).

4.2 Synergies with other IFIs

In line with the objective of maximisation of the value added of its intervention, the Bank has developed over the years a strong institutional and operational cooperation with he other International Financial Institutions that are majority owned by the EU and/or Member States, viz. the European Bank for Reconstruction and Development (EBRD), the Nordic Investment Bank (NIB) and the Council of Europe Development Bank (CEB).

This cooperation is formalised at institutional level, for instance by the Bank's shareholding in EBRD or the signature of a Memorandum of Understanding. Regular contacts at senior management level have been successfully translated into concrete co-operation at operational level over many years in the former Accession Countries of Central and Eastern Europe (and now in particular in the Western Balkans Region as well as Russia). Co-operation may typically include joint appraisals and co-financing of projects, thereby drawing on each institution's expertise, financial resources and policy objectives.

5. Financial capacity for adding more value

Full implementation of the value added approach for the EU and Accession Countries as outlined above will lead over time to smaller, more complex and higher risk transactions.

As may be concluded from the Risk Management Report that is submitted separately, the Bank is highly capitalised in relation to the minimum regulatory capital requirements under Basel II. **The Bank's strong financial situation will therefore allow for a gradual shift in risk pattern without jeopardising its AAA rating.** This financial situation is underpinned by the Bank's capital base (further enhanced by the support of its shareholders though callable capital) and the net surplus generated, which **could be used to support additional provision or the constitution of additional dedicated reserves,** such as those created for venture capital or SFF, or for **other specific initiatives** that are consistent with the Bank's mission and key priorities. Moreover, the Bank benefits from its strong risk assessment and management structures as well as from the quality of its loan portfolio. Over the last years, the quality of the EIB's loan book has further improved, with the best credit risks (internal loan grading from A to C) making up 96% of the portfolio, compared to a current minimum target level of not less than 90%, thereby leaving ample space to absorb operations with a higher risk profile.

ANNEX II

II Partner Countries

1. The EIB's status as development banker: risks and challenges

The Bank's role has been reviewed in the broader context of the efficiency and effectiveness of the overall EU Development Policy and in the light of the current debate on the achievement of the Milennium Development Goals. Clearly, the "New Frontier" for the EIB lies outside the EU: this is where the Bank must now prove its worth as a development institution.

The EIB is not new to lending in Partner Countries: in the Mediterranean and ACP it has been active for four decades. Lending volume here is modest compared to EIB operations in the EU, but quite significant when compared to the economic size of recipients and the operations of most other IFIs. Indeed, the Bank has established a reputation as a reliable, pragmatic and efficient lending institution in many parts of the world.

At the same time, the new and reinforced mandates that have been entrusted recently to the Bank - particularly FEMIP and the Cotonou Investment Facility - have raised both the Bank's visibility as an institution financing development and expectations of its contribution to achieving goals of development aid. Thus the Bank is coming under increased scrutiny from both its shareholders and other interested parties on how effective it is in achieving such goals[4]. This reflects a general tendency that is prompted by criticism on the effectiveness of aid in the past and by more stringent budget constraints while the achievement of MDGs calls for increased and more efficient resources.

How well placed is the Bank to face such a challenge? Development banking clearly differs in nature from the EIB's mainstream operations within the EU. In most low- and middle-income countries where the Bank operates outside the EU, many of the "systems" and "institutional arrangements" that are expected to function smoothly in the developed world are underdeveloped or inexistent. Hence the value added brought by the EIB and other similar development institutions to the projects that they sponsor resides not only in the cost of finance, but very often also in the access itself to the appropriate mix of financial instruments. Many public sector projects, particularly in low income countries, involve externalities that justify a subsidy and hence call for a grant element. And institutional support (e.g. through formal technical assistance or informal interaction with the project team) and policy reforms (e.g. regulatory changes, tariff increases etc.) are typically just as important. There is no proper development finance without one or other source of grant resources even if loans are a powerful multiplicator of budgetary resources.

While the EIB is aware of its obligations as one of the financial arms of EU development finance policy and while it has acquired considerable knowledge of development finance issues, its practice is influenced by its capital structure and the culture of its core business within the EU and Accession Countries. Thus there is inevitably a tendency to assess – and present – results primarily in terms of the volume of loans rather than the effectiveness of projects in achieving development goals. Moreover, the Bank's risk-bearing ability is constrained by its statutory rules and capital structure: while the Bank already gets involved to some extent in the various aspects of development banking mentioned here, this involvement remains limited, and the Bank cannot operate as a fully-fledged development bank.

As a consequence, the Bank is criticised for its lack of risk appetite, the relatively narrow focus of its activities on projects, giving insufficient consideration to institutional and policy dimensions etc. It is sometimes perceived as insufficiently aligned with EU development policy objectives.

---

[4] The Development Committee of the European Parliament is preparing a report on the development impact of EIB operations.

More generally, there is a risk of missing an opportunity to integrate coherently an important slice of EU aid. While the Council, the Commission and bilateral agencies are clearly in the lead with regard to overall policy issues and grant aid, there is ample scope for delivering development assistance in the form of loans, particularly in the case of middle-income countries, but also in low-income countries in support of the private sector or autonomous revenue-earning public entities. Being the largest European lender in North Africa, the Middle East and sub-Saharan Africa, the EIB has an important role to play together with the Commission's AIDCO, agencies of the Member States and other IFIs to strengthen and expand and better integrate the financial instruments supporting EU development policy.

2. The way forward

Better serving the development objectives and policies of the Union has implications for the EIB. This new approach may require changes at the levels of the nature and content of its mandates, the Bank's modus operandi and the structure and organisation of its relevant services.

2.1 Nature and content of the mandates

The EIB so far has been constrained not only by its mainstream culture, but also by the concept of "mandate". Rather than being in a position to develop its own approach and strategy on the basis of a broadly defined mission (e.g. provide loans and other forms of support to contribute to sustainable economic development), the EIB has been entrusted, over time, with the responsibility of implementing a growing number of diverse mandates, each with its own particular features reflecting specific circumstances and political arrangements rather than rational design.

Developing a more consistent approach would strengthen the Bank's effectiveness as a development institution. In the meantime, specific adjustments to each of the mandates ought to be considered in order to achieve the objectives of EU development and external relations policies.

- ***Western Balkans***

EIB activity will continue to increase and to focus on basic infrastructure (energy and transport) where the need for continued investment is still large[5]. As these countries get closer to the EU, the scope of EIB activity is likely to expand[6], in partnership with the Commission, other EU donors and IFIs.

- Neighbours

This category includes all countries that will be covered by the Commission's New Neighbourhood Policy. The EIB's lending mandate for **Mediterranean Partner Countries** has significantly evolved, with successive Council decisions in 2002 (creating the Facility for Euro-Mediterranean Partnership, or FEMIP) and 2003 (Enhanced FEMIP). As the largest European lender in the region, EIB has begun to play an important role, together with the Commission's AIDCO, agencies of the Member States and other IFIs, in strengthening, expanding and better integrating the financial instruments that support EU development policy. Support for private sector development (including infrastructure needed by the private sector) has become FEMIP's priority. In addition to previously available risk capital, new instruments[7] have been put in place to increase the Bank's ability to meet its objectives. In the future, private sector development will remain the core priority for FEMIP, while special attention will also continue to be given to regional projects. The mandate is clearly predicated on the assumption that countries are willing to reform in order

5 The newly established Trust Fund, established with the support of the Italian Government, will prove useful in supporting technical assistance and studies.

6 Local municipalities, environmental protection, health & human capital, and the private sector.

7 A special endowment to support project-related technical assistance, FEMIP Trust Fund for upstream technical assistance and equity investments, Special FEMIP Envelope for operations with a higher risk profile.

to improve their business climate and increase productivity. Fora have been instituted to facilitate policy dialogue and reform ownership.[8]

Implementation of the new mandate for **Russia and Belarus, Moldova and Ukraine** will proceed as planned, but it is too early at this stage to anticipate future trends in terms of amounts, eligible sectors or geographical coverage. These will depend on political developments as well as on experience with the implementation of the mandate in the coming years. At the same time, the treatment within a single neighbourhood policy should lead to developments similar to those of FEMIP but taking into account the role of the EBRD in the region. Countries of the Caucasus have also been integrated by the Council within the neighbourhood policy.

- Other Countries

The new features of the **Cotonou Investment Facility** have already been agreed in the framework of the ACP-EU negotiations. However, pending agreement on the Future Financial Perspectives, the amount of a second endowment has not yet been formally decided. Two important changes have been introduced with regard to interest subsidies, now available also for post-disaster situations and no longer capped at 3% for public sector projects when a higher grant element is required by IMF conditionality. Grant funding will be available for technical assistance, even for projects that are not eligible for interest subsidies.

The **Republic of South Africa** has its own mandate. This country is the “dynamo” of southern Africa and because of the importance of the South African democratic and institutional model, EIB operations there have a demonstration effect. It might be advisable to set up a special risk capital facility in order to offer a broader range of products – e.g. equity, mezzanine finance and guarantees - and support smaller and riskier projects. Such a facility could operate as a revolving fund, as the Cotonou IF.

The current **ALA** mandate has a specific “mutual interest” objective. A narrow definition of eligibility under this objective leads the Bank to support mostly projects undertaken by large European companies. However, a more developmental content could be adopted in low-income ALA countries. Eligibility could also be extended to include environmental projects, particularly those reducing greenhouse gas effects, or to projects fostering regional integration or other EU priorities.

Cross-cutting issues

In the set-up of EIB’s external mandates, the access to the EU or MS budgets, whether for a free guarantee or for any other form of concessionality or technical assistance, represents the “grant” element allowing to effectively provide the appropriate mix of development finance instruments, especially in the poorer countries. The more the EIB is requested to move towards “development banking” in these countries, the more access it will require to such grant resources, whether from EDF or AIDCO or other sources.

- Risk appetite and recourse to Member States or EU guarantees

The Bank’s Statute and financial structure are designed to meet the requirements of operations within the EU, and unless its current capital allocation and risk management criteria can be adjusted the Bank cannot sustain its current level of lending in Partner Countries without the support of a guarantee. Up to a point, reserves can be set aside to allow the Bank to take risks beyond what is currently allowed. Examples such as the SFF within the EU and the SFE for FEMIP countries could indeed be extended within the limits of the reserves that the Bank’s shareholders would be willing to set aside for such purposes. However, a hypothetical earmarking of the Bank’s own funds to provision for the current level of external lending would conflict with other objectives of Bank policy. Indeed a typical development bank structure is based on a gearing ratio of 1:1 (as opposed to 2.5:1

[8] Semi-annual experts meetings and annual Ministerial meetings, from both EU and partner countries.

in EIB), a paid-in ratio of between 25% and 50% (as opposed to 5% in EIB) as well as periodic replenishment of capital (as opposed to self-sufficiency in EIB).

While the Bank has demonstrated its ability to carry out close to a quarter of its operations under mandate on the basis of the risk sharing mechanism, it is clear that with very few exceptions, such as operations developed through FEMIP, this mechanism can only be used when project sponsors are European companies. The implication is that, under the Bank's current credit policy, risk sharing cannot be used to support the local private sector, which does not have access to guarantees that are compatible with EIB requirements. Hence unless the credit policy can be substantially relaxed, any decision to further reduce the coverage provided by the EU Guarantee Fund[9] might not only constrain the overall volume of operations but, more importantly, might also have an adverse impact on the Bank's support of local private enterprises.

Support for the private sector remains the main focus for the Cotonou Investment Facility (IF), but it is becoming increasingly clear that original expectations for private sector development were too optimistic in relation to the investment climate in most ACP Countries. Under Cotonou, the IF is charged to "aim at being financially sustainable" and to operate "on market-related terms". This has until now been interpreted in a very cautious way, implying a high degree of risk aversion in the credit risk policy guidelines established for the IF. Consequently the volume and development impact of IF operations have been below expectations. As foreseen at the time they were agreed, the Bank is preparing a review of the IF credit risk policy guidelines which is scheduled for submission to the IF Committee and the Bank's Board of Directors this summer. A higher level of risk appetite for the IF (in parallel with Bank operations within the EU) would imply a more flexible approach to the Cotonou aim of keeping the IF financially sustainable, which has until now been interpreted to mean maintaining the real value of the funds and which is seen to have taken priority over the IF development impact objective.

- Leveraging loans with grants; concessionality and technical assistance

In recent years, the importance of combining loans and grants has become clear. Illustrative cases are the EU's water facility or the combination of IFC loans with IDA grants. Although it is evident that both subsidies and the way they are administered must be justified case by case, certain projects will continue to require softer terms, notably, but not only, in low income countries. Candidates for subsidies are public sector projects or PPPs, typically in essential infrastructure sectors, because of externalities that private sponsors cannot internalise without some form of financial support. Softer terms may also be required to help maintain public debt at a sustainable level.

Grants can also be a powerful lever when used to support project preparation (through studies), to improve project design, implementation or operation (through project level technical assistance) or to improve the (often essential) institutional framework (through upstream capacity building and technical assistance). The experience with such funds is well underway in the case of FEMIP. It will need to be continued and extended to other lending mandates.

For the second Financial Protocol of the Cotonou Agreement, the Commission has proposed to allocate an additional € 1.1 bn capital injection into the IF and a subsidy endowment of € 400 m. The EIB considers this scale of concessionality as the minimum necessary to enable financing of public sector projects in poor countries under HIPC or other IMF/donor-imposed borrowing constraints.

2.2 Modus operandi in Partner Countries

If the EIB is to develop its role as a development bank when operating outside the EU, its approach needs to be modified accordingly. A natural response would be to rely on developing the bank's comparative advantage as an investment finance institution: the

[9] Or raise the percentage of operations to be structured under the risk sharing mechanism, which is equivalent.

Bank would devote more attention to the developmental impact of the projects it finances[10], which in turn requires strengthening action upstream (country/sector strategies of intervention), on the project itself (identification, preparation, technical assistance) and downstream (monitoring, impact assessment). The ultimate aim would be to further increase the quality of projects and their probability of success.

This approach constitutes an evolution rather than a radical change from current practice – there would be no attempt to shift to policy dialogue and adjustment lending as, say, the Bretton Woods institutions. It would entail, however, a more strategic attitude towards project acquisition, shifting from the current demand-driven approach to one built on country and sector intervention policies[11]. This would imply closer cooperation and exchange of information with the Commission and other IFIs that have relevant expertise, particularly the World Bank, and other MDBs. Of course, while taking into account sectoral reform commitments made by Partner Countries to other IFIs, the Bank would nevertheless maintain flexibility in setting its own conditionality.

2.3 Structural and organisational changes

As EIB external lending is of a substantially different nature from operations in the EU and implies a different *modus operandi,* how should the Bank get organised to face this challenge? The question is already out in the open as witnessed by the Council's decision to review in December 2006 the issue of the future of FEMIP and of the possible "incorporation of an EIB majority-owned subsidiary dedicated to the Mediterranean partner countries", or a recent letter from the Commissioner in charge of Development to the President of the EIB about the implementation to date of the ACP Investment Facility. Various options that are likely to be discussed in the run up to the renewal of mandates are broached in what follows.

One option is that operations should continue to be carried out within the EIB, but building on the existing institutional arrangements to make them more effective.

Alternatives would be the creation of one or several subsidiaries of the EIB (for all Partner Countries or limited to Mediterranean Partner Countries)[12] with the possible participation of the Commission, of interested Member States and/or bilateral aid agencies and /or relevant Partner Countries. The advantages would be: political visibility, focus on development and appropriate management and governance structures to that end. The disadvantages would be higher capital costs, particularly if there were more that one subsidiary, and lengthy start-up periods.

A bolder change would be to manage in a single new joint venture the external lending operations of the EIB and the relevant budget-based activities of AIDCO. The advantages would be some of those of a subsidiary in a reinforced way, but this would also bring coordination, coherence and consistency, in practice making a strong impact on the global effectiveness of EU development finance. On the side of disadvantages, it would be even more complex and longer to put in place.

---

10 In the case of the Cotonou Investment Facility, a pilot Development Impact Assessment Framework has recently been put in place, following consultation with the Commission and the relevant Member States Committee.

11 Such an approach has recently been launched in several Mediterranean partner countries under the reinforced FEMIP, in the framework of the EIB's MOU with the Commission and the World Bank.

12 A subsidiary could possibly be established, at least as a first step, using the "management company" model, frequently used for investment funds: this would be a separate legal entity, with a small, nominal capital, entrusted with the management of EIB external lending activities. Advantages compared with a full subsidiary would be a lower cost and shorter start up. It would also benefit from greater visibility and more independent budget and governance than under the present situation, but less so than would a full subsidiary.

ANNEX III

III Funding Strategy

The pillars of the Bank's funding strategy are the optimisation of the funding costs on a sustainable basis and enhancement of market liquidity and transparency. It is proposed to maintain this strategy line.

This strategy has further consolidated EIB's position as the leading AAA-rated non-sovereign benchmark borrower, enabling it to grant loans on the best possible terms and thus continue to serve the policies of the EU. This will continue to be achieved through the synergies resulting from a coordinated approach to benchmark and targeted issuance, i.e. by issuing large liquid benchmark bonds in EUR, USD and GBP, maintaining EIB's responsiveness to changing patterns of investor behaviour and currency diversification, stepping up efforts to develop local capital markets of emerging economies and in particular those of countries seeking EU membership and selected FEMIP countries and offering customised financial products targeted at specific investor needs in all available currencies and structures. These strategies have to be implemented in the context of the market environment prevailing in the international capital markets.

With a yearly funding volume at around EUR 50bn remaining fairly stable for the coming years, the Bank is one of the world's largest international fixed-income issuers (excluding sovereigns and other issuers with large domestically-focused programmes).

The three core currencies of EUR, USD and GBP on average comprise some 85-90% of annual funding volumes and this is likely to be maintained. The fixed income markets in each of these currencies have very distinct characteristics and the Bank's funding operations are structured to maximise currency-market expertise thereby tailoring its strategy to the dynamics of each market.

Amongst the major currencies the currency composition of the Bank's funding programme is adaptive to market events and circumstances. In recent years, EUR and USD have each provided about 35% of annual funding with GBP contributing around 20%. Over the foreseeable future, the EUR benchmark market is thought to offer much flexibility in terms of volume, although price will be a key consideration.

The incentive effects of benchmark bond issuance and concerted efforts to maximise delivery of alternative funding in the form of structured product have yielded beneficial results in the form of attractive funding costs, product diversification and the ability to respond to investor requirements with tailor-made instruments. Over the last 5 years, from a negligible start, structured products now comprise approximately 20% of annual funding. Looking ahead it is expected that this proportion will be roughly maintained thereby keeping a desirable balance between capturing attractive funding opportunities and prudent risk management, operational as well as reputational considerations.

The Bank will continue to support expanding local currency lending through funding in the New Member States. It has contributed to capital market development in these regions and in tandem established some of the largest local currency borrowing programmes other than those of local sovereigns, thereby supporting the Bank in becoming the largest external lender in these countries.

ANNEX IV

IV Capital Increase

1. When will the Bank need a capital increase?

The Bank requires a capital increase when the stock of outstanding loans approaches 250% of subscribed capital. Should the stock of outstanding loans reach this limit, the smooth development of Bank lending would be disrupted. The table below depicts the developments of the main variables having a bearing on this relationship.

Projection of lending volumes, lending ceiling and headroom at year-end (€bn)								
	2003	2004	2005	2006	2007	2008	2009	2010
Annual lending volumes (€bn)								
Capital increase scenario	41.8	44.5	47.4	50.4	53.6	57.1	60.8	65.4
Outturn and COP projections	42.3	43.9	44.9	46.0	47.4	48.8	50.3	51.8
Difference	*0.5*	*-0.7*	*-2.5*	*-4.3*	*-6.2*	*-8.3*	*-10.5*	*-13.6*
Loans outstanding (€bn)								
Capital increase scenario	272	295	322	348	377	407	435	468
Outturn and COP	248	266	296	323	349	375	397	420
Difference	*-24*	*-29*	*-26*	*-26*	*-28*	*-32*	*-38*	*-48*
Lending ceiling (€bn)								
Capital increase scenario	375	390	390	390	390	390	390	390
Enlargement Treaties	375	409	409	409	412	412	412	412
Difference	*0.0*	*19.3*	*19.3*	*19.3*	*22.1*	*22.1*	*22.1*	*22.1*
Headroom (€bn)								
Capital increase scenario	103	95	68	42	13	-17	-45	-78
Current situation	127	143	113	87	63	37	15	-8

The first part of the table reviews the evolution of the annual lending flows and of outstanding loans. Until 2004 actual lending closely tracked that of the 2003 capital increase scenario. Over the last four years, cumulative actual lending was below the reference values retained in the capital increase scenario by less than € 200m. The COP 2005-07, approved by the Board of Directors last December, breaks from the close tracking of the previous four years: Total loan signatures in this period are expected to be € 13bn below the capital increase scenario.

The second part of the table compares the stock of outstanding loans, as envisaged at the time of the 2003 capital increase, with actual figures to 2004 and thereafter prospective amounts, based on COP lending volumes. Although the annual flows of activity have been broadly in line with the flows expected at the time of the capital increase, outstanding loans at the end of 2004 are € 29bn lower than envisaged when the 2003 capital increase was set up. The main reason for this discrepancy is the appreciation of the EUR against most other currencies, especially the USD and GBP, since late 2000. At the end of last year the stock of *disbursed* loans amounted to € 224bn (at end 2004 exchange rates). Valued on the basis of the end 2000 exchange rates, used for the capital increase scenario, the same stock of loans would amount to €245bn, i.e. € 21bn more than at present. Obviously as outstanding stocks of disbursed loans are progressively amortised, the wedge introduced by differences in exchange rates between the capital increase scenario and actual stocks is eroded as one looks further into the future. But as the COP 2005-07 envisages that annual lending flows will be lower than envisaged in 2002, the wedge between the expected stocks of loans and that considered for the capital increase simulation is preserved. **By the end of 2007 (at end 2004 exchange rates), outstanding loans are expected to reach € 349bn, that is € 28bn lower than expected at the time of the capital increase.** At constant exchange rates, the stock of outstanding loans grows by slightly less than € 28bn per year. Hence, the appreciation of the euro since end 2000 and the lower level of lending foreseen in the COP 2005-07 should extend the life of the capital increase by about one year.

Current statutory provisions cap outstanding loans to 250% of subscribed capital. The timing of the next capital increase also depends on the evolution of subscribed capital. The third panel of the table compares the actual lending ceiling (250% of subscribed capital) with that considered at the time of the capital increase. At the time, it was assumed that the first enlargement wave would boost the subscribed capital by 4% (i.e.; €6bn) to €156bn and that the subsequent enlargement would not occur before the end of 2007. However, the May 2004 capital increase differed substantially from the base scenario retained in the capital increase simulation. Firstly, the amount of subscribed capital allocated to the new Member Countries that joined the EU on 1 May 2004 stands at €7.5bn; i.e. € 1.5bn more than initially considered. Secondly, at the same time, the capital subscribed by Spain increased by € 6.2bn. Hence, since 1 May 2004, the subscribed capital of the Bank increased to € 163.7bn; € 7.7bn more than expected at the time of the capital increase. This additional capital can be leveraged by a factor of 2.5 and pushes up the lending ceiling by € 19bn compared to the base case. Thirdly, the terms of the adhesion of Bulgaria and Romania for the capital of the Bank are now known.[13] These two countries will subscribe to a capital increase of € 1,142m when they join the European Union in 2007 or 2008. Hence **by the end of 2007, the lending ceiling of the Bank will stand at € 412bn, i.e. € 22bn higher than in the original scenario**.

As shown in the bottom part of the table above, the 2003 capital increase scenario considered that the headroom would be exhausted in the course of 2008. The last line of the table shows that, on current lending trends[14] and the (known) evolution of the lending ceiling, the headroom will be exhausted in the course of 2010. Hence the **Governors would have to agree to the terms of the next capital increase in June 2009**; i.e. two years later than initially envisaged. At this stage one should note that the assumption of a 3% lending growth in 2008 and beyond does not play any major role in the timing of the next capital increase. Annual lending growth from 2008 onwards would have to exceed 13.6%, for the gearing constraint to become binding in the course of 2009 and to require a capital increase to be agreed in 2008.

The simulations reported above are conducted on the basis of the end-2004 exchange rates. Should the euro appreciate (respectively, depreciate) against the other major currencies, the expected life of the capital increase would be extended (respectively, reduced) compared to the simulation reported above. It is obvious that the Bank has no control of the future evolution of exchange rates, but that **the timing of the next capital increase could be affected by exchange rate developments.** For sake of illustration, one should note that should the euro weaken again to the lowest levels seen at the turn of the last century (say 0.85 USD and GBP 0.6 per euro), the headroom would be exhausted in the course of 2008, requiring an agreement on a capital increase by June 2007.

Ratification of the EU Constitution will lead to changes in the statutory gearing provision. The main changes relate essentially to the inclusion of reserves in the denominator of the gearing ratio and the proper treatment of equity participations in the gearing limit. From the perspective of when the Bank will need the next capital increase, the revised statutory provisions will further extent the time before the next capital increase has to be agreed upon.

2. Will the Bank be able to finance the next capital increase?

While it is clear that there are some uncertainties considering the precise time when the next capital increase will be required, consider that the Bank has to seek the Governors' agreement to a capital increase in June 2009 at the time of the AGM. Both the size of the capital increase and the financing arrangements need to be defined.

The first question concerns the required size of the 2010 capital increase. There is no fixed rule on this issue. The last two capital increases were constructed on the basis that they would last at least five years. If the 2010 capital increase has to last five years, the gearing limit would not be breached before the beginning of 2015. The only variable that influences the required size of the capital increase is the growth rate of new lending. The table below

13 Given the uncertainty about the adhesion timing of Bulgaria and Romania, its influence on the capital of the Bank was not taken into account in the 2003 capital increase scenario.

14 This is constructed on the assumption that total annual lending from 2008 onwards grows by 3% per year.

considers five different annual growth rates (0%, 3%, 5%, 6.6% and 9.6%). For sake of comparison, the 2003 capital increase was based on 6.6% annual lending growth, while the actual lending growth in the period 2001 to the end of the current COP in 2007 stands at 4.35%.

The size of the 2010 capital increase

Annual lending growth from 2008	Outstanding loans end 2014	Required capital beginning 2010	Required 2010 capital increase
0%	463	189	15%
3%	502	205	24%
5%	532	217	31%
6.60%	556	227	37%
9.60%	608	247	50%

If annual lending from 2008 onwards were frozen at its 2007 level (€ 47.38bn), the capital increase required in 2010 would only be 15%. Annual lending growth of 3%, 5%, 6.6% and 9.6% would require a 2010 capital increase of the order of 25%, 33%, 40% and 50%.

Since the Bank is committed to the principle of financial self-sufficiency (i.e., it will fully finance capital increases from its own resources without cash injection from shareholders[15]), the feasibility of any capital increase has to be gauged on the basis of the means available. By the time the Governors meet in June to approve the capital increase, the Bank will have accumulated about € 7.5bn of additional reserves. Will that be enough to finance the next capital increase?

The financing of the 2010 capital increase

Annual lending growth from 2008	Required 2010 capital increase	Increase in subscribed capital (€bn)	Resulting subscribed capital (€bn)	Full funding requirements (€bn)	Paid in capital (€bn)	Statutory reserve (€bn)	Deficit in statutory reserve (€bn)	Additional reserve (€bn)	Year when statutory reserve fully funded
0%	15%	24	189	3.65	1.22	2.43	0.00	3.83	
3%	24%	40	205	6.03	2.01	4.02	0.00	1.45	
5%	31%	52	217	7.78	2.59	5.19	-0.31	0.00	2009
6.60%	37%	62	227	9.26	3.09	6.17	-1.78	0.00	2010
9.60%	50%	82	247	12.36	4.12	8.24	-4.89	0.00	2012

The table above analyses this question. For capital increases up to 30%, the means available (€ 7.5bn) will be sufficient to fully fund the capital increase at the time it is agreed. For larger capital increases, the Bank would be able to fund from reserves the paid-in portion and a share of the increase in the statutory reserve. In subsequent years, annual surpluses would bring the statutory reserve to its target ratio of 10% of subscribed capital. The incomplete financing of the capital increase does not pose a problem in itself. Indeed, the 2003 capital increase was not fully financed. However, as long as the statutory reserve has not been put to its target level of 10% of subscribed capital, the replenishment of the statutory reserve has the first call on the surplus, and the Bank will not be able to allocate part of the surplus to support specific initiatives until the statutory reserve is fully funded.

In conclusion, while the 2003 capital increase was structured to cover at least five years of lending (to end 2007), after the 2003 capital increase, and the additional increase in subscribed capital in 2004, the capital of the Bank is now expected to be sufficient at least

15 This does not apply to enlargement related capital increases where new Member States have to pay to bring their share of own funds in line with that of previous shareholders.

until 2010, all things being equal, so that there should be no need for an increase in capital in 2008 as was envisaged three years ago. The financing of the next capital increase will not pose particular difficulties, and the principle of financial self-sufficiency can be maintained.