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ECONOMIC GROWTH IN THE EUROPEAN UNION: FACTS PROVE WELL FUNDED INTEGRATED MNE/SME GLOBAL APPROACH WILL WORK

Introduction

1. During the recent informal ECOFIN meeting of 13 September 2014 a new mandate for the European Investment Bank was addressed. This is in line with the call for such expansion by European Investment Bank (EIB) President Dr Werner Hoyer 3 February 2014, followed by the formal tasking of the EIB by the March 2014 European Council to find out how such expansion can best be achieved. The key driver in both cases is European growth. "We are so focussed at our current problems that we do not plan for future growth through investment", said Dr Hoyer. Now even a doubling of EIB's Capital is considered. Not only Small and Medium-sized Enterprises (SMEs) – whose borrowing capacity is naturally limited – but major European MultiNational Enterprises (MNEs) should benefit of optimal conditions for future EU lending. If such conditions cannot be agreed, the net loss for Europe's growth is colossal. First of all for Europe's SMEs; and second of all for European employment, innovation and technological development.

2. After all, the *total* EU market for major infrastructure projects in the next ten years is around EUR 4,700 billion (USD 5,890 billion) based on studies by McKinsey and four other sources as quoted in an external working paper of the EIB. Prof. Dr. Dieter Helm suggests to be careful with this amount as it is dependent on EU Member States' political will and economic growth. Anyhow the EU volume is *dwarfed* by the approximately USD 31,110 billion for major projects *outside the EU* (as projected by the World Economic Forum). Of course it is becoming for the EIB to act as a financier of development projects. But actually it is even better able to do so if it makes a decent profit on major extra-European infrastructure projects whose risks are low and whose income and job generating effect for the EU are infinitely larger.

3. This document provides numbers and statistics for a thorough qualitative and quantitative analysis of the economic and social benefits for the European economy of an expansion of the EIB mandate to projects outside – and thus SME growth inside – the EU. It does so by first looking at global competitiveness and the phenomenon of 'tied lending'. Next it follows the logic of Europe's SME umbrella organisation UEAPME with regards to the requirement for MNEs and SMEs to closely cooperate and the EU institutional

requirement to promote this through Public Private Partnerships. Finally it looks at the EU system of guarantees which delivers the EIB its AAA status – mainly because of the back up by 28 Member States but also because of its prudent lending policy which is expected to remain undisturbed once EIB refocuses at the extra-EU infrastructure projects market.

1. Tied Financing

1.1 Subcontractors/Some telling recent examples

4. The tied lending provided by Korean, Japanese and Chinese Banks entails the imposed condition that companies participating in these infrastructure projects are required to subcontract Korean, Japanese and Chinese companies. This does not only cause the leakage of technology, networks, experience and expertise out of Europe, but also creates a missed opportunity for European subcontractors to benefit from such large-scale projects outside the EU.

5. As part of a project in Africa to construct a 1200 MW electricity plant with a total investment cost of USD 2.6 billion, Japanese sovereign institutions provided project finance debt worth USD 1.98 billion. Out of a total equipment value of the project of **USD 1,440 million**, approximately **USD 700 million was spent on Japanese contracts** in the main construction contract, flowing back into the Japanese economy. As a result, **49%** of the total contracts of the project was subcontracted to Japanese companies as part of the conditionality of the tied financing provided by the Japanese bank. Thus, as part of the conditions of tied funding the EU companies engaged in the project were required to subcontract Japanese companies, leading to an enormous benefit for Japanese SMEs.

6. Similarly, as part of a project to construct a 400 MW cogeneration plant located in Central Asia with a total investment cost of USD 1.3 billion, Japanese and Korean investors provided a project finance debt of USD 390 million and USD 169 million respectively. Out of an equipment value of around **USD 850 million**, approximately **USD 400 million of Korean content** in the main construction contract is set to flow back to the Korean economy with the conditioned Japanese content still under discussion. Thus, approximately **47 %** of the total equipment value consisted of Korean content alone, as the EU companies participating in the project were required to subcontract Korean companies instead of selecting EU SMEs as preferred partners.

7. Finally, in a 400,000 barrels/day crude oil refinery with a total of USD 8.5 billion project finance debt located in Asia, Korean and Japanese sovereign institutions provided to EU companies USD 1.02 billion and USD 595 million project finance debt respectively. Construction and engineering contracts flew back into the South Korean and Japanese economy, although their exact value is not yet clear.

8. This means that as a result of the provision of project finance debt by Korean and Japanese financial institutions, a significant part of the construction contracts within such projects flows back to these entities' national economies. As demonstrated in two of the three case examples, approximately 50 % of the construction contracts concluded by EU companies are subject to requirements on Japanese or Korean content imposed by tied financing. One can thus conclude that even if the support of Asian sovereign financiers is strictly speaking not export related or 'tied', in practice this financing is clearly linked to their state's commercial diplomacy objectives and involves important contractual flows to their national economies.

9. As a consequence, **if these Japanese and Korean subcontractors would be replaced by European subcontractors**, by virtue of the leverage provided by EU financing of those same projects with comparable conditionality, this would culminate into a potential added value for the EU's industry and service sectors. Similarly, it would lead to enhanced employment, technology and innovation development in Europe, most notably for European SMEs. The introduction of an EU content requirement, as part of the provision of guarantees, will ensure that an integrated synergetic approach will develop between Multinationals and SMEs through Public Private Partnerships.

10. Comparing the pipeline of projects in Europe (USD 5,890 billion) to the deal pipeline outside the EU (USD 31,110 billion) it is apparent that the greatest opportunities for European Multinationals and SMEs in the infrastructure sector lie with long-term international projects. However, the global market share of EU industry is rapidly declining and lack of access to finance leads European companies in the arms of Asian tied-lenders. In order to regain the global competitiveness of the EU infrastructure industries these projects will now need to be pursued with the use of EIB guarantees.

1.2 Partnerships between large companies and SMEs

11. Small and Medium-sized Enterprises (SMEs) can greatly benefit from major infrastructure projects signed by multinationals. According to UEAPME, Europe's SME umbrella organisation, subcontracting is the key relationship between European SMEs and large companies, enabling SMEs to participate in the large-scale infrastructure projects both inside and outside the EU. This will benefit them and the EU in terms of innovation, technology development, employment, and economic growth. The *Annual Report on European SMEs 2012/2013*, published by DG Enterprise and Industry of the European Commission, mentions the "business relationship between large firms and SMEs acting as subcontractors" and stresses that the "high performance of large businesses is associated with a corresponding high performance of the SME sector".

12. Furthermore, the European Commission financed an external study entitled *EU SMEs and subcontracting*, published in 2009, which provides an overview of qualitative and quantitative aspects of subcontracting, with a special focus on European SMEs. The Study states that "subcontracting arrangements (especially with larger enterprises) may represent a key way for SMEs (or at least for those SMEs with highest growth potential) to access a series of critical missing resources. Examples of these include larger markets (including in some cases international), finance, technology, management skills and knowledge". Also, among the additional benefits of subcontracting for SMEs are:

1. Job creation;
2. Use of spare capacity;
3. Increased output;
4. Improved labour and capital productivity;
5. Greater product/process specialisation.

13. In particular, it has been documented that SMEs that have access to international markets and long-term projects enjoy further benefits as compared to those working at the national level only. The positive effects of internationalisation have been highlighted in the Report *Internationalisation of European SMEs*, published by the European Commission in 2010, which addressed the positive link between international activities and innovation for SMEs. The Report states that "internationally active firms introduce product/service and process innovations more often than non-internationally active firms. Almost half of the internationally active firms introduced new products or services in the past three years (overall average only 32%) and in the same period almost one third introduced process innovations (overall average 22%)". Also, in the 2013 document entitled *Public Private Partnerships in Europe: a new growth dynamic,* MEP Paul Ruebig stated that European SMEs, when acting as subcontractors in Public Private Partnerships, contribute for an average of 85% to the total value of the PPP.

14. According to sources at UEAPME, generally around 50% of the business of SMEs in Europe relies on contracts signed with large companies. Therefore, infrastructure projects outside the EU will contribute directly to innovation and technology development inside the EU. Thus, it can be concluded that the participation of European companies in large-scale international projects will lead to enormous benefits in terms of employment and innovation in Europe, as SMEs play an important role as subcontractors, most notably in PPPs. These are the key ingredients to boost European economic growth.

2. Guarantees

2.1 Description EIB Guarantees

15. The European Investment Group is made up of the European Investment Bank (EIB) and the European Investment Fund (EIF). The Group provides guarantees to large and small projects in order to make them more attractive to other

investors. They provide guarantees for senior and subordinated debt, either in a standard form or as a debt service guarantee similar to that offered by mono-line insurers. Beneficiaries can be large private and public projects or partner intermediaries providing SME financing.

16. The EIF cooperates with a wide range of financial intermediaries such as banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks or any other financial institution providing financing to SMEs, or guarantees for SME financing. The EIF has two main guarantee instruments:

0. Credit Enhancement/Securitisation (guarantees for securitised SME financing instruments);
1. Guarantees/Counter-guarantees for portfolio of micro-credits, SME loans or leases (management of EU Commission initiatives).

17. The COSME Loan Guarantee Facility (LGF) supports European enterprises' growth and research and innovation. Through COSME LGF, the EIF offers guarantees and counter-guarantees, including securitisation of SME debt finance portfolios, to selected financial intermediaries to help them to provide more loans and leases to SMEs. The EIB offers different guarantee instruments, namely:

1. The Loan Guarantee Instrument for Trans-European Network Transport, to guarantee medium term revenue risks from public-private partnership transport schemes;
2. InnovFin, managed together with EIF, to boost research, development and innovation.

18. As a general background, the EU has given the EIB a number of mandates to perform certain lending operations under an EU budgetary guarantee. DG ECFIN assures the review of existing mandates and prepares new ones. The EU guarantee has been the key instrument ensuring the compatibility between the EIB's highly leveraged financial structure (different from other International Financial Institutions (IFIs)), the significant high inherent risk of lending to third countries, the need to avoid a deterioration of the Bank's AAA rating whilst limiting the EIB capital consumption.

2.2 Default risk of project finance bank loans

19. The 2014 Moody's Special Comment examines the default and recovery performance of unrated project finance bank loans between 1990 and 2012 on the basis of the Basel II (BII) and the Moody's Definition of Default (MDY). It describes project finance as an "efficient way to fund capital intensive and strategically important industries where underlying business risk is relatively stable and predictable". Moreover, Moody's specifies that project finance senior debt facilities are typically structured to be "robust to potentially severe risks, including significant macro-economic and performance stresses".

20. First of all, Moody's refers to the ultimate recovery rates of project finance bank loans, which is the amount recovered through foreclosure or bankruptcy procedures in event of a default, expressed as a percentage of face value. Generally, "ultimate recovery rates for project finance bank loans average 80%. However, the most likely ultimate recovery rate was 100%". Moreover, Moody's claims that the average ultimate recovery rates are broadly consistent across geographical regions; also for projects located in OECD (80.3%) and non-OECD countries (79.2%) based on (BII).

21. More specifically, the Study finds that the 10-year Average Default Rates (MDY) in project finance loans in the Infrastructure sector, is among the lowest when compared to the average: **3.1% as compared to an average of 6.4%.** Also, when projects are executed in public private partnership setting, the risk of default is even lower with an average default rate (MDY) of **1.9%.** Moreover, the average ultimate recovery rate (BII) for PPPs is **87.3%,** which is **significantly higher** than the average ultimate recovery rate (BII) of 80% for the Study Data Set as a whole. The Moody's report concludes the following: "These results provide some evidence to support the view held by many market participants that PFI/PPP is a discrete sub-sector lying at the low-risk end of the project finance spectrum".

22. Moody's research suggests in terms of risk of default, projects outside of the EU do not pose higher risks in terms of ultimate recovery rates. As a consequence, there is not a higher risk that guarantees on projects outside the EU will have to be paid out. Furthermore, the average ultimate recovery rate is 80 %, with the most likely ultimate recovery rate of 100% i.e., no economic loss which occurs almost two thirds of the time, which ensures that the risk of loans not being paid back is limited. The cumulative default risk for infrastructure projects is below average, the provision of guarantees on loans to infrastructure projects outside the EU is therefore neither likely to lead to a higher risk of default on the EIB's outstanding loans, nor to jeopardise its credit rating. Consequently, the notion that the EIB or the EU's Member States will have to take on increased risk or financial commitments, when providing guarantees for long-term infrastructure projects outside the EU, has been nullified by empirical evidence that demonstrates the low default rates of infrastructure projects over the last decades.

3. Connection between internationalisation and competitiveness

23. Member States' fiscal stimulus measures, e.g. increases in national government spending on research and innovation amounting to several billion euros, entail the provision of subsidies to SMEs and national industries through innovation programmes. However, economic history has demonstrated that the government tends not to be the expert at selecting the most innovative technologies and business plans (i.e. 'picking the winners') for state-funded

innovation programmes, as opposed to the market in which experts rigorously assess the market value of a proposed technology and financial specialists make calculated and high-level risk assessments (C.f. Schuman Foundation/EIB study, March 2014). Consequently, the effects on GDP, employment and technology development in the Member States are suboptimal. Moreover, such policies will lead to fragmented national approaches, which will be less effective than an integrated EU-wide system.

24. This failed innovation policy will then be pursued at the tax payers' expense as it will lead to higher taxes being imposed in order to finance the increase in government spending. Finally, fiscal stimulus will lead to an increased budget deficit and state debt ratio culminating into increased pressure on the Member State to conform to the EU Stability and Growth Pact.

25. Alternatively, the case for EIB Guarantees for EU multinationals' infrastructure projects outside the EU is that through providing guarantees, these EU companies will regain competitiveness at hardly any additional cost to Member States' budgets. By overcoming the market failure of access to finance a level playing- field will be created, which will enable the EU Multinationals to win tenders for projects outside the EU. These multi-billion infrastructure projects may be expected to deliver stable profits, which results in a stable Return on Investment for equity investors and ensures the EIB does not have to pay out the guarantee. Through the provision of EIB guarantees projects with a high Return on Investment and low default risks, the capital markets can finance these projects, for example through loans from European banks and institutional investors. This means that the provision of guarantees, as contrary to national stimulus policies, will not come at the burden of the European taxpayer and thus constitutes an effective policy-tool to boost European growth.

26. This can lead to the conclusion that fiscal stimulus using taxpayers' money is not as efficient as EIB guarantees, especially when taking into account the catalyst effect of EIB guarantees on leveraging global capital markets. An effective system of guarantees generates positive revenue flows through a higher Return on Investment. In order to ensure an optimal use of guarantees they must be backed up by thorough risk assessment, which may prevent the default of ill-conceived projects and the guarantee being triggered. Through the reduction of the failure rate of projects the costs of providing the guarantees will decline. Thus, instead of fiscal stimulus a system of EIB guarantees will provide economic rewards at hardly any cost for tax payers at all.

4. Pension funds and insurance companies

27. *4.1 Europe's largest pension funds and bank/ insurance companies ready to invest in extra-EU infrastructure projects – but require EIB guarantees*

In order to determine the needs of institutional investors with regard to investments outside the EU PA Europe contacted the two largest pension funds in Europe, as well as Europe's top-ten largest (bank) insurance companies. These companies confirmed the high potential of investments outside the EU and the constraints of the current regulatory environment in this regard. However ***all concluded to be ready to invest in major infrastructure projects outside the EU.***

28. It was confirmed that the vast majority of most institutional investors' investments were concentrated in the traditional asset categories: stocks, shares and equity. By investing more in the asset class of alternative investments, which includes infrastructure, institutional investors will be able to diversify their portfolios thereby reducing concentration risk and benefiting from increased Return on Investment.

29. According to these companies, the regions of the world that offer the most secure Return of Investment are North America and Europe, closely followed by Asia and to a lesser extent Latin America and the European Neighbourhood. Russia and Africa offer the least secure return on investment.

30. The investors encounter restraints with regard to investing in infrastructure projects outside the EU: *"Political risk is an important concern for long-term investors like ourselves, in particular the risk that the regulatory framework is changed significantly during the life of a project. We do not invest in countries where the political risk is considered too high."*

31. The constraints on investments are both of a national (regulatory framework) and international (political risk) nature. In addition to regulatory and political stability, other frequently mentioned constraints for institutional investors include currency volatility and the uncertainty regarding the creditworthiness of counter-parties.

32. During conversations it was clearly stated that the solution for overcoming these domestic and international constraints is to utilise a system of EIB guarantees.

Conclusions

33. The conclusions are:

a. The infrastructure projects market outside the EU is at least a factor 5.8 larger than inside the EU;
b. SMEs are for around 50% dependent on subcontracting by MNEs; if MNEs through tied lending cannot subcontract EU SMEs, this leads to a substantial loss; this loss is multiplied if non-competitive lending in the EU prevents very qualified EU industries to win major infrastructure projects;

c. According to Moody's and Basel II standards the EIB will not engage with risk if it engages with (tied) lending for major extra-EU infrastructure projects; to the contrary, the examples of Asian State-owned banks demonstrate a consistent pattern of profitability and inward investment;
d. The two largest European Pension funds and two top-ten (bank)insurance companies all are ready to invest in major non-EU infrastructure projects but require guarantees to engage in such lending;
e. All EU reports demonstrate that cooperation between MNEs and SMEs must be promoted as the best way through which sustained economic growth can be achieved without burdening the European budget.

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