The UK's Future Relationship with the European Investment Bank

Submission from The Infrastructure Forum

Friday 14 September 2018

Summary

1. The Infrastructure Forum has produced a Working Group report – 'The Future of the European Investment Bank in the UK'. It established that the UK was among the highest recipients of EIB project loans.
2. The Working Group has found that EIB loans have been particularly important to the housing sector, environmental and social infrastructure projects. Such projects would struggle to replace EIB money in the capital markets if the EIB cannot lend to the UK post-Brexit.
3. EIB lending to UK projects has declined significantly following the result of the referendum on EU membership in June 2016.
4. It is unlikely that the UK will retain its full membership to the EIB post-Brexit. The Draft Withdrawal Agreement has set out plans for the EIB to repay the UK's called-in capital once the agreement is signed, after which the current terms of EIB lending to the UK will no longer apply.
5. The UK will need to establish a third country agreement with the EIB as an immediate priority in order to enable EIB lending to continue, even at a reduced level. A country agreement between the EIB and the UK would extend the necessary privileges and immunities to enable the EIB to lend. The Cotonou Agreement between the European Commission and the 79 African, Caribbean and Pacific countries provides a model which the UK could replicate to achieve this relationship with the EIB.
6. Securing such an agreement would protect those projects that most rely on EIB money and provide access to the hard and soft benefits associated with the EIB.
7. The UK should extend the Infrastructure and Project Authority's UK Guarantees Scheme to bridge the gap in funding that will emerge in the UK infrastructure market. The Guarantees Scheme should be empowered to provide more extensive guarantees during the construction phase of projects as well as to begin to utilise its powers under the Infrastructure (Financial Assistance) Act 2012 to provide loans to infrastructure projects.

Introduction

1. The Infrastructure Forum brings together investors in and builders and operators of UK national infrastructure. It established a Working Group in 2017 to examine the significance of and future options concerning EIB lending in the UK. Its work included structured discussions at CEO level with members of The Infrastructure Forum's network.

2. The Infrastructure Forum's Working Group published its report 'The Future of the European Investment Bank in the UK post-Brexit' in January 2018. Subsequently, the government's Draft Withdrawal Agreement has outlined a staggered repayment plan of the UK's called-in EIB capital of 11 yearly instalments equal to €300million starting from December 2019 with a final payment of €195.9million in December 2030.[1] It also provides that new loans may be awarded to UK projects until the point at which the Agreement is signed,[2] after which the UK will become a third country.

3. This suggests that it is unlikely that the UK will remain a full member of the EIB post-Brexit and should investigate other ways of engaging with it.

4. One promising route explored in this submission is to negotiate a country agreement.

5. A domestic replacement for the wider roles of the EIB in the UK infrastructure market might be pursued once a country agreement is in place.

The UK and the EIB

6. All EU member states are members of the EIB by virtue of Article 308 of the Treaty on the Functioning of the European Union,[3] and can be recipients of EIB loans.

7. UK projects have received a significant proportion of EIB loans over the years. As Figure 1 shows, total EIB loans to UK projects have steadily increased since 1973. From 2012 to 2015 there was a particularly significant from €3.6billion to a peak of €7.8 billion.[4]

[1] Department for Exiting the European Union, *Draft Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community*, p.96, Chapter 4, Article 143.4.
[2] Ibid., Article 130.2.
[3] *Consolidated versions of the Treaty on the European Union and the Treaty on the Functioning of the European Union*, 2012/C 326/01, Section 2, Chapter 4, Article 308.
[4] European Investment Bank, *Project Loans*, 2017.

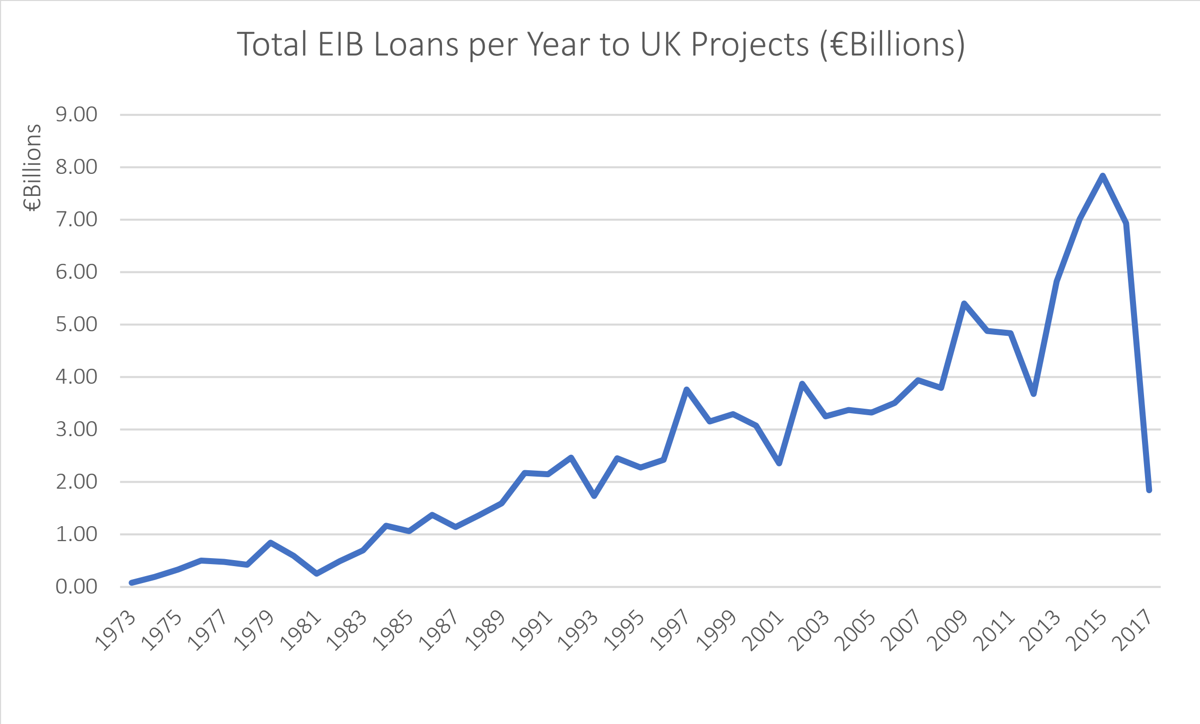

Figure 1

8. Subsequently, there has been a de facto standstill on EIB lending to the UK; the amount of financing received by the UK in 2016 declined to €5.2billion and in 2017 to €1.89billion following the result of the UK referendum.

9. The UK will likely become a third country in relation to the EIB once the Withdrawal Agreement is signed. This will have two particular effects: UK projects may receive loans as a third country recipient, but the scale of lending would be much reduced and EIB lending will be disrupted by the 16.1% reduction in capital reserves which back its ability to borrow on the capital markets. [See paragraph 29.]

10. The EIB issues loans to projects in non-member states where the projects concerned align with EIB objectives. In 2016, 10% of signatures on EIB loans were to projects in non-member states.[5] By way of comparison, UK projects constituted 9% of all EIB signatures in 2016.[6]

11. In 2017, signatures on loans to UK projects dropped to 3% of total EIB loans signed.[7] Figure 2 shows the value of loans awarded to UK projects in 2017 compared with those to non-member states.

[5] European Investment Bank, *Financial Report*, 2016, p.3.
[6] Ibid., p.8.
[7] European Investment Bank, *Financial Report*, 2017, p.8.

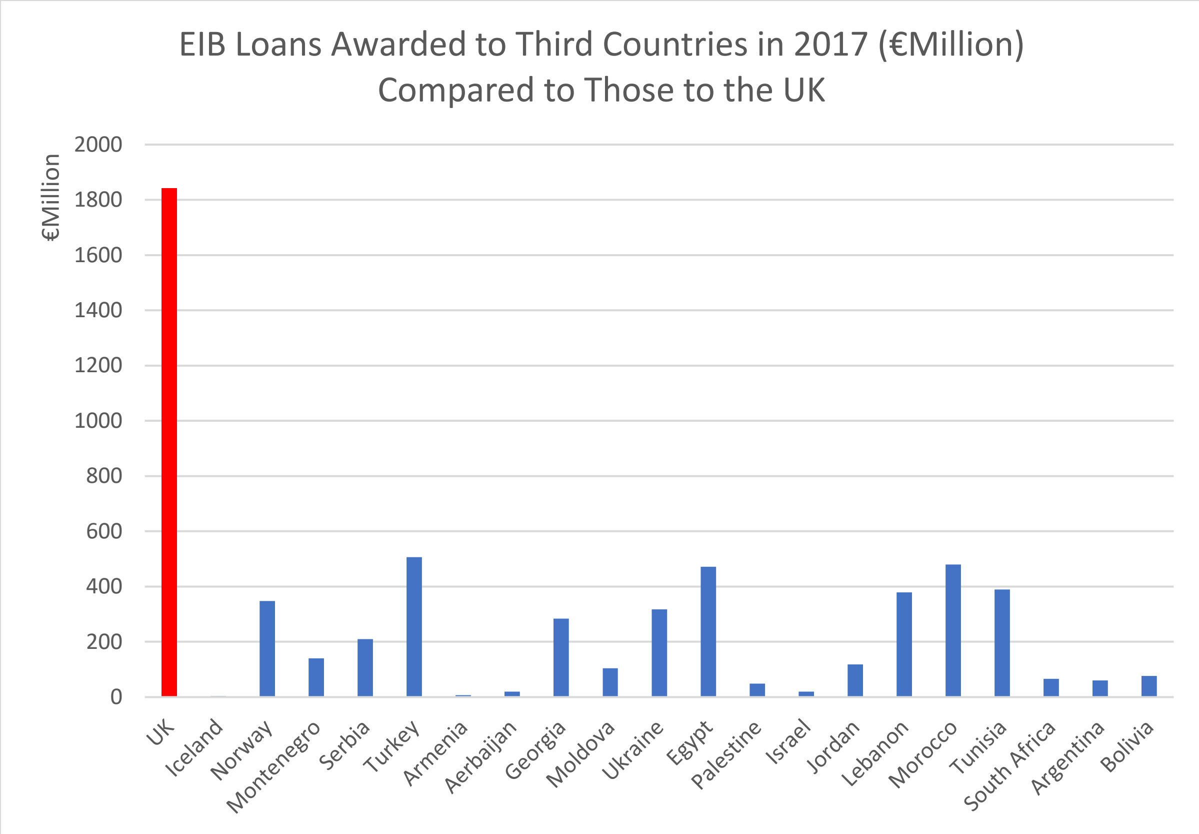

Figure 2

12. Even though EIB lending to UK projects has declined significantly since the referendum it is obvious that the UK remains a significant beneficiary of EIB lending on a scale larger than third country recipients. The UK should expect a further drop in the number and value of loans to UK projects when it becomes a third country.

13. Under the Draft Withdrawal Agreement privileges and immunities will continue to apply to UK project loans from the EIB signed before the end of the transition period.[8] Privileges and immunities will not extend to loans signed once the UK is no longer an EIB member.

14. To continue to receive EIB loans, the UK will need to sign an agreement extending privileges and immunities to lending to the UK in this new capacity. Article 209 of the EIB Statutes state that "The Union may conclude with third countries and competent international organisations any agreement helping to achieve the objectives referred to in Article 21 of the Treaty on European Union and in Article 208 of this Treaty."[9]

[8] Department for Exiting the European Union, *Draft Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community*, Article 113.2.

[9] European Investment Bank, *Statute and other Treaty provisions*, p.13.

15. Such an agreement can be made on an individual project basis or on a national basis. The process is more efficient if a national agreement pre-establishes key conditions such as the evidence of a statutory regard for privileges and immunities.

16. The EIB's 2017 Financial Report stated that "The majority of non-EU activities are covered by guarantees from the EU (External Lending Mandate) or the EIB's Member States (Cotonou Agreement), in the form of either a comprehensive guarantee or a political risk guarantee."[10]

17. The Cotonou Agreement provides a model of such an agreement.[11] It was signed in June 2000 between the European Commission and 79 countries from Africa, the Caribbean and the Pacific (ACP) and has facilitated EIB loans to these countries.

18. A similar agreement with the UK on the precedent of Cotonou would:

    a. Establish the Bank's right to engage in activities in the UK;

    b. Confirm that the Bank is not subject to taxation or currency control in the UK when engaging in its permitted banking activities;

    c. Provide rights, privileges, protection and immunities for the Bank and its assets, the projects the Bank funds and the Bank's staff in the UK;

    d. Establish a mechanism for the UK to agree to the Bank's activities inside its territory; and

    e. Establish dispute resolution mechanisms for (i) any disputes which may arise about projects funded by the Bank or (ii) between the Bank and the UK about the framework agreement.

19. Specifically Protocol 2 on Privileges and Immunities, Chapter 1, Article 1 of the Cotonou Agreement provides that:

> "The representatives of the Governments of the Member States and of the ACP States and the Representatives of the Institutions of the European Communities, and also their advisers and experts and the members of the staff of the Secretariat of the ACP States taking part, in the territory of the Member States or of the ACP States, in the work either of the institutions of the Agreement or of the coordinating bodies, or in work connected with the application of the Agreement, shall enjoy the customary privileges, immunities and facilities while carrying out their duties and while travelling to or from the place at which they are required to carry out such duties.
>
> The preceding paragraph shall also apply to members of the Joint Parliamentary Assembly of the Agreement, to the arbitrators who may be appointed under the

[10] European Investment Bank, *Financial Report*, 2017, p.11.
[11] See: European Commission, *The Cotonou Agreement and multiannual financial framework 2014-2020*, 2010, 22 June 2010.

Agreement, to members of the consultative bodies of the economic and social sectors which may be set up, to the officials and employees of these institutions, and also to the members of the agencies of the European Investment Bank and its staff, and to the staff of the Centre for the Development of Enterprise and the Centre for the Development of Agriculture."[12]

20. Templates exist which help in establishing third country agreements with the EIB. For example, in 2014 the EIB published 'EIB template contractual clauses on environmental matters',[13] outlining how environmental standards should be included in non-EU country agreements. Such templates could be used to help construct a third country agreement between the UK and the EIB.

21. If no such agreement could be put in place, terms would have to be negotiated on a project-by-project basis which would significantly reduce the likely number of loans awarded to UK projects.

22. The Infrastructure Forum's Working Group concluded that EIB money offers an additional number of hard and soft benefits for recipients that would be lost upon the cessation of the UK's membership:

    a. The EIB provides funding with a **long tenor** at a **lower cost than the capital markets** for projects with a total cost in excess of €25million.[14] This subsidised lending enables infrastructure projects in the UK to be delivered more cheaply than they could be otherwise.

    b. EIB **can lend to SMEs**. Its total investment exceeds EUR7.5million.[15] This was seen as a particularly significant role which would be at risk.

    c. It acts as a **cornerstone investor on higher risk projects**, providing up to 50% of finance when required. This promotes **crowding in on new technologies**. The EIB was for example an early investor in offshore wind and a key investor in Tideway.

    d. During times of market contraction, the EIB is able to **continue to lend when commercial loans dry up**. This acts as a **stabilising force for markets** and keeps financing streams open.

    e. The presence of the EIB on project finance **reassures foreign investors on market default risk**, as the EIB is a AAA-rated lender. This effect is particularly acute on large syndications where the EIB can **lead negotiations with experienced teams**.

[12] Ibid., p.179—180.
[13] See: European Investment Bank, *EIB template contractual clauses on environmental matters*, 2014.
[14] European Investment Bank, *Project Loans*, 2017.
[15] Ibid.

f. The longer tenors of EIB finance compared with the private sector **reduce refinancing risk following construction**. Finance can be agreed for periods from 36 months to 30 years. This long termism may be difficult to replace.

g. Loans from the EIB **offer flexibility**. They can be:

   i. **Drawn down in tranches** over the lifetime of the agreed finance, rather than as an upfront lumpsum which helps treasury teams with balance sheet management.

   ii. Issued in **different currencies**.

   iii. Issued at **either fixed or variable interest rates**. Rates on future tranches can also be forward fixed.

h. Many in The Infrastructure Forum's network praised the quality of EIB due diligence and the conditionality into which it provides social objectives and sustainable projects.

23. To evaluate the impact of the loss of EIB money, users and potential users of EIB finance were asked 'On a scale of 1 to 10, where 1 means no impact and 10 means having a major detrimental impact, what do you this the impact on the UK infrastructure market would be if the EIB no longer issued loans to UK projects?'. Most respondents answered around a 4 on that scale – a disruptive but not catastrophic impact to UK infrastructure. No respondents answered either '1 or 2' or '8 to 10' suggesting that the impact of the EIB no longer issuing loans to UK projects would not be insignificant.

24. Many in the sector consider that routine project finance is available from the private banking sector for most current users of EIB loans albeit at significantly higher cost, except during downturns and periods of economic difficulty when these sources tend to dry up.

25. Utilities markets were one example where it would be relatively straightforward to replace EIB finance; however, it was estimated that this increased cost could range from 50 to 100 basis points above the rate of interest offered on EIB loans. This increased cost which would have to be passed down to consumers.

26. Some of those responsible for social, environmental and housing projects believed that it would be much more difficult to replace EIB funding in these areas. They welcome the availability of funding from the EIB specifically directed to these purposes, lent by experienced and supportive teams.

27. Figure 3 shows the distribution of EIB loans to UK projects by sector from 1973 to 2017 and demonstrates that the loss of EIB money will be felt particularly in some sectors – social, environmental and housing projects.

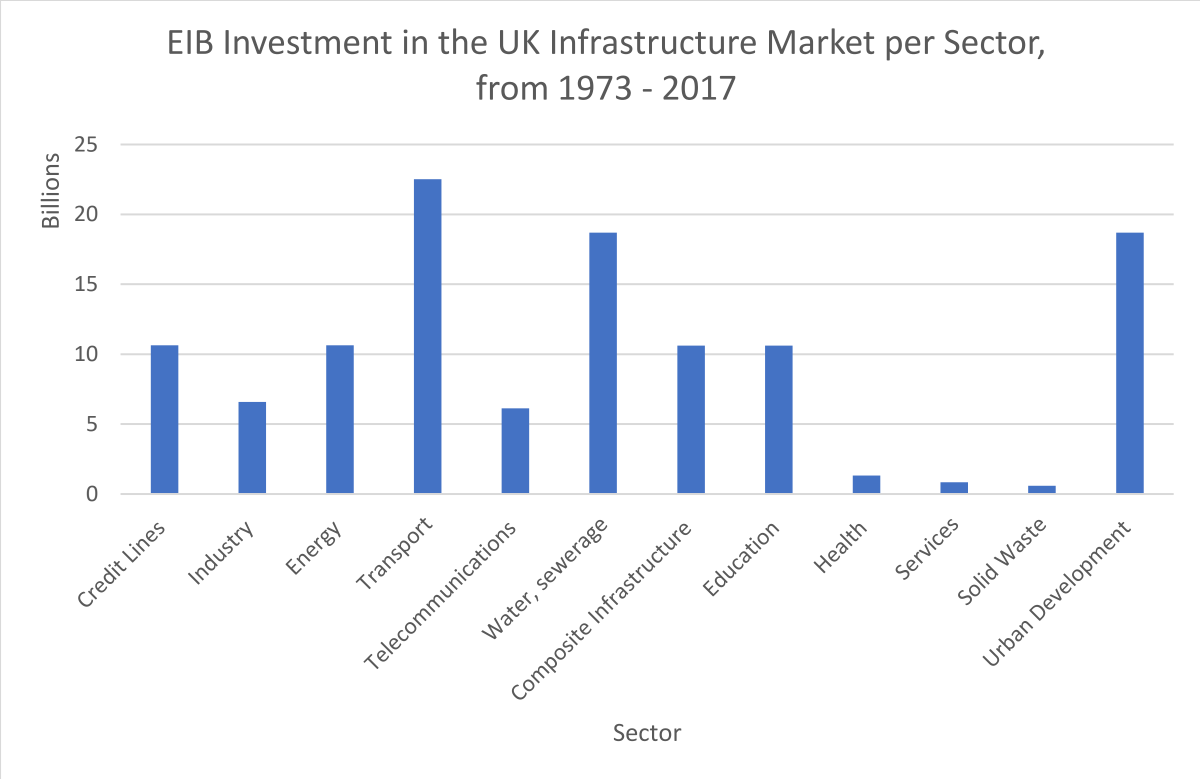

Figure 3

28. The EIB has announced that it is in the preliminary stages of developing a new fund, similar to that of the European Investment Fund (EIF), which will provide loans to projects in third countries with interests aligned to those of the EIB.[16] Given the existing relationships and experience of the UK infrastructure market arranging EIB loans, this fund *may* be available to the UK post-Brexit if the UK is unable to negotiate full membership status. It should be noted, however, that this new fund is primarily intended for development purposes.

29. Other things being equal, the ability of the EIB to lend will be reduced as a result of the reduction of capital reserves triggered by the UK's withdrawal.

30. The UK has a 16.1% value stake in the EIB, which amounts to €39.2billion in subscribed capital.[17] By Article 5 (1) of the Statute of the European Investment Bank, each member state is currently required to pay 8.9% of their value stake in the Bank.[18] Accordingly, €3.49 billion of the UK's value stake has been called up and paid in to the Bank's reserves.[19]

[16] J. Comte, 'EIB proposes new subsidiary for lending outside the EU', *Global Capital*, 5 December 2017.
[17] European Investment Bank, *Financial Report*, 2016, p.47.
[18] European Investment Bank, *Statute and other Treaty provisions*, p.9.
[19] European Investment Bank, *Financial Report*, 2016, p.47.

31. The Bank's total called up capital is €21.69billion.[20] Once the UK's capital has been repaid in accordance with the Withdrawal Agreement,[21] the EIB's called up capital will be reduced to €18.2billion – a significant reduction.

32. The EIB maintains a AAA credit rating,[22] enabling it to seek finance from capital markets and act as the World's largest multilateral lender. €56.4 billion was raised on capital markets in 2017,[23] with loan signatures worth €69.9 billion in 2017.[24]

33. Article 20 of the EIB Statutes provides that "The Bank shall borrow on the capital markets the funds necessary for the performance of its tasks."[25] This supplies the necessary capital to finance the lending activities of the Bank and its other cashflow needs, including prefunding of the borrowing programme.[26]

34. Therefore, the value stakes of EIB member-states *back* EIB loans; they *do not provide the funds* for investment.

35. The President of the EIB, Dr Werner Hoyer, wrote to member states in June 2018 requesting an increase in the percentage of called-up capital of remaining member states to make up the deficit caused by the UK's departure from the EIB.

36. Reports suggest that a number of member states, including Denmark, Sweden and the Netherlands, demanded sweeping governance changes to the EIB as a condition for meeting this increased capital call.[27]

37. The Bank agreed to the governance reforms proposed by these member states in August 2018. The most significant of these to note was the independent supervision of the Bank's lending by the European Central Bank (ECB).[28]

38. It has also been reported that some member states wish to seize this opportunity to alter their relative percentage contributions to the EIB to more accurately reflect the growth in their economies.

39. Poland, for example, has a 2.1% stake in the EIB which amounts to €447.5million,[29] yet their GDP has increased from $255 billion when they entered the EU in 2004 to $524 billion in 2017.[30] This economic growth should be reflected in an increase in its capital call and accordingly voting rights in the EIB.

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[20] European Investment Bank, *Financial Report*, 2017, p.6.
[21] Ibid., p.2.
[22] The European Investment Bank, *Credit Rating*, 2017.
[23] European Investment Bank, *Financial Report*, 2017, p.13.
[24] Ibid., p.8.
[25] Article 20 (1), European Investment Bank, *Statute and other Treaty provisions*, 2013, p.19.
[26] European Investment Bank, *Financial Report*, 2016, p.4.
[27] M.Kahn and A.Barker, 'European Investment Bank bows to calls for reform', *Financial Times*, 7 August 2018.
[28] Ibid.
[29] European Investment Bank, *Financial Report*, 2017, p.47.
[30] World Bank, *Public Data: Gross Domestic Product - Poland*, 2018.

40. At present, Germany, Italy, France and the UK all contribute the highest proportion of 16.1%, amounting to 64.4 of the Bank's total capital reserves. The influence of Germany, Italy and France would be concentrated if the capital call was raised on member states at present ratios once the UK leaves.

41. The impact that changes to the EIB's governance will have on its lending facilities and decisions is not yet known.

Domestic Replacements

42. The UK should consider a domestic solution to bridge the lending gap that will arise in the UK infrastructure market once it has left the EIB and a third country agreement is in place.

43. The Infrastructure Forum's EIB Working Group explored possible options for a domestic replacement of the EIB in its report:[31]

UK Guarantees Scheme

44. The Working Group strongly advocated the extension of the UK Guarantees Scheme (UKGS) run by the Infrastructure and Projects Authority and HM Treasury. The scheme in its present form guarantees the principal loan and interest payments on debt issued to projects up to the value of £40billion.

45. The Infrastructure Forum has proposed that "a strengthened version of the UKGS could be developed to offer guarantees for projects during the construction period, in which most risk is encountered."[32]

46. Expansion of this guarantee facility would offer many of the soft benefits of EIB lending; the EIB is viewed as an experienced and knowledgeable lender therefore its presence on a loan can encourage investors into projects involving new technologies and provides reassurance of foreign investors.

47. Furthermore, the Infrastructure (Financial Assistance) Act 2012 provides that HM Treasury can offer financial assistance to any person for the provision of infrastructure.[33] The UKGS could therefore provide loans, in addition to guarantees. This would offer the closest replication of the EIB by a domestic institution in the UK.

British Investment Bank

48. The creation of a 'British Investment Bank' (BIB) to replace EIB funding in the UK has frequently been mooted. There are many continental examples, such as the Nordic

[31] The Infrastructure Forum, The Future of the European Investment Bank in the UK.
[32] Ibid., p.18.
[33] Infrastructure (Financial Assistance) Act, 2012, HL Bill 43, 55/2. 1.2.

Investment Bank and Germany's Kreditanstalt für Wiederaufbau, which have had success in offering both loans and guarantees to national infrastructure projects.

49. If the financial structure of a BIB was based on that of the EIB, it would need a large amount of initial capital to back its ability to borrow on the capital markets. The most efficient way to fund this capital investment, given current low interest rates, would be to issue Government bonds.

50. The Working Group proposed that a BIB should aim to build a capital pool close to that of the €3.9billion currently invested in the EIB, so that it could provide a similar level of lending to UK projects.

51. The National Audit Office, however, argued that such an institution would require between £15billion and £20billion in starting capital which could prove a significant burden on existing spending commitments.[34]

52. The National Infrastructure Commission published its National Infrastructure Assessment in July 2018 which argued that "government should maintain access to the European Investment Bank if possible. If access is lost, a new, operationally independent, UK infrastructure finance institution should be established by 2021. To enable this, government should consult on a proposed design of the new institution by Spring 2019. The consultation should cover:

- Functions, including provision of finance to economic infrastructure projects in cases of market and coordination failures; catalysing innovation; and acting as a centre of excellence on infrastructure project development, procurement and delivery.
- A clear mandate, including sound banking, additionality and having a wider economic and social impact.
- Governance to safeguard the operational independence of the institution."[35]

53. The Infrastructure Forum welcomes this consultation but recognises that a British Investment Bank would though take a long time to build up the capital and experience required to replace the EIB's role in the UK.

Expansion of British Business Bank

54. The British Business Bank (BBB) could also be expanded to fill this lending gap.

55. The limits on BBB investment in venture capital funds was increased in 2017 from 33% to 50% by the Chancellor and has brought forward £400 million in additional funding; however, this does not come close to replacing the €7.8billion lent to UK projects by the

[34] NAO, Exiting the EU: The financial settlement, 2018.
[35] National Infrastructure Commission, *The National Infrastructure Assessment*, 2018, p.159.

EIB prior to the referendum in 2015. This could provide a similar role to the EIB, in particular by supporting SME's and new technologies, but the UK will need to offer a much larger lending facility to fully replace the hard and soft benefits of EIB.

Public Works Loan Board

56. The Public Works Loan Board (PWLB) is a statutory body, part of the Debt Management Office, which is in turn an executive agency of HM Treasury.[36] It issues Government loans to Local Authorities and other similar bodies from the National Loans Fund. Expansion of this facility could fill the lending deficit in areas of acute reliance on EIB loans, such as housing and environmental projects.

57. PWLB funds are limited as outlined: "Section 4 (1) of the National Loans Act 1968 limits the aggregate amount that may be outstanding in respect of commitments entered into by the Public Works Loan Commissioners. The Local Loans (Increase of Limit) Order 2008 increased that limit from £55 billion to £70 billion. Section 300 of the Finance Act 2014 (which requires authorisation by HM Treasury to come into force), allows a further increase of the limit up to £95 billion (principal) on the total of loans outstanding to the PWLB at any one time."[37]

58. Extending the mandate of the PWLB to allow it to issue loans to domestic infrastructure projects would offer funds with similar social benefit considerations and could continue to operate during economic downturns. This would also be less disruptive than creating an entirely new institution.

59. Current Eurostat guidance would mean that infrastructure projects funded by the PWLB would be on balance sheet if PWLB money constituted more than 50% of the total funding,[38] and subject to statistical consideration of varying degrees if funding from the PWLB exceeded 10%.[39] This should be carefully considered when deciding on a domestic replacement for EIB money.

Conclusions and Recommendations

60. The UK infrastructure market will be adversely affected by any reduction in EIB lending. This submission suggests that the UK should pursue an agreement with the EIB to establish the privileges and immunities required for EIB lending to the UK as a third country as an immediate priority. This will allow those projects that most rely on EIB money, namely housing, environmental and social infrastructure, to access these loans when the UK is no longer a full member of the EIB.

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[36] UK Debt Management Office, *Public Works Loan Board: About the PWLB,* 2017.
[37] HM Treasury, *National Loans Fund Account 2016-17*, July 2017, p.6.
[38] European PPP Expertise Centre and Eurostat, *A Guide to the Statistical Treatment of PPPs*, September 2016, p.131.
[39] European PPP Expertise Centre and Eurostat, *A Guide to the Statistical Treatment of PPPs*, September 2016, p.131.

61. Once such an agreement is in place, The Infrastructure Forum believes that the UK should consider scaling up the existing UK Guarantees Scheme to provide guarantees for infrastructure project loans as well as its own lending facility. This could replace EIB lending which is no longer available.