Bulletin

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UK ACCESS TO EU FINANCE FOR INVESTMENT AFTER BREXIT

The European Union has been a steady source of finance for UK infrastructure projects and regional investment, through grants from European structural funds and loans from the European Investment Bank (EIB). These flows of long-term, low-cost finance are clearly in question as Britain leaves the EU. So what happens when the European taps are turned off? This bulletin in our post-referendum series explores the implications for the UK – and for the principal European funding institution itself.

As a member of the EU, the UK's contributions to its budget are offset in part by access to a multiplicity of investment programmes and financial instruments supporting European policy objectives.

Key Brexit questions, therefore, are:

- What access, if any, can Britain expect to have from any of these sources after leaving the European Union?
- What grandfathering or transition arrangements will be made to protect research, investment and regional development over the period of departure?
- How should domestic policy be developed to compensate for the drying-up of these sources of funds?

To address this range of questions, we need to start with a clear understanding of where, why and how EU funding is currently coming to the UK, and on what scale.

The funding menu

The main sources of finance include structural and investment funds, funding for research, and loans, investments and guarantees from the EIB Group. Some of these funds are inter-related, so that an EIB loan may be part of a package for a project including support from one of the European structural funds.

Between 2014 and 2020, the UK is expected to benefit from about €16 billion of support from European Structural and Investment Funds

The European Structural and Investment Funds (ESIF) are intended to help reduce economic and social inequalities between the EU's regions and nations (Box 1), with the money being distributed through 17 national and regional programmes. Unsurprisingly, given its relative affluence, the UK is not one of the biggest recipients: out of €454 billion allocated for the current period (2014-20), the UK is expected to benefit from only about €16.4 billion of ESIF funding, or 3.6 per cent.[1]

[1] http://ec.europa.eu/regional_policy/en/funding/ and https://www.gov.uk/government/policies/european-funds

Box 1: EU structural funds

There are currently five European Structural and Investment Funds, a source of finance first put in place in the 1970s:

- The *European Regional Development Fund* (ERDF), intended to strengthen economic and social cohesion in the European Union by correcting imbalances between its regions.
- The *European Social Fund* (ESF), whose aim is to improve employment and education opportunities in the EU.
- The *Cohesion Fund*, to reduce economic and social disparities and promote sustainable development in Member States with a Gross National Income (GNI) per head below 90% of the EU average (in line with the fund's objectives, the use of GNI takes into account income earned abroad and remitted back to the country in question).
- The *European Agricultural Fund for Rural Development* (EAFRD), intended to strengthen the EU's agriculture and forestry sectors, and rural areas in general.
- The *European Maritime and Fisheries Fund*, linked to the objectives of the Common Fisheries Policy.

The current budget for EU structural funds is €454 billion over the 2014-20 period, with most going to the first three. The UK receives funding from the ERDF and ESF, but not from the Cohesion Fund. Current ERDF funding priorities are innovation and research; the digital agenda; support for small and medium-sized enterprises (SMEs); and the low-carbon economy.

Structural funding is concentrated on the "less developed" regions of the EU, with GDP per head of less than 75 per cent of the EU average. Two UK regions fall in this category: Cornwall and the Isles of Scilly, and West Wales and the Valleys.

But UK is also, of course, a recipient of European research funding, where its share is higher. Over the period 2007-13, for example, the UK received €8.8 billion out of a total of €107 billion EU expenditure on RDI, although this was still only the fourth largest share in the EU.[2]

However, the UK received the second largest share from Framework Programme 7 (FP7), under which research funding was awarded on a competitive basis (also in 2007-13). Bids for Horizon 2020, the programme covering the next period, look set to deliver a similarly-substantial share to the UK.[3] Overall, as our separate forthcoming bulletin will show[4], the UK was a substantial net beneficiary from research flows, getting back about 1.6 times its contribution to the research budget.

Banking on the EIB

Of equal significance to the UK are the activities of the EIB Group – composed of the EIB and the European Investment Fund (EIF). The EIB is the world's largest multilateral financing institution, signing loans and guarantees of nearly €70 billion a year. (For comparison, World Bank Group commitments in 2016 amounted to $64 billion.)

The EIB co-finances long-term investments right across the EU, from large-scale infrastructure and environmental projects to higher education and social housing. Its institutional mandate is to implement the policies, strategies and programmes of the EU, including – just for example – the Energy Union, the Capital Markets Union, and the Digital Single Market Strategies.

The EIB is an attractive source of finance for major infrastructure projects because it provides access to long-term lending with advantageous conditions: on average, lower interest rates or longer terms than are available from commercial lenders. This is possible because the EIB raises funds through

[2] UK Office of National Statistics (ONS) estimates cited in "*UK research and the European Union- The role of the EU in funding UK research*", The Royal Society (December 2015).

[3] Based on an assessment of the first two years of the Horizon 2020 programme, the UK had the largest share of participation in signed grant agreements among all Member States, and the second highest share of funding: http://ec.europa.eu/research/evaluations/pdf/h2020_2-years-on_brochure.pdf.

[4] Frontier Economics, "*Plugging the Gap*", February 2017.

issuing bonds in capital markets across the world on the strength of its credit rating and preferred creditor status.

Credit rating agencies identify some major factors that justify EIB's credit standing and triple-A rating: notably, of course, joint European sovereign ownership and support. But the rating agencies also point to outstanding asset quality (e.g., an impaired loan ratio of 0.3% at end of 2015); and conservative risk management. The overall credit quality of EU public and private EIB borrowers has improved significantly in the past three years.

Many projects co-financed by the EIB could probably be financed entirely without its participation, but at a higher financial cost. So its support is intended to be reserved for projects that address significant market failures.

Between 2011 and 2015, the EIB has signed loans, guarantees, and credit lines for over €300 billion within the EU and nearly €340 billion overall. Slightly over €29 billion (or 8.6% of the total) have been deals with UK private and public project sponsors (Table 1). This puts the UK in a similar bracket to Germany and France over the 2011-15 period, though some way behind the largest recipients Spain (15.2%) and Italy (14.0%). Recently published provisional statistics for 2016 point to a similar picture, with the UK accounting for €6.7 billion (8%) of the €84 billion of EIB Group signed investments for the year.

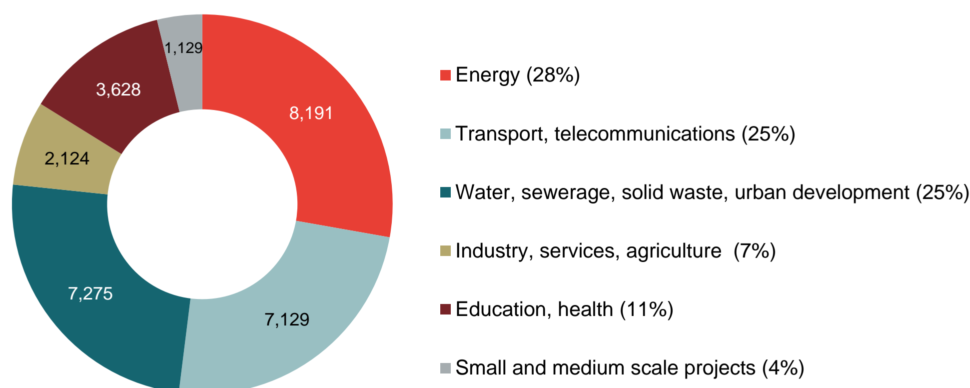
Table 1: EIB finance contracts and the UK's share

	2015		2011-15	
	€ billion	%	€ billion	%
UK	7,768	*10.0*	29,115	*8.6*
Inside EU	66,691	*89.9*	301,581	*88.9*
Outside EU	7,830	*10.1*	37,520	*11.1*
Total	77,521	*100.0*	339,101	*100.0*

Source: EIB 2015 Statistical Report[5]

Over 75% of EIB's lending to the UK goes to network infrastructure projects (e.g., energy, transport, telecommunications, water, and wastewater). As Figure 1 shows, the rest is spread across industry, agriculture and social infrastructure (e.g., education and health). And as Box 2 illustrates, even if the UK's share of EIB funding has been less than its share of European output, the EIB has been involved in the financing of many of Britain's biggest construction projects over the past thirty years, making some of its biggest loans.

Figure 1: EIB lending in the UK (2011-15, €m)



Source: EIB[6]

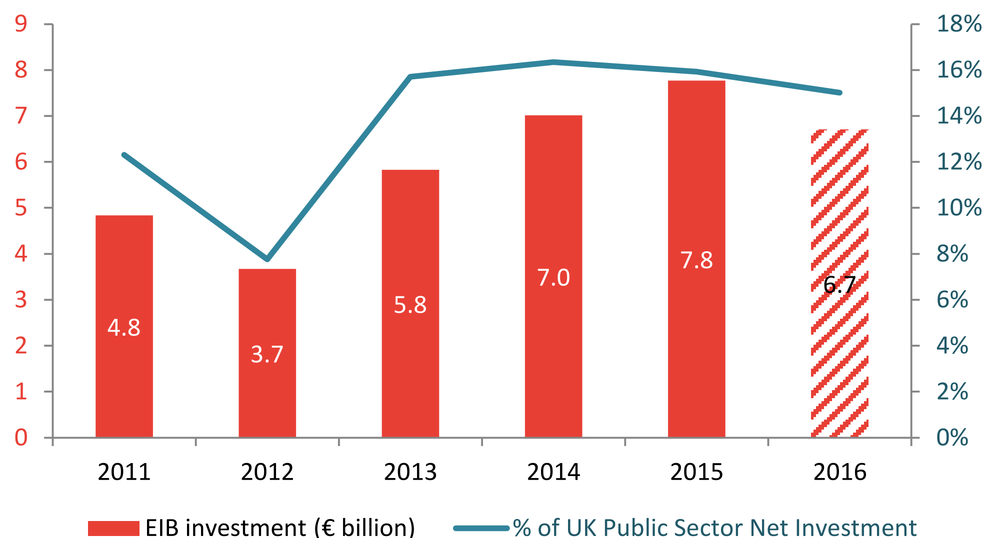
In 2015, for example, EIB investments in the UK economy totalled €7.8 billion, the EIB's largest-ever engagement in the country, equivalent to 16% of UK's total public sector net investment – a definition that is rather broader than investment in infrastructure (Figure 2). Provisional figures indicate a similar level of support in 2016 (after taking account of the weakening of sterling following the

5 http://www.eib.org/infocentre/publications/all/statistical-report-2015.htm

6 http://www.eib.org/projects/regions/european-union/united-kingdom/index.htm

referendum vote). This included £1.3 billion of loans for social housing (a record for the EIB in any European country), the Bank's largest ever loans to universities and more than £1 billion of support for transmission network upgrades and offshore wind farms.

Figure 2: EIB investment as % of UK public sector net investment



Source: Frontier Economics, based on EIB and UK published statistics. Note: 2016 figures are provisional.

Box 2: The EIB's big ticket items

The EIB has supported many flagship infrastructure projects in the UK. It has co-financed practically every large and significant modern transport infrastructure investment in recent times, including the Channel Tunnel, the second Severn Crossing, extensions to the London Underground's Jubilee and Northern lines, and Crossrail, the last-named with two loans: one for €1.1bn in 2009 for the project's initial tunnel construction phase; and another of €590 million in late 2013 to help finance a fleet of high-capacity, state-of-the-art trains.

The Thames Tideway Tunnel – designned to comply with environmental standards and ecological objectives set by the EU, through the Urban Wastewater Treatment Directive, and the UK Environment Agency – has been supported by a €1.25 billion EIB loan signed in 2012.

In 2014, the EIB signed with the UK's National Grid the largest-ever single loan in the Bank's 58-year history, amounting to €1.92 billion, to improve energy transmission and upgrade the country's electricity infrastructure. However, this was exceeded, in 2015, by a €1.4 billion loan to Transport for London to finance the upgrading of existing lines and stations on the London Underground, and the construction of a network of cycle paths in the capital. In 2015 EIB also signed its largest-ever single loan to a university, €279 million, to improve and expand the teaching and research facilities at Oxford.

Sharing the risk

Unsurprisingly, perhaps, Britain has attracted a larger share of the funds supplied by the equity investment arm of the EIB group. Between 2011 and 2015 the European Investment Fund (EIF) part-invested €2.3 billion in 144 UK-based venture capital funds and similar entities. According to estimates by the private equity industry, this amounted to a third of all such investment made by the EIF.

The EIF was created by the EU in the 1990s. Unlike the EIB, which is wholly owned by the EU's Member States, the EIF is a public-private partnership, with commercial banks and other private financial institutions among its shareholders.

The EIF is a major risk finance provider for small and medium-sized enterprises (SMEs) and "mid-caps" – companies with a market capitalisation of €2-10 billion. The EIF's main lines of business include investments in equity funds, microfinance and the issuing of guarantees for the securitisation of SME loan and leasing portfolios.

In 2015, the EIF's equity participations in the UK amounted to €656 million, invested in two co-investments and in 16 funds, 11 of which are multi-country funds investing also outside the UK. That same year, the EIF signed five guarantee and securitisation transactions totalling €280 million, supporting SMEs in the UK.

Which way is out?

Plainly, the extent of UK's future access to long-term finance from the EIB and structural funds depends on the timing and nature of its exit from the EU. Brexit poses a particular conundrum for the EIB, since the departure of a member (and shareholder) was not provided for in the bank's statute.

A country must be a Member State of the European Union to become a shareholder of the EIB (the new EU Member States from Central Europe and the Baltic States became shareholders as they joined the union). But there is no procedure laid down for a withdrawal of shareholders, the transfer of, and payment for, shares, and/or the distribution of assets. The necessary amendments to the EIB statute will have to form part of the negotiations that will follow the UK's triggering of Article 50.

At present, the UK has a 16.11% shareholding in the EIB, the same as France, Germany and Italy. UK's paid-in capital in the EIB is close to €3.5bn (Table 2). The UK also proposes a permanent member of the EIB's Management Committee, and historically British officials have been prominent in the leadership of the EIB.

Table 2: UK's stake in the EIB

	Shareholding	Paid-in capital	Callable capital
UK	16.11%	€3.50bn	€39.20bn
EIB	100.00%	€21.70bn	€243.28bn

Source: EIB 2015 Financial Report

For the moment, clearly, UK will remain a shareholder of the EIB. And, perhaps more importantly, all EIB outstanding loan contracts in relation to UK-based projects will remain valid, and all disbursements defined in these contracts will continue to take place as anticipated.

Moreover, following the referendum, the EIB announced that it will continue to appraise new UK-based projects until EIB's shareholders decide to change lending activity. So it will be "business as usual" until the UK exits the union.

This is good news for the UK, given the emphasis its new government has placed on infrastructure and RDI investments. It is also good news for the EIB: given the substantial lending commitments associated with the European Fund for Strategic Investment (EFSI), also known as the "Juncker Plan", the sudden loss of a country of operations such as the UK, with a solid project pipeline, would be a major setback. Arguably, EFSI goals, especially the intention to stimulate more than €500 billion of new investment by the end 2020, may not be attainable without projects in the UK. But after 2020, what then?

In theory, the EIB's European Agency status makes UK's exit negotiations with the bank independent from UK's exit negotiations with the EU. In practice, of course, these negotiations will be inextricably linked. To make a guess at the possible outcome, let's consider two very different scenarios: something very close to the status quo, and full exit from all institutions.

Staying good friends…

The UK and other Member States could agree that it is in everybody's best interests to keep everything "as close as is" in relation to the EIB and the UK's shareholding in it. The EIB statute would, of course, have to be modified to accept non-EU Member States among its shareholders and borrower countries. But to be an "outsider" shareholder in a regional development bank is not unprecedented. The European Bank for Reconstruction and Development (EBRD), for example,

counts among its shareholders non-European countries such as the US, Canada, Japan and South Korea, among others.

Much less usual, however, is for those shareholders wearing an "outsider" T-shirt to also be borrowing countries of operation. However, as Table 1 illustrates, the EIB does do some leading outside the EU.

In the period 2011-15, 11% of EIB's €339 billion in total investment was allocated such projects. Countries in the European Free Trade Area (EFTA) and EU Enlargement regions accounted for the biggest slice of this – about a third of the total of €7.8 billion in 2015 – with the rest dispersed as far as Africa, Asia and Latin America. EIB lending outside the EU is determined by a series of EU mandates supporting international development and co-operation objectives.

However, if the UK were allowed continuous access to EIB finance after leaving the Union, it would surely be conditional upon compliance with all outstanding EU policies, procedures and legal requirements (e.g., procurement and environmental standards) in the design of all UK-based projects co-financed by the EIB. Those projects would, as now, continue to be designed and appraised in terms of the strength of their contribution to EU policies. But this constraint may be more apparent than real, since most EU policies with respect to infrastructure investment chime with the UK's declared priorities.

From a business perspective, both parties stand to win from continued UK membership in the EIB. But from a political perspective, it may be difficult to negotiate and agree such an outcome

From a business perspective, both parties stand to win from such a scenario. Credit rating agencies currently assume in their "base case" that Brexit will not cause a major disruption to EIB operations. Britain's departure would affect both its business profile and, potentially, its credit rating, through its reduction in callable capital. It would deprive the EIB of one of its largest joint shareholders (to whom it lends proportionally less than its share in the Bank), and a mature and well-functioning market with a healthy portfolio of performing loans and a robust project pipeline. It would obviously be to its advantage if the UK stays put.

The UK, likewise, would benefit from retaining continued access to low cost, long-term finance for network and social infrastructure projects and RDI investments, and the EIB's expertise, at a time when the Bank has been increasing its UK lending and potential borrowers have gained familiarity with its processes.

From a political perspective, however, it may be difficult to negotiate and agree such an outcome. For the UK government, it is hard to see how continued membership would match up to the Prime Minister's slogan that "Brexit means Brexit", or why Britain should continue to hold, rather than monetise, a share in an institution that delivers a less-than-proportionate share of investment to the UK. Other Member States may meanwhile resist an outcome that allows their main financial institution to be a cornerstone investor in flagship UK projects.

…or clean break?

To achieve a full exit, the UK could try to sell its equity stake in the EIB and repatriate the €3.5bn of paid-in capital. It could use this to help set up a "National Infrastructure Bank", or similar, to finance the type of projects the EIB currently supports – along the lines of the proposed Canada Infrastructure Bank, for example, or even institutions that operate in parallel with the EIB in individual European states.

The UK does not have an institution comparable with Germany's Kreditanstalt fur Wiederaufbau, set up way back in 1948 to support postwar reconstruction, or France's Caisse de Depots et Consignations, which has an even longer pedigree, dating back to 1816. Recent experiments with the Green Investment Bank and the Business Bank have taken the UK some way in the same

direction, while responsibility for delivery of major schemes has been put in the hands of the Infrastructure and Projects Authority.

But on the whole, Britain has relied on private finance, mobilised by the wide range of infrastructure funds marketed in London. In its report on the National Infrastructure Delivery Plan, published in 2016, the government estimated that around 50% of the infrastructure pipeline to 2020-21 would be financed and delivered by the private sector.

Creating a similar type of institution to the EIB in the UK would require a strong justification given the developed nature of its financial markets. It will also require a focused mandate, tailored to attract private sector finance, and a shareholder agreement as to the government's ongoing role. There must remain a strong possibility that a future government would decide on privatisation - as it has done already, at least in principle, with the Green Investment Bank.

The UK would be better off outside the EIB from the national accounts viewpoint, since departure would eliminate the contingent liability which its share of EIB's callable capital represents (Table 2). But by the same token, it might not to be possible to monetise its equity stake. Each Bank shareholder has, in effect, written a put to the EIB for top-up capital, and this means the UK may be long €3.5 billion of paid-in equity but short over ten times that in callable capital, making it at least arguable that the UK would have to pay to exit.

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In any case, the national accounts effect would, to at least some extent, be offset by the additional borrowing the UK government would have to undertake to replace EIB funding, either through gilts or Treasury-backed infrastructure bonds.

As we have seen, it is of course possible that the EIB would continue to lend to British projects even if the UK were no longer a shareholder or a member of the EU. But on departure the UK would of course lose its place in EIB's Management Committee, the Board of Directors, and the Board of Governors, and therefore any ability to influence EIB's strategic directions and lending decisions. And after a divorce that is unlikely to be amicable, it is hard to see that UK infrastructure would be high on the EIB's list of priorities.

Keep calm and carry on (while it lasts)

The UK government is keen to promote infrastructure as a source of productivity growth, and the 2016 Autumn Statement signalled the Chancellor's concern to prevent Brexit causing a slowdown in the necessary investment. Given the UK's heavy reliance on private finance for its infrastructure development, there is clearly a risk of collateral damage from uncertainty while the terms of Britain's exit are negotiated. For so long as the EIB taps remain open, policy-makers, project sponsors and private co-financiers will do well to fill up with as much of its low-cost finance as they can secure.

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