

# RECLAIMING PUBLIC BANKS

A thought provoking exercise





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## Introduction

# Reclaiming Public Banks – a thought provoking exercise

The crisis in global capitalism may still be far from over, but now, six years on from the collapse of Lehman Brothers and the economic crisis conditions that struck so emphatically, we appear far removed from the atmosphere of opportunity that gripped much of civil society and progressive moments for a few slender months.

If the neoliberal project and the attendant labyrinthine financialised economic structure and mechanisms appeared to be on the rocks, tarnished and vulnerable to alternative, socially just ways of organising economies and of 'doing economics', then it is safe to say they are now well and truly back on their feet. And while real economic recovery remains elusive across much of the global system, there are clear signs that neoliberalism is not only resurgent, but that it is booming and looking to – and in fact now starting to – deepen its impact on contemporary society. It is as if the 2008 crisis and related economic turmoil in its aftermath had barely taken place. Unless of course you're one of the millions of people who have lost jobs, lost real earnings, lost quality of life and lost hope as a result of the myriad of stop-gap, emergency measures imposed with impunity by governments and international bodies on society collectively as a remedy for capitalism's monumental transgressions.

Amidst all the words – and all the huffing and puffing – that have accompanied the efforts from a wide range of progressive movements to set the ground for realising new, more just economic models, one certain phrase has become more familiar than just about any other: *"It is easier to imagine the end of the world than to imagine*

*the end of capitalism."* Despite what appears to be a new onslaught of generalised capitalist intent, involving among other things concerted moves to monetise nature, to exclude everyone but commerce from clean energy developments and to generate new financialised investment instruments, Counter Balance is not done *imagining*.

We present this discussion paper as a starting point, based on our various work over the last few years on the publicly-owned international financial institutions, for civil society to engage in thinking on how to remodel these key players in the global economy – the public development banks – along lines necessary to put them *fully* in the service of society and our shared environment.

Assessing our main target institution, the European Investment Bank (EIB), but with application crucially to the EIB's sister institutions around the world that can collectively leverage billions of vital investment flows, we explain first of all some of the most prominent failings of the so-called EU bank with reference to its contemporary, unfit for purpose activities.

We then proceed to describe the EIB's place and function within the globalised, financialised economy, and attempt to sketch out the beginnings of how to shake up the status quo: how to – and we acknowledge the scale of the challenge – conceive of and realise a new type of public intervention into the economy, one whose primary aim is to definancialise the economy by progressively re-absorbing wealth fluctuating on private capital markets within the realm of operations backed by public investment finance, such as can be provided by institutions such as the EIB.

We conclude with just a few stepping-off points – some principles for a generalised new business model applicable to public financial institutions that require your engagement, your creativity ... and your imagination.



Coal Down award Schuman Square Brussels

# 1. A faulty state-backed business model serving markets and not people

A range of public investment banks exist already and are even experiencing a revival in several European countries.

An important reason for their current success is their ability to balance austerity measures. As public investment banks typically raise money through issuing bonds on the financial markets, their investments can boost the economy without affecting national budgets. As such they are a welcome tool for politicians in times of crisis but it is far from evident how they can be reclaimed for the common good, as seen in the case of the European Investment Bank.

The EIB is the EU's bank. It is driven by EU policies and its investments are supposed to enhance these policies and contribute to the achievement of the policy goals. While it works closely with the other EU institutions, the real power lies with the 28 member states who own the bank. In theory this provides a solid foundation: EU policies as guidelines, checked by the European Commission and the European Parliament, and while the ownership of the bank by the member states may allow for conflicting national interests, it also guarantees that national checks and balances mechanisms apply.

When challenged by civil society, EIB management at the highest level has repeatedly insisted that the bank is driven by EU policies. So if more progressive energy, climate or social lending policies are sought at the EIB, first you seek to change the relevant EU policies and goals that guide the bank in its day to day operations. Beyond the often instrumental use of this justification by the bank to shift public pressure onto other European institutions, it is worth reflecting on how much recent policy developments at EU level have had a negative impact on the possibility to reclaim the EIB for the common good.

Furthermore, even if EU policy and goals would be mainstreamed to become more geared towards the public interest, it remains very difficult to reclaim the EIB and make it work for citizens at large. Indeed, fundamental aspects of how the bank operates help to explain the discrepancy between theory and practice. In this chapter we will focus on a few emblematic aspects that determine and influence the nature of the EIB, and how they are preventing it from operating in the public interest.



## The EU's reaction to the Arab spring

Catherine Ashton's plea for financing "deep democracy" launched the debate on the EU's reaction to the Arab spring in early 2011. Shortly after, European leaders, eager to expand their interests in the middle east and north Africa (MENA) region, agreed on a financial package of EUR 7bn for the region. This amount would be largely channelled through the EIB and the EBRD (the European Bank for Reconstruction and Development).

The decision was taken rashly. A few months earlier the EU and its member states were still doing business with dictatorial regimes. Without any thorough assessment of their activities, the tactics were changed. Now 'democracy' and 'human rights' were the buzzwords, but the portfolios of the banks mandated to channel the money barely changed.

The EIB has been operating in the Mediterranean since 1979. Almost EUR 10bn of the total EUR 23bn invested by the bank in the region over the past three decades has gone to Egypt and Tunisia alone. According to the EIB's own figures, of the EUR 1.87bn loaned by the EIB to Egypt between 2006 and 2010, 92 percent went to energy projects – four fifths of this to promoting fossil fuels. Of the EUR 1.8bn loaned to Tunisia in the same period, half went to energy projects, with ten percent of this amount invested in infrastructure for transporting gas to Italy. These figures are a clear indication of the unbalanced lending portfolio of the EIB.

Although the EIB is mandated to promote development in beneficiary countries outside of the EU, there is scarcely any lending to health and education, for example, in the bank's lending archive for Egypt and Tunisia. The EIB's understanding of development has been a narrow one. As elsewhere, the EIB has evaluated the progress of North African economies mainly on the basis of GDP growth, paying no attention to the internal distribution of wealth.

Nevertheless, without any publicly documented assessment of the EIB's portfolio and its past activities, the EU urged the bank to lend more. Given its poor track record, it is unclear how the EIB was expected to combat social exclusion, endemic poverty, inequality and corruption – the main drivers of protest in the Arab Spring countries. The results to date have been poor, and despite the worsening situation in the region (exemplified by a military coup and the ongoing widespread human rights violations in Egypt), EU leaders have not revised their decision. The banks are still active.

## The “good old days” of infrastructure-led growth proposed again in the financialisation era

Large infrastructure projects are at the core of the European plan to drag the old continent out of one of the most profound crises – economic, financial and political – ever witnessed in modern Europe. According to the European Commission, to meet the Europe 2020 objectives the EU's infrastructure investment needs could require as much as EUR 2,000bn in the sectors of transport, energy and information and communication technology.

In this context, a third wave of privatisation is being prepared: having already privatised many public companies in Europe and created the legislative framework to promote PPPs (public-private partnerships) in order to help them receive funding beyond privatisation, today public guarantee mechanisms aim to create the right conditions for private investors to finance and own large infrastructure projects in the long term. This imperative looks to satisfy only the needs of the private sector – financial and non-financial – by having the public sector take on the risk.

In October 2011 the European Commission communicated its investment plan to re-launch the construction of large infrastructure in the sectors of

energy, transport and digital communication technology. The ‘Connecting Europe Facility’ (CEF) is an integrated process into which the Commission is trying to blend key investment decisions in areas that were previously separated. The aim of the initiative is to finance the infrastructure that will build the ‘backbone of Europe’ in energy, transport and digital data transmission, based on a vision promoted since the 1990s of Europe as a “key player in global trade” and expanding its market at the global level.

This is a vision that is de-contextualised from the territories in the EU, where communities are demanding improvements to local transport systems, including local and metropolitan railways that million of commuters use every day, as well as the localisation of production and the urgent change of the unsustainable and heavily subsidised global trade system. Such infrastructure will lock the economy of the European territories into an old economic model of production and trade for the next 50 to 100 years. It is also a model which is neither green nor transformative, pushing further into the distance the transition to an economic model with low emissions, and reducing the potential for a deep transformation of the energy and production model in Europe.

Aside from public funding that should be made available through the CEF, governments and financial institutions have put their brains together to propose ‘innovative’ financial instruments aimed at guaranteeing investment in expensive large infrastructure. This should happen in the context of the current crisis, where private banks and investors are unwilling to risk their capital in long term investments that are often neither economically nor financially viable. In October 2011, the Commission presented the ‘Europe 2020 Project Bond’ initiative as one of the “risk sharing” initiatives that will support the CEF in mobilising private capital for infrastructure investment.

In June 2012, the EIB launched the Europe 2020 Project Bond pilot project using the budgetary resources of the European Commission through project bonds that will be sold on capital markets to private and institutional investors. These Commission funds should act as a “first loss piece” (this means any payments from the project company must be made to regular investors ahead of the Commission's interest), thus enabling the EIB to provide millions of euros through the Project Bond Credit

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**Werner Hoyer, president of the European Investment bank, speaking about the European Commissions plan to invest €315 billion in the EU economy. Photo: European Parliament, Flickr, CC BY-NC-ND 2.0**

Enhancement (PBCE), and subsequently allowing the projects to leverage the rest on the financial markets. Eligible projects for the pilot phase include those that are not attractive for institutional investors due to financial and economic risks that cannot be covered through so-called private “monolines insurances”, a financial tool now much less active in long term investments since the 2008 crisis.

The ‘Project Bond Initiative’ (PBI) is the EIB and Commission’s much vaunted solution for attracting institutional investors (such as pension funds and investment funds) into large infrastructure financing through ‘credit enhancement’ of relevant constructing consortium and ‘improved rating of bonds’ directly linked to the infrastructure financed. Projects that will benefit from the PBI and the PBCE will receive a higher credit rating – getting closer to the ‘AAA’ rating equal to the best state bonds – and they will cover up to EUR 200m or 20 percent of the project cost. The credit enhancement will be delivered in practice by the EIB through a subordinated instrument – either a loan or contingent facility – to support senior project bonds issued by a project company (Senior Bonds). The objective of the initiative is to “widen access to sources of finance” and “minimise funding costs” for the private actors engaging in large infrastructure construction.

The new Juncker investment plan announced at the end

of 2014, that aims to leverage EUR 315bn and in which the EIB will play a central role, will make use of this financial instrument and similar guarantee mechanisms. As such, this latest EU recovery plan may strengthen inequality through mechanisms which tend to socialise risk and privatise profits.

After more than two years of EU project bonds, experience shows that the risks involved are very real. The Spanish Castor gas storage facility for example, is the first and probably most notorious project that has been refinanced through EU project bonds. After the first gas injections caused a series of hundreds of earthquakes, the project had to be halted – but due to a contractual clause it was the Spanish government that had to cover the losses. Spanish civil society groups were well represented to speak out against this project which first caused physical and later on financial shocks – with EUR 1.4bn worth of debt being passed on to Spanish citizens through their gas bills<sup>1</sup>.

Similar scenarios are possible for many potential projects across Europe that will be financed with a guarantee from the European Fund for Strategic Investment (EFSI) which is central to the Juncker plan. If it manages to spur growth, the question remains – for the advantage of whom, and at what cost for all others?

<sup>1</sup> <http://www.counter-balance.org/first-eu-project-bonds-fail-and-will-cost-spain-eur-14-billion/>

## The involution of EU politics and culture: the case of the new EU energy security strategy

Europe imports roughly 80 percent of the oil and 60 percent of the gas that is being used inside the EU. According to the European Commission, this dependency on fossil fuels will increase in the coming years as internal production decreases. To avoid the feared black-out scenario the European Commission is actively looking outside its borders. This is reflected in the conclusions of the European Commission's 2011 Communication on the external dimension of the EU Energy policy ("Engaging with Partners beyond our borders") where it states that: *"A coherent, dynamic and proactive external energy policy is vital to enable the EU and its Member States to establish a lead position in energy geopolitics, to effectively promote both EU and national energy interests beyond the EU's borders, and to contribute to the competitiveness of European industry"*<sup>2</sup>.

The EU's external energy ambitions have been confirmed recently in a long list of proposed 'EU priority projects'<sup>3</sup> that includes gas pipelines, gas storage facilities, regasification plants, long distance and cross-sea electricity interconnections linking hydropower facilities in the Balkans and large-scale solar plants in North Africa, as well as coal and nuclear power plants in northern Europe.

The emphasis on fossil fuel project in the EU energy security agenda is undermining the EU's and the EIB's own emissions reduction and energy efficiency objectives. The win-win deals which the EU likes to emphasise are not benefiting the climate nor local people and the environment if you consider the impacts of these projects.

But the new strategy goes beyond merely securing physical energy supplies from outside the EU – what might be termed the 'energy resources grab'. In its trade and investment deals with neighbouring countries, the EU is equally negotiating access to local energy markets for European companies – what can be labelled the 'energy market grab'. By linking both energy infrastructure and

energy markets in neighbouring countries to its own, the EU wants to be the dominant player. It not only seeks to use neighbouring countries' energy sources, but is also limiting the opportunities of these countries to develop their own domestic renewables and low carbon technology industries.

The EIB is already being asked to get involved in the financing of some of these massive, costly and risky large-scale infrastructure projects. Among others, it has financed the Mostorod oil refinery in Egypt, a project that has been strongly opposed by local CSOs.

Another huge project is the Southern Gas Corridor that aims to bring gas from Azerbaijan all the way to Italy and could possibly open the door to gas supplies from Turkmenistan and even Iraq. The EU is also eyeing the new gas reserves that have been discovered in the Middle East and is trying to secure deals with Israel, Cyprus and Greece.

The vision of the European Commission raises important questions about the role that the EU should play in promoting sustainable energy access in Europe and in neighbouring countries, as well as in sub-Saharan Africa. Today the predominant institutional vision in the EU is that energy should be traded on larger markets, predominantly produced from fossil fuels, and that centralised, private production and management of energy infrastructures is the way forward.

Counter Balance is engaged in attempting to deconstruct and challenge this ideology. Does the EU energy policy really reflect the vision that EU citizens have today about their and other world citizens' sustainable future? When hundreds of billions of euros are still being channelled into large-scale fossil fuels based infrastructure, what remains to catalyse the immediate reduction of greenhouse gas emissions inside the EU before reaching the point of no return in 2015 – as stated by the international scientific community – and to start the transition that will allow the EU to reduce its internal emissions by at least 30 percent by 2020? Moreover, what are the human rights implications and the real social costs of the steadily advancing EU energy security strategy, and who will ultimately cover these costs?

<sup>2</sup> Communication from the European Commission on security of energy supply and internal cooperation – "The EU energy policy: Engaging with partners beyond our borders". COM/2011/0539

<sup>3</sup> Projects of Common Interest (PCI), [www.ec.europa.eu/energy/infrastructure/pci/pci\\_en.htm](http://www.ec.europa.eu/energy/infrastructure/pci/pci_en.htm)

## The never ending failure of carbon markets

The EU's Emissions Trading System (ETS), the EU's flagship policy to address climate change, was introduced in 2005 and has given rise to currently the largest carbon market worldwide. The ETS includes 'cap and trade' and 'offsets' systems which allow participants to buy and sell emissions permits and offset credits in order to comply with their reduction targets or simply to make a profit on the market. The idea is to reduce industrial greenhouse gas emissions cost-effectively by creating incentives for climate-friendly innovations and so move industry onto a low-carbon path.

But the scheme has failed to do so. The EU's fixation on 'price' as a driver for change has not only locked in an economic system dependent on polluting extractive industries. The failure is also set to spread more widely insofar as the ETS is used as a template for other carbon markets proposed for countries such as Brazil and Australia, and as a model for other 'ecosystem service' markets in biodiversity, water and soils.

EU governments and the European Commission are determined to maintain the ETS as the central pillar of the EU's climate change policies. However, it is evident that the structural failures of the ETS cannot be fixed. In particular the ETS has not reduced greenhouse gas emissions. In fact, benefiting from an excess of free emissions permits as well as cheap credits from offset projects in Southern countries, the worst polluters have had little to no obligation to cut emissions at source. Offset projects have resulted in an *increase* of emissions worldwide: even conservative sources, including researchers at Stanford University, estimate that between 1/3 and 2/3 of carbon credits bought in the ETS "do not represent real carbon reductions"<sup>4</sup>.

The first two phases of the ETS (2005-2007 and 2008-2012) allocated free permits according to historical emissions, acting as a *de facto* subsidy for the biggest polluters. The over-allocation of permits enabled the continued use of existing technologies and rubbed out any incentive for a transition towards low-carbon production processes. At the same time the ETS ultimately increases social and environmental conflicts in Southern countries. The Clean Development Mechanism (CDM), the biggest offset scheme, has brought about severe social



Coal power plant in Datteln (Germany) at the Dortmund-Ems-Kanal, Photo by Arnold Paul, 2006. CC-BY-SA-3.0 license

and environmental consequences to communities where the projects are implemented, including land and human rights violations, displacements, conflicts and increased local environmental destruction. Yet, in spite of growing evidence of negative impacts, offset use in the ETS grew by 85 percent in 2011.

As a consequence of this European climate policy the EIB has also in recent years become very active in supporting the development of carbon markets. In particular the EIB pledged EUR 589m for six different carbon funds. As a consequence of this questionable European policy approach, the EIB has a portfolio of carbon offset projects that includes gas flaring, large dams and carbon forestry schemes that could unleash widespread land grabs. However the EIB is also getting involved in pilot initiatives which go far beyond provisions under EU law. This is the case of EIB support for carbon funds promoting forest offset projects that will generate credits not eligible for the internal ETS in the new commitment period up to 2020, such as the Althelia Climate Fund recently supported by the EIB<sup>5</sup>.

In Counter Balance's view, instead of propping up carbon markets, the EIB could play a key role in transforming public infrastructure to curb emissions in Europe. This would involve starting with the phasing out of support for fossil fuel projects and reassessing the carbon footprint of the EIB's portfolio in order to strategically change the interventions of the bank in the energy, transport and industrial sectors in Europe.

<sup>4</sup> "A realistic Policy on International Carbon Offsets". Michael W. Wara and David G. Victor. Working paper 74, April 2008.

<sup>5</sup> "Banking on forests: The European Investment Bank's belief in financial alchemy to fix the climate crisis: The case of the Althelia Climate Fund", Re: Common and Counter Balance, December 2014, [http://www.counter-balance.org/wp-content/uploads/2014/12/1415112543wpdm\\_briefing-banking-on-forests.pdf](http://www.counter-balance.org/wp-content/uploads/2014/12/1415112543wpdm_briefing-banking-on-forests.pdf)

## Fuelling corruption risks and abuse of tax havens

The EIB's use of intermediated loans and private equity funds risks facilitating corruption and tax evasion.

Corruption – broadly defined as “the abuse of public or private office for personal gain” – takes many forms, from petty extortion to the amassing of personal wealth through embezzlement or other dishonest means. Its corrosive impacts on development and on democratic accountability have been widely documented. As a financial institution promoting development, it is vital for the EIB to stamp out corruption, especially in its own operations.

The EIB has made strong statements against corrupt practices in recent years. Launching the bank's revised anti-fraud policy in 2008, EIB former president Philippe Maystadt stated that: *“It is our responsibility to ensure the proceeds of EIB loans are not misused and this policy therefore reflects our determination to be ever vigilant in seeking to combat fraud and corruption in EIB-financed activities.”*

The EIB policy states its commitment to “‘zero tolerance’ of corruption, fraud, collusion, coercion [and] money laundering”. It adds too that “the EIB is committed to ensuring that its loans are used for the purposes intended and its operations are free from prohibited practices,” and that “the Bank will work to prevent and deter prohibited practices [and] money laundering.”

Every now and then, however, the EIB forgets what it means in practice to have a ‘zero tolerance’ policy on fraud and corruption. In Nigeria, for example, a lot of money was invested in companies related to former Delta State Governor James Ibori and his associates, all alleged to have taken part in large scale corruption and money laundering both by the Nigerian anti corruption service and the London Metropolitan Police. Through a private equity fund, Emerging Capital partners Africa Fund II (ECP Africa Fund II), the EIB invested in Nigerian companies reported to be ‘fronts’ for the alleged laundering of money said to have been obtained corruptly by James Ibori.

This case shows the need for more democratic control over EU development funds. The money the EIB lends in Africa comes from the European Development Fund and is invested through the Investment Facility. This instrument is not under the control of the Court of Auditors’ Statement of Assurance, that is the annual report produced by the Court which examines the

accounts of all revenue and expenditure of the Union, their reliability and the legality and regularity of the underlying transactions. Furthermore, there is a clear gap in the implementation of the anti-money laundering law at European level, given that there is no regulation applying the recommendations of the inter-governmental Financial Action Task Force against money laundering and financing terrorism directly to the European institutions, such as the EIB. This means that being a bank incorporated in Luxemburg – a country regarded by many as an offshore financial centre that offers favourable tax conditions to investors – the EIB has to report alleged financial crimes only to the authorities of Luxemburg, which so far have not been among the most active in the Eurozone in denouncing the laundering of the proceeds of corruption and tax evasion through their national banks.

The EIB is one of the few international financial institutions to have adopted an official policy on tax havens, so-called ‘non-cooperative jurisdictions’. This has been a step forward partly due to civil society pressure, but it is also proving to be ineffective as annually numerous EIB loans continue to end up with companies that are engaged in avoiding taxes. In particular, loans through financial intermediaries are sensitive to tax evasion practices as they are almost impossible to check.

### Conclusion:

Despite the fact that the EIB is a policy driven bank and that EU policies should be changed and made more coherent in several cases in order to promote social justice and environmental sustainability in Europe as well as globally, the bank often acts in contradiction with the same policies or supporting projects for the benefit of the few, and not local affected communities and the environment. In short, the EIB does not perform the role of a public bank acting for the common good.

In order to reclaim a public investment bank such as the EIB, it is necessary to challenge the mission, vision and business model of the institution in order to shift this to an operational model distinctly outside of profit-oriented market logic and under stricter public control and scrutiny. Such a transformation thus inevitably raises the question of who should decide such a redefinition of the mission, vision and business model, and how – in order to avoid replicating the mistakes of the past.

## 2. Reclaiming the EIB to definancialise the economy?

In the current debate over economic recovery and public stimulus needed to boost economic growth again – in particular in advanced economies – as an alternative to the harsh fiscal austerity measures imposed throughout the crisis, many commentators have hinted at the possibility of rediscovering some type of Keynesian public intervention.

Even former neoliberal hardliners, including the management of the International Monetary Fund and lead editorialists of the Financial Times and other mainstream opinion-makers, who have always been opposed to any form of public intervention in the economy, are today very vocal supporters of expansionary fiscal and monetary policies.

Many governments have implemented some form of fiscal stimulus and Keynesian-type intervention. Monetary policy levers have also been pulled, as in the case of the heterodox ‘quantitative easing’ implemented by the US Federal Reserve with injections of trillions of dollars into the economy through lending to the US Treasury or directly to commercial banks.

Some of these interventions have been justified as merely temporary, while others are seen more as a key counter-cyclical lever to address market failures, boost public investment and bring economies back to growth with important long term implications.

This is why the EIB, certainly since 2008, has been rediscovered by European decision-makers as a central mechanism for pumping money into the economy for long term investments. Notably, however, a primary aspect of the EIB’s crisis intervention has involved lending to financial intermediaries and banks whose relationship with corporations and the productive economy remains highly disputed given the ongoing recessionary conditions.

Nevertheless, all these forms of public support to long-term investment are seen as simply happening in a free market context and according to its logic. This involves public investment banks and governments attempting to use their intervention in order to make investment



European Investment Bank, Luxembourg

appealing for private investors, without a substantial distortion of market dynamics and competition. In some quarters, though, it is argued that contrary to what decision-makers claim to be carrying out through PPPs and new financial innovations (namely leveraging private finance for public interest investments), in reality this approach consists in the leveraging of publicly available resources by private markets in order to extract more profit for the few to the detriment of communities and society as a whole.

In fact once again, as already witnessed at the beginning of the century with financial liberalisation and deregulation, the interventions currently being proposed and implemented can be viewed as a ‘private Keynesian’ approach, aimed at stabilising and further boosting the private sector and market development per se as the key engine of economic growth. Consideration of the structural failure of the market in generating the current crisis and, more broadly, in addressing real investment needs in the productive economy, far beyond business as usual, is simply not on the agenda.

Therefore, there is an urgent need to qualify what such a genuine public intervention in the economy would look like and for what purposes, and whether we are talking about a private-oriented Keynesian approach or, instead, a public-oriented one outside pure market and profit-making logic.

However, even a Keynesian or ‘New Deal’ approach – along the lines of what was implemented in the 1930s and as called for by many today, possibly tinged with some green investment spending – is questionable as



an effective strategy in today's very different global context. Today public interventions, even when intended to be implemented outside market logic, face the same the risk of feeding once again the expansion of private capital markets where profits and financial liquidity end up through the facilitation of public finance. In fact we face and are confronted by a single global capital market within which public finance institutions have become dependant on its functioning and its constant need to extract endless profit from any operation. The financial markets, moreover, are the subject of an ongoing crisis of accumulation – excess accumulated wealth chasing too few profitable investments – that remains the deeper underlying cause of the unfolding crisis in which we are living.

In short, any public intervention, though it may be conceived and planned for good reasons, ultimately risks being subordinated to the functioning of – and decisions made by – the actors dominating these markets. Without measures put in place to restrict this market reality, such as reintroducing controls over the international movement of capital and significantly taxing financial wealth, profits, rents and transactions, it is unlikely to put an end to the disruptions inevitably resulting from this state of affairs.

## Public finance versus capital markets

Over the last few decades private capital markets have expanded significantly at the global level. Today more than USD 200 trillion are invested in equity and debt stocks worldwide<sup>6</sup>, of which approximately USD 150 trillion is accumulated private financial wealth<sup>7</sup>. Every day this looks for new productive and financial assets able to guarantee good returns for investors, something that has become more and more difficult in recent years. In this context predatory investors are ever ready to assault any promising investment, financialise it from scratch – that means making it functional to the accumulation logic of capital markets – and subordinate it to needs that differ from those of the majority of the population and productive actors.

Beyond the rhetoric that emanates from decision-makers nowadays, it is worth asking ourselves why “there is no money left” for public spending for social and environmental purposes? Why is it that only the private capital markets can be turned to for such investments?

<sup>6</sup> <http://www.economist.com/node/21524908>

<sup>7</sup> <http://www.cnbc.com/id/101058356>

This problem is taking place precisely at the same time as there is excessive capital flushing around – accumulated – on private capital markets. This hunger for profitable investment and extra-profit often generates investments driven by short-term profit maximisation that causes social damage and environmental disasters. In particular, more wealth is often extracted from the public sphere, also through public finance mechanisms, for the speculative benefits of the few. The repayment of public debt, whose value fluctuates on speculative financial markets, by citizens' taxes and public assets' privatisation, is a clear example of such an extraction of wealth. This is why we should reclaim – somehow – part of that wealth or extra-profits into public hands in order to finance what is really needed, and soon.

But which private wealth are we thinking specifically to tap into newly formed public investment banks? These banks, such as the EIB, are already able to finance themselves on the capital markets by issuing very well rated bonds as a result of being guaranteed by a range of powerful states. A variety of investors already buy these bonds, primarily to diversify their portfolio given that an AAA-rated bond is a fairly safe investment although it provides limited returns compared to other, riskier securities that might involve much higher returns.

In particular, so called institutional investors, such as pension funds, mutual funds or insurance funds, have to manage a very mixed portfolio in order to reduce risks and meet some of their goals, including guaranteeing some minimal pension to retired workers. That is why institutional investors usually invest in relatively safe havens, such as publicly guaranteed bonds.

However, as a result of the financial crisis, some of these investors have lost a significant proportion of their managed wealth, and today they are struggling to recover and may have to get into riskier investments in order to generate more profits. Globally we are talking about USD 80 trillion, and this sum is set to grow<sup>8</sup> given the slow privatisation of the pension, health and insurance systems introduced in emerging and advanced economies. Sitting on such a large amount of cash, fund managers constantly need to assess and figure out how to generate enough profits to sustain their business cycle at a time when the economy is not performing so well and financial markets are quite volatile.

<sup>8</sup> <http://www.thecityuk.com/assets/Uploads/Fund-Management-2011.pdf>

Additionally there is substantial pressure from capital markets and corporations to relax the limitations for these funds to invest into riskier long-term operations, such as large-scale infrastructure. In fact, institutional investors that manage citizens' savings or pensions have traditionally had significant limitation imposed on them in order to prevent excessively risky investments that could put at risk investors' repayments in the long-run. A new trend of allowing more risk-taking is quite visible both in developing and developed countries (as recent cases in the Philippines and Italy show). Such an approach bears significant risks in the long-run and should be resisted.

Instead of having public offering guarantees for new public-private schemes aimed at reducing risks for private investors and making investments more appealing while leaving the management of the investment in the hands of the latter, a public investment bank could:

- proactively offer a stable, moderate and capped return to institutional investors willing to diversify their portfolio, ultimately by issuing some very long-term targeted bonds just for them;
- then manage the resources directly raised from investors for interventions taking place outside the pure short term profit maximisation logic of markets, and be able to produce in the long-run a moderate return.

In such a scenario, institutions acting in the public interest will decide on their own, without interference from the private sector, which interventions in the economy to support. Progressively, therefore, a greater amount of private wealth could be managed not by private investors but by public institutions acting in the public interest.

## Not just pumping money into the economy: Where and how?

Yet shuffling back trillions of euros into existing public banks, such as the EIB, will not change a great deal because today these institutions operate in a way which is functional to capital markets: any such flow of these trillions would move back into their hands and mechanisms. And these types of public investments would essentially be fraught with the same problems as identified above.

**Reclaiming private wealth for the common good is urgent, but it should be placed into *renewed* public investment banks and mechanisms designed to be capable of avoiding the mistakes of the past.**

Thus the problem is not simply one of having governments reverting to the use of fiscal policies and publicly-owned financial institutions to boost public investments. **The key issue today is how to make these investments happen in spite of the ongoing expansion of capital markets and the aggressive threat entailed by them.**

Therefore it is not just a matter of pumping more money into the right investments, but also of how to subordinate the remaining majority of private finance to the logic and functioning of these much needed societal investments. This is precisely the opposite of what is happening today when institutions such as the EIB use the leverage of public funding to attract large amounts of private capital and financing interventions which originate in, are managed by and generate wealth solely for private capital markets and not the majority of the population.

In short, **the issue is to think of a new type of public intervention into the economy, one whose primary aim is to definancialise the economy by progressively re-absorbing wealth fluctuating on private capital markets within the realm of operations backed by public investment finance.**

This is a pre-condition for making any public investment sustainable and accountable to public interest goals in the long run.

## The power of public finance

Civil society has been much distracted by the mantra of the free market, in particular at the EU level. The result has been that most of its financial proposals to fulfil urgent needs in society – from mitigating and adapting to the climate crisis, to addressing the ongoing global development crisis and other legitimate needs identified from a social justice perspective – have been conceived within the existing constraints of public finance and the logic of expanding capital markets, given that these have taken on an almost unchallengable supremacy.

Therefore, when talking about reforming public finance institutions, too often attention has been focused simply (and perhaps understandably) on shifting existing subsidies, from the bad to the good – for instance from fossil fuels to renewables – or to reorient the existing portfolios of international financial institutions, such as the World Bank or the EIB, as if the financing of the transformation

**Civil society has been much distracted by the mantra of the free market, in particular at the EU level**

of the entire economy in order to meet climate, development and social justice challenges is just a zero sum game (“Let’s shift the few public resources available, comparative to private wealth, from one place to the other ... and the world will change”).

Such an approach has left untouched the mechanism through which capital markets continue to grow exponentially to the detriment of public financial institutions that are, in turn, progressively subordinated to their accumulation needs and pattern. Thus we could also have in the short term more private investment facilitated by the public in more sustainable projects and sectors, as long as these are reckoned and ultimately proven to be highly profitable. Such a momentum, though, would soon start stripping new and green economic industries of their wealth and capacity, thus resulting in similar unsustainability in the long run, or be oriented simply to the creation of a few gigantic economic and speculative actors.

While facing this risk, some argue that if we abandon austerity measures and increase public spending through more debt, the resultant resources could be used autonomously and separately from the will of private investors in order to meet the challenges of climate action and the related transformation of the development model that we face more and more acutely.

Yet it is an illusion to think that simply more “welfare” resources saved from public budgets will be enough to meet the gigantic challenges we face today in the environmental and social spheres. It is not just a matter of increasing national yearly budgets but the necessity of establishing a new pattern of sustained public investment to transform our society for the better in the long run.

And it is equally simply disingenuous to think that existing market logic – in particular that driving private capital markets – will spontaneously readapt to meet this challenge, because according to the market approach investment will go only to profitable sectors and projects, that today tend to be those more negatively impacting the environment and wealth redistribution. Financial markets have amply demonstrated how profits can be produced both when the economy is buoyant and when it collapses, when a food crisis erupts or when an energy crisis emerges. Financialisation is plainly a miracle for those interested in extracting extra profits from any human activity.

Therefore, the key issue today is rethinking public

finance and, in particular, public investment, not just as an alternative means to private finance to support what we need, but more precisely as the most transformative tool we can have to shrink private capital markets and rechannel private wealth into public interest mechanisms acting progressively outside pure market logic. The financing of the socio-ecological transformation of society cannot happen if we do not also transform wealth accumulation mechanisms, and thus significantly reduce the role of capital markets.

You can claim that public finance is one of the most powerful mechanisms (if not the most) to subordinate capital markets to public interest policies. And not simply according to a redistribution logic, but primarily through a capital allocation that differs from the market- and only profit-driven logic, because it is guided by the goal of fulfilling social and environmental needs.

Therefore it is important to concentrate our attention on what kind of new generation of public banks we need at European, national and possibly even local level, in order to finance a fair transition to a low-carbon economy while at the same time shrinking and subordinating private capital markets to a new type of “new deal” of public intervention in the economy.

Consequently, we have to analyse what it would entail to reclaim existing public investment banks for the public good, if possible, and to what extent we can transform them for the achievement of our goals.

Or should we create new institutions from scratch?

## The case of the EIB and its inappropriate development model

Roughly more than half of outstanding EIB loans directly target the private sector (both corporations and banks), the remainder going to public institutions. Given the prominent role of the private sector in highly liberalised economies, this does not sound like a surprising trend for a public investment bank.

However the EIB actively believes that the private sector is the main engine of economic growth, and in particular that a deep private financial sector is the backbone for any economic development. This belief is disputed by some sections of academia and certain analysts<sup>9</sup> who,

especially in the case of developing countries, advise to first consolidate economic growth through the expansion and strengthening of public finance and the domestic banking system at national level, and then eventually to internationally liberalise some aspects of the financial sector and allow an expansion of financial markets.

The approach of the EIB in favour of the private financial sector is evidenced rather strongly by a certain amount of abuse involving financial intermediaries that are a significant part of the bank’s portfolio, a strategic choice often justified by the need to reach out to small and medium enterprises – including in developing countries too, where lending via intermediaries comprises up to 37 percent of the EIB’s non-EU lending volume<sup>10</sup>. These intermediaries may be either private commercial banks, often linked with European financial institutions, or non-banking actors, such as private equity funds. The EIB’s management sees it as crucial to strengthen private financial actors operating in developing countries as a key tool to deepen financial markets and thus – presumably – drive economic growth and at least some development for the poor.

In recent times the EIB has also become relevant within the European development debate, given the intention by the European Commission and influential European governments to drastically revise the existing development finance architecture.

In particular, the private sector is being legitimised more and more as a key engine of “inclusive growth” and development, to the point where limited public overseas development assistance resources – recently under stress due to economic recession in Europe – are being made available for *blending* with private capital raised on the markets in order to thus concede some concessional lending, including directly to the private sector, at very affordable rates. Such a financial market-based development logic is highly problematic and is seen by some as a financialisation of development finance itself, which de facto subordinates development policies and their financing not just to the intrusive role of the internationalised private sector, but chiefly to the fluctuations of private and speculative capital markets – see box below.

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2003

10 [www.counter-balance.org/counterbalance-eib.org/wp-content/uploads/2011/01/Hit-run-development\\_WEB.pdf](http://www.counter-balance.org/counterbalance-eib.org/wp-content/uploads/2011/01/Hit-run-development_WEB.pdf)

9 Among many authors, ‘Globalisation, Economic Development and the Role of the State’, Ha-Joon Chang, Zed Books/Third World Network,

## Trusted and experienced partners?

In the case of intermediated lending, by pre-approving projects as a group instead of appraising them individually, the EIB makes it extremely difficult to track the final use – and destination – of large sums of international public money. At the same time the EIB is conducting an increasing amount of its development investing via private equity. This means a further shift away from traditional project finance to investments via entities that clearly prioritise profit maximisation over, for instance, sustainable development goals.

While the EIB may insist that it selects “trusted and experienced partners” for such investments, much of the evidence suggests otherwise. Cases researched by Counter Balance in recent years suggest that EIB funds may well have been misused for egregious practices such as tax evasion, money laundering and personal enrichment. The EIB’s due diligence and project partner selection in such cases have been compromised, casting doubts not only on how fit for purpose these newly favoured investment models are but also on the overall development effectiveness of the EIB’s activities in developing countries.

When it comes to the transparency of the EIB’s intermediated development finance, a further glaring failing has been identified by Counter Balance’s analysis: the bank provides next to no information on where this money ends up, principally because it is not obliged to provide rigorous feedback. Furthermore the EIB appears reluctant to encourage intermediaries to publicly disclose at least some details regarding the loan packages they have been allocated.

This inflexible stance thus favours commercial confidentiality and ignores the overwhelming public interest in knowing how European public money is ultimately being deployed.

All of this calls into major question the EIB’s fulfilment of its legal development responsibilities.

According to its mandate to lend outside the EU, the EIB must “foster: sustainable economic, social and environmental development of [developing] countries; their smooth and gradual integration into the world economy; the campaign against poverty; as well as

compliance with objectives approved by the EU.<sup>11</sup>” When development money is made available to unaccountable financial bodies with no development interest or experience, goes untracked by the EIB and might result in alleged corruption and money laundering, it is hard to see how the EIB is meeting its legal obligations under its mandate.

A similar problem has arisen involving EIB microfinance lending.

For decades now, microfinance has been the darling of international donors, development financial institutions and multilateral agencies. However, microfinance is no longer solely regarded as a tool to get people out of poverty. The question of how to maximise profits deriving from microfinancing activities has become at least equally important.

Recent events such as the financial crash in 2008, the Andhra Pradesh scandal in late 2010 and the recent repayment crisis in Morocco, Bosnia, Pakistan and Ecuador bear witness to this. It is in this context that the EIB started – as one of the latest entrants – its microfinance activities.

Although its microfinance specific portfolio still represents a very small fraction of its total portfolio (only EUR 881m from 2003 to 2010<sup>12</sup>), it has been growingly steadily over the years. Counter Balance has taken a closer look at the microfinance activities of the EIB, a relatively new sector for the bank. While the EIB scores better than average on some indicators, it does not manage to escape the microfinance trap: social performance is generally subordinated to the goal of financial sustainability for the involved financial actors.

In particular, Counter Balance’s analysis detected a lack of strategy and vision by the EIB: essentially, it just follows the markets. Particularly in countries with limited capital markets, the bank is involved in investment vehicles rather than in reaching out to the poor. Once again the EIB opts for the use of financial intermediaries, often operating through global markets, to support local microfinance financial institutions instead of having a direct link with them and their beneficiaries. In so doing, the EIB chooses to shirk responsibility and backs away from directly managing the lending portfolio concerning the choice of the ultimate beneficiaries, and accountability chains become longer and obscure.

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11 EIB External Lending Mandate 2007-2013.

12 [www.eib.org/attachments/thematic/microfinance\\_brochure\\_en.pdf](http://www.eib.org/attachments/thematic/microfinance_brochure_en.pdf)

### 3. Some principles for a new business model

If managed well, public investment banks could be a key driver of the transition towards socially and environmentally sustainable and equitable societies.

However, in order to transform public banks into a tool for progressive change, a totally different business model is required.

Based on the principal failures – as described above – that Counter Balance has identified concerning the model of the EIB, some principles for guiding the definition of a new business model can be briefly outlined as a basis for further creative reflection, analysis and discussion by civil society in the coming years. Before further promoting some reforms of public financial institutions in the spirit of “do-no-harm”, Counter Balance believes that a principle discussion on goals and values should take place in order to drive a possible transformation of existing institutions.

By way of concluding, and as an initial basis for further discussion, we list below some of the principles we have identified so far:

**1. Re-investing profits:** The new public investment banks should not have a profit making motive and aim to produce profits for themselves, nor to give dividends to those public administrations that own them. Any resulting budget surpluses should be reinvested or, where specific economic conditions may require it, set aside in reserve funds to be used in a counter-cyclical manner in the event of subsequent economic crises.

This would be the first step towards “decommercialising” public investment banks. Re-establishing them under public law – rather than private law – would facilitate access to information by citizens and communities affected by these banks’ lending activities. Furthermore, because of their specific nature and mission these banks should be exempted from capital adequacy regulation and other provisions under the Basel III Accord – which today tends to enhance lending to already bankable and highly profitable entities. This would enable public banking to finance projects with high added value in terms of social justice and poverty reduction for instance – projects that could otherwise be considered as risky.

**2. A long term investor:** The new banks should not contribute to the covering of short term market failures, such as temporary equity participation into private companies or financial institutions that go bankrupt. On



City of London, photo Manes/Re:Common

the contrary, public investment banks should invest to address structural market failures precisely where markets alone are not interested in allocating capital because of a lack of sufficient profits.

Given that public investment banks raise capital on the markets to be invested or lent on, this principle approach would contribute to the draining of private accumulated financial resources into the public interest sphere, so that decisions about how to invest those private resources would be more and more “socialised” and made in the public interest. In this regard, public banks would play a key role in de-financialising and re-publicising economic systems. At this stage, it seems that such a possibility is more linked to political will than to legislative or financial constraints.

3. The banks would significantly minimise their **use of financial intermediaries** in their lending, contrary to the dominant trend present today at the EIB and other national institutions. This entails that public banks would have a proper banking license and thus would deliberately compete with private banks and non-

banking institutions in financing – at lower interest rates – companies and local administrations when deemed appropriate.

Regarding alternative financial intermediaries which deserve to be supported because of their ethical, transparent, publicly accountable and not-for-profit work (such as some ethical banks, cooperative banks or microfinance institutions), public investment banks could participate in this sector through direct equity shares in these companies, or eventually develop partnership agreements aimed at developing joint programmes and co-financing. In this regard a specific public registry of eligible financial intermediaries worthy of public support should be established and regularly updated according to stringent criteria and effective monitoring procedures.

Those criteria and procedures would be elaborated through public consultations involving in a meaningful process public authorities, civil society and citizens.

4. Consequently, **a different internal organisational model** should be adopted, distinct from the one followed by existing public investment banks, in order to make it possible to lend directly to small companies and projects without intermediaries and to cope with higher transaction costs.

In this context, the banks' staff and management would be paid less than the current salaries available in other institutions in order to minimise working costs and require a political commitment by employees. Internal incentive and disincentive systems would be rigorously reviewed and decoupled from lending volume imperatives and the amount of profits produced. New monitoring structures and indicators related to the socio-ecological transformative impact of operations financed would also be adopted. The internal set-up of renewed public banks should reflect a trend of focusing more on quality than quantity.

5. In their lending to the private sector, the banks would implement very **strict environmental, social and human rights due diligence** in line with the highest international standards and norms, and would covenant non-financial conditions in loan agreements. All information about operations in the pipeline would be publicly available according to the principle of public

interest overriding any specific commercial interests, with no exemptions permitted.

Stringent binding clauses related to fraud and environmental and social impacts should be an integral part of financing contracts. These specific clauses would be made public and encompass a clearly defined set of sanctions in case of failure to fulfill the contracts' clauses. Visibility and transparency will be crucial in order to ensure that the current shortcomings related to lending to the private sector are properly addressed.

In addition, when operating outside of the EU, financing operations should contribute to the general principles guiding EU external action, as referred to in Article 21 of the Treaty on European Union (TEU), of promoting and consolidating democracy and the rule of law, human rights and fundamental freedoms, and to the implementation of international environmental agreements to which the EU is a party. Enshrining these principles at the heart of public banks' operations would represent a major step forward in achieving greater coherence for development.

#### **6. Which kind of financial resources should public investment banks intermediate in order to act to definancealise the economy and redirect private wealth back into the public sphere?**

It should be central to understand how workers' wealth, managed by pension funds, could be taken back under public management and away from the extraction of value operated by fund managers on financial markets. Similarly, postal savings and some other forms of citizens and workers' savings could be managed by these banks, to a certain extent. Raising these financial resources would probably need specific financial instruments, such as bonds too be issued just to some precise investors with some liquidity constraints (not sellable at all times), as well as the need to cap the interest rate paid. In this way fund managers would be forced to share the long-term aim and risk of each operation while being prohibited to hedge these risks either financially or against other investments that bring dubious social and environmental benefits to most of society.

#### **7. At what level should these banks primarily intervene with their lending and investments?**

In order to shorten the "savings chain" and restore more direct citizens' control over decisions about how

**When operating outside of the EU, financing operations should contribute to the general principles guiding EU external action, as referred to in Article 21 of the Treaty on European Union (TEU), of promoting and consolidating democracy and the rule of law, human rights and fundamental freedoms,**

to allocate funds, it would be important to adopt a “subsidiarity” principle, as defined already – and often not applied well – in the EU architecture. This means decisions and resource management should take place at the most adequate level. For local projects, national or regional banks are better placed to carry out projects. Within this, larger public institutions could still exist and, given their sovereign status, they could help with raising funds at a larger scale and lower costs, to be then channeled toward lower and local institutions for lending. However such an approach still raises questions about equity between different territories and regions experiencing different economic and financial conditions, so that eventual compensatory mechanisms should be put in place with a related transparent governance. In any case subsidiarity would give priority to the local level in terms of ultimate decision-making about how funds should be used.

## 8. Who decides in the end about the use of public funds?

This remains the toughest question to be answered under the current institutional set up of public investment banks, even should they comply with and implement the previous seven principles laid out above.

As a matter of fact, it would be quite limiting and not sufficient to bring some investment banks back into public hands. A key issue would remain as to how the representation of citizens and affected communities’ interests should be reflected in banks’ governance structures. And among different constituencies, how much the ultimate beneficiaries – as those directly affected by lending – should have priority and greater power above others. This takes us beyond the traditional – and today failing – political representation system. It is not just an issue to have a transparent resident board cleared of any conflict of interest for its members (which for instance the EIB does not have today), nor just a question of how many seats should eventually be given to non-government representatives, including trade unions, NGOs or other social movements. It is not even simply an issue of how other democratically elected institutions, such as local councils or parliaments, should sit on the board too.

The key issue remains how to structure a business model which intrinsically brings new and more democratic forms of governance.

Thus we should look at the entire chain of the functioning of the banking institutions: how capital is raised, how decisions are taken, how capital is invested.



New York Stock Exchange, photo Dojmi/Re:Common

One route to explore and follow could be the principles of “mutuality” – when the existence of the organisation is based on the purpose to raise funds from members and then use these to provide members and customers with common services. This means that members on the one hand own and run the bank, while on the other hand benefit from the services it provides, without distributing dividends to external shareholders and lowering the risks of running for maximised profits and gains. Such a system theoretically ensures that profits are largely re-invested for common benefits.

And we should consider what this would mean for a community-controlled public investment bank acting in the public interest – we may end up by recognising that only a dilution of power can bring more control and responsibility as well as assurance of greater success for the operations of such institutions.

These eight points could be a major point of departure away from the market-led model followed by public investment banks in Europe today. Yet they are unlikely to be suitably transformative if more fundamental issues are not addressed. This paper was conceived with the intention of highlighting these issues and, too, to urge civil society to engage in a conversation with Counter Balance to address these challenges.

# NOTES



# RECLAIMING PUBLIC BANKS



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