

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672

102 S COMM 9: HOUSE SPEC. COMM. ON PERMANENT FUND 1977-78

blocks averaging 75 shares. Clearly, this kind of marketing will not broaden participation in equity ownership. Quantitatively, however, this was a very big issue: During the decade previous to the issue, gross new issues of Canadian preferred stock averaged only \$132 million, compared to the \$150 million sold in one shot by CDC.

CDC has shown some profit in terms of earnings per share every year.

CANADA DEVELOPMENT CORPORATION

<u>Year</u>	<u>Capitalization</u> <sup>1</sup>	<u>Value of Holdings</u> <sup>2</sup>	<u>Earnings/Share</u>
1975	708	857	\$0.31
1974	548	549	\$0.81
1973	344	465	\$1.89
1972	138	200	\$0.57

<sup>1</sup>Capitalization = Capital stock plus retained earnings, in \$000's.

<sup>2</sup>Value of Holdings = Investments plus fixed assets of wholly-owned subsidiaries, in \$000's.

Given the \$10+ price of shares, earnings have been modest. They have fluctuated with the general conditions of the Canadian economy and have been well below the CDC Board's stated profit target of 15 percent.

CONSOLIDATED BALANCE SHEET  
December 31, 1975  
Canada Development Corporation

	1975	1974
	(thousands of dollars)	
<b>ASSETS</b>		
Current Assets	\$ 378,430	\$ 321,811
Investments	354,581	332,354
Fixed Assets of Subsidiaries	502,792	216,271
Other Assets	41,73	29,155
TOTAL	<u>\$1,277,537</u>	<u>\$899,591</u>
<b>LIABILITIES</b>		
Current Liabilities		
Short-term loans	\$ 95,198	\$ 97,484
Accounts payable and accrued liabilities	95,674	74,752
Dividends payable	4,280	1,437
Income and other taxes payable	15,222	3,575
Long-term debt due within one year	10,416	15,672
Total	220,790	192,920
Long-Term Debt	250,358	137,439
Deferred Income Taxes	25,337	9,744
Interest of Minority Shareholders in Subsidiaries	73,218	11,172
Total	569,703	351,275
<b>SHAREHOLDERS' EQUITY</b>		
Capital Stock	564,563	422,000
Retained Earnings	91,699	74,744
Excess of Book Value over Cost at Date of Acquisition of Subsidiary	51,572	51,572
Total	707,834	548,316
TOTAL	<u>\$1,277,537</u>	<u>\$899,591</u>

## VII. RELEVANCE TO THE ALASKA PERMANENT FUND

In analyzing the relevance of the Canada Development Corporation to the Alaska Permanent Fund we will review the major headings in this memorandum in order: Purposes, Sources and Uses of Funds, Management, and Accountability.

Purposes: The purposes of the Canada Development Corporation appropriate for consideration by the Permanent Fund are:

- 1) to encourage the establishment and maintenance of strong Canadian controlled enterprises;
- 2) to widen investment opportunities for Canadian investors; and
- 3) to operate for a profit.

The achievement of the first two goals is conditioned by and dependent on the third. Profit is the operational goal most frequently and explicitly mentioned by management in its official reports. They attempt to make a case for their pursuit of profit by claiming that the partially public benefits of the first two goals will never be realized unless a rate of profit and growth higher than that enjoyed by foreign controlled elements of the Canadian economy are achieved. In the first annual report, management stated,

If we as a nation are to increase the Canadian content of our economy, it must be essentially by encouraging the sound growth of Canadian-controlled enterprises at a pace which exceeds that of their non-resident-owned competitors.

In the case of altering the balance of Canadian/Foreign control of Canadian industry, the statement above amounts to a tautology. In terms of providing wider investment opportunities in Canadian enterprise to Canadians, the statement is true to the extent that CDC issues must out-perform competitive securities in order to be attractive to investors. Canadian investors have access to international capital markets, and, in 1970, 40% of the securities held by institutions and individuals in Canada were of foreign issue.

The achievement of extraordinary profits by an investment holding company like CDC is unlikely. Recent work in investment portfolio theory and the experience of the securities industry in the past decade have demonstrated the futility of attempting to "out-perform" the market in the long run.

CDC may even be compounding its difficulties by investing in as few enterprises as it does. This investment strategy may lead, and in CDC's case has led, to unstable earnings and cash flow. Such a situation may inhibit the planning of future operations.

CDC's investment operations raise issues of control over the exploitation of natural resources, operations of the Canadian capital market and ownership structure of major industries, all of which are legitimate concerns of the Federal government and the Canadian people. The proponents of CDC in its present form

convinced Parliament that it was necessary to give up control over these matters in order to achieve the more limited goals in the statute. However, what the government got for relinquishing such controls is of questionable value. Lack of government input into CDC operations is the major weakness of the institution.

Sources and Uses of Funds: The management of the Canada Development Corporation has intentionally developed a strong equity base with only 40 percent debt in order to undertake the kinds of long-range, high-risk strong ownership positions which are essential to carry out its purposes.

On the other hand, the Canada Development Corporation must maintain a very strong return on its invested capital in order to attract the substantial private investment in the Canada Development Corporation which it is seeking. The Permanent Fund will not have such a constraint, which has both negative and positive aspects. From a positive standpoint, it will not be forced to get such a market return; from a negative standpoint, it will not have the correction of the marketplace monitoring its investments quite so carefully.

Management: The Canada Development Corporation has the kind of strong, independent, professional staff necessary to any successful development bank. The Canada Development Corporation follows the wise course of only overseeing the major strategic

planning decisions of its subsidiaries and affiliates, and not involving itself in day to day decision making

Also, the Canada Development Corporation management has been given the very broad managerial discretion to make investment decisions which is contemplated in the current draft of the Permanent Fund.

Accountability: On the other hand, the Canada Development Corporation is a preeminent example of a development bank which does not have sufficient accountability to either the executive or the legislature.

## INTRODUCTION

The National Enterprise Board, established under the Industry Act of 1975, is a public financial and promotional institution whose principal objectives are to assist the economy of the U.K., to promote industrial efficiency and international competitiveness and to expand opportunities for productive employment.

From 1968 to 1971, the British government operated a public financial institution with a similar purpose--the Industrial Reorganization Corporation (IRC). IRC's functions were limited to promoting and providing finance for mergers which the directors felt would help effect the rationalization of an industry. (Many of Britain's manufacturing sectors are characterized by firms too small to compete on an international scale.) IRC generated a great deal of opposition from private financial interests which felt that they were being subjected to unfair competition. The institution was disbanded by the newly elected Tory government in 1971. NEB, which incorporates the functions of IRC into the comprehensive program described below, began operations in November 1975.

### I. PURPOSES

In order to meet these broad objectives the NEB carries out several different functions. Some observers feel these functions

are not consistent with each other. In planning its investments, the Board is to apply standard commercial criteria of profitability. On the other hand, it is viewed by government and its own directors as an instrument of national industrial policy and is therefore responsible for meeting various public policy criteria in its operations. The implications of NEB's mixed agenda will be examined in the detailed enumeration of the institution's purposes below.

NEB's operations fall into four conceptually separable classifications:

- a) Finance for Industrial Investment - NEB acts essentially as an investment banker, purchasing the equities of private firms where it feels the investment will show a reasonable return, will help effect the purposes of the Act and will not displace private investment. NEB also makes loans on commercial terms.
- b) Industrial Holding Company - NEB is responsible for the strategic management and financial monitoring of several large nationalized firms.
- c) Assistance to Companies in Financial Difficulty - NEB administers capital assistance to firms in temporary financial difficulties. Funds for this activity are provided by the Secretary of State for Industry who is also responsible for deciding which firms will be considered for such assistance.

d) Promotional Activity--NEB offers assistance in procuring foreign contracts for British firms or groups of firms and in coordinating the activity of regional development authorities.

Each of these four purposes is analyzed below.

a. Finance For Industrial Investment

NEB's main function is the provision of finance for industrial investment, particularly for the expansion and modernization of productive facilities in manufacturing. In addition, finance or advisory services may be provided to promote industrial restructuring. Finance is normally provided in the form of equity, but loans at commercial rates of interest may also be provided.

NEB's investment policies are shaped by an interim statement of guidance from the Secretary of State for Industry, which is now pending statutory enactment. Except for those investments made at the direction of the Secretary\* (see Section c), profitability, defined as the projected discounted rate of return to capital, is to be the main investment criterion. Subsidiary to this are certain public policy considerations, including:

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\*Note: In this profile, "Secretary" denotes the office of the Secretary of State for Industry.

- i. preparing for growth by action to increase longer-term capacity in key sectors of manufacturing industry;
- ii. increasing exports or savings imports; and
- iii. where there is a choice of location, creating new jobs in areas of high unemployment.

NEB devoted considerable time to identifying sectors where its assistance would be most beneficial in terms of promoting efficiency. They incorporated data and analysis from the White Paper accompanying the Industry Act and a 39-sector industry study by the National Economic Development Councils into their annual investment plans. NEB intends to use these studies and other analysis provided by the Secretary to guide future investment policy.

b. Industrial Holding Company

The NEB acts as a holding company for a number of shareholdings previously held directly by the government. The portfolio will be added to from time to time as a consequence of the NEB's role as a provider to new equity finance and through the purchase of existing shares in companies. In addition, the NEB has power under the Act to set up new enterprises or to participate in joint ventures with the private sector.

The basic job of the NEB as shareholder is to ensure a proper

return is secured to the taxpayers who provide capital through the Consolidated Fund, the general tax revenues of the British government. In so doing, the Board does not intend to participate in day to day management. Their oversight consists in most cases of making arrangements for the provision of regular monthly information to the NEB on performance and financial prospects, for the provision of annual and long-range plans for the approval by the NEB and for the submission (in the case of subsidiaries-- wholly-owned companies) of major capital investment proposals, acquisitions and disposals for approval.

Many of the "transferred companies'" problems have arisen from unstable industrial relations resulting from the inability of management and labor to work out satisfactory wage and productivity provisions. There are three high union officials on the NEB's ten-member Board of Directors. Their presence may be interpreted as a move to force some rapprochement between labor and management, given the Board's responsibility for strategic management and oversight of the troubled enterprise.

c. Assistance to Companies in Financial Difficulty

The NEB may be directed by the Secretary to assist a company in financial difficulties which needs to be restored to a sound state for reasons of employment or industrial policy. In some

cases, the Board will consider the provision of funds in some combination of commercial and subsidized terms. In such cases, the NEB will be reimbursed specifically for their involvement; and to ensure that their financial discipline is not undermined, these activities will be accounted for separately.

d. Promotional Activities

Foreign Contracts - In keeping with its policy to expand exports, the NEB attempts to use its central organizing and financial capabilities to help British industries compete for large foreign contracts. According to the Directors' analysis, "Overseas contracts are becoming so large in value, and the conditions attached to them so onerous, that many UK companies do not have a big enough asset base to undertake the risks; in addition there is a tendency among developing countries to favour tenderers with some form of government backing." NEB has announced that it is willing to joint venture with firms or groups of firms competing for such contracts. In 1976, it assisted in two such projects. The contracts were, however, awarded to other bidders.

Regional Activities - The Secretary's interim policy statement directed NEB to give particular weight to creating jobs in areas of high unemployment. In accordance with this direction, NEB has set up offices in Liverpool and Newcastle. The Regional

Directors' initial task has been to establish their offices, to build up close relations with public and other bodies concerned with regional development and industrial investment in their regions, and to seek out companies with potential which might require finance from the NEB to fulfill their modernization and expansion plans.

## II. SOURCES OF FUNDS/CAPITALIZATION

NEB's investments are financed wholly by the national government. NEB may draw on two sources within the government: the National Loans Fund, and "public dividend capital" appropriated annually by Parliament to the Secretary of State by the Treasury for use in industrial investment. The National Loans Fund is a revolving fund to be used to make loans to private firms. The amount of money in the fund and the annual volume of loan activity is set by Parliament; it is administered by the Secretary. NEB may borrow from the Fund at private commercial rates and lend this money to the firms in which it invests. NEB must repay these loans on a fixed schedule set in advance in consultation with the Secretary. NEB may charge a small interest rate differential to its borrowers to cover its costs in originating and monitoring the loan.

Public dividend capital is another pool of investment funds

made available to the Secretary by Parliament, with controls similar to those exercised over the National Loans Fund. Repayment of these advances are flexible. Dividends and recovery of capital are set by the Secretary in consultation with NEB on a yearly basis. In 1976, NEB paid no dividends on the public dividend capital it received and subsequently invested in the firms it financed. Returns on public dividend capital are to be paid into the Consolidated Fund.

The Secretary and the Treasury must approve all advances from both the National Loans Fund and public dividend capital. The Board must supply accounts of the application of these funds to both offices.

The Treasury may authorize the use of general tax revenues to guarantee repayment of loans undertaken by NEB. The Treasury must notify Parliament of all such guarantees.

As of December 31, 1976, the breakdown of funds received by NEB was:

Public Dividend Capital

Debt assumed from the government upon transfer of investments; Directed by Secretary of State to be treated as public dividend capital:	Subsidiaries	418.4
	Associates	6.2
	Others	1.2
		<u>425.8</u>
<u>Issued to NEB during 1976</u>		54.0
<u>Total</u>		<u>479.8</u>

Loans

Capital debt assumed from transferred companies:	77.8
New loans issued to NEB during 1976	21.3
Total	99.1

(All figures in £ million.)

Since NEB does not market securities, debt/equity ratios are not material to its success in obtaining further funds for investment. More important will be its return on capital and the performance of its subsidiaries. These factors will figure prominently in the Secretary's decision to continue providing investment funds to NEB.

III. USES OF FUNDS/INVESTMENT OPERATIONS

NEB's assets consist largely of investments and loans to five large public corporations transferred to it by the government. All of these companies have suffered financial, managerial and labor problems in the last few years. They have been only marginally profitable or have shown losses. The book value of these companies' assets was £624.1 million at the time of transfer. Their negotiated price, discounted for their market problems and used for calculating returns to NEB, was £495.7 million. During 1976, NEB made £40.41 million in new equity investments and £20.13 million in loans to these companies.

The operating status of NEB's major industrial holdings as of the date of transfer from the government was as follows:

British Leyland Ltd.

	<u>12 months to Sept. 1975</u>	<u>15 months to Dec. 1976</u>
Sales	£1,868 mill.	£2,692 mill.
Profit (Loss), Before Tax	(76.1)	70.5
U.K. Employment	191,000	183,000

British Leyland is a major manufacturer of motor vehicles and allied products. The companies comprising this conglomerate had shown steady losses during the Sixties. They were consolidated and nationalized in 1973. British Leyland's small profit in 1976 is attributed to higher export margins resulting from the decline of the pound. The firm's major problem is that it has been unable to produce enough vehicles to meet demand. This is due mainly to disrupted labor relations. During the 15 months ended December 1976, 7.1 million man-hours were lost due to strikes and subsequent layoffs.

Data Recording Instrument Co. Ltd.

	<u>12 months to Sept. 1975</u>	<u>15 months to Dec. 1976</u>
Sales	£10.15 mill.	£8.50 mill.
(Loss) Before Tax	(0.14)	(0.09)
U.K. Employment	923	1,030

Data Recording is a young firm producing computer peripheral equipment. Some 60 percent of its output is sold overseas. Its management has announced expansion plans calling for a doubling of employment in the next four years. However, the sales figures above do not seem to warrant such optimism.

Ferranti Ltd.

	<u>12 months to Sept. 1975</u>	<u>15 months to Dec. 1976</u>
Sales	£86.3 mill.	£108.5 mill.
Profit (Loss) Before Tax	(0.5)	4.1
U.K. Employment	16,651	15,576

Ferranti is a conglomerate producing many lines of heavy electrical equipment and electronic instruments. Its operations are international, with subsidiaries in Canada, Brazil and Scotland. As of the end of 1976, divisional management was being decentralized in an attempt to accelerate the increase in profitability indicated above.

Herbert Ltd.

	<u>12 months to Sept. 1975</u>	<u>15 months to Dec. 1976</u>
Sales	£49.7 mill.	£49.4 mill.
Profit (Loss) Before Tax	(13.4)	(0.7)
U.K. Employment	6,716	6,017

Herbert is one of Britain's largest machine tool manufacturers. This industry had been particularly hard hit by the recession of the early Seventies, and the firm had been forced to postpone planned equipment modernization. As of the end of 1976, domestic and foreign orders were increasing. Herbert was planning to complement upgrading of its capital with wide-reaching decentralization of divisional management responsibility and worker participation in plant-level management.

Rolls Royce Ltd.

	<u>12 months to Sept. 1975</u>	<u>15 months to Dec. 1976</u>
Sales	£602.1 mill.	£620.2 mill.
Profit (Loss) Before Tax	4.5	(21.9)
U.K. Employment	62,375	59,758

Rolls Royce Ltd. produces aircraft engines and industrial turbines. The automotive division was separated from the firm upon nationalization in 1971. Recessionary declines in demand for air travel and electricity cut severely into the derived demand for Rolls Royce's products. Declining sales leading to increased unit costs forced management to close three plants and curtail subcontracting business. Despite steady international orders for military aircraft engines, RR intends to continue cut-backs in capital expenditure and production.

During 1976, NEB also invested in new and existing smaller firms, mostly in the machine tool, computer and metalworking industries. These investments amounted to £11.51 million in equity and £21.18 million in loans.

#### IV. MANAGEMENT

NEB is managed by a Board of Directors consisting of two full-time and eight part-time members. The two full-time members, Chairman and Deputy Chairman, are former senior executives of industrial enterprises. Of the eight part-time members, five are business executives and three are union officials. The Board is the ultimate authority in investment decisions except in those cases reported in the "Functions" section.

The Board is assisted by a professional staff of 47, headquartered in London with regional branches in Liverpool and Newcastle.

#### V. ACCOUNTABILITY

##### Accountability to the Executive

The NEB is subject to a great deal of oversight by the Secretary of State for Industry and the Treasury. NEB must satisfy these officers that its investments are sound by commercial criteria (except in the case of investments directed by the Secretary).

NEB STATEMENT OF SOURCE AND APPLICATION OF FUNDS  
for the period from 20 November 1975 to 31 December 1976

	<u>Note</u>		
<u>Source of Funds</u>			
From Her Majesty's Government			
Public dividend capital	14	53.97	
National Loans Fund	15	<u>21.29</u>	75.26
From Her Majesty's Government upon the transfer of investments and loans under Section 5 of the Industry Act 1975			
Public dividend capital	14	425.79	
Capital Debt	15	<u>77.84</u>	<u>503.63</u>
 <u>Application of Funds</u>			
Overall Excess of Expenditure over Income	7		1.09
Less Depreciation			<u>.05</u>
			1.04
Purchase of Fixed Assets	7		.65
Purchase of investments			
Subsidiaries	9	40.41	
Associates	11	10.70	
Others	10	<u>.81</u>	51.92
Loans to			
Subsidiaries	9	20.13	
Associates	11	.76	
Others	10	<u>.42</u>	21.31
Investments transferred by Her Majesty's Government			
Subsidiaries	9	418.36	
Associates	11	6.24	
Others	10	<u>1.19</u>	425.79
Loans transferred by Her Majesty's Government			
Subsidiaries	9	74.59	
Associates	11	<u>3.25</u>	77.84

It must also make an effort to fulfill a rather long list of public policy responsibilities as well. These include:

- 1) location of new facilities in areas of high unemployment;
- 2) ensuring the furthering of democratic managerial practice;
- 3) ensuring that the use of funds is consonant with anti-inflation policy;
- 4) ensuring that public corporations maintain financial discipline;
- 5) assisting and coordinating activities with regional planning agencies; and
- 6) ensuring protection of consumer interests.

Commercial standards for investment are well understood, and there exist permanent agencies within the government to monitor NEB's performance on this account. No standards or mechanisms of oversight have been brought forth by which to judge NEB's performance on the social criteria or to hold it accountable.

In setting guidelines for NEB, the Secretary acknowledged that the institution had to be left with enough discretion to respond flexibly to quickly changing investment opportunities. Thus, government oversight is to be exercised through the review of three-year investment plans submitted annually to the Secretary. The plan is to include sections dealing with:

- a) existing NEB holdings (with particular attention to the activities of large companies);
- b) acquisitions, joint ventures and new ventures; and
- c) assistance operations;

with a discussion of the balance between these various activities.

The Secretary may enforce his decisions through two mechanisms discussed above, regulation of certain investment activities and control over the amount of investment funds available to NEB. Should the policies of the Board and the Secretary seriously diverge, these provisions could become powerful sanctions on the discretion of NEB management. At the moment, however, relationships between NEB and the government seem more collaborative than adversary.

The overall framework of the NEB's accountability to the government on matters of public policy and financial goals is given above. Here we list certain types of investment operations which require notification of or approval from the Secretary of State.

Notification of the Secretary is required when:

- 1) commitments exceed £10 million or the investment raises new or significant policy issues;
- 2) NEB acquires more than 10 percent of the voting shares of a company; and/or

3) the acquisition may require investigation under monopoly laws.

Approval is required when:

- 1) NEB wishes to dispose of securities;
- 2) commitments exceed £25 million; and/or
- 3) the costs of acquiring share capital exceed £10 million or confer upon NEB more than 30 percent of voting stock in a company.

Most of these restrictions on investment activity were enacted in order to assure the business community that NEB would not use its access to large amounts of government funds to compete at an advantage with private investors. NEB is subject to the same laws regarding ownership acquisition and disclosure that apply to private investors; it may not make use of privileged information such as planning agreements worked out between the government and private firms; it may not compel private owners to sell out.

#### Legislative Accountability

NEB is only indirectly accountable to Parliament through ministers appointed by them. Parliament also controls the amount of National Loans Funds and public dividend capital available to all recipients.

## VI. EVALUATION

The most remarkable aspect of the NEB is the array of conceptually separable functions it is to fulfill and problems it is to address. After only one year of documented activity, it is impossible to assess the Board's performance. We can, however, review NEB's functions and design to make some prognosis on its chances of success. First we must review interpretations of Britain's present industrial difficulties.

Since 1960, the post-tax rate of return on physical capital to British commercial and industrial companies has fallen from 8 percent to near zero. The cause most frequently identified by commentators on this phenomenon is lack of sufficient reinvestment to maintain capacity. However, recent studies have shown that Britain's rate of reinvestment has been stable and comparable to those of other Western industrialized countries.

Recently, attention has been focused on the low productivity of labor as the major cause of unprofitable manufacturing activity. In manufacturing and utility sectors, Britain's enterprises rank consistently lowest in international comparisons of output (sales) per unit of manpower employed. This condition is particularly acute in the nationalized industries where, for example, British Leyland uses about twice as much manpower/unit as its continental counterparts producing similar cars with similar

equipment. Frequent strikes cut further into productivity of capital. For obvious political reasons, both Labour and Tory governments have been obliged to maintain employment and have thus subsidized losses in nationalized enterprises and in larger private manufacturing companies as well. Unions, therefore, face few constraints, in terms of membership job loss, in pressing for more and more costly wage and benefit settlements. Nationalized industries have also been subject to price controls in the face of continuously rising factor costs.

These are only a few of the problems facing large-scale industry in Britain; they face conditions weighing on all import-dependent industrial economies. They do, however, have the advantages of a relatively modern industrial plant and a highly trained technical and managerial elite.

What are the prospects for NEB's various roles given the simplified analysis above? Taking them one at a time:

Provision of Investment Capital: NEB's operations are a substantial improvement over previous British systems of capital assistance to private firms. Under older programs, the Treasury had to be petitioned for virtually every disbursement of investment funds, bureaucratic response tended to be slow to the point of obstructing the completion of deals. Furthermore, most assistance was in the form of loans with inflexible repayment terms.

Recipients often had to petition for further assistance to pay off their government loans.

Within rather high per investment limits, the NEB may act on its own initiative, without executive approval. Since its own source of capital for new investments is predominantly public dividend capital (76 percent of the total funds available to it in 1976), it may advance equity to the companies it invests in. Thus, NEB can absorb long gestation periods necessary for new enterprises or new operations within existing enterprises to show profits.

Holding Company: The problems facing Britain's nationalized industries are too complex, too embedded in historical patterns of class, social and economic relations for any super-managerial authority to turn around in the foreseeable future. The NEB may provide one of many desperately needed forums in which labor and management representatives can be induced to address common problems.

Assistance to Financially Troubled Companies: This is NEB's least enviable and least-to-be-emulated function. To the extent that the analysis above holds true in individual cases, provision of additional capital under any terms is economically inefficient. It may, however, be politically necessary. NEB keeps separate accounts for such activities and is reimbursed for them. Thus,

the "subsidy" nature of these activities is acknowledged in NEB's records, allowing for the application of other-than-commercial standards in judging performance.

Promotional Activities: Both the foreign contract and regional development functions seem to be sensible approaches to creating markets and encouraging coordination, particularly in sectors dominated by small units. Coupled with NEB's financial powers, these could be particularly effective services for increasing Britain's international competitiveness.

VII. RELEVANCE TO THE ALASKA PERMANENT FUND

Purposes: The British National Enterprise Board, like the Canada Development Corporation is relevant to the Alaska Permanent Fund in that its central function is to finance the restructuring of ownership to ensure that assisted firms are efficiently operated under British management control.

Like the Canada Development Corporation and like the proposed draft of the Alaska Permanent Fund, the British National Enterprise Board is required to return a profit on investment that essentially meets the norms of the marketplace. On the other hand, the British National Enterprise Board statute goes one major step beyond that of the Canada Development Corporation in requiring that any subsidies are borne directly by the British General Fund and not by the National Enterprise Board. That implication exists in the current draft of the Alaska Permanent Fund but should be made more explicit.

Finally, the principal weaknesses of the British National Enterprise Board are the conflicts in incompatible goals. As was emphasized in the July 11 memorandum to the House committee, this is a principal danger of an improperly structured development bank. Any separate goals such as the separate and conflicting tasks of the British National Enterprise Board should

be separated into subsidiary institutions which have sources and uses of funds and management capable of dealing with those distinct functions.

Sources and Uses of Funds: The British National Enterprise Board is, of course, 100 percent financed by the British government. Unlike the Canada Development Corporation, it does not have to float its stock issues or bonds on the private market. Therefore it does not have a market sensitivity.

The Canada Development Corporation is too sensitive to the marketplace; the British National Enterprise Board is not at all sensitive to the marketplace. The result is that the British National Enterprise Board can and does make unsound investments which are unproductive and in the long run a disservice to the British economy. The ideal is a mixed public and private financing in which the initial capitalization of the government provides flexibility but the subsequent financing is from the marketplace and is market sensitive as, for instance, in the case of the European Investment Bank. The Alaska Permanent Fund can be organized to create a substantial multiplier of private financing on its public capital which will both improve its performance and make more efficient use of its resources.

Management: The British National Enterprise Board, like the Canada Development Corporation, does not involve itself in the day to day management decisions of its affiliates or subsidiaries, a policy which should again be followed by the Alaska Permanent Fund.

It is also important to note the balance among government, business and labor on the British National Enterprise Board, a balance which may or may not have any relevance to Alaska.

Accountability: The British National Enterprise Board statute and its executive implementation provide some of the most striking models for the legislative and executive oversight of a large and powerful development bank.

First, NEB's financial reporting standards are extremely rigorous. Even in its Annual Report, all accounts are unconsolidated, so that the performance of subsidiaries and special purpose funds is apparent from casual perusal. For example, the conversion of a large portion of Rolls Royce government debt to public dividend capital was duly noted. This was a relaxation of financial discipline contrary, perhaps, to NEB's stated policy. However, this information was picked up by the British financial press and used by members of Parliament to bring political pressure to the struggle to impose stricter standards on nationalized industries. Since the solutions to

Britain's industrial problems must be worked out in the political as well as the economic and financial spheres, the informed participation of the interested public may serve as an important control on NEB's activity.

Secondly, day-to-day investment activities are subject to regulations designed to ensure that NEB is not displacing private market investment. While the success of these regulations is impossible to measure, it should be noted that CDC is under no such control.

Thirdly, and most importantly, NEB must justify its requests for investment funds on an annual basis to the Secretary of State for Industry, who makes the final decision on the disbursement of these funds. The Secretary is, in turn, accountable to Parliament, which appropriates the money. On one hand, this ensures that NEB's management is using its funds in a manner consonant with national policy and financial responsibility (to the extent these two goals do not conflict). On the other hand, such approval mechanisms may involve bureaucrats far removed from the operations of the assisted firms. They may also inhibit the timely provision of funds necessary to negotiate and effect deals. However, this does not seem to have been a problem so far.

B. EXPANSION OF SMALL AND MEDIUM SCALE PRODUCTIVE ENTERPRISE

CONNECTICUT DEVELOPMENT AUTHORITY  
Discussion Draft

September 14, 1977  
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INTRODUCTION

The Connecticut Development Authority (CDA) is one of many independent state agencies in the United States designed to assist existing small- and medium-sized firms in obtaining long-term debt financing for expansion and upgrading of physical plant and equipment. Created in 1973 by an act of the Connecticut state legislature, its operations to date are noteworthy on several accounts:

- 1) They have been self-sustaining. All operating expenses have been financed by service fees and float from efficient cash-flow management.
- 2) Screening procedures have been rigorous. Virtually all CDA service users have been financially successful.
- 3) Management has been innovative in harnessing the private money markets to provide finance to firms which, due to their small size, have had restricted access to capital on suitable terms, particularly during tight money periods.

I. OPERATIONS: PURPOSES, SOURCES AND USES OF FUNDS

The Authority manages five programs, each of which deals with a somewhat different aspect of providing expansion capital to small- and medium-sized firms. The volume of these operations in the past three years is shown in Table i, in terms of number of loans closed or insured and their total dollar amounts. Since

Table I  
 \$ AMOUNTS IN MILLIONS

Program	Self-Sustain	Umb. Bond	Ind. Mort. Ins.	Small Business	Contractor
Year					
1974 #	37	18	2	5	-
\$ amount	172.4	5.1	4.4	.09	-
1975 #	19	8	3	9	-
\$ amount	48.6	4.3	5.2	.10	
1976 #	11	10	8	5	2
\$ amount	35.3	4.9	21.2	.09	.04
Total #	67	36	13	19	2
\$ amount	256.3	14.3	30.8	.28	.04

sources and uses of funds are functionally tied to each other by these financial mechanisms, these two important topics will be discussed in the context of the individual programs rather than summarized separately as in the other profiles in this series.

CDA's three major programs, both for volume of business and for purposes of illustrating the match of perceived need for financial services to program design are:

- 1) The Industrial Mortgage Insurance Program which insures loans made by private institutions to finance the purchase of plant and equipment;
- 2) The Self-Sustaining Revenue Bond Program through which the CDA administers a conventional state-wide industrial revenue bonding system; and
- 3) The Umbrella Loan Program, a direct industrial mortgage lending operation financed by revenues bonds of the Authority.

The Umbrella Program is the most innovative and aggressive of these operations and, for purposes of program design, the most important.

#### A. Self-Sustaining Revenue Bonds

In Connecticut, industrial revenue bonds are sponsored at the state as opposed to the local level. IRB's are a mechanism by which a state or municipal authority may transfer the tax-

exempt status of the interest it pays on borrowings to bonds of private industrial concerns. The recipient firms usually use the proceeds of such issues to finance new plant or pollution control facilities. These securities are evaluated in the market solely on the financial condition of the borrowing firm. Thus, state involvement lowers the interest cost, but not the risk, information or transaction costs--factors influencing the availability--of such capital. Hence the term self-sustaining. CDA charges a fee to cover the legal, investigative and administrative costs of such issues. These fees are used to cross-subsidize the more costly and time consuming operations involved in the other programs managed by CDA.

#### B. Industrial Mortgage Insurance

##### Purpose

Commercial banks tend to view smaller firms as risky borrowers due, mostly, to the volatile nature of the markets in which they operate. Larger firms are favored borrowers for several other reasons, including:

- 1) They offer the prospect of entering into larger, more profitable customer relations with the lenders for services such as business accounts (compensating balances).

- 2) Loan origination costs per unit of earning assets tend to be less the larger the loan.

3) Commercial banks are seldom willing to make loans with long repayment periods appropriate for the financing of plant and equipment, and small firms do not have access to the corporate bond and private placement markets which provide long-term finance to larger firms. CDA claims that banks have been willing to extend their typical five to seven year terms when participating in the insurance program. This reduces the borrowers' annual debt burden.

4) Small firms often cannot afford the downpayment on an asset required by banks under reserve requirements. Insured loans are not counted against reserve requirements under certain circumstances. Thus banks are induced to lower their up-front requirements of small borrowers.

#### Salient Features of the Service

Recent empirical studies show that, during periods of high loan demand, loans to small businesses are the first to be curtailed. In order to counteract the reluctance of commercial banks to lend on favorable terms to smaller businesses, CDA offers to insure all payments, interest, principal and property insurance, on loans for up to 90 percent of the value of new or expanded real assets and 80 percent of the value of equipment. Loans to recreation and commercial projects are not eligible for

coverage, nor are working capital loans. All loans must be secured by a first mortgage on the asset. Eligible borrowers include firms wishing to locate or expand facilities in Connecticut, community foundations, private developers or realty holding companies. Other important features of the service are:

Eligible projects: Manufacturing and processing or research facilities and offices or warehousing attached thereto;

Project limits: Real property - \$10 million  
Equipment -

Maximum terms: Real Property - 25 years  
Equipment - 10 years

Application Fees: Sliding scale determined by loan amount.  
Maximum - \$7,500  
Minimum - \$300

Premiums: Real Property - 1/2 percent of outstanding balance  
Equipment - 1 percent of outstanding balance.

#### Screening and Review

A bank which agrees to be the primary mortgage lender to a firm seeking an insured loan applies to the CDA for coverage on behalf of the borrower. The CDA screening process includes a review of the borrower's eligibility under the programs and a brief review of the firm's financial condition and plans. The bank

performs the usual assessment of the borrower's ability to repay the loan. The program rejection rate is approximately 10 percent.

### Financing

The CDA supports its obligations under insurance contracts through an insurance fund in which all premiums are deposited. As of December 31, 1976, this fund stood at \$2.4 million. Should this fund prove insufficient to meet its obligations, CDA may request that the State Bond Commission authorize the issue of general obligation bonds up to \$100 million in order to cover defaulted payments.

Operating expenses of the program are covered by application and commitment fees.

### Operating History

The Mortgage Insurance Program was begun in 1961 under the management of the Connecticut Industrial Building Commission. It was taken over by CDA in 1973. As of July 1976, the program had insured 123 loans (not including loans made under the Umbrella Program), and had suffered only three defaults. Through cooperation with creditors in disposing of insured property, none of these defaults ever led to a charge on the insurance fund. Bond authorization for \$600,000 was used in one case to finance the

acquisition of a defaulted property. The CDA has been able to lease the repossessed facility at rates which more than cover debt service on the bonds.

Volume of activity under this program for the past three years has been three, two and eight loans per year, respectively. For the prior 10 years, the average number of loans insured was 11. The decline in insurance contracts may be traced to a cyclical loosening of the market for loan funds and to competition in similar services from the CDA's Umbrella Bond program. Because the Umbrella program has been used to deal with loans below \$1 million, the average amount of the loans in the Insurance program has risen.

C. The Umbrella Bond Program

During the period 1970-1972, when markets for commercial loans to small companies were particularly tight, the management of CDA determined that it was necessary to take more positive action (than that permitted by an insurance program) to address the problems enumerated in the previous section. The CDA now issues tax-exempt bonds, the proceeds of which are used to provide long-term loans to small companies seeking first mortgage finance for plant and equipment. The process by which this is accomplished is rather complicated and might best be understood through a brief, step-by-step outline.

The Process

- 1) CDA solicits and receives loan applications from small firms with eligible projects.
- 2) After screening similar to that of a commercial bank's, applications are submitted to the Board of Directors for approval.
- 3) If the loan application is accepted, the borrower is issued a conditional loan commitment which (s)he uses to help procure temporary financing from a private institution for the construction of the project. The Authority may only make loans secured by completed projects.
- 4) Upon completion of the project, the Authority takes a mortgage from the borrower, the proceeds of which are used to pay off the construction loan. Umbrella program borrowers are required to participate in the Industrial Mortgage Insurance program. In order to finance this loan, the Authority has procured a \$12 million line of credit with two commercial banks. Before the success of this scheme had been demonstrated, the Authority had issued Bond Anticipation Notes to cover interim financing. The line of credit reduces uncertainty over the terms and availability of interim financing, which in turn makes it less likely that CDA will violate IRS rules pertaining to arbitrage. During this period before a bond is issued to provide permanent financing for the mortgages, the Authority may charge its borrowers an interest rate of 1/2 percent above its own cost of funds.

5) When a sufficient number of loans have been made such that their repayment would secure a marketable revenue bond issue (about \$10 million--minimum), the loans are consolidated into several series on the basis of size and maturity. (Series cannot exceed \$1 million due to IRS regulations.) These revenue bonds are then sold to the public.

6) A portion of the proceeds of these bonds is used to pay off the interim creditors. The borrower's terms are then restructured so that interest rates under permanent financing are 1/2 percent above the Authority's cost of funds under the bond issue. After costs of issuance are paid, the remainder of the bond proceeds are placed in a Special Capital Reserve Fund whose function is described below. Principal and interest payments on the bonds are so structured that repayment of the loans should cover them.

#### Salient Features of the Service

Other features of the service are similar to those of the Insurance Program. The only significant difference is the project limits: \$500,000 for real property, \$400,000 for equipment. Besides being necessary to meet IRS requirements for unconsolidated reporting and filing, this limit targets services to smaller firms.

### Screening and Review

The screening process used by the Umbrella Bond program is considerably more stringent than that at a commercial bank. Besides the usual financial records and projections, independent asset appraisals, security checks, insurance on principals, personal pledges and on-site investigations are required. These policies have paid off in that there have been no defaults during the program's five-year operating history.

Authority officials claim that the extra cost imposed on borrowers to meet these requirements are more than compensated by reduced interest and more favorable repayment terms of Umbrella loans.

### Financing

In order to facilitate sales in an already crowded market for tax-exempt securities, the Umbrella Bonds have extensive financial backing. Should loan payments be insufficient to cover debt service, the first pool of funds to be tapped is a Special Capital Reserve Fund maintained at the level of one year's debt service. Should this fund fall below the required level, the Authority must use the Insurance Fund to make up the deficit. This fund is backed by general obligation bonding authority. Should these resources be insufficient to restore the Reserve Fund to its required

level, money from the general fund of the state is "deemed to be appropriated" at the end of each calendar year to make up the deficit. Since this backing requires no legislative approval, it is a good deal stronger than the "moral obligations" which underlie most revenue bond issues. In some states, this arrangement is likely to be unconstitutional.

Operations are financed by the 1/2 percent spread between borrowers' interest rates and the Authority's cost of funds, application and commitment fees and float generated by deposit of loan payments prior to disbursement of debt service.

#### Operating History

The Umbrella program was established in 1972. As of January 1977, 173 firms had submitted formal applications of which 80 had been rejected or were voluntarily withdrawn. Seven were in process and 86 had been approved. Of these, 67 had been closed, and 66 were outstanding with a balance aggregating \$24.4 million. Approved loans not yet closed totaled about \$6 million.

These loans have been financed by two bond issues; one in 1975 for \$23.5 million, of which \$20 million was applied to permanent mortgage financing; one in 1977 for \$10.5 million of which \$9.2 million will be applied to permanent financing. The average loan size has been about \$300,000 with the majority being for 25

years. Interest rates to borrowers, including insurance premiums, were 9.38 percent for real property and 9.3 percent for equipment on the first issue, and 7.23 and 7.73 percent for the second issue. Commercial interest rates without insurance coverage at the time of these issues were approximately 10.5 and 9.5 percent, respectively.

Considerable delay and difficulty accompanied the first bond issue, despite its AA rating due to the dislocations in the tax-exempt market caused by New York City's financial difficulties and the unprecedented form of the issue itself. The second issue, however, went off smoothly, the bonds being well-accepted in the marketplace.

#### D. Other Operations

CDA also administers, for the Connecticut Department of Commerce, two smaller programs funded by occasional general obligation bond issues of the state.

##### Cooperative financing of 502 Local Development Corporations -

Under this program, the CDA lends 50 percent of the front-end investment which a local development corporation must raise in order to receive either SBA or EDA long-term financing. CDA is empowered to lend up to \$2 million of its resources for this seed money financing. As of July 1976 it had made \$228,000 in such loans.

Contractor's Loan Programs - The CDA has provided small loans on a contract by contract basis to construction firms who demonstrate a need for working capital to carry out procured contracts. CDA accords priority to minority businesses.

## II. MANAGEMENT

The CDA is a subdivision of the Connecticut Department of Commerce. However, it is an independent agency whose operating decisions are made by a seven-member Board of Directors. The Board consists of the Commissioners of Finance and Commerce, the Treasurer and four members appointed by the governor, who have tended to be executives in private financial institutions. The Board is assisted on all Umbrella Loan decisions by a nine-man screening committee composed of experts in various sub-areas of industrial finance. Each loan write-up is submitted to three members of the committee who review the proposal and return a recommendation to the Board. These outside reviewers are compensated by a set fee for each loan reviewed.

The professional staff of ten, which performs most of the screening loan evaluation and program administration functions, consists of an Executive Director, managers for the programs, and loan officers. The fact that this staff is subject to state civil service regulation has caused some operating problems.

Because the state civil service commission regulates the Authority's hiring practices and the salaries it may offer, CDA has found it difficult to hire staff in the timely manner required by professional financial operations. It has also found it difficult to retain qualified personnel since the private market provides higher salaries and more opportunities for advancement to those with commensurate skills.

Although CDA is an independent agency, it is very much tied to the Connecticut Department of Commerce in which it is housed and whose Commissioner is Chairman of the Board. On one hand, this close connection is beneficial in that the Department's promotional activities are a source of new business. On the other hand, differences of opinion concerning professional judgment on financial matters have arisen between the Board and the Staff.

### III. ACCOUNTABILITY

#### To The Executive

The Authority's operations are, for the most part, unencumbered by executive oversight or control. Approval of the Treasurer and the State Bond Council is needed in order to issue bonds, and yearly reports must be submitted to the Commissioner of Commerce. Indirect power may be exercised through appointments to the Board. However, any sanctions go into effect only if the

Authority is in financial trouble or wishes to expand its already generous program limits. Given CDA's record, this situation is not likely to arise soon.

Given the stringency of IRS regulations on disclosure and arbitrage and the competitiveness of an already-glutted tax-exempt market, it would appear that CDA is more fully accountable to the IRS, the banks with whom it cooperates, and its investors than to any state governmental body for its financial performance.

In terms of public benefits, CDA does require loan applicants to submit employment estimates for their projects. However, the Authority makes no attempt to analyze the incremental impact of their operations (new as opposed to retained jobs, replacement of private sources of investment funds, etc.). Authority managers state bluntly that these considerations are secondary to maintaining the financial credibility of CDA operations.

#### To the Legislature

CDA is not required to report its activities to the state legislature. This body exercises no sanctions over the operations of the Authority.

#### IV. EVALUATION

The CDA has been particularly effective in countering the

informational and cyclical money market problems which many observers feel account for recurrent contractions in the long-term debt market for small firms. The benefits of the Authority's services can be divided into two classes: assistance in making capital markets more efficient, the pecuniary benefits of which accrue mostly to banks and investors; and assistance to firms receiving financial services, to the extent that these services would not have been offered on as favorable terms, or at all, by the private market.

#### Making Capital Markets More Efficient

Numbers of applications for CDA services have been highest during periods of tight money, indicating that the Authority picks up the private institutions' lower priority customers. Yet the Authority's borrowers and insurees have not been bad credit risks. In fact, the default rate on CDA's portfolio of "risky" loans is considerably lower than that of most banks'. This constitutes some evidence that the Authority is tackling informational problems sloughed off by banks and investment houses which prefer to lend to bigger customers. Through the Insurance Program and the Umbrella program, CDA reduces the information costs involved in adequately assessing the creditworthiness of small firms to banks and individual investors. The expenses for this

service, however, are borne by the borrowers through fees and premiums and by the taxpayers who must somehow make up revenues foregone due to the use of tax-exempt financing.

Benefits to service users have included access to capital during a period of universally-recognized shortage in the case of the first Umbrella Bond issue and access to capital on extremely attractive terms in the case of the second. Participants under both the Umbrella and Mortgage Insurance programs enjoy lower down payments and decreased annual debt burden, both of which may be important factors for firms with uncertain or variable cash flows. The size of these benefits, however, is nearly impossible to estimate.

Finally, it should be remarked that the CDA's success and integrity are due to the efforts of its management rather than to any features of its legal structure or capitalization. Similar arrangements have led to unproductive allocations of capital and serious defaults in mortgage insurance programs in other states and most notably in special-purpose public authorities with tax-exempt bond issuing powers.

V. RELEVANCE TO THE ALASKA PERMANENT FUND

Purposes: The principal importance of the Connecticut Development Authority to the Alaska Permanent Fund is as the best North American model of a state-sponsored development bank financing intermediate- and long-term capital for medium and small business on a collaborative basis with the private marketplace. The Connecticut Development Authority has been extremely efficient in carrying out that purpose.

The Connecticut Development Authority, however, need not take 90 percent of the risk in all of its financing. In that regard, the Massachusetts Industrial Finance Agency (modeled after the Connecticut Development Authority in most respects) is pursuing a course much more like that of the European Investment Bank in taking only 40 percent of the risk, once again ensuring local and private market participation in both the risk and the resources.

Sources and Uses of Funds: The sources and uses of funds of the Connecticut Development Authority are again the ideal model for this purpose of appropriate state backing to ensure that virtually all of the used funds are raised in the private market. The Alaska Permanent Fund will be able to set up the same kinds of reserves with its own capital resources without the

need of any Alaska General Fund backing, in my judgment, given the vast size of the Alaska Permanent Fund's paid-in capital resources.

Management: The Connecticut Development Authority has built up an extremely fine management, but has tended to lose good staff or not be able to hire them in the first place because of the constraints of a Civil Service salary structure. Were the Connecticut Development Authority capable of hiring independent professional staff as does the Canada Development Corporation or the European Investment Bank, it might be an even stronger institution.

The Connecticut Development Authority has also made good use of professionals from the private market both on its board and on its investment committee to ensure that its decisions are sound.

Accountability: CDA is essentially unaccountable to any division of the Connecticut state government. Any sanctions reserved to the executive are activated only in the event of severe financial crisis, say the default of a substantial number of insured or umbrella loans. Even the token legislative oversight entailed in "moral obligation" arrangements has been relinquished. This

insulation from democratic scrutiny and control has not left CDA operations free of political influence. The Executive Director of the Authority has reported confidentially that professional staff judgment on loan applications has been compromised, on occasion, by pressure from appointed officials to take on the deal.

## C. COMMUNITY DEVELOPMENT IN UNDERDEVELOPED AREAS

COMMUNITY DEVELOPMENT FINANCE CORPORATION  
Discussion Draft

September 14, 1977  
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### INTRODUCTION

The Community Development Finance Corporation (CDFC) is a state-owned institution designed to provide equity investment in enterprises sponsored by community-based economic development organizations in depressed areas of Massachusetts. It was created by an act of the Massachusetts state legislature in 1975. It is funded by a \$10 million general obligation bond issue authorized in 1976. At present, the CDFC Board of Directors has been appointed; counsel and accountants have been selected. However, the institution is not yet staffed, nor has it undertaken any investment activities.

Despite this lack of actual operating experience, CDFC is of considerable interest to policy-makers concerned with state assistance to community-based economic development in depressed areas. The institution has been the object of a great deal of interaction, not to mention controversy between government officials, businessmen, community leaders and academics. All these groups sought to have their political and economic interests in the design of CDFC's structure and operations. Some of these concerns have been addressed in the definitions, statements of purpose, required findings and operating procedures specified in the CDFC bill. Others, less easily-specified, will have to be worked out on a case-by-case basis when operations begin.

The basic issues discussed in this profile are:

1) The nature of the financial needs of firms likely to locate in depressed areas; why these needs are seldom met by conventional financial institutions; how CDFC's proposed structure and operations are designed to meet these needs.

2) The mechanisms by which investment funds are to be targeted to eligible areas and projects. Where is investment likely to produce the greatest good in terms of increased employment and its concomitant benefits? What organizations are likely to be most capable of managing the investment?

3) The methods by which financial responsibilities and rewards will be distributed among CDFC, the management of the ventures it finances and the local public organization sponsoring the venture. How can the motivations of the key participants be balanced: the desire of the management of the enterprises financed for an adequate return on investment of time, energy and capital; CDFC's claim to a return on its investment sufficient to maintain operations; and the local organization's wish to ensure that substantial benefits accrue to its constituents?

4) By what standards, financial and social, can CDFC's performance be measured, and how can the various participants be held accountable?

I. PURPOSES

CDFC's purpose is to help increase levels of employment, capital ownership, tax revenues and overall economic activity in depressed areas by providing financial services to firms located or intending to locate in those areas. (See Section B for the legislative definition of depressed areas.) The plan for the type of financial services CDFC would offer proceeded from an analysis of the type of firms that could operate efficiently in depressed areas and their financial needs. The elements of this analysis were drawn from academic and empirical work on the determinants and patterns of business location and from the operating experience of financial, non-financial and governmental managers in Massachusetts. The argument for CDFC's planned operations is as follows:

1) Massachusetts employment, particularly in the manufacturing sector had been declining rapidly for at least 15 years prior to the formulation of the CDFC idea. The effects of this decline were particularly visible in cities and towns dependent on one or a few manufacturing plants for their economic activity. These towns contained high levels of surplus, semi-skilled labor and abandoned or underutilized physical plant.

2) Empirical analysis of the composition of employment level change, taking the individual states as the unit of observation, demonstrated that:

a) The creation of new firms and the expansion of existing firms contributed most of the increases in the number of jobs in a given state.

b) The contraction or closing of existing firms composes the greatest portion of the decrease in the number of jobs within a given state.

c) Interstate movement of business activities, despite the publicity such incidents received, accounted for little change in employment levels in the states of origin or destination. Most interstate moves were accounted for by the relocation of branch plants of corporations serving a national market. These moves were usually in response to conditions such as differential factor costs and proximity to markets which state governments, acting independently, were powerless to affect.

4) The actual location of smaller and newer firms was not adequately explained by cost-minimization. In the absence of such behavior, their location might be influenced by active state promotion and financial assistance. These firms accounted for approximately 80% of the manufacturing employment in Massachusetts.

5) At the time, CDFC was first proposed, the United States was suffering its worst recession since the Great Depression. New stock issues had slowed to five per year, and venture

capitalists were reluctant to invest in any company in its early stages of development. Without such investment, firms were unable to develop products, markets and operations to the point where they could attract debt financing from conventional sources.

6) The experience of business and financial people in Massachusetts indicated that there were many businesses, falling into several distinct categories, whose potential viability would be greatly enhanced by the provision of equity capital, but which could not offer the potential for return (30% is a frequently mentioned rule of thumb) sufficient to attract commercial venture capitalists.

The categories of firms were:

a) Manufacturers of high-technology products who needed time, money and freedom from debt burden to develop products and markets.

b) Firms in manufacturing industries which had been bought and subsequently mismanaged by national corporations and were now threatened with closure. In some cases, local management had fought to restructure ownership and control, re-establishing the plants as viable enterprises. Equity financing was essential to such deals in order to obtain favorable treatment from lending institutions.

c) Many local development organizations were involved in initiating and managing projects such as rental housing and community service facilities, which improved the living conditions of their constituents. Most of these projects required property development, which in turn required equity to leverage construction loans and mortgages. The organizations themselves were seldom able to generate such equity, and the major institutional sources of equity--the Federal Government and private foundations--were cutting back such funding.

Thus, categories of enterprises which could operate, or, in the case of housing and services, should operate in depressed areas were identified. All three types needed financing which did not impose an inflexible repayment schedule, and all observers of the financial scene agreed that this kind of financing was unavailable through conventional private channels.

The use of State funds to provide such financing was further justified on the basis that the Commonwealth would capture pecuniary benefits in addition to conventional return on investment. These would consist of increased income sales and business tax collections and decreased welfare and unemployment insurance payments amounting to about \$3000/year per job created or retained.

## II. SOURCES OF FUNDS/CAPITALIZATION

CDFC's source of investment funds is the proceeds of a \$10 million state general obligation bond issue. These funds will be transferred to CDFC in a lump sum. Increments to this capital would require further legislative bond authorization. The interest and principal on the bonds will be paid out of general state tax revenues as opposed to operating revenues of CDFC.

This form of capitalization is justified by the following argument:

1) According to the analysis of the economic conditions in depressed areas presented above, equity financing of enterprises is the most potentially productive form of capital assistance to businesses in these areas. So far, CDFC is the only state financial intermediary designed to provide equity financing.

2) CDFC cannot count on a regular stream of returns from these investments. Therefore, it could not meet its own financial responsibilities if it were forced to pay off its investment capital on an inflexible schedule demanded by debt financing. The experience of SBIC's and MESBIC's demonstrate that intermediaries charged with making equity investments cannot fulfill their mandate if they themselves rely on loans for their

investment funds. One response of these institutions to their capitalization has been to invest conservatively, usually through debentures, in order to assure a regular income stream. The other has been to make equity investments and run the risk of going broke, which several SBIC's have. In neither case is the statutory function, for which these institutions have been granted special borrowing rights, been carried out.

3) The use of general tax revenues to pay off the bonds issued in behalf of CDFC is justified on two counts:

- a) It matches the sources of costs and prospective benefits. In the long run, it is hoped that the increased employment provided by CDFC-financed enterprises will generate benefits to the general fund in terms of increased tax collections and decreased welfare payments.
- b) It matches costs and benefits on the time dimension. Debt service costs will be paid over a period of 20-30 years, and the benefits described above should accrue over a similarly long period.

### III. USES OF FUNDS/OPERATIONS

#### A. General Powers

In order to tailor its services to the specific financial

needs of each project, the CDFC Board has been granted a panoply of financial powers and broad discretion over their use. CDFC may finance all costs of a project which the directors deem recoverable and necessary to the carrying out of the act's purpose. Thus, money to finance market surveys, product planning, early staffing and working capital could be advanced as well as more traditional finance secured by physical assets. CDFC may also provide directly or pay for technical advisory services to the venture. CDFC may advance such finance in the form of purchase of equity, convertible debt instruments or straight loans. It may formulate and readjust the terms for loan repayment or payment of dividends to accommodate the venture's cash flow as it evolves. CDFC may also acquire, hold and transfer real property where necessary to further the establishment or expansion of an enterprise.

Although CDFC has the statutory flexibility to advance money on longer and less onerous terms than private financial institutions of any type, it is constrained to seek some return on its investments if it is to continue operations. The way in which financial returns must be realized and the constraints thus imposed on CDFC financing operations are discussed in section D.

B. Targeting

There are two sets of targeting requirements involved in the statutory directions to CDFC investment activity: one defines eligible sponsoring agencies as Community Development Corporations (CDCs) not dissimilar to regional and local development corporations in Alaska; another defines eligible geographic areas.

Targeting to CDCs - All CDFC financing is advanced to CDCs, which then transfer the funds to the ventures. The statutory requirements for eligible CDCs have been formulated to assure that they are accountable to their constituents.

In the legislation, a CDC is defined as, "a quasi-public, non-profit corporation organized under the General Laws to carry out certain public purposes and with by-laws providing that:

- 1) it is organized to operate within a specific geographic area coincident with existing political boundaries;
- 2) that membership in the corporation shall be open to all residents of said area who are eighteen years or older;
- 3) that at least a majority of its board of directors shall be elected by the full membership with each member having an equal vote;

- 4) that the by-laws of the Community Development Corporation shall provide that any other directors be either appointees of elected state or local government officials or appointees of other non-profit organizations having as a purpose the promotion of development in the designated geographic area;
- 5) that said elections shall be held annually for at least one-third of the members of the Board of Directors so that each elected director shall serve for a term of at least three years;
- 6) that the designated geographic area shall be consistent with some existing, or combination of existing, political district, provided that the aggregate population of such geographic area shall not exceed one hundred and fifteen thousand people based on the most recent appropriate census."

In addition to these formal requirements, observers and supporters of the bill have suggested that several further criteria be incorporated into CDFC's operating guidelines.

These include:

- 1) The organization should be active in the community prior to CDFC funding, although not necessarily in economic development. Involvement in social service

provision or political organizing provides a community group with the opportunity to develop stable leadership, strategy and visibility that may contribute to its ability to manage a subsidiary or ensure community support of a sponsored venture. Evidence of prior activity also indicates that the CDC is not a "front" set up by private interests merely to take advantage of CDFC financing. Finally, prior experience provides the CDFC Board with some basis for judging the competence of the CDC's management to oversee the use of state funds.

- 2) There should be paid management and/or professional staff responsible to the CDC board. This might insure continuity and stability of venture oversight or management.
- 3) The leadership of the CDC should have demonstrated initiative in soliciting the participation of its constituents. Evidence of this activity might include frequency of public meetings, the publication of newsletters and other publicity efforts.

Targeting to Depressed Areas - The CDFC legislation requires that CDFC operate exclusively in depressed areas. The legislation defines a target area as "any area in which, according to the

most recent government census, the household income is reported to be at least 15% lower than the reported income for the Boston standard metropolitan statistical area" or "any contiguous area in which the board of directors of the particular CDC finds and publishes in accordance with statistical criteria previously established by the CDFC that substantial conditions of blight, economic depression, and widespread reliance on public assistance exist in said area."

CDFC is perhaps the only government financial intermediary that places restrictions on the location of the projects it will finance on the basis of descriptive statistical criteria. On the other hand, these criteria are not unambiguous. There is no specific measure of "average household income" in the 1970 census. The two closest approximations are "mean family income" and "median family income." (The median is a preferred descriptor of income distributions since it is not subject to bias stemming from concentrations in the low or high ends of the distribution.) The lists of eligible towns differ depending on which measure is used, and the preferred "median" excludes some of Massachusetts's most visibly depressed towns.

However, an area does not have to be a city or a town in order to qualify for CDFC financing. The legislation states that a CDC must be located in a target area that is consistent with

political boundaries." This might be a state representative district, a ward or even a precinct. Many cities that do not qualify do have sections within them that do.

C. Balancing the Interests of the Parties in Individual Projects

Any CDFC-financed project involves three organizations with different, and in some cases conflicting, aims.

Management of the venture wishes to obtain financing on the favorable terms CDFC can offer. It can be assumed that they wish to give up as few of the operating prerogatives and financial returns of conventional management as possible.

Members of the CDC want to be able to exert sufficient control over the venture to assure that the jobs it offers CDC constituents are as well-paying, secure and satisfying as possible. If the CDC itself is able to take an equity position in the venture, it will want to realize a return on its investment in order to finance its own operations or further investments.

CDFC wants to assure that the purposes of the bill are met by its investments and that it can recover its investment plus sufficient surplus to finance further operations.

All of these claims are on the same pool of funds; revenues generated by the venture.

The key to balancing these claims is the form of participation the CDC takes in the project. The six possible forms allowed by the legislation are as follows:

- a) The project is conducted by a wholly owned subsidiary of the CDC.
- b) The CDC owns a majority of the voting stock of the corporation or other organization conducting the project.
- c) The CDC owns a majority of the capital stock of the corporation or other organization conducting the project.
- d) The project is conducted by a limited-dividend corporation or other association organized under the laws of the Commonwealth to provide public benefit and which exists for a public purpose.
- e) The project is conducted by a non-profit corporation including local development corporations organized under the Small Business Act.
- f) In all other cases, adequate provision is made for reporting to the CDC, and that the CDC must approve all major transactions including but not limited to any sale, merger, dissolution, the sale or issue of substantial amounts of stock and corporate reorganization.

No one form of participation will be suitable or preferable in all cases. Particular circumstances will differ from venture to venture and CDFC will have the flexibility to consider each deal separately. In projects conducted under clauses d and e below, the forms of participation are determined by the statutes which govern federal and state programs. We focus on two types

of participation: the wholly owned subsidiary (form a) and the joint venture between a CDC and a private entrepreneur (forms b, c and f). The national CDC experience indicates that both joint ventures and wholly owned subsidiaries can be viable vehicles for economic development. There are different costs and benefits to the various parties from both.

Wholly Owned Subsidiaries: A wholly owned subsidiary requires that the CDC provide or hire its own management. This could limit the resources available to other activities in the community. However, by undertaking the entire financial and managerial responsibility for a venture, the CDC could develop considerable management skills, produce a product useful to its constituents, control the labor practices of the venture and retain all earnings for other CDC activities. The fact that a venture is a wholly owned subsidiary is no guarantee that the company will contribute to community goals. There have been CDC subsidiaries which have provided few benefits to local residents. Therefore, CDCFC will need to be certain that adequate safeguards of community interests are written into any investment agreements it underwrites.

Joint Ventures with Majority CDC Ownership: A joint venture requires much less CDC staff time and in-house expertise than a subsidiary. However, it also generates less earnings for the CDC and allows the CDC less control of the venture's activities. On the other hand, the prerogatives and returns given up by the CDC are generally appropriated by the venture's management, a situation which should leverage more watchful and energetic private control of the enterprise.

Forms b and c in the legislation provide for joint ventures in which the CDC owns a majority of either the voting or the capital stock. This strong CDC ownership position and the influence implied by that ownership may be sufficient to represent and protect the community's interests. The CDC would be able to share in the benefits--both earnings and employment--if the venture succeeds. Similarly, the CDC can protect the interests of the community if the venture does poorly. For instance, the CDC could determine the distribution of labor cut-backs and the proceeds from the liquidation of assets.

Joint Ventures with Minority CDC Ownership: There may be cases in which the CDC is willing to assume a minority ownership position in the venture (form f) in return for substantial employment or other benefits. In those cases, the CDC's interest can

be protected by including specific legally binding requirements in the agreement between the CDC and the entrepreneur. Examples of these requirements are as follows:

- 1) The venture must obtain the express written approval of the CDC before undertaking any expansion of operations outside the local area and before altering any of the Articles of Incorporation or By-laws.

- 2) The management agree to make reasonable efforts to hire and promote local unemployed people as long as the quality of work was not sacrificed.

It is clear that any agreement between a CDC and the venture it sponsors will require compromise by both parties, especially in regard to managerial prerogatives. It is important that CDCFC ensure that the extent of each party's prerogatives is stated as explicitly as possible in the documents of the transaction.

A final issue is the financing of the CDC's equity position if it does not have internally generated funds to purchase it outright. The functions and appropriate rewards to CDCFC and the venture management are those of the conventional financier and entrepreneur. The CDC's presence can appear to be a legal formality (to assure the publicness of the expenditure) and a political necessity (to assure that constituents and local

political leaders feel they are being involved in the expenditure of community resources). What economic justification is there for CDFC subsidizing the CDC's equity participation?

First, the CDC may offer services in packaging the deal and mobilizing community support for the venture which will accrue to the venture as pecuniary benefits. Second, the possibility of monetary returns may induce the CDC to monitor the venture's financial and social performance vigorously, helping to assure CDFC that its objectives are being accomplished. One proposal for providing this equity position is to award the CDC a "finder's fee" of 5-10% of the venture's returns, depending on the CDC's role in assembling the deal.

D. Constraints on Uses of Funds Caused by Sources

The Board's investment decisions are constrained primarily by CDFC's capital structure. For all intents and purposes, CDFC's original \$10 million bond authorization is its entire, non-renewable capitalization. The institution may seek to borrow or issue bonds to finance further operations, but here they would be constrained by market perception of the quality of the assets--the ventures--which would generate the repayment stream.

The only reliable way in which CDFC could prolong its operations is to recover its equity investment. It may sell the securities of the ventures it holds. The CDC, by statute, holds the right to first refusal for any sale of securities of the venture it sponsors. If, as is most likely, the rate of return on the ventures is below the conventionally marketable level--say 14-16%--CDC's will be the major secondary market for these securities.

Even if CDFC realizes no capital gain or some loss on these sales, in selling its interests to CDC's it will be fulfilling one of its secondary objectives, "to enhance capital ownership in depressed areas."

CDFC may try to make part of its stream of investment returns more predictable by providing financing in the form of debt or warrants. These are cash flow problems which can only be worked out as the program's operations evolve.

#### IV. MANAGEMENT

The nine-member CDFC Board of Directors is responsible for all investment decisions. Three of these members are state cabinet secretaries. The other six are gubernatorial appointees serving staggered terms of five years. Two are to be individuals experienced in investment finance, three are to be representatives

of CDCs from eligible target areas and the final member is to represent organized labor. It is important to notice that all interests involved in any individual CDFC deal are represented on the Board.

The staff, whose number will be determined by the volume of business CDFC receives or generates is headed by a President. This designation for the chief staff officer was chosen over "Executive Director" in order to reinforce the fact that CDFC has been designed as a business enterprise, not a social service organization. The staff will enjoy a great deal of discretion in undertaking the promotional activities necessary to generate financial opportunities and in structuring the terms of individual deals.

#### V. ACCOUNTABILITY

Financial -- CDFC will keep standard financial accounts and will report annually to the state legislature. These reports and the books on which they are based will be audited periodically by state officials. From an operational point of view, CDFC will be held accountable for its financial performance by the constraints imposed by its capitalization. These constraints are described in Section IIID.

Social - The CDFC Board has engaged an accounting firm experienced in the operations of public authorities to design reporting and measurement systems to be used in evaluating the Corporation's progress in achieving its non-financial objectives. The consultants have been charged with designing methods to project employment, both by number and types of jobs to be created by a proposed investment. They are also developing methods by which to estimate a project's impact on tax collections and state expenditures.

Before CDFC money can be advanced to a project, the Board must find that all jobs in the enterprise will be full-time and non-seasonal, pay 150% of the minimum wage and provide medical benefits. Further statutory guidelines may be enacted after CDFC begins operations.

#### VI. EVALUATION

CDFC's proposed operations raise complex financial and political issues. While those issues concerning the nature of its services and targeting have been largely worked out in the CDFC statute, critical problems remain. Despite the pages of required findings and precautions in the bill, CDFC could fail to carry out its mission due to any number of managerial decisions. By investing too conservatively in too few enterprises,

CDFC would merely be displacing private market activity. If investment decisions are overly determined by political considerations and subsequently fail, CDFC will not only shorten its own life but discredit an important and controversial approach to depressed area development.

The program's success is dependent on the ability of individual CDC's to use the availability of CDFC funding to leverage the cooperation of private business ventures. The history of such attempts is predominantly one of failure with a few encouraging exceptions. One of the lessons of this experience has been that new community-based enterprises often require technical assistance if they are to succeed. The Massachusetts state government has so far made no explicit provisions for providing such services to CDFC-financed ventures. Criticism of the program from community groups has focused on this point.

Equally important for success will be the CDFC's ability to manage its limited financial resources. Choices in this matter, however, will largely be determined by the success of the ventures in which CDFC invests.

VII. RELEVANCE TO THE ALASKA PERMANENT FUND

Purposes - CDFC is offered as an example of a program designed to provide community development finance to depressed areas. In this regard, the two most important points of the CDFC experience are 1) that the program design was based on an analysis of the economic problems of depressed areas in Massachusetts and 2) that provisions for targeting investment, based on this analysis and the experience of similar efforts, were built into the CDFC statute.

Capitalization - CDFC's lump sum financing by general obligation bonds of the state allows it the flexibility to provide financing in a timely manner on terms suited to the individual enterprise. This form of financing also imposes the discipline of a finite pool of funds. The corporations' investments must generate a return if it is to continue operations.

Uses - The current draft of the Alaska Permanent Fund statute is seriously flawed in that it does not permit equity investments in community development projects. The long experience of CDCs in the United States demonstrates that this type of finance is necessary if community-based enterprises are to succeed.

Management - The need to balance the political interests involved in CDFC's operations is reflected in the composition

of the Board, which includes representatives of the state, the financial community and CDCs.

Accountability - Accountability for operations such as CDFC's requires, first, a set of reporting and measurement procedures to evaluate performance along financial and social criteria. Reporting conventions and criteria exist by which to judge financial performance, and CDFC has begun to develop similar procedures for judging performance on social criteria. Accountability also requires effective sanctions to unsatisfactory operations. In the case of financial performance, unwise or wasteful performance is kept in check by CDFC's finite (and rather small) capitalization. Effective sanctions in response to unacceptable performance on social criteria have not yet been developed beyond the required findings necessary for investment disbursal.

## D. REGIONAL ECONOMIC DEVELOPMENT

EUROPEAN INVESTMENT BANK  
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### INTRODUCTION

The European Investment Bank (EIB) was established in 1958 by the Treaty of Rome, the charter of the European Economic Community. It is an autonomous, publicly-owned financial institution whose primary function is to lend long-term to projects promoting the balanced development of the member economies and of the Community as a whole. The Bank also guarantees a small number of loans each year.

### I. PURPOSES

#### Statutory Goals

According to its statute, the EIB's purpose is to contribute to the "balanced and steady development of the common market" by lending to:

- a) projects for developing less developed regions;
- b) projects for rationalizing industries or for developing new activities called for by conditions arising from the establishment of the Common Market, where these projects are of such a size or nature that they cannot be entirely financed by the various means available in the individual Member States; and/or
- c) projects of common interest to several Member States which are of such a size or nature that they cannot be entirely financed by the various means available in the individual Member States.

Evolved Management Goals

These were the goals of the bank at its inception. For all practical purposes, the bank now allocates its funds among:

- projects in less developed regions of the Community (e.g., southern Italy, Ireland, northern Denmark, western France);
- projects in industrial regions where redevelopment and investment in fresh activities is called for by the decline of established industries;
- projects of special interest for the development of the Community as a whole (e.g., advanced technology, and especially energy supply and distribution systems);
- infrastructure projects of common interest to several Member States such as railways, motor ways and telecommunications; and/or
- projects involving technological and economic cooperation between enterprises in the different member States.

EIB has been directed by the European Commission, its parent organization, to assist regional development efforts, but the Bank may exercise its discretion in how to do so. In examining EIB's lending policies, capitalization and operations, we will focus on the mechanisms which facilitate the regional reallocations and employment of capital the bank is able to effect.

### Lending Criteria

EIB sets lending criteria which follow from its position as a multinational, publicly-owned bank which can facilitate specific development projects through the provision of capital. These criteria are:

a) The project must further development of the Common Market. The Bank will finance capital investments which relate to well-defined, economically homogeneous projects, geared to a specific objective which can be obtained in a set period of time.

b) The project must either be implemented within the territory of the EEC or, if outside the territory, be of common benefit to all the members of the Community (e.g., an oil supply facility).

c) The project must, in the case of infrastructure, contribute to increased economic productivity or, in the case of a private enterprise, must offer prospects of a reasonable return on investment.

d) EIB financing should not replace financing available from other, particularly national, sources.

### Eligible Borrowers

a) Public and private enterprises may borrow directly from the Bank provided their project meets the criteria discussed

above. EIB will finance investments by foreign corporations as long as their project is located within the EEC's territory.

b) Banks and other financial institutions may also borrow directly from the EIB to finance loans to enterprises which meet EIB's criteria. In fact, this is the method the EIB uses to make its funds available to small- or medium-sized ventures.

c) Finally, the EIB will lend to autonomous state or regional authorities, such as the German Lander, which retain certain powers under federal systems of national government.

#### Restrictions on Use of Funds

EIB loans may not be used

- a) to finance cash requirements of firms or working capital;
- b) to finance speculative real estate development; and/or
- c) in the case of governmental authorities, to finance state social overhead capital such as health and welfare services.

EIB will not negotiate loans below 1 million UA directly. Its funds are channeled to enterprises with such small capital needs through intermediate institutions under the "global loan program." Direct loans to projects run from 20 to 30 million UA.

Lending Terms

EIB will not lend funds equalling more than 40 percent of the value of the asset to be financed. This policy requires local promoters and financial institutions to share the risks of the enterprise and, hopefully, forces them to bring their detailed knowledge of local conditions to the careful evaluation of the project.

The terms of most EIB loans fall into the seven to twelve year range. In the case of particularly desirable infrastructure projects, it may be stretched to 20 years.

IB requires appropriate security for all its loans. Usually this takes the form of a guarantee of repayment by the state in which the project is located. Other forms of security acceptable to the Bank are:

- a guarantee from a public authority with a good credit rating;
- a guarantee from a major bank, industrial or financial group; and/or
- a claim on specific assets which are liquid enough to cover the outstanding balance at any time.

Interest rates are uniform to all borrowers across several classes of loans, defined by the currency in which they are disbursed and their repayment period.

## II. SOURCE OF FUNDS/CAPITALIZATION

EIB's share (equity) capital is provided by the treasuries of the nine states comprising the EEC. The total amount of subscribed capital and the amount to be contributed by each member is determined by the Bank's Board of Governors. Capital is subscribed in the form of a pledge, a portion of which the members deposit with the Bank. These deposits plus reserves funded by EIB operating surpluses must, under statute, equal 20 percent of pledged capital; this is more than sufficient to meet EIB's debt service should its borrowers be unable to repay loans in the short term.

This "paid-in" portion has ranged from 25 percent to its current level of 15.7 percent of subscribed capital during the 19 years of EIB operations. The balance of the pledge may be called in by the Board of Directors should these funds be needed to meet Bank obligations. Thus, members are permitted free use of the greater portion of their pledge. In 1976, pledged capital amounted to 3.54 billion UA of which 557 million was paid in.

Under its statute, EIB may not have loans or guarantees outstanding in amounts greater than 250 percent of its subscribed capital. In practice, EIB has been considerably more liquid. In 1976, loans outstanding of 5.49 billion UA were held against capital and reserves of 3.96 billion. Total EIB borrowings were

4.72 UA backed by 3.54 billion in equity, for a debt/equity ratio of only 1.33.

EIB maintains this high degree of backing to ensure access, on favorable terms, to European debt markets; its low paid-in/subscribed capital ratio to minimize the burdens of participation to its members. This arrangement seems viable so long as there is no sustained period (several consecutive years) of loan defaults. In that case, EIB would have to rely on its members' ability and willingness to contribute further portions of their subscriptions in order to meet obligations.

Given EIB's financial performance, such a crisis is not likely to arise. During the past seven years, operating revenues have exceeded annual operating expenses by at least 15 percent. Instead of paying out the surplus to the member states as dividends, the EIB internalizes them to supplement its various reserve funds. The growth of these funds is traced in Table 1.

The EIB's ability to transfer its profits into these reserve funds without paying taxes has allowed the funds to grow at an impressive rate. These reserves may replace paid-in capital in accounting deposit requirements. So, even though the Bank is non-profit, it does act to the direct pecuniary benefit of the member nations by using its "profits" as reserves which decrease the need for paid-in capital. Should the reserves get large

Table 1  
GROWTH IN RESERVE ACCOUNTS  
1970-1976

<u>Reserves:</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>
Statutory	57.3	63.7	68.5	97.7	110.0	130.0	150.0
Loan Risk	56.0	64.0	71.0	105.0	118.0	143.9	174.7
Equalization	9.0	9.0	9.0	13.0	13.0	13.0	13.0
Monetary Risk	5.0	5.0	12.5	23.0	29.0	33.5	38.4
Building	2.0	4.0	6.5	11.0	16.0	25.0	45.0
<b>TOTAL RESERVES</b>	<b>129.3</b>	<b>145.7</b>	<b>167.5</b>	<b>249.7</b>	<b>286.0</b>	<b>345.4</b>	<b>421.1</b>