

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 86 / 2

121 SCOMM 9: HOUSE SPEC. COMM. ON PERMANENT FUND 1977-78

VII. RELEVANCE TO THE ALASKA PERMANENT FUND

Purpose: 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 implementaiton 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.

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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:

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- 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 CDCFC 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
Discussion Draft

September 14, 1977
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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
TOTAL RESERVES	129.3	145.7	167.5	249.7	286.0	345.4	421.1

enough, the Bank may be able to order increased subscriptions without calling in any capital.

The European Investment Bank acquires virtually all its loan funds on the European bond market. Although the Bank resorts mainly to the European market, it has been able to sell its debt internationally, particularly in the United States and Japan.

The issues range from a low of 6.3 million UA to a high of 239.1 million, averaging from 20 to 40 million. About 40 percent of these issues are placed privately. Since 1974, the Bank has raised more than 800 million UA per year through the sale of bonds. Virtually all the public issues are underwritten by syndicates composed of European commercial and savings banks.

The interest rates the EIB must pay are in line with its strong backing. Rates rose from about 7.0 percent in 1972 to nearly 10.0 percent in 1974, and has since declined. In fact, the Bank has just adjusted its uniform lending rates downward to reflect this movement.

The most noteworthy aspect of the EIB bonds is that they are all long-term. There are a few occasions where the Bank borrowed for less than seven years. Most issues are for at least 10 years, with some going for as long as 15 to 20. The lengths of these liabilities match that of the productive capacity of the assets EIB finances--capital intensive plant and infrastructure.

Table 2
FUNDS RAISED UP TO AND INCLUDING 1976

Year	Issues				Participations by third parties in EIB loans (mil. UA)	Funds raised (mil. UA)
	Number	Amounts (mil. UA)				
		Private issues	Public issues	Total		
1961	3	7.6	13.8	21.4	-	21.4
1962	2	-	32.3	32.3	-	32.3
1963	3	8.0	27.2	35.2	-	35.2
1964	5	13.5	53.3	66.8	-	66.8
1965	4	-	65.0	65.0	-	65.0
1966	6	24.0	114.5	138.5	-	138.5
1967	8	40.0	154.5	194.5	-	194.5
1968	13	112.5	100.0	212.5	-	212.5
1969	9	63.7	82.3	146.0	-	146.0
1970	7	66.6	102.3	168.9	-	168.9
1971	20	208.0	204.9	412.9	-	412.9
1972	19	133.4	328.6	462.0	17.5	479.5
1973	22	207.0	401.0	608.0	4.3	612.3
1974	16	704.2	121.3	825.5	-	825.5
1975	26	318.6	495.1	813.7	17.0	830.7
1976	17	221.0	510.9	731.9	17.0	748.9
1961-1976	180	2128.1	2807.0	4935.1	55.8	4990.9

The EIB has enviable access to the European bond market and is beginning to offer its issues in the American and Japanese markets. The burgeoning growth of its demand for funds, shown in Table 2, has not compromised this access. The benefits of timely access to funds, long repayment terms and favorable interest rates derived from EIB's strong backing are transferred to its borrowers.

III. USES OF FUNDS/LENDING OPERATIONS

By Sector

Over EIB's operating history, its loans, in terms of money volume, have been concentrated in infrastructure projects, predominately in energy, transportation and telecommunications. EIB has made about four times as many loans to industrial sectors as to infrastructure projects. However, total money volume of these loans was only about half of that devoted to infrastructure. Manufacturing projects have received the preponderant number of industrial loans. Table 3 summarizes this allocation pattern and Tables 4 and 5 give more complete breakdowns of historical and current activity.

By Objective

In reporting its loan activities by statutory objectives, EIB

Table 3
EIB FINANCING, 1976 AND TOTALS 1958-1976

Sector	1976			1958-1976		
	#	Amt. (mil. UA)	% of Total	#	Amt. (mil. UA)	% of Total
<u>Infrastructure</u>						
Agriculture	1	30.1	2.8	8	123.9	2.0
Water Supply	6	74.3	6.8	19	220.9	3.7
Transport	6	107.2	9.9	60	1001.2	16.7
Telecommunication	8	200.1	18.4	38	853.7	14.2
Other	-	-	-	2	16.3	0.3
Energy	18	376.5	34.7	109	1764.2	29.4
Total	39	788.2	72.6	236	3980.2	66.3
<u>Agriculture, Industry and Services</u>						
Agriculture	-	-	-	5	7.5	0.1
Industry	120	297.8	27.4	874	2004.0	33.4
Services	-	-	-	7	13.7	0.2
Total	120	297.8	27.4	886	2025.2	33.7
<u>Grand Total</u>	159	1,086	100	1122	6005.4	100.0

All figures in millions UA.

Table 4

SECTORAL BREAKDOWN OF FINANCING PROVIDED WITHIN THE COMMUNITY, 1958-1976

Sector	Number		Amount (million u.s.)		% of total
	Total	of which global loan allocations	Total	of which global loan allocations	
Infrastructure	236		3 980.2		66.3
Agricultural development	8		123.9		2.0
Water supply and distribution	19		220.9		3.7
Transport	60		1 001.2		16.7
Railways	14		221.8		3.7
Roads, bridges and tunnels	34		587.9		9.8
Shipping and inland waterways	8		144.9		2.4
Airlines	3		41.7		0.7
Other	1		4.9		0.1
Telecommunications	38		853.7		14.2
Other	2		16.3		0.1
Energy	109		1 764.2		29.4
(Production)	(77)		(1 243.7)		20.7
Nuclear	29		620.2		10.3
Thermal power stations	13		138.2		2.3
Hydroelectric and pumped storage plant					
Development of oil and natural gas deposits	17		245.5		4.1
Solid fuel extraction	16		223.1		3.7
(Transport)	2		16.7		0.3
Transmission lines	(32)		(520.5)		(8.7)
Gaslines and oil pipelines	6		65.8		1.1
	26		454.6		7.6
Agriculture, industry and services	886	553	2 025.2	262.4	33.7
Agriculture, forestry, fishing	5	4	7.5	2.0	0.1
Industry (2)	874	548	2 004.0	255.9	33.4
Mining and quarrying*	18	15	12.8	6.1	0.2
Metal production and semi-processing*	77	31	558.4	22.5	9.3
Construction materials*	63	39	107.2	20.1	1.8
Woodworking	39	37	19.2	13.2	0.3
Glass and ceramics	25	13	33.2	6.9	0.6
Chemicals*	97	25	457.2	12.1	7.6
Metalworking and mechanical engineering	153	119	166.9	52.9	2.8
Motor vehicles, transport equipment	32	19	139.5	8.3	2.3
Electrical engineering, electronics	47	32	74.4	18.4	1.2
Foodstuffs	132	95	159.4	46.3	2.7
Textiles and leather	65	53	37.2	23.2	0.6
Paper and pulp*	28	23	29.6	10.3	0.5
Rubber and plastics processing	41	30	58.7	12.7	1.0
Other	14	11	6.9	3.9	0.1
Building - civil engineering	4	4	1.7	1.7	—
Global loans	39	—	141.6(3)	—	2.4
Services	7	3	13.7	1.4	0.2
Tourism	5	3	9.3	1.4	0.1
Research and Development	2	—	4.4	—	0.1
Grand Total	1 122	553	6 005.4	262.4	100.0

(1) See note 4 to Table 2, page 23.

(2) Of which basic industries (marked with an asterisk): 1 165.2 million u.s.

(3) This amount represents the unallocated portion of the global loans.

Table 5
SECTORAL BREAKDOWN OF FINANCING PROVIDED WITHIN THE COMMUNITY, 1976

Sector	Number		Amount (in million E.C.U.)	
	Total	of which global loan allocations	Total	of which global loan allocations
Infrastructure	39		788.2	72.6
Agricultural development	1		30.1	2.8
Water supply and distribution	6		74.3	6.8
Transport	6		107.2	9.9
Railways	1		19.7	
Shipping and inland waterways	5		87.5	
Telecommunications	8		200.1	18.4
Energy	18		376.5	34.1
(Production)	(11)		(247.6)	
Nuclear	3		111.3	
Thermal power stations	2		33.4	
Hydroelectric and pumped storage plant	2		42.1	
Development of oil and natural gas deposits	3		60.5	
Solid fuel extraction	1		3.3	
(Transport)	(7)		(128.9)	
Gaslines and oil pipelines	7		128.9	
Agriculture, industry and services	120	86	297.8	47.5
Industry (1)	120	86	297.8	47.5
Mining and quarrying*	3	3	2.2	2.2
Metal production and semi-processing*	21	11	103.3	8.3
Construction materials*	8	7	7.2	3.6
Woodworking	4	3	3.8	1.4
Glass and ceramics	2	1	4.7	0.6
Chemicals*	15	8	23.7	4.2
Metalworking and mechanical engineering	14	13	3.7	3.1
Motor vehicles, transport equipment	4	3	17.1	2.0
Electrical engineering, electronics	9	8	6.3	4.6
Foodstuffs	16	15	7.7	6.0
Textiles and leather	5	5	4.4	4.4
Paper and pulp*	3	3	1.3	1.3
Rubber and plastics processing	7	4	11.9	2.1
Other	1	1	0.1	0.1
Building -- civil engineering	1	1	0.6	0.6
Global loans	7	—	13.7 (2)	—
Grand Total	159	86	1 006	100.0

(1) Of which industries (marked with an asterisk): 218.7 million E.C.U.
(2) Difference between the sum of the 7 global loans granted in 1976 (€1.2 million E.C.U.) and the sum of the allocations from other than global loans (€2.5 million E.C.U.)

consolidates its three mandates (see page 1) into two classifications: projects for "regional development" and projects of common interest to several member countries. Some projects cannot be unambiguously classified and are counted in both categories. About 18 percent of all projects undertaken by EIB since it began operations have been so counted. Keeping that in mind, some 76 percent of EIB's 6 billion UA in loans have been justified on the basis of furthering the development of less developed regions. Projects of interest to several countries have been mostly in the fields of energy and transportation. Table 6 shows a more complete breakdown of loans by objective.

Global Loans

The management of EIB recognizes that small enterprises are the dominant type of industrial organization in labor-intensive sectors. These firms seldom have capital needs which match EIB's 1 million UA direct lending minimum. However, they are an important source of employment and, in certain sectors and areas, an efficient form of organization.

In order to meet these firms' needs, EIB lends to intermediate institutions, usually regional development authorities who in turn lend to small firms. The authorities are allocated a given amount and are given a finite period in which to use the funds.

Table 6
FINANCING PROVIDED WITHIN THE COMMUNITY IN 1976 AND FROM 1958 TO 1976
Breakdown by Economic Policy Objective

Objective	1976		1958-76 (*)	
	million u.s.	%	million u.s.	%
Regional development (1)	820.0	100.0	4 558.6	100.0
Belgium	17.9	2.2	75.1	1.6
Denmark	9.1	1.1	35.7	0.8
Germany	9.2	1.1	366.4	8.0
France	60.1	7.4	846.0	18.6
Ireland	57.4	7.0	164.1	3.6
Italy	347.1	42.3	2 200.6	48.3
Luxembourg	—	—	4.0	0.1
Netherlands	30.4	3.7	70.5	1.5
United Kingdom	288.8	35.2	799.2	17.5
Common interest to several Member Countries (2)	438.6	100.0	2 470.1	100.0
Energy	376.5	85.9	1 490.3	60.3
Thermal power stations	30.4	8.1	30.4	1.2
Hydroelectric and pumped storage power stations	42.1	11.0	141.4	5.7
Nuclear	111.5	29.4	598.6	24.2
Development of oil and natural gas deposits	60.5	16.2	258.6	10.5
Solid fuel extraction	3.3	0.9	77.9	3.1
Gaslines and oil pipelines	128.9	34.2	153.4	6.2
Transport	16.4	3.7	589.6	23.9
Railways	—	—	103.9	4.2
Roads and bridges	—	—	423.9	17.2
Shipping	16.4	3.7	40.4	1.6
Airlines	—	—	6.5	0.3
Other	—	—	4.9	0.2
Telecommunications	—	—	30.5	1.2
Other infrastructure	—	—	16.3	0.7
Protection of the environment	—	—	18.0	0.7
Industrial cooperation	25.9	5.9	213.6	8.7
Research	—	—	2.7	0.1
New technology	19.7	4.5	19.7	0.8
Modernisation and conversion of undertakings (3)	—	—	89.4	3.6
<i>DEDUCT to allow for duplication in the case of financing justified on the basis of both objectives - 172.6</i>				
Total	1 086.0		6 005.4	

(1) Article 130 (a) and (b) of the Treaty of Rome.

(2) Article 130 (c) of the Treaty of Rome.

(3) Article 130 (b) of the Treaty of Rome; these projects, classified as projects of common interest, have now been included under 'Common interest to several Member Countries' by way of simplification and in view of the modest amount involved. In the 1976 Annual Report, 1976-77, the total amount of 133.9 million, of which 99.5 million, relating to projects included among 'Common interest to several Member Countries', has now been deducted to avoid duplication: 133.9 - 99.5 = 34.4 million.

Projects so financed must meet EIB criteria and be located in a specified area, usually one of the less-industrialized regions. If suitable projects cannot be found within the specified time, the loan money is restored to EIB.

In the nine years of this program's operations, 404 million UA have been allocated to various regional authorities, of which 262.4 million has actually been disbursed. EIB has withdrawn from participating national and regional financial intermediaries 11 of the 38 global loans it has made in the last eight years. Apparently these institutions were unable to find suitable investments, and EIB was intent on enforcing its lending criteria. The average size of the loan has been 474,000 UA, and most have been concentrated in depressed areas of Italy, France and Germany. Although the global loan program represents a sound concept, allowing small firms access to an expanded capital market, it comprises a very small part of EIB's total lending activity--about six percent in 1976.

The overriding impression left by this review of EIB's operations is that the Bank takes a regional approach to its lending--acknowledging the interaction of public investment and private productivity. It then cooperates with national and regional level public and private financial institutions to provide capital to directly productive enterprises.

This pattern has been particularly evident in EIB's operations in the Mezzogiorno (southern Italy), one of the most depressed regions in Europe. Over the years 1961-1972, the Bank provided 7.5 percent of all investment capital coming into the region, concentrating its investments in roads, telecommunications, energy distribution systems and capital intensive industry. I cooperated with the World Bank and Italian public and private financial institutions in encouraging coordination and planning, providing capital to finance these plans where Italian sources were insufficient.

IV. MANAGEMENT

There are three basic levels of administration at EIB. The Board of Governors is responsible for strategic decisions; ensuring that statutory directives are carried out, designating levels of subscribed capital, authorizing changes in policies conditioned on movements in exchange rates, etc. Each member state appoints one Governor. A majority of the Board, representing at least 40 percent of subscribed capital, is necessary to carry motions.

The Board of Directors is responsible for all lending and borrowing decisions. They are appointed by the Board of Governors and have renewable terms. The number of directors from each

member state is set by statute, and the larger states, France, Germany, the United Kingdom and Italy are most heavily represented.

The Management Council, headed by a President, is responsible for seeing that the professional staff carries out the Director's decisions. The EIB retains agents and industry specialists in all member states to evaluate and monitor loans. Loan agreements are executed under the national laws of the state in which the project is located.

V. ACCOUNTABILITY

There is a minimal formal structure of reporting and sanctions by which the Board of Directors, EIB's operating decision-makers, are held responsible for their work. The Board of Governors, acting on behalf of the executive of their respective states, must approve the Directors' Annual Report. If performance is not satisfactory, Directors may be dismissed. States may further effectively censure Bank decisions by refusing to subscribe more capital. But all these measures would operate only in extreme cases of mismanagement or violation of statutory directives. In the important daily work of lending and borrowing, the Directors seem to have a free hand.

VI. EVALUATION

EIB is an operating arm of the European Commission, the central planning and policy-making body of the European Community. We have seen that EIB's major operations have been concentrated in aiding efforts to develop regions characterized by lack of industrialization (the Italian Mezzogiorno) or inefficient industries declining under the force of increased competition stemming from the lowering of trade barriers (Belgian coal regions).

The European Commission has not yet developed a Community-wide policy for coordinating the planning and finance of economic development in subnational regions. In such efforts, national authorities must take the initiative and be responsible for overseeing or executing the planning, financing and administering activities involved. Where the financing of costly industrial plant or infrastructure is involved these authorities may not be able to raise sufficient capital in a timely manner. The private or quasi-public financial systems of the several members states are set up primarily to service national needs. As yet there exists no institutional mechanism to coordinate these systems to provide the massive amounts of capital necessary to finance large-scale development projects.

EIB is designed to do just this. With its solid equity backing, it can raise large amounts of capital quickly in the inter-

national bond market on the terms necessary to finance long-lived assets such as capital intensive physical plant and infrastructure. Because EIB borrows and lends in stable currencies, some promoters in countries with weaker currencies have been unwilling to take EIB loans. They would suffer a loss if their national currency, in which they would receive the revenues generated by the asset financed, were devalued in relation to the currency in which they would have to pay off the loan. This risk is offset in many cases by the favorable interest and repayment period terms on which EIB can offer its funds. For example, Italian firms and authorities have been EIB's largest borrowers.

Real economic factors affecting a borrower's potential performance are not susceptible to EIB influence. Long and concerted effort is needed, for instance, to improve infrastructure, labor productivity and the stability of the regional population in the Mezzogiorno before it becomes a suitable location for the capital intensive facilities the EIB prefers to finance.

The Bank appears to take these considerations into account in pursuing its policies. First, it lends to infrastructure projects, where the ability to mobilize large amounts of capital is critical. Second, it will not lend more than 40 percent of the value of an asset. In a fact, its participation has been substantially less in most cases. EIB seeks to provide the incremental

amount of financing needed to implement a project which already enjoys sound national managerial and financial backing. Financial responsibility is thus not transferred from local government and business organizations whose political and economic fortunes are closely tied to the success of the projects. Unfortunately, EIB's performance, in terms of allocating capital to efficient uses, cannot be inferred from its financial success. Most of its loans are secured by guarantees from national governments. The performance of its borrowers is not reported in central documents. Due to the guarantees, poor performance does not show up as a default rate. The pattern of financial responsibility and ultimate accountability therefore corresponds to the European Commission's as yet decentralized regional development policy.

VII. RELEVANCE TO THE ALASKA PERMANENT FUND

Purposes: The primary way in which the European Investment Bank is relevant and important to the Alaska Permanent Fund is in the strong regional orientation of the European Investment Bank, where 63 percent of its portfolio has been invested in the development of lesser developed regions of Europe. It is important to note that although the vast percentage of its resources has been employed in regional development, only six percent of those resources have been employed through the "global loan program." The importance of that point to the Alaska Permanent Fund is that the global loan program would be most analogous to a regionalized effort in which the regional projects of the Alaska Permanent Fund were implemented through the regional and local community development corporations. This matter bears further consideration.

It is also worth noting that the European Investment Bank rarely takes more than 40 percent positions in its loans, to ensure that the risk and responsibility are borne by both local financial institutions and the private marketplace. Analogously, in Alaska, this is the intent of the present language of the Alaska Permanent Fund and in the case of regional development suggests the wise course of joint venturing with the

regional corporations and with the private marketplace in all regional loans.

Sources and Uses of Funds: There are three principal matters concerning the European Investment Bank's capitalization which are worth noting for the design of the Alaska Permanent Fund:

First, all of the earnings of the European Investment Bank have been retained for reinvestment in strengthening the capital structure of the European Investment Bank. This is a different use of retained earnings than those of either the Alaska, Inc. proposal or a proposal to use the earnings for General Fund purposes at some future date.

Second, with a strong equity base the European Investment Bank has been very successful in borrowing the substantial amount of its capital needs in European and worldwide private capital markets. This is a very important model for the Alaska Permanent Fund. In designing the Alaska Permanent Fund the \$2 to \$4 billion of oil revenues should be viewed as a paid-in equity capital base for the Alaska Permanent Fund against which it can then borrow for its lending purposes on world markets.

Third, the European Investment Bank has a nice balance of its sources and uses of funds. The majority

of the European Investment Bank's borrowings in world capital markets are for seven to ten years, to support expansion capital lending running seven to ten years. The longer infrastructure loans of 15 to 20 years are then in turn supported by borrowings in the international capital market of from 15 to 20 years.

Fourth, all of the infrastructure investing is backed by a government guarantee. In my judgment, it would be much more efficient for Alaska to do the majority of its infrastructure financing through the Permanent Fund, but backed by general revenues.

Management and Accountability: The management and accountability issues of the European Investment Bank are less relevant to the Alaska Permanent Fund.

E. AN ALASKA CENTRAL BANK OWNED BY LOCAL COOPERATIVE DEVELOPMENT BANKS

1. BRITISH COLUMBIA CENTRAL CREDIT UNION
Discussion Draft

September 14, 1977
Page 117

I. PURPOSES

The British Columbia Central Credit Union is a private, federally-chartered financial institution owned by the credit unions of British Columbia. Established in 1944, its major function is that of a reserve bank for British Columbia's 178 credit unions. In 1970, it merged with the B.C. Credit Union League, a promotional and educational institution and has since provided a wide range of financial and administrative services to its members. Credit unions require most of these services in order to compete with other types of financial institutions for the deposits and loan business of British Columbia savers. In general, credit unions are too small to undertake the capital expenditure and staff requirements necessary to provide these customer services efficiently.

Credit Unions in British Columbia - Credit unions are deposit institutions offering a full range of customer services. Their investments tend to be concentrated in home mortgages, consumer credit and property development. They are distinguished from banks in that they are cooperatively owned by their depositors, each of whom is entitled to one vote in electing the board of directors and who may participate in membership-management meetings.

All members are required to have a "common bond," a legally construed economic association. These bonds may be of three types: community (those who live or work in a given political jurisdiction serviced by the credit union), associational (e.g., ethnic or church groups) or occupational. About one half of the credit unions in B.C. have community common bonds.

In 1975, there were 178 credit unions with 261 branch offices in B.C. These serviced some 600,000 members, about 23% of the population and composed some 23% of all deposit institution offices in the province. About one half of these offices are located in the greater Vancouver area.

The industry has grown remarkably and become more concentrated in recent years. Since 1971, membership has been growing at a compound annual rate of 11%, assets at 35%. In 1971, there were 217 credit unions holding slightly less than \$500 million in assets. In 1975, the 178 credit unions held over \$1.5 billion in assets, with half of these held by the 15 larger units. (The remaining units are extremely small, median asset size being less than \$70 million.) Credit union assets account for 10% of those held by all financial institutions in the province (20% if corporate business is excluded). Individual units are usually located within communities serviced by commercial banks and are in competition with them for deposits.

Distribution of assets - There has been a sharp rise in the demand for housing in B.C. due to the migration of large numbers of young families. Consequently, the credit unions' assets have become concentrated in home mortgages. In 1971, they composed 62% of the \$400 million in loans outstanding. In 1975, they composed 76% of the \$1,280 million in loans outstanding. Other credit union assets include municipal, provincial and federal government securities and consumer loans.

Liabilities - The main source of funds to credit unions is the deposits of members. Credit unions offer term and demand accounts as well as retirement and home owner savings plans. The latter two types of deposits have grown at a remarkable compound annual rate of over 100% in the past four years. Of the \$1,409 million on deposit in 1975, 36% were in demand and 64% were in term accounts.

Liquidity - Credit unions are required by law to maintain liquidity reserves with a bank, a central credit union or in qualifying federal government securities equal to 10% of deposits shares and borrowings. Virtually all British Columbia credit unions maintain their reserves and surplus in B.C. Central. In recent years, aggregate Loan/Deposit ratios for the industry have exceeded 90%. The credit unions as a whole, then, have

demanded funds from other sectors of the capital market. This borrowing and the cash management involved have been handled by B.C. Central. B.C. Central's functions within the credit union system and its mediating role between the system and the outside capital market is the subject of the following sections.

B.C. Central Operations

Financial - B.C. Central's main financial function is to provide individual credit unions with funds sufficient to meet local loan demand when local deposits prove inadequate. These funds are provided in the following forms:

- non-restricted reserve credit lines equal to 10% of the credit union shares and deposits for use only in meeting any net reduction in shares and deposits due to increased loan demand;
- restricted and non-restricted credit lines to credit unions equal to four to six times a credit union's monthly cash flow for operational purposes. Approved lines of credit under these first two provisions equaled \$262 million in 1975;
- term loans to credit unions to finance office buildings and credit union mortgage loans;

- emergency loans through the Canada Deposit Insurance Corporation.

Actual borrowings by credit unions from B.C. Central have grown rapidly in recent years from \$26.1 million in 1971 to \$91.8 million in 1975, reaching a high of \$108 million in the tight money market of 1974. Credit union credit line and loan requirements are worked out annually in consultation with B.C. Central's financial staff on the basis of financial statements, loan records and cash flow projections.

Credit union deposits are not covered by the Canadian Deposit Insurance Corporation. Insurance of deposits is handled by another central institution, the Credit Union Share and Deposit Guarantee Fund. The Fund is administered by a five member Board of Directors, three of whom serve on the B.C. Central Board. The Fund, which stood at \$13 million in 1975, is capitalized by annual assessment of member credit unions. The Board of the Fund may intercede directly in the operations of individual credit unions experiencing financial difficulties and may grant financial assistance where deemed necessary.

B.C. Central provides other important financial services to its members. These include centralized check clearing, bad debt collection, investment management for retirement and home ownership saving plans and secondary marketing of credit union

mortgages. The last service is another form of increasing member liquidity.

Non-financial services - B.C. Central's most important non-financial service is the provision of on-line teller terminal data processing to handle deposit and loan transactions in local offices. In 1975, this system covered one-half of all credit union offices. The savings in time and cost effected by this system increase credit union ability to compete with other deposit institutions. Other nonfinancial services provided for the most part on a fee basis are economic forecasting, personnel recruitment, printing and supply purchase, collection assistance, data processing and systems development, market research, facilities design and planning, education, advertising and public relations, legal counsel, housing development and travel services. B.C. Central also provides financial services to British Columbia's 108 cooperatives.

II. SOURCES OF FUNDS/CAPITALIZATION

Equity - B.C. Central's major source of equity is the sale of shares to member credit unions. In 1975, members held 6.26 million shares with a par value of \$31.3 million, all of which was paid in to B.C. Central. B.C. Central is required by law to maintain a 10/1 debt/equity ratio. Their debt consists

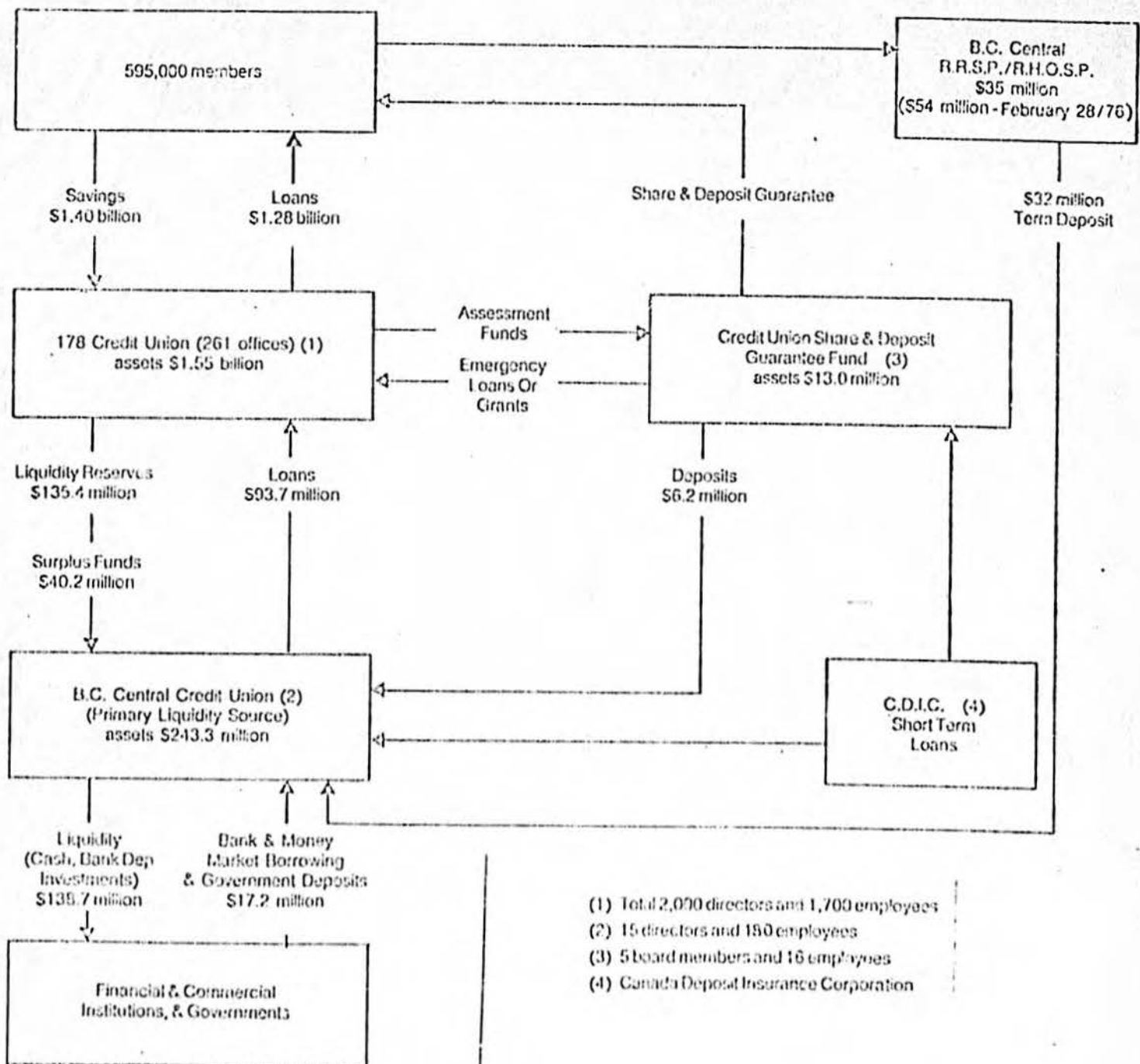
of deposits and borrowings; equity of membership shares, retained earnings and provisions for dividends. Despite rapid recent growth of deposits in the credit union system and consequently in B.C. Central's deposits, its debt/equity ratio was a fairly conservative 5.7 in 1975.

Deposits - B.C. Central's deposits are comprised of the liquidity reserves and surplus funds of its members. As credit union deposits have grown, so has B.C. Central's; from \$49.7 million in 1971 to \$195.8 million in 1975. These developments are illustrated in Table I. B.C. Central also receives one-half the total in the Credit Union Share and Guarantee fund as deposits. In 1975, this amounted to \$6.2 million. Central pays interest on all deposits, which composes its largest capital expense. See Table 3.

Borrowings - Because credit unions' lending activity has outstripped their deposit base in recent years, they have been demanders of funds from sources outside their system. These demands are mediated by B.C. Central. To finance loans to credit unions, B.C. Central borrows from Canadian, US and foreign banks and has established non-restrictable credit lines with three of the largest Canadian commercial banks. Borrowings vary greatly from year to year depending on the level of deposits

FIGURE I
Credit Union Financial System in British Columbia

December 31, 1975



- (1) Total 2,000 directors and 1,700 employees
- (2) 15 directors and 150 employees
- (3) 5 board members and 16 employees
- (4) Canada Deposit Insurance Corporation

TABLE I

Summary Statistics for B.C. Central Since 1971

(000's except where indicated)

	1975	1974	1973	1972	1971
ASSETS					
Liquid Assets	\$127,885	\$ 61,824	\$ 64,408	\$ 50,541	\$35,626
Loans to members	91,823	108,973	56,705	45,371	26,177
Total assets	243,290	193,225	141,721	109,027	67,807
LIABILITIES					
Notes payable	4,500	12,490	13,150	23,519	5,643
Members' Deposits	195,817	145,048	101,685	66,389	49,679
Members' Shares	31,300	24,815	18,317	12,746	9,153
INCOME AND EXPENDITURES					
Income	27,175	19,938	12,768	7,296	4,916
Expenses (financial)	18,941	13,906	8,032	3,962	2,706
Net Income	2,299	1,621	1,103	1,343	1,008
Dividends per share	35¢	35¢	35¢	30¢	30¢
Percent Growth in Assets	25.9%	36.3%	30.0%	60.8%	29.7%