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The European Investment Bank and the Euro

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The EIB was the first financial operator to undertake to convert ECUs into EUROs *at a rate of 1-to-1* with effect from the start of the third stage of EMU.

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C O N T E N T S

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Introduction

The EIB, the European Union's financial institution, provides funding for major projects in the form of individual loans (medium- and long-term loans exceeding ECU 25 million over a period of up to 20 years) which are granted directly to public or private operators or via financial intermediaries. Smaller projects are financed by means of general loans granted to banks or financial institutions operating at regional, national or European level. The EIB provides only partial financing, which may not exceed 50% of the total cost of a project. The Bank therefore complements other European financial institutions (the Structural Funds, etc.) and private operators.

For its market dealings the Bank is able to borrow large amounts at a cost which reflects its AAA rating awarded by international rating agencies, which base their assessments on, in particular:

- the quality of the portfolio;
- the soundness of the balance sheet;
- the involvement of the Member States.

The low cost at which the EIB is able to borrow on the capital markets allows it in turn to grant loans which reflect its excellent standing and its desire to act as a financial intermediary which is not seeking to maximize its profit. The rates charged by the Bank are only a little higher than the rates at which it borrows and this small margin enables it to cover its operating costs.

The EIB's activities on the capital markets are important because of its significance as an institution, which may be accounted for by two main factors:

- the EIB is the European Union's financial institution;
- in terms of the volume of its borrowings the EIB is the world's largest non-sovereign borrower.

The European Investment Bank also has a major role to play in preparing for the introduction of the Euro and it has launched certain initiatives which make it a precursor in the transition to a single currency.

For the record, it should be pointed out that the EIB's institutional activities have manifested themselves in the form of the support which it has provided for the process of monetary integration from the very beginning. With regard to the ECU - of which it is the major lender and the major borrower - the EIB has actively supported the setting up of the ECU Banking Association.

This is why it was particularly concerned to develop close cooperation with the Commission as soon as the Treaty on European Union was signed, with a view to assessing the constraints and the initiatives associated with the transition to a single currency and in the context of the preparations for that transition. It has also fostered an on-going interactive relationship with the administrative and monetary authorities involved in the European unification process.

However, the EIB's activities have mainly been operational in nature. To enable it to complete its task successfully and to prepare itself for the single currency the EIB has decided, like all other banks, to set up a Euro Committee with particular responsibility for finance-related legal matters. The committee's task is to decide how the EIB is to approach the Euro from a financial point of view, whilst observing the necessary legal constraints. This report will be mainly concerned with the EIB's operational activities, which continue to be a highly topical issue.

1. The EIB's operational activities

As the EU's financial institution, and in view of its advantageou characteristics, namely:

- the world's largest non-sovereign borrower,
- the world's fifth-largest borrower if sovereign borrowers are included,
- its AAA ('excellent') rating,
- the soundness of its balance sheet,
- its tried-and-tested financial technology,

the European Investment Bank has the potential to become the largest non-sovereign issuer of Euros.

In addition to the major issues it has effected the European Investment Bank also tends to effect Euro *benchmark issues* on the financial markets.

The EIB is keen to help secure the objective laid down in the *Commission Green Paper*[1] as regards financial markets, i.e. to achieve - as quickly as possible - *a critical mass of financial operations in Euros* which will have a 'snowball' effect and will consolidate the transition to a single currency.

The Green Paper stresses *'the importance that the use of the ECU*[2] *achieves a critical mass of activities as of the start of Phase B. The more economic agents move to the ECU for their operations, the more credible the EMU process. A critical mass at the start of Phase B would provide a strong commitment to economic agents, given that a significant volume of their operations will be carried out in ECU'.*

Phase B, which is defined in the Green Paper as the effective start of monetary union, begins *'by the Council fixing the conversion rates of participating currencies and by the ESCB assuming responsibility for the single monetary policy'*. Article 109j(4) of the Treaty on European Union specifies that this decision by the Council concerning the selection of the Member States which will make up the 'Euro area' must be taken by 1 July 1998.

This objective is only an intermediate stage, the ultimate intention being to ensure *the liquidity of the Euro markets*. To achieve this objective the EIB, acting through its Euro Committee, has launched three initiatives which are described in each of the following three parts: support for Ecu/Euro parity on a 1-to-1 basis, the initial issue of securities denominated in Euros and the launch of tributary issues.

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[1] *Green Paper on the practical arrangements for the introduction of the single currency*: submitted by the Commission (COM(96)333 final.

[2] The Green Paper appeared *before* the Madrid European Council (15-16 December 1995), which took the decision to adopt *Euro* as the new name for the single European currency.

2. Support for ECU/Euro parity on a 1 - to - 1 basis

The Madrid European Council took the decision to name the future European single currency the *Euro*. The adoption of the term *Euro* is more than just a semantic change from ECU to Euro; it was stipulated in the Madrid European Council Presidency Conclusions that *'the specific name Euro will be used instead of the generic term 'ECU' used by the Treaty to refer to the European currency unit.'*

The adoption of this name has the advantage of clarifying the following issue: the conventional ECU (*European Currency Unit*) is only a *'basket of currencies'*. Although its value naturally depends on market fluctuations, it also depends on the inherent value of its various component currencies (of which the leading one is the German Mark).

The third stage of economic and monetary union (EMU) which, as confirmed by the Madrid European Council, will begin on 1 January 1999, will be marked by the final introduction of the Euro to replace the currencies of the Member States which are in the 'first wave' of the transition to the Euro. On that same day the basket of currencies which is known as the ECU, will be replaced by the Euro, a currency in its own right. The Treaty on European Union (*'Maastricht Treaty'*) stresses that this replacement of the ECU by the Euro will have no effect on the value of assets and contracts which are denominated in ECUs and will in future be denominated in Euros.

The EU Treaty states that *'at the starting date of the third stage, the Council shall, acting with the unanimity of the Member States without a derogation, (...) adopt the conversion rates at which their currencies shall be irrevocably fixed and at which irrevocably fixed rate the ECU shall be substituted for these currencies, and the ECU will become a currency in its own right.* ***This measure shall, by itself, not modify the external value of the ECU'***[3].

At the Madrid European Council the Heads of State and Government, who were aware of the importance of providing further details regarding the adoption of the name 'Euro', pointed out that *'the substitution of the Euro for national currencies should not of itself alter the continuity of contracts, unless otherwise provided in the contract. In the case of contracts denominated by reference to the official ECU basket of the European Community, in accordance with the Treaty, substitution of the Euro will be at the rate of one to one, unless otherwise provided in the contract'*[4].

The European Investment Bank was the first financial operator to provide direct support for this parity by launching, in March 1996 (i.e. only a few weeks after the Madrid European Council), a five-year ECU 500 million loan and gave an explicit official commitment that, after the transition to a single currency, the interest and capital would be paid in Euros on a one for one basis.

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[3] Article 109l(4) of the EU Treaty - author's highlighting.

[4] Madrid European Council, Presidency Conclusions, A(I)(6).

This operation created 'a landmark precedent for other borrowers, boosting the trust of the financial markets in the future single currency'.[5]

A joint statement was issued by the Commission and the European Investment Bank on 31 July 1996, which refers to this commitment: *'From the start of monetary union, on 1 January 1999, all interest payments and repayments of the principal will be made in the single European currency, the Euro. The substitution will be at a rate of one for one in line with the Treaty on European Union (the Maastricht Treaty), in particular Article 109/4).'*

Furthermore, in this same statement, *'The European Commission confirms that this same principle will apply to all ECU-donimated loan instruments issued by the European institutions, including those dating from before the Madrid European Institutions, including those dating from before the Madrid European Council. All outstanding loan instruments will therefore be treated in the same way at the start of monetary union.'*

Similar undertakings had already been given by the French Treasury and by the UK financial authorities, but they were in respect of existing loans. The EIB's initiative therefore represents the first issue in respect of which a guarantee that ECUs will be converted into the Euros on a one to one basis is given in the information accompanying the issue.

3. Initial issues of securities denominated in Euros

In addition to providing support for the one-to-one ECU/Euro exchange rate, the EIB wished to reassure the markets as regards the inevitability of the process of introducing the single European currency, the Euro. It is for this reason that it decided to act as a precursor, by launching the first loan denominated in Euros. This initiative goes much further than issuing securities in ECUs with a guarantee of convertibility, since it is based on a currency which, until 1 January 1999, will exist only in the Treaties, i.e. as a *virtual* currency.

Until that date the replacement by the Euro of the currencies of the participant Member States cannot be regarded as an *actual reality* but, rather, as a *virtual reality* accompanied by a very strong probability.

The major efforts made by the European governments as a whole and the convincing results they have achieved in their attempts to meet the criteria nonetheless enable us to discount any possibility that transition to the third stage of EMU will be postponed[6].

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[5] Statement by Sir Brian Unwin KCB, President of the EIB, at the annual meeting of the Board of Governors, Luxembourg, 9 June 1997.

[6] Following a number of public statements by political leaders, the Commission published a study produced by the Legal Service on the way in which Article 109j(4) of the EU Treaty is to be interpreted, which concludes that the first sentence of the paragraph in question does not make it possible to set a date for transition to the third stage of EMU which is later than 1 January 1999, either by a decision taken in 1997 or by a later decision.

This is perhaps an opportunity for emphasizing once again the importance of the EIB's initiative involving the issue of securities denominated directly in Euros and, to a certain extent, the trust which is thus placed in the inevitability of the process leading to the introduction of a single currency.

Hence, the EIB launched the first issue of bonds denominated in Euros on 31 January 1997, for a 7-year period and to a total value of 1 billion Euros. Until the start of the third stage of EMU (1 January 1999) the interest on this loan will be paid in ECUs; after that date the interest and the capital repayments will be paid in Euros. The way in which the market welcomed this loan is a positive indication of the trust which it has in the Euro and in the fact that it will be introduced on a specific date. The European Investment Bank is thus playing a full role as the European Union's financial institution by strengthening the foundations of the Euro.

4. The EIB's advance strategy: tributary issues

In order to encourage the swiftest possible formation of a critical mass of operations in Euros the European Investment Bank has decided to adopt an *advance strategy* until the date on which the Euro is introduced. The main tactic in this critical-mass formation strategy is to issue securities directly denominated in Euros, even before the formal decision to convert to the Euro is taken by the European Council of Heads of State and Government. The EIB has also decided that this main tactic (a bold but essential one) could be supplemented by issues of a different type but serving the same purpose: *'tributary issues'*.

Tributary issues are securities issued by the EIB in a European currency, the purpose of which will be to *swell the main flow of operations in Euros* generated by the securities issued directly in Euros when national currencies are abandoned in favour of the single currency. These issues are characterized by two particular clauses concerning *redenomination* and *consolidation*, which will make the operation possible.

The ***redenomination*** clause comprises an option which the EIB may choose to exercise in order to convert, *after 1999*, securities issued in one of the European currencies (German Marks, French Francs, Pounds Sterling, Italian Lire, etc.) into securities *denominated in Euros*. This clause is an *option* (i.e. a right which the EIB will exercise at the appropriate time (after 1 January 1999)) which will make it possible to ensure in advance that there will be a certain number of operations denominated in Euros which will help to form a critical mass without there being any need to increase the number of issues denominated directly in Euros. Although the market responded very well to the first 1 billion Euro issue launched by the EIB on 31 January 1997, this does not mean that it is willing to absorb any number of issues of this kind before 1 January 1999, i.e. within a relatively short period of time. The approach therefore needed to be diversified.

The second clause included in the *tributary issue* launch specifications is a ***consolidation*** clause. This enables the EIB, after it has exercised its right of redenomination in 1999, to gather together and *merge all issues previously redonominated in Euros* so as to achieve *a single issue in Euros*. Exercising the *fungibility capability* of securities redenominated in Euros is possible only because they were issued under the same terms and conditions (same duration, same language, same laws, etc.).

These two options of redenomination followed by consolidation make fungibility possible between securities which were initially issued in different currencies, i.e. ***cross-currencies fungibility***, at every point along the rate curve, thus increasing the liquidity of the market.

The result will be a significant volume of issues denominated in Euros which will create a certain amount of liquidity in the Euro market: *'The fungibility of these issues with the Euro will enable the Bank to create its own benchmarks and yield curve early for the Euro and strengthen the markets' liquidity from 1999 onwards'*[7]

These two options will of course be exercised with full respect for the rights of the holders of the securities concerned.

So far the issues which have been made as part of this advance strategy and with a view to exercising the redenomination and consolidation options are as follows:

- issue in Dutch Guilders ⇨ 1 billion
- issue in French Francs ⇨ 3 billion
  ⇨ 3 billion
- issue in Portuguese Escudos ⇨ 20 billion
- issue in German Marks ⇨ 1 billion
- issue in Italian Lire ⇨ 1.5 trillion
- issue in Euros (31 January 1997) ⇨ 1.3 billion

Thanks to the *redenomination* and *consolidation* options applicable to these securities, the total represents an aggregate amount at present of approximately ***4 billion Euros***. This means that the market in Euro securities (i.e. in a currency which so far exists only in a virtual sense) already amounts - as far as the EIB is concerned - to almost 4 billion Euros.

The consequences of this advance strategy, based on the redenomination and consolidation options, will be many:

- ❒ the creation of advance redenominations on the market;
- ❒ the assurance that a critical mass of securities denominated in Euros will be formed;
- ❒ advance liquidity of the market in securities denominated in Euros;
- ❒ identification of the European Investment Bank as a reference issuer of Euros, *before and after 1999*.

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[7] Statement by Sir Brian Unwin KCB, President of the EIB, at the annual meeting of the Board of Governors, Luxembourg, 9 June 1997.

5. Prospects for the future

The EIB intends to continue acting in association with the other Community bodies. Not only will the strategy of involvement in the formation of a critical mass and the definition of a *'benchmark'* be extended but other areas too, which directly concern the transition to a single currency, will receive support and input from the EIB.

Among the factors which indicate that, for the EIB and others too, the transition to the single currency is already a tangible reality are redenomination methods, in particular: the application thereof to 'legacy debt'; market conventions and variable-rate reference indices; harmonization of the rules governing domestic financial markets; and coordination of the activities of securities committees.

CONCLUSIONS

The action taken by the EIB with regard to the Euro is bold and it perfectly reflects the precursor role which the Bank intends to play in the process of transition to a single currency.

Even though the Heads of State and Government have not yet met as a European Council in order to draw up a list of the countries which will be in the 'first wave' of the transition to a single currency, the European Investment Bank already regards the Euro as a reality and is acting in such a way as to ensure that financial operators take the same view.

The expression of support for one-for-one ECU/Euro parity a few days after the Madrid European Council, in the form of a major issue in ECUs which would be *'officially and explicitly'* convertible into Euros with effect from the date on which the single currency is introduced, constituted the first strong signal.

The first issue *directly denominated in Euros* represented a decisive step by the EIB on the road to a single currency and has been supplemented by *tributary issues*, a financial innovation which is as bold as it will be effective as it seeks to achieve a critical mass of operations denominated in Euros.

These factors should make it possible to reassure investors and other market operators as regards the inevitability of the changeover to a single currency and to send positive signals to the political leaders of the various European countries to counter the doubts which some of them have expressed regarding the feasibility of introducing a single currency on the date laid down in the Treaty on European Union, i.e. 1 January 1999.