ANALYZING THE ROLE OF COMMERCIAL BANKS IN THE ABSORPTION OF EUROPEAN FUNDS

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Abstract

In this article, the authors focused on analyzing the role of commercial banks in absorbing community funds. Allocations of non-reimbursable Community funds for the member countries of the European Union are important because these funds aim to overcome some difficulties and bring all the countries closer to the EU standards. Emphasis is also placed on the analysis of structural funds, with an emphasis on the situation of some Member States in accessing these sources of funding. Structural funds are, unfortunately, difficult to use by the states that have become members of the European Union due to the lack of projects and the possibility of co-financing. The studies also focus on the comparative analysis of the absorption of European funds from Romania, Hungary and Lithuania. To illustrate more clearly what has been said in this study, tables and graphic representations are presented. The analysis can be extended, including through the use of econometric methods.

Keywords: *community fund, bank, absorption, budget, investment*
JEL Classification: *G21*, *G24*

Introduction

EU structural funds – the second most important budgetary instruments of the EU – have been underutilised in many new EU Member States, whereas credit activity has been stagnant or recovering only slowly. Better utilisation of structural funds may hold the promise of stimulating public and private investment, strengthening productivity in sectors that are key for competitiveness and growth while, at the same time, offering considerable co-financing and pre-financing opportunities for the private financial sector.

Private financial actors could contribute to leverage EU grant funds through their knowledge of local corporate sectors and on-going search for innovative entrepreneurial concepts and financial instruments. In the process this may alleviate constraints on co-financing that the official sector has experienced, in particular in times of budget consolidation. Coupled with their efficiency in project evaluation and monitoring commercial banks may bring the needed dynamism to local industry and services.

Global banking groups have a strong presence in Central and Eastern Europe. Branches and subsidiaries of foreign banks have a market share of about 75 per cent in the total assets of the banking system in Hungary and Latvia and close to 90 per cent in Romania. All three EU Member States have received balance of payments support from the international financial community.

The commitment of the parent banks is essentially twofold: first, subsidiaries in the designated countries were to maintain adequate capital buffers and second, each bank group would maintain certain exposure levels. With these commitments, which are voluntary, a destructive 'run to the exit' in any of the crisis-stricken countries was successfully averted.

Exposure is considered net of liabilities and defined in broad terms vis-à-vis the country as a whole, including claims on the subsidiary (both assets and capital), loans to households, firms, financial institutions as well as government bonds. The funding of the subsidiaries constitutes the largest exposure component. Banks have generally fulfilled their exposure commitments, but have pointed out that in a shrinking economy with subdued loan demand, some of the liquidity they held in their subsidiaries remained idle in the absence of investment opportunities. Indeed, credit growth is still subdued in Romania, hovers around zero in Hungary and remains negative in Latvia. Given risk management considerations within banks, the rising financing needs of the government could only be partially a satisfactory response to the request for investment opportunities. Therefore, a key challenge going forward is to reinvigorate the economy and increase the demand for credit by the private sector.

Literature review

Dumitrescu and Soare (2014) describe financial instruments specific to European structural and investment funds. Anghel, Dumitrescu, Dumitrescu and Niţă (2016) are concerned about the role of the banking system in attracting European funds, Berica (2011) is developing on a similar theme. Branten and Purju (2013) describe the innovative financial instruments of European funding programs. Beltratti and Stulz (2012) perform a global benchmarking of lending activity. Dornean (2015) is concerned about the impact of European funds used for regional development in Romania. Chava and Purnanandam (2011) assess the effects of bank crises on some of their client segments. Anghelache (2016, 2015) describes the up-to-date state of the economy of Romania. Babecky et.al. (2010) is concerned about nominal and real salaries in European firms. Huizinga and Laeven (2012) are concerned about the characteristics of bank assessments in the context of financial crises, Calomiris and Nissim (2014) are developing on a similar subject. Zaman and Cristea (2011) analyze the problems related to absorption of structural funds in Romania. Anghelache et.al. (2016) describe a set of models for studying the absorption of European funds, Opritescu (2012) applies a Hermin model. Anghelache, Soare and Dumitrescu (2016) are concerned about the use of IT platforms in European project management. Cassola, Hortacsu and Kastl (2013) assess the 2007 subprime credit crunch in the light of the European Central Bank's short-term funding instruments. Sauer and Sturm (2007) are concerned about the usefulness of Taylor's rules in understanding the monetary policy of the ECB. Tosun (2014) builds a comparative analysis of the absorption of European regional funds. Lima and Cardenete (2007) is concerned about the impact of European funds on the regional economy. Cetorelli and Goldberg (2012) are developing on bank globalization. Neculita et.al. (2013) studies the correlation between European integration, financial resources and attracting European funds to the Central and Eastern European region. Fender and McGuire (2010) are concerned about the correlation between bank structures and international shock propagation, Schnabl (2012) is studying the spread of liquidity shocks. Guadalupe and Cunat (2009) analyze the characteristics of competition in the financial and banking sector. Schenone (2010) assesses the value of their informational advantage by banks. Wehinger (2012) studies the transition to market-based funding.

Methodology and data

Structural Funds in the European Union

The activity of banks, in their constant search for investment opportunities, can be influenced by European structural funds in two ways. Firstly, by increasing demand for loans in all sectors of the economy, as a direct result, at macroeconomic level, of the use of European structural funds in the economies of the member countries. The second, at microeconomic level, banks can actively and directly participate in the financing of eligible projects. In this paper, we want to explore the second aspect, namely the role banks can play in increasing the absorption of European funds by involving them both in the administrative selection and monitoring of projects as well as in the pre and co-financing.

The European Union has allocated a total of € 178 billion to the new member states between 2007 and 2013 using three instruments:

• the European Regional Development Fund (ERDF), which finances: investment in companies (in particular SMEs) to create sustainable jobs; infrastructure linked notably to research and innovation, telecommunications, environment, energy and transport; financial instruments (capital risk funds, local development funds, etc.) to support regional and local development and to foster cooperation between towns and regions and technical assistance;

• the European Social Fund (ESF) which seeks to improve employment by supporting actions in the following areas: adapting workers and enterprises through lifelong learning schemes and innovative working organisations; access to employment for job seekers, the unemployed, women and migrants; social integration of disadvantaged people and combating discrimination in the job market and strengthening human capital by reforming education systems;

• the Cohesion Fund (CF) is aimed at Member States whose Gross National Income per inhabitant is less than 90 per cent of the Community average (this includes all ten new members) and finances activities under the following categories: trans-European transport networks and environment including renewable energy, rail and public transport.

These three funds account for 35% of the European Union budget and have been allocated to 51% of the 10 new member countries. The following table details country allocation.

Structural funds available to the new Member States compared to EU as a whole

Table 1

	2007-2013			2010		2011	
New Member States	bn EUR	% of 2010 GDP	% of total	bn EUR	% of GDP	bn EUR	% of GDP
Structural funds for growth and convergence							
Bulgaria	6.9	19.3	3.8	1.0	2.9	1.1	3.0
Czech Republic	26.7	18.3	15.0	3.8	2.6	4.0	2.6
Estonia	3.5	25.0	1.9	0.5	3.5	0.5	3.6
Cyprus	0.6	3.7	0.4	0.1	0.5	0.0	0.3
Latvia	4.6	27.7	2.6	0.7	3.9	0.7	4.2
Lithuania	6.9	26.7	3.9	1.0	3.8	1.1	3.9
Hungary	25.3	26.2	14.2	3.6	3.8	3.8	3.8
Malta	0.9	14.5	0.5	0.1	2.1	0.1	2.0
Poland	67.3	19.0	37.8	9.4	2.7	10.0	2.7
Romania	19.7	16.0	11.0	3.1	2.5	3.3	2.5
Slovenia	4.2	11.7	2.4	0.6	1.7	0.6	1.7
Slovakia	11.6	17.6	6.5	1.7	2.5	1.8	2.5
Total	178.1	19.0	100.0	25.6	2.7	27.1	2.7
Other funds							
Rural development	37.6	4.0		5.6	0.6	5.5	0.6
Fisheries	1.4	0.1		0.2	0.0	0.2	0.0
All funds	217.0	23.2		31.4	3.4	32.8	3.3
The EU budget	bn EUR	% of 2010 GDP	% of total	bn EUR	% of GDP	bn EUR	% of GDP
Total	975.8	8.0	100.0	141.0	1.2	143.0	1.1
Struct. funds for growth and conv.	346.1	2.8	35.5	49.4	0.4	50.6	0.4
Rural development	96.4	0.8	9.9	14.4	0.1	14.4	0.1
Fisheries	4.3	0.0	0.4	0.6	0.0	0.7	0.0
All funds	446.8	3.7	45.8	64.4	0.5	65.7	0.5

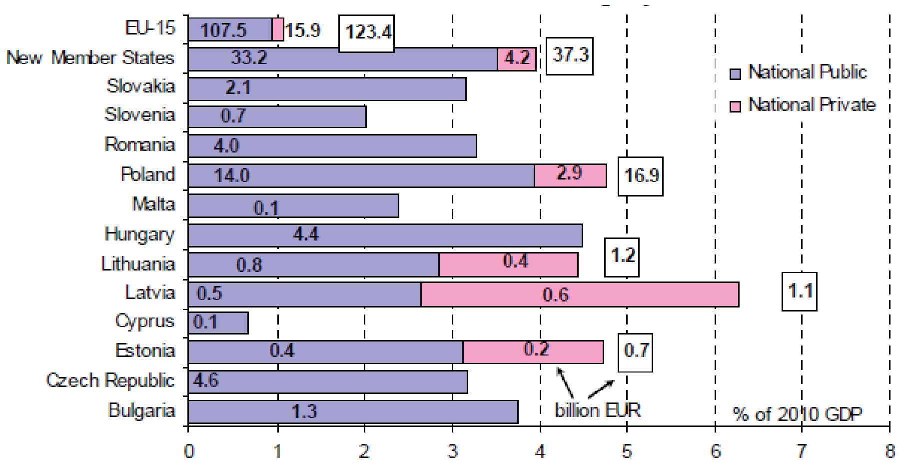
Source: The European Bank Coordination ("Vienna") Initiative, The Role of Commercial Banks in the Absorption of EU Funds, Report by the Working Group, 2011, pag. 5

The need for co-financing

The level of co-financing rates for the Structural and Cohesion Funds of the European Union is determined by the relative development level of each beneficiary Member State on the basis of the objective pursued for each cohesion policy and the type of fund used. Thus, using gross domestic product as an indicator of the level of development for Member States that had a Gross Domestic Product below 85% of the European Union average for the period 2011-2013, for projects funded by the European Regional Development Fund, the European Social Fund and the Fund Of Cohesion, may be financed from these funds up to 85% of the eligible investment costs. For more developed countries, the percentage varies between 50 and 85%.

National contribution to EU funded projects in 2007-2013

Figure 1



Source: The European Bank Coordination ("Vienna") Initiative, The Role of Commercial Banks in the Absorption of EU Funds, Report by the Working Group, 2011, pag. 6

Over the period 2007-2013, the new EU Member States have allocated € 37.3bn (approximately 4% of GDP in 2010) to the co-financing of projects from European funds. Of this amount, the largest share - € 33.2 billion (89%) - was allocated to national budgets, and the difference (€ 4.2 billion) was funded by private funds. Of the 12 new Member States of the European Union, 8 have allocated over 3% of GDP (for the entire period considered) for the co-financing of these projects, three of them Hungary, Poland and Bulgaria allocating even more than 3.5% from a fiscal point of view is a great effort.

Also, following the graph above, we note that only four countries (Poland, Lithuania, Latvia and Estonia) have co-financed projects funded by European funds with private funds.

It is also important to underline that this budgeting of co-financing funds should not lead to an increase in national public spending but rather by allocating them to cover eligible national public expenditure to be financed in this way.

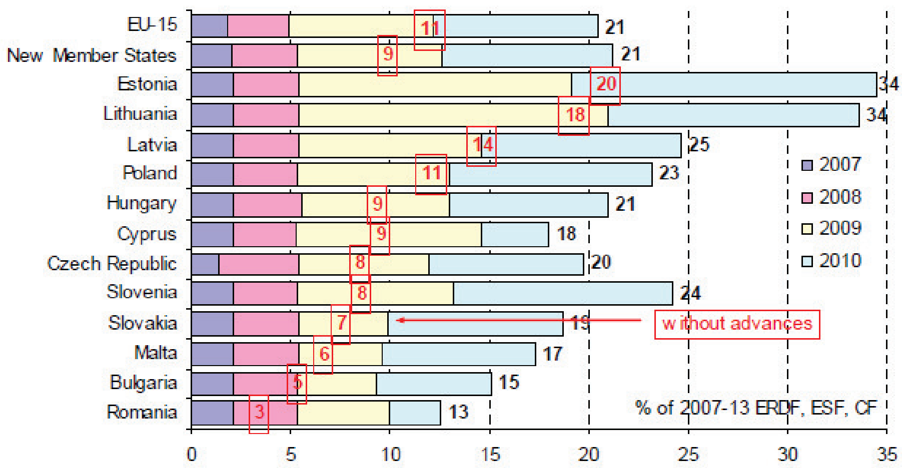
Lack of absorption of European funds

Although the Member States of the European Union - and especially those in Central and Eastern Europe - had at their disposal important sums allocated under the various funding funds, we can say that, overall, their absorption took place at a much slower rate In most countries. „Champions"

in this chapter were Romania and Bulgaria, which mobilized only 13% and 15% respectively of the funds allocated for the period 2007-2013. Although these figures indicate a very low absorption rate, if we lower the amounts paid in advance, we will reach even lower weights, 3% and 5%, respectively.
The late adoption of the draft guidelines on cohesion, cohesion policy and the programs funded (even at the end of the first year of implementation, 2007), the lack of administrative capacity and the existence of an economic and financial crisis overlapping throughout the exercise (2008-2011) Among the main causes that led to this lack of absorption. Besides these causes, in the particular case of Romania and Bulgaria, we can identify another cause, namely the lack of experience and the lack of knowledge of the relevant procedures due to the accession to the European Union in 2007, at the same time with the launch of these programs.

Absorption of EU funds in new and old Member States until mid-2010

Figure 2



Source: The European Bank Coordination (“Vienna”) Initiative, The Role of Commercial Banks in the Absorption of EU Funds, Report by the Working Group, 2011, pag. 7

Analyzing the graph above, however, we can note that if we compare the rate of absorption without advance payments of the new Member States to that of the old Member States the difference is small, 9% compared to 11%, and for the absorption rate including advances, Two groups is the same (21%).

Absorption of European funds in Hungary, Latvia and Romania

Analyzing the data in the following table, we have some important aspects. Thus, Latvia enjoys a high rate of payments, which leads, on the whole, to a good absorption of European funds. However, due to a commitment rate of 50.5%, the evaluation and selection of projects is below average. Among the new Member States, Hungary is at the middle of the ranking, largely due to a high employment rate (64.5%) for regional development operational programs with considerable funds (€ 5.8bn). Regarding the situation of Romania, we note that it faces difficulties at all levels (selection and evaluation of projects, their implementation), due to a lack of administrative capacity. To improve administrative capacity, an operational program with a budget of € 0.2 billion was created where we can say that absorption is better.

Absorption in Romania, Latvia and Hungary according to Operational Programmes

Table 2

Operational Programme (billion EUR)	EU funds (1)	Committed (2)	Paid (3)	Commit-ment ratio (2)/(1)	Payment ratio (3)/(2)	Absorption ratio (3)/(1)
Romania						
Human Resources Development	3.5	1.5	0.5	44.1	30.7	13.6
Administrative Capacity	0.2	0.1	0.0	62.9	25.0	15.7
Regional Operational Programme	3.7	1.7	0.5	45.6	27.9	12.7
Economic Competitiveness	2.6	1.2	0.3	47.6	27.8	13.2
Transport	4.6	2.0	0.6	44.6	27.8	12.4
Environment	4.5	2.0	0.6	43.7	28.8	12.6
Technical Assistance	0.2	0.1	0.0	47.7	26.9	12.8
Total	19.2	8.7	2.5	45.1	28.5	12.9
Latvia						
Human Resources and Employment	0.6	0.3	0.2	50.2	82.1	41.2
Entrepreneurship and Innovations	0.7	0.4	0.3	50.1	72.6	36.4
Infrastructure and Services	3.2	1.6	0.6	50.7	39.6	20.1
Total	4.5	2.3	1.1	50.5	50.1	25.3
Hungary						
Economic Development	2.9	1.5	0.7	51.5	45.5	23.4
Environment and Energy	4.2	1.9	0.7	44.6	34.9	15.6
Transport	6.0	2.7	1.3	44.6	48.4	21.6
Social Infrastructure	1.8	1.0	0.3	54.2	29.3	15.9
Implementation	0.3	0.1	0.1	45.0	98.4	44.3
Operational Programmes for several regions	5.8	3.7	1.5	63.4	41.0	26.0
Social Renewal	3.5	2.0	0.6	57.6	30.8	17.7
State Reform	0.1	0.1	0.0	64.6	42.3	27.3
Electronic Public Administration	0.4	0.2	0.1	61.8	44.9	27.7
Total	24.9	13.1	5.3	52.6	40.4	21.3
New Member States	178.1	90.5	37.8	50.8	41.8	21.2
EU-15	168.0	95.1	35.0	56.6	36.8	20.8

Source: The European Bank Coordination ("Vienna") Initiative, The Role of Commercial Banks in the Absorption of EU Funds, Report by the Working Group, 2011, pag. 8

Semnificația potențială a implicării băncilor

Deși nu pot sprijini eforturile directe de consolidare a capacității administrative, băncile pot, totuși, să joace un rol în absorbția fondurilor europene. În primul rând, băncile pot utiliza cunoștințele proprii privind evaluarea și selecția proiectelor, în cazul fondurilor structurale europene, atât în beneficiul întreprinderilor mici și mijlocii cât și în cel al instituțiilor publice. De asemenea, băncile pot accelera executarea proiectelor prin acordarea unei prefinanțări înainte de acordarea avansurilor de către autoritățile care gestionează fondurile europene sau simultan cu acestea. Al treilea rând ar putea cofinanța proiectele europene, având în vedere că toate cheltuielile unui proiect nu sunt finanțate din finanțări europene. De fapt, aceasta ar putea fi cea mai mare oportunitate de a acorda împrumuturi pentru bănci. În tabelul următor, am proiectat aceste posibilități ale băncilor de acordare a unor împrumuturi pentru cofinanțarea proiectelor europene, într-un procent de 25% din cheltuielile neeligibile ale acestor proiecte. Totodată, am presupus că partea de cheltuială ne-eligibilă este egală cu cea care poate fi finanțată din fonduri europene. În urma calculelor efectuate, rezultă că această cofinanțare ar conduce, în perioada 200-2013, la o creștere a creditului cu 1,1% în medie pe an pentru Letonia și 1,8% pentru România și Bulgaria. Dacă am presupune că rata de cofinanțare ar fi de 50% în loc de 25%, desigur, aceste cifre s-ar dubla. Deoarece nu toate programele operaționale prezintă același interes pentru bănci, valorile calculate reprezintă desigur, limita maximă.

EU funds and lending opportunities in Romania, Hungary and Latvia

Table 3

Operational Programme (annual average in 2007-2013)	EU funds	budget contribution	private contribution	total	co-financing at 25%	contribution to total credit growth
	million EUR				million EUR	annual %
Romania						
Human Resources Development	496.6	87.6	-	584.2	146.0	0.30
Administrative Capacity	29.7	5.4	-	35.1	8.8	0.02
Regional Operational Programme	532.3	93.9	-	626.2	156.6	0.33
Economic Competitiveness	364.9	65.3	-	430.2	107.5	0.22
Transport	652.3	161.7	-	814.0	203.5	0.42
Environment	644.6	156.9	-	801.6	200.4	0.42
Technical Assistance	24.3	6.1	-	30.4	7.6	0.02
Total	2744.7	576.9	-	3321.6	830.4	1.73
Latvia						
Human Resources and Employment	78.7	8.4	5.5	92.5	23.1	0.14
Entrepreneurship and Innovations	105.2	14.8	34.8	154.9	38.7	0.23
Infrastructure and Services	458.7	44.4	52.4	555.4	138.9	0.81
Total	642.6	67.6	92.6	802.9	200.7	1.17
Hungary						
Economic Development	408.4	72.1	-	480.5	120.1	0.21
Environment and Energy	597.0	105.3	-	702.3	175.6	0.31
Transport	861.0	151.9	-	1013.0	253.2	0.44
Social Infrastructure	254.6	44.9	-	299.5	74.9	0.13
Implementation	45.0	7.9	-	53.0	13.2	0.02
Operational Programmes for several regions	824.5	145.5	-	970.0	242.5	0.42
Social Renewal	497.5	87.8	-	585.3	146.3	0.26
State Reform	20.9	3.7	-	24.6	6.2	0.01
Electronic Public Administration	51.2	9.0	-	60.2	15.1	0.03
Total	3560.2	628.3	-	4188.4	1047.1	1.83

Source: The European Bank Coordination ("Vienna") Initiative, The Role of Commercial Banks in the Absorption of EU Funds, Report by the Working Group, 2011, pag. 10

For example, the annual allocation for Romania under the Economic Competitiveness Program amounts to € 430 million, of which 85% is co-financed by European funds. Assuming that the non-eligible expenditure side is equal to the eligible one and considering a 25% co-financing rate, we can predict an additional amount of bank credit of 107.5 million Euros annually, which would lead to an expansion of the Credit of 0.25% per year.

The role of commercial banks in Romania and Bulgaria in increasing the absorption of European funds

Bulgaria and Romania are confronted with the greatest challenge in absorbing EU structural funds. The overall absorption rate is low relative to both funds allocated and national income overall, and, given the context of an ongoing economic and credit contraction, national authorities are committed to taking steps to raise absorption, including through a closer involvement of commercial banks.

Representatives of parent banks of the large foreign-owned banks operating in Romania and Bulgaria agreed that an improvement of EU funds absorption coupled with an increased involvement of banks in this process might offer alternative investment opportunities for banks and, consequently, could contribute to reviving credit activity.

Conclusions

The EU structural funds constitute significant resources available to EU Member States. These funds are particularly important for the new Member States, for which the funds yet to be disbursed could amount to up to 2 per cent of GDP per year for the remainder of the current financial perspective. While absorption rates have been also low in the old Member States, the lack of capacity to better absorb EU funds has been particularly acute in the new Member States. The latter have been lately confronted with subdued economic growth, constraints in bank funding to the private sector as well as budgetary constraints on public investment.

The majority of Member States have decided to manage structural funds directly or through state agencies. However, in the new Member States this approach has been faced with

sizeable difficulties given the constraints in institutional capacity, and the relatively recent adoption of the EU *acquis* prior to the accession rounds in 2004 and 2007. The current financial crisis forces governments to explore more efficient mechanisms for delivering EU grants in support of companies and to reduce financing gaps in the public sector, in particular in view of the fact that unutilised funds will no longer be available three years after they were first granted.

Several Member States have experimented with utilising banks as intermediary bodies outside the public sector to accelerate EU funds absorption, in particular in channelling funds

to SMEs. Banks may perform, *inter alia*, the functions of project assessment, fund disbursements, monitoring and reporting to public administrations and on-site inspections.

By involving commercial banks in these activities a number of concerns need to be addressed.

First, banks look legitimately after their business interests in the provision of commercial loans focussing on the bankability of projects, which not necessarily matches the public interest motivation behind the grant financing by the EU. This may lead to conflicts of interest when banks are involved in both the selection of projects and financing. There may be also doubts that those banks which are ultimately motivated by developing lasting client relationships with private clients will act as impartial agents for the Managing Authorities in project selection and monitoring. This concern may also be shared by banking sector supervisors which may have apprehensions regarding large exposures or an unbalanced or unsustainable earnings structure.

Second, from the perspective of the national Managing Authorities, a suitable procurement process will need to identify qualified banks delivering such services at a competitive price. Public payments to commercial banks will need to stay clear of concerns over state aid, to avoid the distortion of competition.

A third concern may arise from involving banks in a process that has been frequently criticised for leading to fraud and misuse of funds. This may expose banks to certain reputational risks, in particular where recipients are large relative to the bank's overall balance sheet. Concerns expressed in the media or held by the public over integrity of key bank clients, may implicate bank management for colluding in fraudulent practices, and could lead to instability in the bank's funding relationships, including from retail deposits. At the same time, this risk underlines the potential from involving banks, which through their established customer relationships will carefully scrutinize projects they commit funding to, and which they will feel in a position to monitor on an ongoing basis.

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