ENVIRONMENTAL FINANCIAL ADVISORY BOARD
UNITED STATES ENVIRONMENTAL PROTECTION AGENCY

DEC 4 2000

Honorable Carol M. Browner
Administrator
U.S. Environmental Protection Agency
Washington, D.C. 20460

Dear Administrator Browner:

On behalf of the Environmental Financial Advisory Board (EFAB), we are pleased to transmit to you the EFAB white paper, "Removing Barriers to Investment in Environmental Infrastructure in Western Europe." This paper examines significant barriers to environmental investments by the U.S. financial services industry in this important part of the world. It also recommends policies to remove these barriers that would benefit U.S. national interests.

Specifically, the paper proposes U.S. support for fair and open competition in financing public purpose environmental infrastructure by eliminating banking practices that close Western European markets to U.S. industry. It also advocates U.S. support for increased financial disclosure by banks and governments so that international agencies can assign more accurate credit ratings to environmental projects in Western Europe.

We believe that the recommendations presented in the paper are particularly timely for the Agency and the Administration because they provide an opportunity to link environmental and financial services in a positive way and to incorporate them in U.S. proposals in the ongoing round of international trade negotiations. We further believe that the proposals properly framed would benefit both the U.S. financial services industry and the world environment.

The Board is available at your convenience to further discuss this paper and to undertake further analyses if needed. Given the time constraints that exist with the trade negotiations, we ask that you forward the white paper for consideration by the U.S. Trade Representative.

Sincerely,

Robert O. Lenna
EFAB Chairman

John C. Wise
EFAB Executive Director

Enclosure

cc: W. Michael McCabe
Acting Deputy Administrator

Environmental Financial Advisory Board

Removing Barriers to Investment in Environmental Infrastructure in Western Europe

WHITE PAPER

This report has not been reviewed for approval by the U.S. Environmental Protection Agency; and hence, the views and opinions expressed in the report do not necessarily represent those of the Agency or any other agencies in the Federal Government.

December 2000

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Removing Barriers to Investment in Environmental Infrastructure in Western Europe

I. <u>Introduction</u>

A. Purpose

Investment in environmental and other infrastructure in Western Europe represents a significant opportunity for the U.S. financial services industry. Legal, financial, and cultural barriers in Western Europe thwart efforts by the industry to pursue these opportunities. These barriers not only limit the growth of the U.S. financial services sector, but also deprive project sponsors of efficient and cost-effective financing. This paper builds the case for removing these barriers and recommends policies that would benefit both the U.S. financial services industry and U.S. national interests.

B. Background

Over the past 25 years, the United States and the nations of Western Europe have demonstrated strong and growing commitments to environmental protection. Moreover, they have increasingly understood that the substantial environmental challenges facing all parties concerned are linked and must be addressed in comprehensive and sustainable ways.

Only through long-term economic growth and development can nations expect to generate the capital and public support necessary to pay the costs of environmental protection. Comprehensive solutions to environmental challenges require considerable resources and expertise. For example, public and private investment in environmental activities in the United States alone is $150 billion per year and growing.

The sheer size of this need illustrates that access to capital markets is critical to continued investment in this area and that financing solutions must be as cost-effective as possible. Therefore, a strong financial services industry is not only necessary to sustain a nation's economic health and growth, but also plays a critical role in improving the quality of the environment through financing infrastructure projects.

The U.S. financial services industry is among the strongest and most efficient in the world. It is no coincidence that the industry and the country are both enjoying an unprecedented era of growth and prosperity. Our national interests are well served by the strength of this industry, and they are closely tied to its continued well-being.

Both the U.S. financial services industry and our national interests would benefit from the removal of barriers to investments in Western European infrastructure. The industry would gain greater access to the world's largest economic bloc. The United States would enjoy the fruits of an even healthier financial sector, new opportunities for U.S. firms to provide goods and services supported by this financing, and improvements in global environmental quality.

II. **Parameters for Discussion**

A. Environmental Infrastructure

We take a broad view of what falls under the rubric of environmental infrastructure. Project areas include, but are not necessarily limited to, drinking water, wastewater treatment, municipal solid waste, hazardous waste, air pollution abatement, clean energy, energy efficiency, co-generation, and natural resource use. Activities include supporting state and local environmental finance institutions and mechanisms, improving project preparation, improving borrower creditworthiness, and providing and leveraging sources of capital.

B. Financial Services Industry

The private financial services industry includes: commercial banks; investment banks; savings institutions; leasing firms; insurance companies (property, casualty, life and health); venture capital entities; and foundations. Companies in these industry sectors provide one or more of a number of financial services including credit extension, equity investment, under-writing activities, credit enhancements, leasing and rental services, and financial risk assessment. The industry as a whole is experiencing a significant consolidation in the number of service providers and a growing concentration of industry assets in fewer companies. This consolidation is occurring through the merger and acquisition of firms in the same and different sectors.

C. U.S. Trade Objectives

For more than 50 years, the United States has strongly supported the overarching goal of trade liberalization. Trade liberalization in this context means open markets, freer trade, and the rule of law in commerce. In pursuing this goal, the United States has expressed a number of objectives for its bilateral and multilateral trade negotiations. Some of the trade objectives that are relevant to this discussion are:

- the right of firms to establish and operate freely;
- equal treatment of foreign and domestic firms;
- equal treatment of World Trade Organization (WTO) members; and
- greater transparency in each nation's regulation of services.

D. Western Europe

For our purposes, Western Europe includes the nations of the European Union (EU): Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom. Outside the EU it includes Iceland, Norway, and Switzerland. It does not include the independent states formed out of the Soviet Union (Russia, Ukraine, etc.); the Baltic states of Lithuania, Latvia, and Estonia; or the former communist nations of Eastern Europe (Poland, Hungary, etc.).

Next, we will examine a number of barriers that the U.S. financial services industry faces in its efforts to finance environmental and other infrastructure activities in Western Europe.

III. <u>Barriers</u>

Many firms in the U.S. financial services industry -- including commercial and investment banks, insurance companies, and accounting and management consulting firms -- are actively engaged in Western European markets. They successfully compete with European and other firms across a wide range of service areas. However, U.S. financial services firms encounter significant barriers as they seek involvement in financing environmental and other infrastructure activities in Western Europe.

The barriers result from laws and regulations, economic and financial practices (some of which are rooted in political and cultural differences with the U.S.), and traditionally closed relationships between Western European financial institutions and their clients. Our examination of these barriers is based on discussions with individuals in the U.S. financial services industry and additional staff research.

A. Governmental Rules

An established legal and regulatory system is an important prerequisite for the legitimate participation of businesses in markets and for the protection of consumers. Major uncertainties exist for businesses operating in the EU, however, because of the overlapping or parallel application of EU community regulations and the individual regulations of the 15 member states. While this system of parallel application was a political necessity for the successful creation of the Union, its continued use hurts European investment and growth opportunities. This lack of regulatory harmony among EU nations is mirrored by a greater lack of harmonization in laws and regulations between the EU and the United States.

Taxes are another area that presents challenges to U.S. businesses operating in Western Europe. Overall, taxes are quite high and vary from country to country. In addition, significant tax barriers still exist with regard to cross-border investment and trade between EU nations. These conditions increase operating costs for companies and retard investment and growth.

Important administrative disharmonies between EU countries also occur with regard to accounting standards and practices, creating the burdens of dealing with many different systems.

The fact that many local governments in Western Europe lack the authority to borrow or issue debt represents yet another barrier (and one that is particularly critical for environmental projects). Local governments must obtain permission from the national government even when they have the desire and resources to proceed on their own. This type of approval process can raise uncertainties and delay infrastructure projects to the point where they are not competitive with other investment opportunities. Devolution of financial control to lower levels of government is needed. While this process has begun in Western Europe, such change is slow.

B. Financial Practices

One troublesome and specific financing problem in much of the world is a history of, or preference for, short-term borrowing. For example, many European sub-sovereign (regional and local) governments consider debt maturities of 7-10 years as long-term, even where the infrastructure funded may have a much longer life (20-50 years). A debt repayment term that is much shorter than the useful life of the funded infrastructure results in dramatically higher annual costs that can make investment in public environmental infrastructure projects unaffordable. Shorter debt repayment terms are also generally considered inequitable since, over the life of the infrastructure asset, many individuals who enjoy the benefits of the service do not pay equally for it. On the plus side, EU municipal debt is eligible for longer maturities/lower rates.

The absence of user fees mechanisms for recovering capital and operating costs is another barrier to financing environmental and other infrastructure projects in Western Europe. Project finance in the classical sense often does not occur. That is to say, project revenues do not finance the project. In Europe, taxes, not user fees, traditionally pay for local services. Moreover, such taxes have been high and competition for the resources generated intense. Governments at all levels do not want to give up these traditional sources of revenue or the ability to use the resources for whatever priorities they wish.

Coupled with these practices, many local governments in Western Europe are unwilling to pay even a small portion of the costs of drinking water, wastewater, and other environmental utilities (all require significant investment in infrastructure). These local governments believe that their national governments have an absolute responsibility to handle the full costs of these vital social services.

C. Banking Relationships

Western European banks have traditionally allocated much of their energy and capital to serving the needs of their corporate and governmental clients through relationship-based lending. These special financial relationships are exceptionally strong, tightly closed, and long-term in nature. They are further strengthened by the fact that banks and other financial institutions in

States. We should also note the danger in strictly characterizing financial services firms as U.S.-based or European-based. With consolidations occurring constantly, more and more of these firms are becoming multi-national.

In any event, legal, financial, and institutional barriers do restrict the activities of the U.S. financial services industry in Western Europe and relief would benefit firms in this industry and the United States as a whole.

B. Opportunities for Environmentally-Related Benefits

Focusing on environmental projects, the removal of these barriers would provide benefits for the U.S. in two areas: opening up access to involvement in environmental infrastructure projects in the EU, and providing access to the new wave of projects in countries projected to soon join the EU.

The commitment to environmental infrastructure in the current EU countries is apparent when we consider some important similarities between the United States and these nations. Both groups recognize the importance of environmental protection in modern economic societies; both have strong, well-developed regulatory apparatuses in place to monitor and enforce environmental compliance; both understand the need to make economic development environmentally sustainable and have incorporated this goal in their governmental policies; and both have made major and growing investments in pollution prevention and environmental abatement controls.

Annual public and private environmental investment in the United States was about $100 billion in 1990. This figure had grown by the year 2000 to about $150 billion. Meanwhile, cumulative environmental investment by European nations was roughly $75 billion and growing in the early-mid 1990s. Environmental project commitments by the European Union through the European Investment Bank alone exceeded $24 billion ECU in the period from 1995 to 1999.

Since some of the barriers identified directly affect environmental infrastructure investments (*e.g.*, limitations on debt issuance by local governments), one of the areas opened up by greater liberalization would be environmental projects.

A second and potentially greater benefit may result from new investments in countries soon to join the EU. The upcoming EU enlargement anticipates the accession of Cyprus, the Czech Republic, Estonia, Hungary, Poland and Slovenia by 2002. Further enlargement involving up to ten other states is planned for subsequent years. This ambitious enlargement process represents tremendous opportunities for the EU as well as significant challenges.

One of the largest challenges will be in the environmental area. As required by the terms of admission to the European Union, the new member states will need to devote considerable resources (as will the Union itself) to bringing their environmental programs and conditions up to

Europe frequently have controlling interests in nonfinancial firms. Many financial observers believe that these institutions have maintained their close public and private relationships even at the expense of profit.

Fortunately for the financial institutions, they have developed creative ways of mitigating the profitability impacts of these relationships. For example, banks in close cooperation with governments and state-owned or controlled banks have developed mechanisms to reduce or offload the banks' exposure to these relationships. One such mechanism involves the pooling of many low-profit bank loans into financial packages/products that are guarantied by the banks and then sold by their investment bank affiliates to the public.

Foreign financial services firms, of course, cannot take advantage of the special financing mechanisms. Thus, they cannot hope to profitably compete with the Western European firms for the original business. It has also proven very difficult in this closed system to determine the nature and extent of local government liabilities that are absorbed by the banking system.

IV. <u>Benefits of Overcoming These Barriers</u>

The barriers described retard the role that the U.S. financial service industry could play in Western European infrastructure investment. Much of the benefit that could be achieved from removal of these barriers would accrue to the U.S. financial services industry itself, through an expanded base of business. We have also identified additional benefits for other U.S. industries, for project sponsors, and for the global environment. Furthermore, our national interest lies not only in advancing the cause for U.S. businesses, but also in facilitating efficient financing for projects that improve environmental quality anywhere in the world.

A. Opportunities for the U.S. Financial Services Industry

Western Europe is a significant economic power. Economically, it is the world's largest monetary bloc with a population exceeding 370 million and a combined gross domestic product of $84 trillion. By comparison, the U.S. market covers 270 million people and has a gross national product of $71 trillion.

The United States and Western Europe enjoy the world's largest commercial relationship. They are each other's largest trade and investment partners. Total trade between them reached $484 billion in 1997, of which $436.3 billion involved the nations of the EU. Two-way direct investment between the U.S. and the EU alone exceeded $750 billion that year. Improving access to financial service markets in Western European countries would benefit U.S. firms.

The U.S. financial services industry has hundreds of billions of dollars invested in Western Europe and the rest of the world. However, these investments are small in comparison to the size of the European market or the size of the industry's investment activities in the United period runs through 2002). Government and corporate bonds, listed futures, and options are all being quoted, priced, and settled in Euros.

The introduction of the single currency is triggering important changes in the policies and behavior of both European governments and European financial service industries. To meet single currency harmonization requirements (*i.e.*, lock in exchange rates), participating EU states cut public budgets to reduce deficits and tightened fiscal policies to reduce central bank interest rates. These actions have led to more stable prices and lower private interest rates.

In order to achieve these reductions, the governments have had to restrain the growth in subsidies to regional and local governments. This has encouraged the emergence of sub-sovereign debt capabilities in the European market as these governments had to look for resources to carry out their infrastructure and other responsibilities. This trend is still in its early stages and should be closely monitored.

The integration of markets in the 11 participating countries has been accompanied by increased consolidation across all business sectors, including financial services. In fact, Europe has been the most active region in the world for cross-border mergers and acquisitions. The need to finance the costs of this growing wave of consolidation has energized West European bond markets. These markets are at a point where long-term bond and loan deals can be done easily.

The combination of consolidation in both other business sectors and financial services has begun to affect historically close business-bank ties. Long established relationships are changing as corporations adjust to new, larger partners. Corporations are also finding that to finance large-scale consolidations they must increasingly issue their own debt. For banks in the EU, the introduction of the single currency has put increasing pressure on profits by eliminating trading in European currencies. This has led them to look to maximize profits in other areas, including corporate banking, causing additional relational stresses.

B. WTO Services Negotiations

Historically, the importance of service industries has not been adequately examined nor have service industries received the political attention that their contribution to national economies would seen to merit.[1] These facts, however, are changing.

In December 1997, the WTO completed its first financial services negotiation. The agreement reached included market-opening commitments from 102 nations. In it, the signatories agreed to a legal framework for international trade, market access in financial services, and a dispute settlement mechanism. The agreement took effect in 1999.

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[1] In ten countries, including the United States and seven in Western Europe, services now account for more than 70% of total economic activity.

the levels of current EU members. However, this situation also represents a considerable market opportunity for both the U.S. financial services and the U.S. environmental goods and services industries. Evaluating and quantifying the potential market is a topic worthy of further study.

Whether as a result of access to projects in the existing EU countries or from expansion, U.S. businesses that provide environmental goods and services also stand to benefit from removal of these barriers. The United States and Europe represent two of the largest markets in the world for environmental goods and services. In the United States, the environmental goods and services industry (EGSI) consists of more than 100,000 companies that employ more than 1.3 million workers and generate more than $180 billion dollars in revenues worldwide. While the U.S. EGSI market is mature and its growth slow, it has export revenues of $16 billion a year and growing. This strong export figure reflects the fact that world EGSI markets exceed $500 billion per year and, unlike the U.S. market, are experiencing strong growth.

Finally, the removal of barriers offers two broader benefits that, while difficult to quantify, are important to U.S. interests. First, enhancing access to and efficiency of environmental financing should accelerate the pace of environmental improvements, especially in countries that have not yet joined the EU. Second, initiatives to remove these barriers offer an opportunity to link trade and environmental issues in a positive light, rather than the negative experiences associated with the WTO ministerial meeting in Seattle, Washington in late 1999. On other fronts, the U.S. government and the governments of other industrialized nations are looking to build positive new relationships between trade and the environment. For example, on July 24, 2000, the G8 nations meeting in Okinawa, Japan issued a Communiqué that reaffirmed their commitment to WTO trade negotiations that are compatible and mutually supportive with social and environmental polices.

V. <u>Trends and Existing Initiatives to Overcome Barriers</u>

Current political and economic trends are already at work to address the barriers identified earlier. While they are probably not sufficient by themselves to solve the problems, these existing trends represent real opportunities to alleviate and/or overcome the barriers. Existing initiatives may also provide the U.S. government with mechanisms to address these and other trade and investment barriers. Some of the most significant opportunities result from ongoing European integration (especially monetary) and timely, ongoing WTO negotiations involving the services industries.

A. European Integration

Many observers consider the adoption and introduction of a single currency (the Euro) by the EU in January 1999 the biggest political event in Europe during the past 25 years. For the 11 EU countries participating in the single monetary market, the Euro has become the currency used in capital markets, by government agencies, and for wholesale corporate payments (the transition

However, much remains to be done to liberalize trade in financial services. The 1997 financial services agreement was just a limited first step. The agreement largely formalized existing bilateral agreements of WTO members within the WTO's large multilateral context. But importantly, it did reaffirm the timetable and framework for future negotiations.

The work to map out the next round of negotiations began earlier this year. On July 14, 2000, the United States submitted a framework proposal for services negotiation (the first nation to do so). In its submission, the United States noted the importance of services in modern economies and recognized the strength of its service industries. The United States stated that it took this action to influence the scope and pace of WTO negotiations, which it wants to cover more sectors and be more open to outside observers.

The next step for the United States is the submission of additional papers later this year containing proposals for the liberalization of specific service sectors (such as financial). This first phase of the negotiations will run through March 2001 with members submitting their negotiating proposals and finishing technical work. All proposals submitted must be at least as liberal as current practice. The negotiations are scheduled for conclusion by 2002.

VI. Findings and Recommendations

The examination conducted in this paper indicates that relation-based banking and attending financing practices represent a considerable barrier to U.S. financial services industry involvement in financing environmental infrastructure in Western Europe. It also reveals benefits for U.S. industry groups and environmental interests from overcoming these barriers.

The combination of the growing importance of environmental investment, the changing nature of financial markets in Western Europe, and the new WTO services liberalization negotiations provides an opportunity for the United States to develop approaches that will strengthen its economy, share the benefits with its best trading partners, and promote sustainable environmental finance. Over the next few months, a significant opportunity exists to address these barriers through the U.S. government plans to submit negotiation proposals to the WTO for liberalizing trade in financial services. Accordingly, the Board recommends that the U.S. government incorporate in its proposals:

- Support for fair and open competition in financing public-purpose environmental infrastructure activities in Western Europe by eliminating the use of restricted-access financing mechanisms that support closed relationship-based banking

- Support for increased disclosure of the environmental financing practices that take place between Western European banks and communities by requiring that all bank and government liabilities and guarantees be clearly delineated in financial reporting and easily available to international credit rating agencies

These recommendations, if adopted, would need to be transmitted to the Office of the U.S. Trade Representative as soon as possible in order to be included in any U.S. proposal on financial and/or environmental services. The Board is available to assist in this process as needed and to answer any questions about the paper.

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

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OFFICE OF
INTERNATIONAL ACTIVITIES

Robert O. Lenna, Chair
U.S. EPA Environmental Finance Advisory Board
Maine Municipal Bond Bank
3 University Drive, Box 2268
Augusta, Maine 04338-2268

Dear Mr. Lenna:

The Office of International Activities has received and is reviewing the Environmental Financial Advisory Board (EFAB) report, "Removing Barriers to Investment in Environmental Infrastructure in Western Europe." While this review goes forward, we would like to offer an interim response to this report (EPA-EFAB-IW-01-01).

We believe the report deals with an important and timely topic, touching as it does on issues currently being developed and negotiated by the United States Trade Representative (USTR) under the World Trade Organization (WTO) framework. In particular, this Office is closely following the WTO negotiations with regard to both financial and environmental services. We strongly believe that finance is an essential consideration for effective and sustainable environmental protection anywhere in the world.

Given these factors, we have referred a copy of the report to the Office of the USTR for their review and comment. Upon completion of our own review and receipt of comments from the USTR and other interested parties, this Office will provide a more comprehensive response to the Board.

In the meantime, let me express our appreciation to EFAB for its consideration of this and other international environmental issues. We look forward to continuing cooperation with the Board on financing issues of concern to the Agency and this Office.

Sincerely yours,

Daniel Magraw

Daniel Magraw
Acting Principal Deputy Assistant Administrator

cc: John Wise

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