Chapter 1
The Concept and Tasks of a "Public Development Finance Institution" as Regards the European Union Law Regulations

In this chapter, the Author outlines the principles of the functioning of public development finance institutions in the legal framework of the European Union. In the Author's opinion, it is important to find the most relevant legal solutions in the area of their functioning, enabling them to be given the status of a public development finance institution.

Public Development Finance Institutions in the Sources of European Union Law

The market economy does not always operate efficiently. The reason for the existence of market economy failures can be, for example, information asymmetry. This phenomenon can be at least partially mitigated by actions taken by public development finance institutions, inter alia by increasing the supply of financing available for investment in areas where market failures have been identified. This is because such institutions have a greater capacity to overcome existing imperfections than entities operating under market conditions. The legal regulations for such institutions in principle emphasise that their activities should be concentrated only in areas where market failures are identified and are therefore inadequately supported by commercial providers of financing.[11]

[11] Communication from the Commission to the European Parliament and the Council of 22 July 2015 – Working together for jobs and growth: the role of National Promotional Banks (NPBs) in supporting the Investment Plan for Europe, Brussels (COM/2015/0361 final).

The activities of public development finance institutions should focus on the following market segments (Schmit et al., 2011; Skuza, 2015f):
1) financing of small and medium-sized enterprises, environmental investments, innovation;
2) participation in projects in line with European Union policies, including those co-financed by international finance institutions, e.g. the European Investment Bank, the European Bank for Reconstruction and Development;
3) financing of local government units;
4) financing areas of a social nature, e.g. social housing, projects in education or combating unemployment;
5) financing export taking into account international regulations.

Bearing in mind the definition of "public development finance institutions" at the level of European Union law, the Author points to Article 2, section 1, item 3 of the Regulation (EU) 2015/1017 of the European Parliament and of the Council of 25 June 2015 on the European Fund for Strategic Investments, the European Investment Advisory Hub and the European Investment Project Portal and amending Regulations (EU) No 1291/2013 and (EU) No 1316/2013 — the European Fund for Strategic Investments.[12] According to this provision, a national promotional bank or institution means a legal entity carrying out financial activities on a professional basis which is given a mandate by a member state or a member state's entity at a central, regional or local level, to carry out development or promotional activities. The above definition is, in the Author's opinion, very general and it can hardly be inferred from it as to the possibility of creating legal regulations defining the rules for the operation of such an entity. In the context of public development finance institutions, however, it makes more sense to refer to the regulations contained in Article 429a, section 2 of the CRR. According to these regulations relating to the rules for the determination of certain prudential indicators, it is an institution[13] (with the profile of a credit institution) that meets strictly defined conditions together, namely:
1) it has been established by a member state's central government, regional government or local authority;
2) its activity is limited to advancing specified objectives of financial, social or economic public policy in accordance with the laws and provisions governing that institution, including articles of association, on a non-

[12] OJ EU L 169 of 1 July 2015, p. 1, as amended.
[13] The provisions of the CRR mainly apply to credit institutions.

-competitive basis; public policy objectives may include the provision of financing for promotional or development purposes to specified economic sectors or geographical areas of the relevant member state;
3) its goal is not to maximise profit or market share;
4) in respect of which, subject to Union State aid rules, the central government, regional government or local authority has an obligation to protect the credit institution's viability or directly or indirectly guarantees at least 90% of the credit institution's own funds requirements, funding requirements or promotional loans granted;
5) it does not take covered deposits as defined in point (5) of Article 2(1) of Directive 2014/49/EU on deposit guarantee schemes[14] or in national law implementing that Directive that may be classified as a fixed term or savings deposits from consumers as defined in point (a) of Article 3 of Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC.[15]

The establishment of a public development finance institution and its legal form in a member state of the European Union is a sovereign decision of each member state. However, it is essential that rules are put in place to prevent potential negative effects from materialising, such as[16]:
1) losses incurred by the State as guarantor of the liabilities of a public development finance institution, stemming from the application of substandard credit risk assessment standards;
2) misallocation of resources due to political decisions;
3) supporting undertakings in financial difficulty;
4) crowding out of the entities operating under market conditions.

The areas of involvement of public development finance institutions should be limited to addressing market failures. However, such an approach cannot be interpreted as involvement in inherently unprofitable projects. Their activities should be profitable (although they should not be focused solely on profit) to maintain a stable financial situation without the need for permanent recapitalisation by the state due to losses incurred.

[14] OJ EU L 173 of 12 June 2014, p. 149, as amended.
[15] OJ EU L 133 of 22 May 2008, p. 66, as amended.
[16] Communication from the Commission to the European Parliament and the Council of 22 July 2015, op. cit.

Activities of Public Development Finance Institutions in the Context of State Aid Issues and Statistical Classification

It should be emphasised that the resources of public development finance institutions are state resources within the meaning of Article 107, section 1 of the Treaty on the Functioning of the European Union (hereinafter TFEU).[17] The activities of such entities are classified as state aid if all of the following conditions are met together, i.e.:

1) any aid is granted by a member state or through state resources in any form whatsoever;
2) it distorts or threatens to distort competition;
3) it favours certain undertakings or the production of certain goods;
4) it affects trade between member states.

In the area of state aid, it is important to distinguish between so-called first and second-level aid. First-level aid is the support that may be granted at the stage of the formation of a public development finance institution or its operation in the form of, for example, a state guarantee or recapitalisation (state – public development finance institution relationship). Such aid shall be considered to be conforming with the common market as long as such support does not impact distortion of competition, i.e. public development finance institutions will only operate in the identified market failure and their possible commercial operations will be properly separated and will not make use of such support (Lizak & Skuza, 2017). Second-level aid, on the other hand, is aid contained in the activities of public finance institutions (institution – client line of aid), which may or may not occur. The activities of public development finance institutions are categorised as State aid if the four criteria mentioned above and specified in Article 107(1) of the TFEU are met. These institutions can operate both on aid principles – based on acceptable legal systems (e.g. General Block Exemption Regulation, *de minimis*) or notified programmes, as long as all the above-mentioned prerequisites for state aid are met – and also on market principles – based on the so-called market economy operator test. The decisions on the approval of state aid issued by the European Commission contain a clause providing for a review after a certain period. Reassessment of the market failures and the remit is necessary to take account of economic development and the evolutions of the market and, by the same token, the evolution of market

[17] OJ EU C 326 of 26 October 2012, p. 47, as amended.

failures. At the request of a Member State, such an assessment is also possible *ex ante*[18] (Lizak & Skuza, 2017).

The activities of public development finance institutions should be accounted for outside the general government sector. However, in the event that credit decisions require government approval or the members of the bodies of such an institution (e.g. the management board) are employed by the government administration, the activities of such an institution would have to be marked as transactions of the government and local government sector. Detailed rules on the statistical recognition of public development finance institutions are contained in Eurostat's European System of National and Regional Accounts (ESA 2010) and guidance provided to Member States.[19]

With regard to the inclusion of public development finance institutions in European Union statistics, it can be pointed out, for example, that, for the sake of transparency in the activities of such institutions, the European Commission has drawn attention to the need to separate development activities from commercial activities (e.g. in the United Kingdom and Latvia). In practice, however, the separation of commercial activities into another entity only included the case of the British Business Bank. This is because the European Commission considered that, in its commercial part, it would operate in a sector where commercial banks are also active and therefore no market failure (commercial financing of the SME sector) was found to exist. Meanwhile, the development part of the British Business Bank (the so-called Mandated Arm) can operate both through aid schemes (based on the *General Block Exemption Regulation* or *de minimis*) and on market conditions (with the proviso that in the market schemes that are introduced, mechanisms must be put in place to ensure that private sector entities are not crowded out (Lizak & Skuza, 2017). In contrast, in the case of another British institution, i.e. the Green Investment Bank, the European Commission acknowledged that the entire operations of this institution were categorised as operations within the market failure, without the need for any division (even in the area of internal regulations of an organisational

[18] Commission Decision of 4 July 2014 on the approval of State aid pursuant to Articles 107 and 108 of the TFEU. Cases to which the Commission does not object (OJ EU C 210, SA.37554, p. 1).

[19] Retrieved from: http://ec.europa.eu/eurostat/documents/3859598/5925693/KS-02-13-269-EN.PDF, http://ec.europa.eu/eurostat/documents/3859598/5937189/KS-GQ-14-010-EN.PDF/c1466fde-141c-418d-b7f1-eb8d5765aa1d, http://ec.europa.eu/eurostat/web/government-finance-statistics/methodology/advice-to-member-states [Retrieved on 1 October 2022]; Communication from the Commission to the European Parliament and the Council of 22 July 2015, op. cit.