



DIRECTORATE-GENERAL FOR EXTERNAL POLICIES  
POLICY DEPARTMENT



**REFORM OF THE  
EUROPEAN  
INVESTMENT BANK:  
HOW TO UPGRADE THE  
EIB'S ROLE IN  
DEVELOPMENT**

DEVE

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## DIRECTORATE-GENERAL FOR EXTERNAL POLICIES OF THE UNION

### DIRECTORATE B

#### POLICY DEPARTMENT

#### STUDY

# REFORM OF THE EUROPEAN INVESTMENT BANK: HOW TO UPGRADE THE EIB'S ROLE IN DEVELOPMENT

#### Abstract

In this briefing paper we evaluate the performance of the EIB in its external lending and policies in relation to developing economies including its response to the financial crisis. We recommend policy changes including greater absolute levels of lending to developing economies and greater risk taking to achieve "more with less". We also recommend tailoring the mandate and lending criteria for developing countries including greater flexibility of lending criteria and standards, a crisis mandate, country level priority objectives linked to MDGs and greater blending of grants and lending. In order to support such changes the need for greater and specialist resources including staff and capital is discussed including the possibility of extending cooperation with other IFIs and the MTR feasibility study for a dedicated subsidiary.

This study was requested by the European Parliament's Committee on Committee on Development.

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## ACRONYMS

ACP	Africa, the Caribbean and Pacific
ADB	Asian Development Bank
AfDB	African Development Bank
EIB	European Investment Bank
IBRD	International Bank for Reconstruction & Development
IADB	Inter- American Development bank
JEREMIE	Joint European Resources for Small and Medium-sized Enterprises
JASMINE	Joint Action to Support Microfinance Institutions in Europe
LIC	Lower Income Countries
Multilateral Development Banks	
MDG	Millennium Development Goals
MIC	Middle Income Countries
MTR	EIB Steering Committee Midterm Review of EIB External Mandate
RDB	Regional Development Banks
SME	Small and Medium-sized Enterprises

## EXECUTIVE SUMMARY

### Introduction

In this Briefing Paper we will evaluate the performance of the EIB in its external lending, particularly but not only, in its response to the financial crisis. We then make suggestions for the improvement of this important institution's policies in its external lending. Such improvements seem particularly timely, as in the changing landscape of finance after the crisis, MDBs and RDBs have become more important in development finance.

The broad context of our proposals is that a key lesson from the major global financial crisis is the greater importance of multilateral and regional development banks especially in providing countercyclical lending, when private lending dries up. Multilateral and regional development banks have in fact performed such a role at a significant level in this crisis, both as regards commitments and disbursements; the EIB, though increasing commitments of lending to non member countries significantly did not increase disbursements at a similar scale as for example the World Bank, the IADB or the ADB, partly due to the fact its' loans are for projects rather than programmes. Of particular concern was that EIB lending to ACP countries actually fell between 2007 and 2009. It seems important for the EIB to create mechanisms and procedures to enhance its' ability to have a more speedy **countercyclical response**.

However, even in "normal" times, there are important **market gaps**, such as for long term lending, for example for infrastructure, or to sectors perceived as higher risk, such as to small and medium sized enterprises ("SMEs"), where development banks have an important role to play, to help complete markets, where these are nonexistent. This is particularly the case for **low income countries** ("LICs"), where market gaps are more widespread, and for low income people who are often excluded from financial services. Where feasible, RDBs like the EIB should try to crowd in the private sector into those market gaps in a sustainable way. But where this is not possible, continued RDB lending will be essential for supporting activities, such as investment in clean energy, where social returns are higher than market returns. Furthermore, investing in sectors which require long term funding is difficult to finance by the private sector, particularly in low income countries. Therefore, it seems particularly important to enhance the role of the EIB in low income countries, especially as the response in lending by the IFIs and the MDBs during the crisis has been more limited for low income countries.

However, we also feel that **middle income countries** ("MICs"), in regions such as Asia and Latin America, would greatly benefit from greater access to EIB lending, as lending to them is restricted by the limited envelope in the current mandate, and as private lending to developmentally important sectors, such as SME's (that generate a high proportion of employment in those countries) is often insufficient, given excessive perception of risk by private actors, even for companies that are profitable in commercial terms. Furthermore, it would seem that areas where the EIB has valuable accumulated expertise in Europe, such as financing regional infrastructure, should also be priority for lending in middle income countries. The fact that many of the developing countries are expected to be growing rapidly in the future implies that their demand for financial services is increasing beyond what existing market institutions can provide.

## Summary of Key Recommendations

### A Need for Greater Risk Taking

We recommend greater EIB risk taking to support incomplete markets so as to crowd-in the private sector and to create “leverage” to reach for greater scale and to achieve “more with less”. Similarly the EIB should fill market gaps, where this will have positive development impacts, provided projects are commercially viable. For this purpose the EIB should use in a more targeted way the guarantee which the EU gives it, as well as put more lending on its balance sheet.

Key points include the following;

- The very important **increase should be in overall exposure and activities to developing countries** including in Asia and Latin America (ALA), as well as for Eastern Neighbours and Russia. This probably includes expanding envelope for ALA- as well as broadening areas of EIB lending to those and other areas, as well as modifying existing memorandums of understanding with other development banks. This expanded lending needs to be consistent with EU development or broad policy objectives and implies greater balance between EIB lending to different regions. Successful financial instruments should be used more consistently across regions. Naturally, expanded lending to low income countries is also extremely desirable.
- **Other forms of increased lending (which in some cases may increase risk taking)** that should be considered include extension of partnerships with the private sector to developing countries, increasing activities in certain higher risk sectors such as SMEs and MFIs, and through higher risk lending and other instruments. The latter includes increased tenor, local currency lending, GNP linked loans and quasi equity instruments plus indirect support of financial sector deepening.
- We recognise the benefit the EIB **AAA rating** brings, especially in funding cost which can be passed to borrowers and are cautious of the impact of risk taking on it. However we also believe that risk taking can successfully be extended under current EIB capital and that risk management can be actively used to mitigate impact of increased risk taking. Furthermore some innovations, like growth linked lending could actually reduce risk of defaults, by making loans more sustainable.

### Tailoring the Mandate and Lending Criteria for Developing Countries

In relation to tailoring the mandate for developing countries we recommend a high degree of flexibility and EIB level discussion in the mandate to adapt it to different country environments. However, it is crucial to have a broad mandate applicable across different developing country regions. We would make the following specific recommendations;

- Greater **oversight by the European Parliament**, at broad levels, (for example giving sector priorities and development criteria), but avoiding oversight of individual loans. This oversight by the European Parliament, as well as the role of the European Parliament as co-decider is a pioneering experience of a regional development bank being accountable to parliamentarians.
- A **specific crisis mandate** including revision of internal procedures and conditionality to allow acceleration of disbursements. This could include sector loans in times of crisis.
- **Country level priority objectives** linked to national development objectives and EU development cooperation aims, with goals relating to the Millennium Development Goals, broader development goals and to mitigating, as well as adapting to, climate change.
- A high level of **blending** of grants and lending with a high percentage of grants for LICs.
- Gradual introduction and relative, as well as progress based, **standards and conditions**.

- A key area for such conditions is **climate change mitigation and adaptation**, area where the EIB has great expertise. Here care must be taken to prefer grant based instruments for activities, such as adaptation-especially in low income countries- where commercial returns may be low or non existent.

### **Need for Greater and Specialist Resources**

An extension of developing country financing, especially in a context of higher risk taking, greater discretion for EIB staff and better tailoring to development aims requires appropriate resourcing. Specific recommendations include the following;

- **Specialist and a greater number of dedicated staff** for lending to developing countries is essential if activities are to be expanded, and have more development criteria; also important for careful monitoring and evaluation of development outcomes and quality of loans. The latter is a new and important priority for the EIB, in the context of its new more explicit development role.
- **Additional dedicated capital desirable** especially if and when new subsidiary created.
- Greater cooperation **with other MDBs, RDBs, European bilateral development agencies, as well as public and private developing country financial institutions would ensure more effective use of resources**. In the case of the former, build for example on experience of collaboration between EIB and bilateral European agencies such as Agence Francaise de Development, KFW and FMO (European Development Finance Institutions), where financial resources are pooled, and one of the institutions does due diligence for smaller loans mainly to SMEs. In the case of the latter far greater collaboration with developing countries' national and regional financial institutions, especially but not only development banks could be very valuable, given their deep local knowledge.

In addition we fully support the feasibility study for a new organizational structure, including consideration of a subsidiary, as recommended by the Midterm Review. A subsidiary for lending to developing countries would imply greater ease to specialize in development issues, given that currently external lending is only 10% of the total EIB lending (of which around half goes to pre- accession countries; thus lending to developing countries, at around 5% of total EIB loans is a fairly marginal activity within the EIB). The existence of a subsidiary could focus development efforts and effectiveness; it could facilitate specializing staff in development lending; it could create a culture focussed more on development needs and involve developing country borrowers. It would be particularly effective if two conditions are met: a) it would be accompanied by an increase in capital for those purposes and b) it would be structured in such a way so that lending to developing countries would continue to benefit from the valuable expertise acquired in EIB lending in Europe.



## 1 OBSTACLES AND ISSUES FOR DEVELOPING COUNTRIES IN ACCESSING FINANCE

### 1.1 An Overview of the Impact of the Financial Crisis on Developing Economies

We start the paper by analysing in some detail the financial crisis and its impact on developing economies, to provide a context for our analysis of the EIB.

Prior to 2003 developing countries had experienced a series of crisis including the 1980s sovereign debt crisis in many parts of the developing world and the 1997 Asian crisis which spread in 1998 to Russia and Latin America. However, from 2003 to 2007 developing economies experienced a period of rapid growth and much greater stability. GNP growth averaged 7% a year, exceeding the developed economies, raising expectations that the UN Millennium Development Goals ("MDGs") might be achieved (OCampo, 2010).

The **2003-2007 booms** was driven by an exceptionally favourable combination of factors for developing economies including financing, which was cheap and plentiful, high commodity prices and booming trade including in manufactured goods. Developing countries benefited exceptionally from these conditions, especially China and India, as well as commodity exporters.

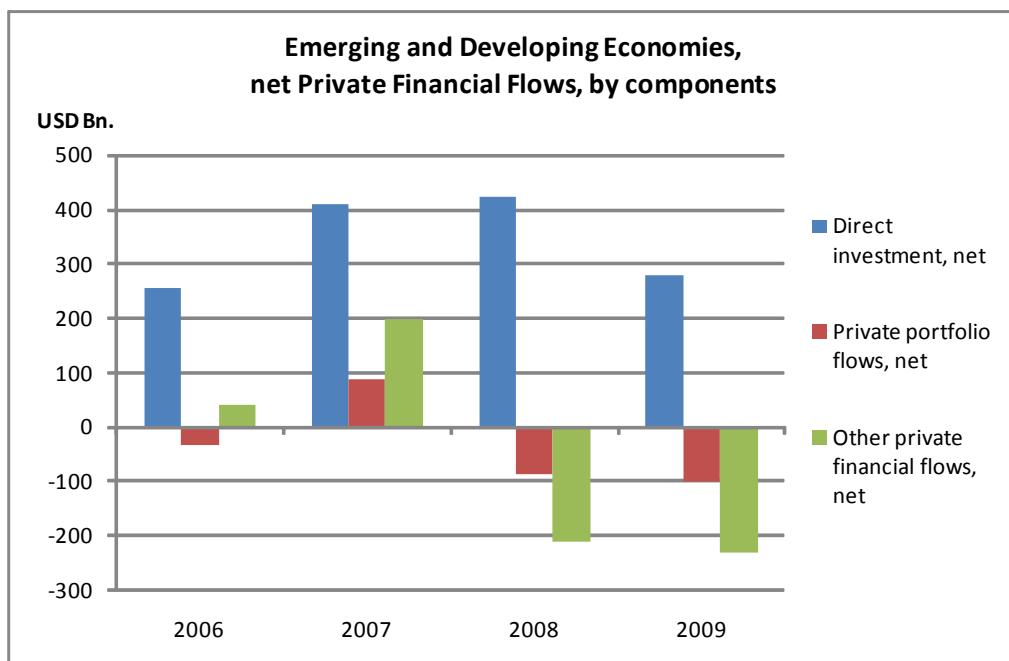
However the conditions **since mid-2007** changed rapidly as the impact of the financial crisis started to spread from its' nucleus in developed countries to developing economies. Initially in 2007 these effects were not harmful to commodity exporters in developing countries, as commodity prices surged, and to those with high foreign exchange reserves which helped to attract capital. However in mid-2008 commodity prices started to decline and the crisis deepened precipitously with the bankruptcy of Lehman's and the consequential seizure of financial markets and a collapse of international trade leading to the worst world recession since the Great Depression.

Now referred to as the "Great Recession", developing countries joined the downturn. GNP for emerging economies' collapsed by over 6% at an annualised level in the fourth quarter of 2008 and by 4% in the first quarter of 2009. However the impact was also sharply differentiated with the Asian giants, India and China, having a more limited slowdown but Emerging Europe, Latin America and a number of East Asian countries having a greater rate of GNP contraction.

#### 1.1.1 Transmission to Developing Countries: The Collapse of Private Capital Flows

The most important channels of transmission of the crisis for developing countries were the seizure of **private capital flows** (especially initially) and the collapse of international trade (1). Direct investment declined rapidly in 2009 and private portfolio flows became negative as early as 2008 and continued to be negative into 2009. According to IMF data, net private capital flows for 2008 were \$130bn net inflow and for 2009 \$52 billion net outflow (i.e. negative), a staggering collapse and reversal from the \$697 billion net inflow in 2007. The biggest collapse was in bank lending with net outflows in 2008 and 2009. Only foreign direct investment, which tends to be more stable due to the long time horizon of investors, remained positive although it too decreased from \$425 billion in 2008 to \$278 billion in 2009 (OCampo, 2010). These changes are illustrated in Figure 1 below.

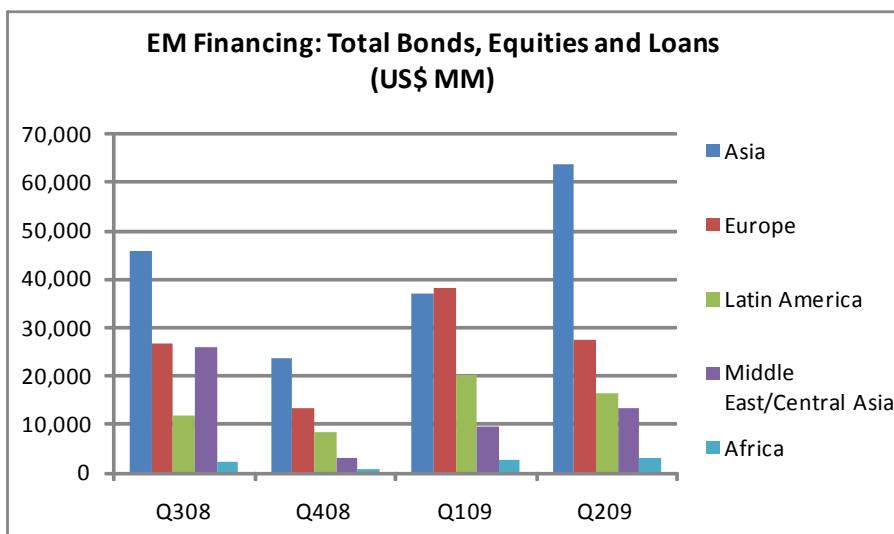
Figure 1: Private Financial Flows by Components



Source: IMF, World Economic Outlook Report, October 2009

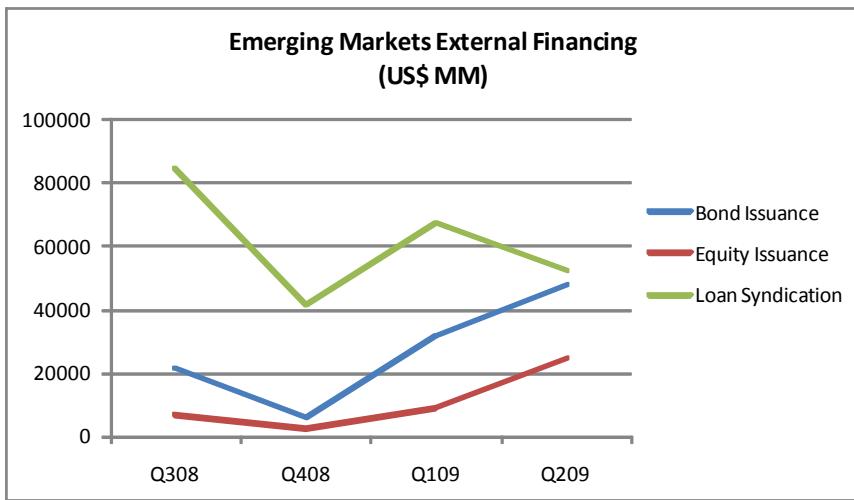
The collapse in private capital flows was in a broad range of **financial flows**, including equity, debt securities and bank lending. In addition to the collapse in new capital flows, secondary market liquidity was extremely poor and the cost of capital, most notably in credit markets, sharply increased as reflected in credit spreads for developing economies. There was virtually no sovereign or corporate bond issuances or equity issuances from emerging economies in international markets between September and December 2008. Local stock markets experienced one of the worst declines in recent periods with the MSCI Emerging Market Index dropping 55% during 2008, representing a \$17 trillion decline in value.

Figure 2: Emerging Market Financial Instruments Issuances



Source: IMF Global Financial Stability Report, October 2009

Figure 3: Emerging Markets, Bonds, Equities and Loans Syndication

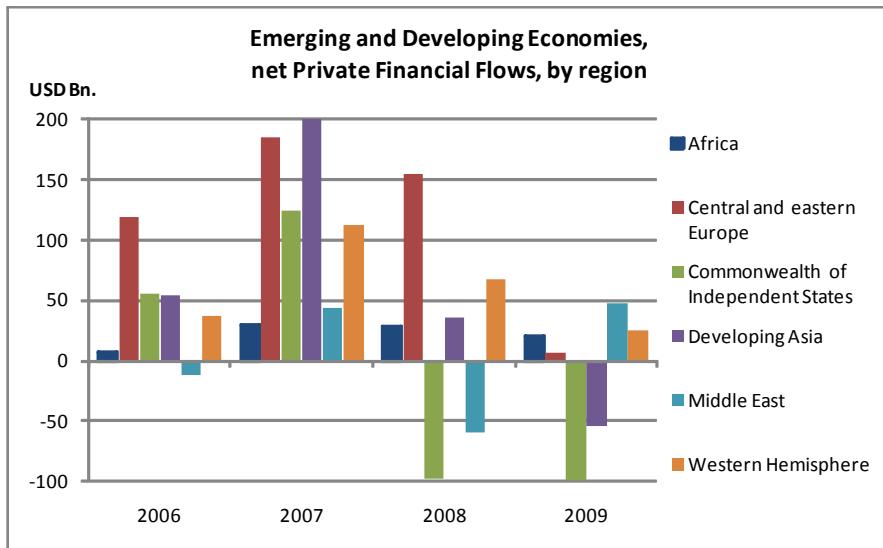


Source: IMF Global Financial Stability Report, October 2009

### 1.1.2 Differentiation of the Impact between Developing Countries

There was however significant differentiation by region. Net flows overall peaked in 2007 and became negative for the Middle East in 2008, for the Commonwealth of Independent States in 2008 & 2009 and for Developing Asia in 2009. For those regions where net flows did not become negative, very significant reductions were seen in 2008 and 2009. The only region relatively unaffected was Africa, but only due to the low pre-2008 net flows for the region, reflecting its generally poor **linkage to global financial markets**. This is illustrated in the figure below.

Figure 4: Private Financial Flows by Region

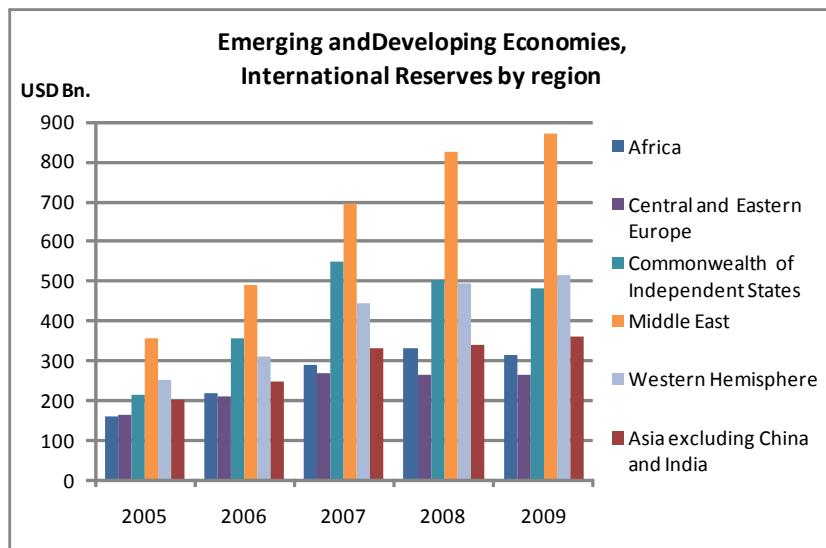


Source: IMF, World Economic Outlook Report, October 2009

The impact of private capital flows was influenced by the level of countries **foreign exchange reserves and external debt**. Those countries whose position was strong before the onset of the crisis in 2008 were better able to weather the financial storm and this was particularly the case in Asia and in oil

exporting countries foreign exchange reserves had been accumulated and external levels of debt. However the sheer scale of the reversal of capital flows impacted all economies regardless of their national financial situation.

Figure 5: International Reserves



Source: IMF, World Economic Outlook Report, October 2009

Figure 6: External Debt (% GDP)

Region	2006	2007	2008	2009
<b>Emerging and developing economies</b>	<b>27.5</b>	<b>27.9</b>	<b>24.2</b>	<b>26.0</b>
Africa	26.3	25.6	22.4	25.4
Africa: Sub-Saharan	28.5	27.9	24.5	27.9
Central and Eastern Europe	52.8	56.5	54.4	66.3
Commonwealth of Independent States	35.7	39.8	33.1	41.8
Developing Asia	19.3	17.5	15.0	15.3
Middle East	32.9	37.3	27.8	31.0
Western Hemisphere	24.0	23.0	20.5	22.1

Source: IMF, World Economic Outlook Database, 2009

Finally the impact also interacted heavily with the level **of trade as a proportion of GDP, and composition of trade**. As noted commodity exporters, especially oil exporters, benefited from the surge in commodity prices in 2008 but later joined those with negative effects as this boom rapidly reversed in 2009. Those with manufacturing exports were impacted as demand in developed countries

collapsed. In Asia in particular, with its export led growth, the contraction of exports was a maximum of 30% in 2008. China compensated with massive domestic demand stimulus, to achieve high overall growth. Chinese exports still dropped by 20% in the first quarter of 2009 compared to 2008. Once again in trade, low income countries were less affected, but only due to their low base prior to the crisis.

### 1.1.3 Key Barriers to Financing Highlighted by the Crisis

As noted during the 2003-2007 period many developing economies were experiencing a strong period of growth supported by private flows. During this period, the value of IFI, multilateral development banks, MDBs, and regional development banks, RDBs, lending in financing development was questioned by some observers due to the scale of private external flows (Griffiths-Jones 2007). Public-private partnerships were active and many IFIs found their funding competing in cost and availability with private capital flows, especially in middle income countries.

However the financial crisis has highlighted the key role that IFIs and multilateral, as well as regional development banks, need to play, including both during crisis and in the longer term post crisis environment.

The most critical issue highlighted again has been the **scale and volatility of private capital flows**. Prior to the crisis the potential role for the private sector as a positive force for development was perceived, in particular due to the scale of the capital flows that could be generated relative to IFI funds. However the potential for those flows to be interrupted by shocks to financial systems including those generated externally to developing countries, where they are completely innocent victims, as in the last crisis, became clearly an essential issue. This volatility was highlighted both in terms of **volume and cost**. The need for IFIs, MDBs and RDBs to be able to lend to developing countries in a counter cyclical way, thus mitigating and managing such volatility is now, perhaps for the first time, very widely accepted.

A secondary issue relating to these flows is the additional susceptibility of developing country capital markets to such shocks. Although all global markets suffered sharp increases in cost and decreases in liquidity, particularly post Lehman's in 2008, emerging markets found for a time that their foreign financing was inaccessible. This reflected the relative shallow depth of **development of capital markets** in emerging markets and the risk appetite of private capital investors, particularly international investors, to rapid reversals. These factors impacted bank lending as well as higher risk capital flows such as equity and venture capital.

Thirdly the role of **domestic policy** as a mitigant is important. During the crisis those countries which have accumulated reserves and reduced external debt were able to mitigate somewhat the impact. However we would emphasise the need for policy flexibility as the uncertain post-crisis environment evolves. For example, fiscal stimulus may be a required policy option. Indeed countries, like China that were able and willing to pursue countercyclical macroeconomic policies in the crisis recovered far more rapidly than those countries who did not execute such policies.

In examining these **lessons from the crisis for MDBs and RDBs**, it is also critical to understand the scale of the private flows which cannot be substituted, even in crisis, by MDBs & RDBs, and hence to assess how their role interacts with the international private capital markets and the development of domestic capital markets, including in ways that smooth flows in times of crisis. There is a requirement to react to crisis conditions but also to assist developing countries longer term to deepen domestic capital markets, so they become less reliant on volatile foreign capital flows. Above all, there is the need for MDBs and RDBs to help developing economies have access to more stable and reliable volumes and cost of external financing, especially long tenor financing. Also essential are instruments like local

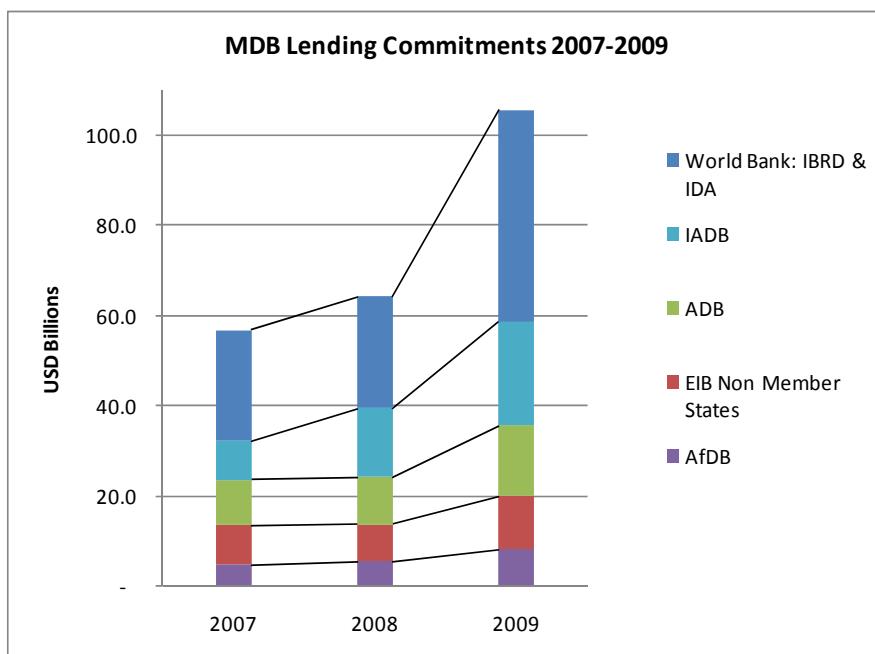
currency paper, growth linked loans with repayment schedules linked to the economic cycle and similar innovative instruments. Further MDBs and RDBs need to be able to implement a counter cyclical role and to act to correct short and longer term market failures, in the absence of the private sector.

The next section will examine the actions undertaken by MDBs, including the EIB, during the crisis and comment critically on their effectiveness before going on to discuss the roles mentioned here in more detail and in relation to the EIB specifically.

## 1.2 The Response of Multilateral Development Banks

The community of multilateral development banks ("MDBs") responded to the crisis with an appropriate sense of urgency. All MDBs **expanded lending** with the IBRD and IDA, for example, increasing commitments by 90% for the year to June 2009 versus the year to June 2008. Other MDBs followed this response and new lending commitments across major MDBs increased from \$64 billion to \$106 billion, or by 64%, from 2008 to 2009. This is illustrated in the figure below.

Figure 7: MDB Lending Commitments 2007 to 2009



Source: Annual Reports of the named MDBs. Estimated unpublished 2009 data for the African and Asian Development Bank's benchmarked against the G-20 Finance Ministers Communiqué in September 2009.

MDBs also sought to **fast track fund** disbursements through either **new facilities** or through changes to current **procedures and conditions**. There was a focus to responses in critical areas including the refinancing of the financial sector, underpinning long term financial markets, supporting the corporate sector and, most importantly, social protection. In addition a number of actions were taken to support trade finance and facilitation. Coordination between MDBs was extended in order to manage the response more effectively.

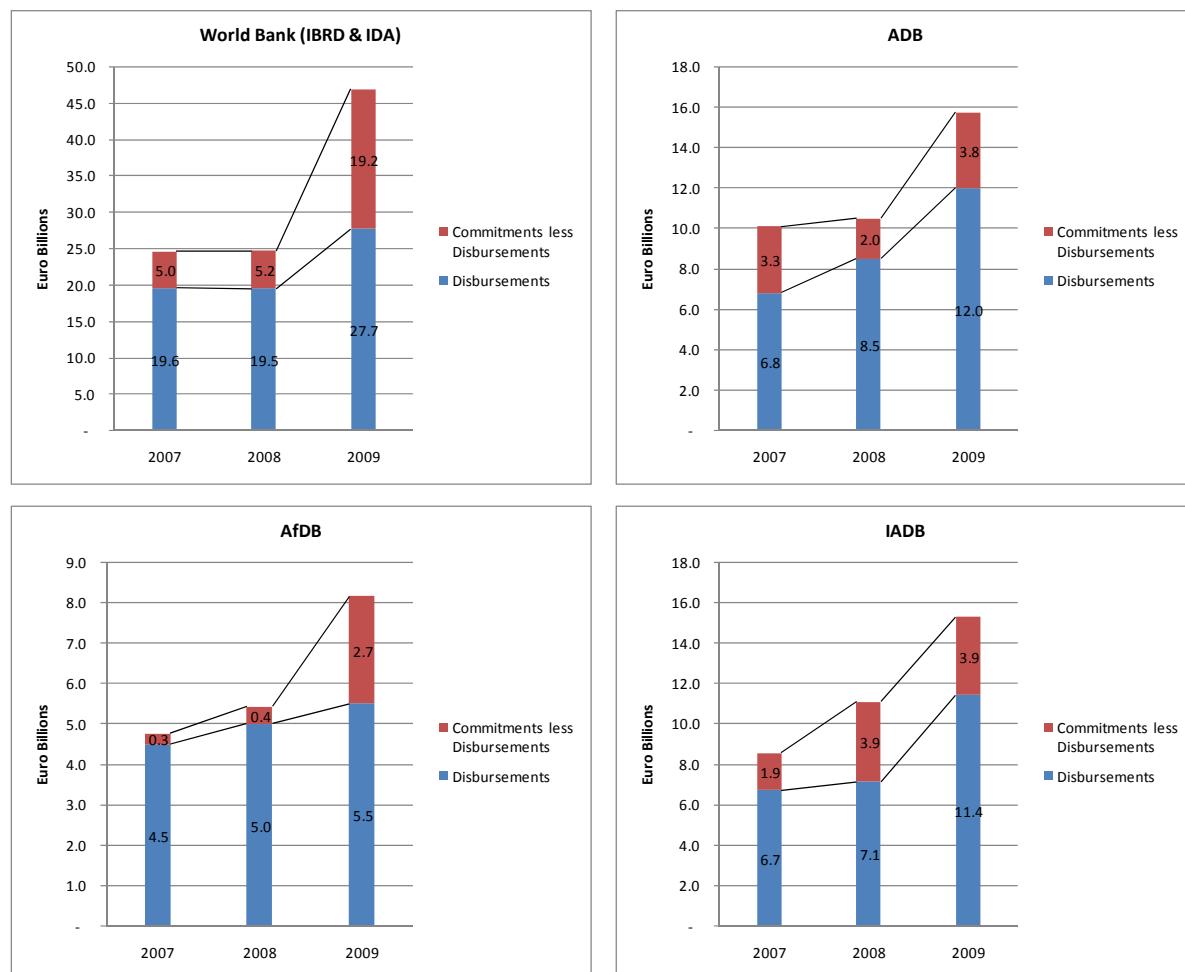
The **World Bank** created a new "fast track facility" of \$2 billion for social protection, a Infrastructure Crisis Facility, \$100 billion of new IBRD commitments and, through the IFC, a series of measures were taken to support trade such as the new Global Trade Liquidity Program. Specific measures were also

taken to support private capital flows and liquidity in financial markets including the Infrastructure Crisis Facility and the MIGA guarantee program providing guarantees to foreign bank subsidiaries in the Ukraine and Russia and political risk guarantees in Central and Eastern Europe and Africa (Massa & Velde 2009).

Other **regional development banks** responded in similar ways. The African Development Bank ("AfDB") response included a \$1.5 billion Emergency Liquidity facility, a \$1 billion Trade Finance Initiative and faster tracking of resources. The Inter-American Development Bank also increased lending commitments and disbursements in a major way, created an emergency liquidity facility and sought to facilitate trade. The Asian Development Bank's response was more constrained due to capital limits, although a doubling of capital was later confirmed, and possibly greater availability of domestic savings that may have implied lower demand in Asia for MDB lending than in other regions.

As can be seen in Figure 8, World Bank Group disbursements increased by an impressive 42% between 2007 and 2009. The performance of some regional development banks, such as the IADB, was even more impressive, with their level of disbursements increasing by 70%, between 2007 and 2009. The Asian Development Bank also increased its lending disbursements by over 75%. This was a very strong counter-cyclical response.

Figure 8: MDBs Lending Commitments and Disbursements, showing the commitment to disbursement "Gap": 2007 to 2009



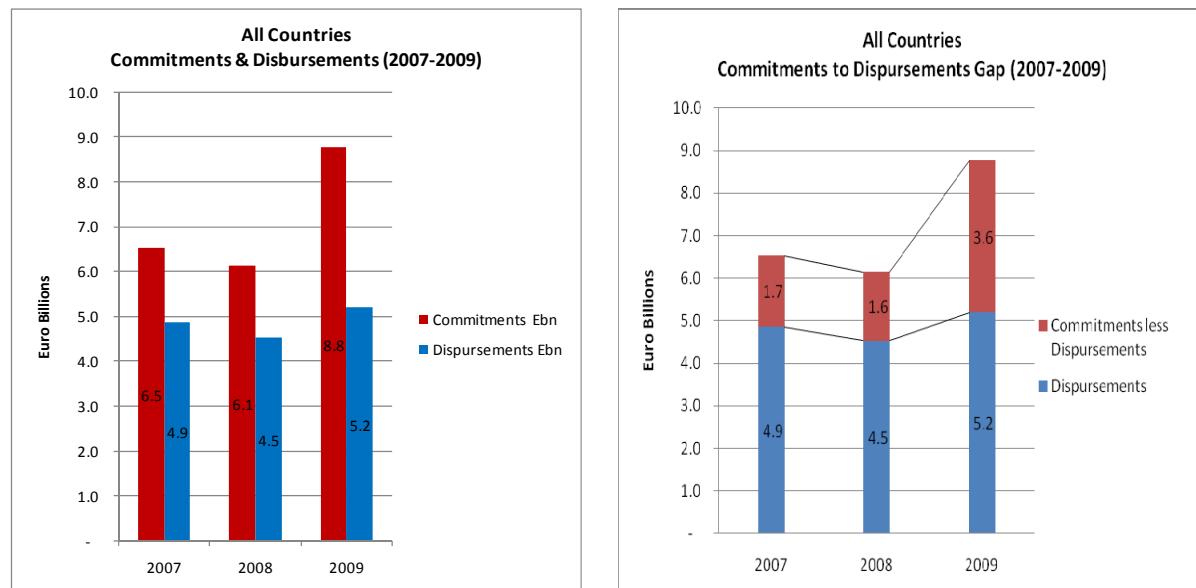
Source: Annual Reports of the named MDBs. Estimated unpublished data for the African and Asian Development Bank's benchmarked against the G-20 Finance Ministers Communiqué in September 2009

### 1.3 The EIB Response

Similarly to other MDBs and RDBs, the EIB was proactive in responding to the crisis. In 2008 the EIB increased overall loan commitments by 21% from €47.8 billion in 2007 to €57.6 billion in 2008 with disbursements rising 12% in the same period. In 2009 lending was further increased to €79 billion. Thus, overall EIB loan commitments to all countries grew by quite an impressive 64% between 2007 and 2009. In 2010 lending was planned to increase by €15 billion. €70 billion or 89% of the total lending for 2009 was to EU countries. Sector and theme focus for 2009 onwards included specific sector programs in SMEs and mid-cap companies, the energy, climate change and infrastructure sectors, clean transport and convergence lending. This included €13 billion in 2009 for SME support via intermediary banks, a 55% increase from 2008. The Bank also sought to bring forward capital increases from 2010 to 2009 with subscribed capital increasing from €67 billion to €232 billion.

In relation to EIB lending to **LICs and MICs** however, as shown in the figures below, the EIB actually decreased its lending commitments and disbursements by 7% and 6% respectively from 2007 to 2008. From 2008 to 2009 the EIB increased its lending commitments by €2.6 billion or 43% to non member states and disbursements by 15% from €4.5bn to €5.2 billion. Overall disbursements to LICs and MICs between 2007 and 2009 only increased by 7% which was very disappointing given the urgency of needs for disbursements during the crisis and the fairly significant increase in commitments achieved by the EIB, which grew by 33% between 2007 and 2009. The increase in EIB disbursements of a mere 7% between 2007 and 2009 compares unfavourably with the evolution of disbursements by the World Bank (43% growth in same period), the IADB (70% growth in the same period) and the ADB (growth of over 75% in this period) However, reportedly (from interview material) EIB disbursements are increasing more rapidly in 2010. It should be emphasized that EIB disbursements may increase more slowly because all lending is project related, unlike other MDBs which have an important part of programme lending. In this context, an important question is whether the EIB should not consider for example sector loans, especially in periods of drought of private capital.

Figure 9: EIB Lending Commitments and Disbursements to Non-Member States 2007 to 2009



Source: EIB internal data

Figure 10: Overview of EIB lending commitments in non-member states in 2007-2009. Euro millions.

	Pre-Accession countries	Mediterranean countries	Eastern Neighbours and Russia	Asia and Latin America	South Africa	ACP countries / OCTs (**)	EFTA countries	Total
<b>2009</b>								
EIB own resources under EU / Member States'	2,865	1,510	233	1,147	280	413		6,447
EIB own resources under own risk facilities	1,475	56		141			170	1,842
EU and Member States Budgetary resources		27				450		477
2009 TOTAL	<b>4,340</b>	<b>1,593</b>	<b>233</b>	<b>1,288</b>	<b>280</b>	<b>863</b>	<b>170</b>	<b>8,767</b>
<b>2008</b>								
EIB own resources under EU / Member States'	2,009	1,195	170	469	203	225		4,270
EIB own resources under own risk facilities	1,444	33						1,477
EU and Member States Budgetary resources		62				336		398
2008 TOTAL	<b>3,453</b>	<b>1,290</b>	<b>170</b>	<b>469</b>	<b>203</b>	<b>561</b>	-	<b>6,145</b>
<b>2007</b>								
EIB own resources under EU / Member States'	1,750	1,205	230	425	113	432		4,155
EIB own resources under own risk facilities	1,176	185		500			146	2,007
EU and Member States Budgetary resources		49				325		374
2007 TOTAL	<b>2,926</b>	<b>1,439</b>	<b>230</b>	<b>925</b>	<b>113</b>	<b>757</b>	<b>146</b>	<b>6,536</b>

Source: EIB internal data

Figure 11: Overview of EIB lending disbursements in non-member states in 2007-2009. Euro millions.

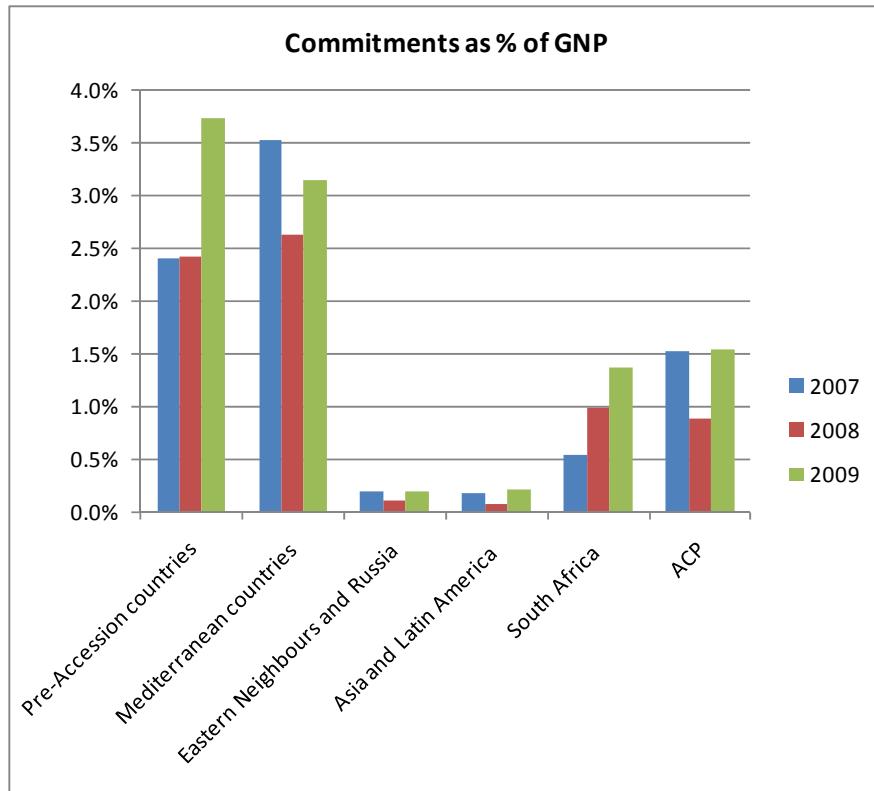
	Pre-Accession countries	Mediterranean countries	Eastern Neighbours	Asia and Latin America	South Africa	ACP countries /	EFTA countries	Total
<b>2009</b>								
EIB own resources under EU / Member States'	1,221	1,178	191	534	130	186		3,439
EIB own resources under own risk facilities	1,060	185		207			76	1,527
EU and Member States Budgetary resources		12				219		230
2009 TOTAL	<b>2,281</b>	<b>1,374</b>	<b>191</b>	<b>741</b>	<b>130</b>	<b>404</b>	<b>76</b>	<b>5,196</b>
<b>2008</b>								
EIB own resources under EU / Member States'	1,170	877	4	376	68	231		2,727
EIB own resources under own risk facilities	1,375	23		45			96	1,539
EU and Member States Budgetary resources		16				243		259
2008 TOTAL	<b>2,546</b>	<b>916</b>	<b>4</b>	<b>421</b>	<b>68</b>	<b>474</b>	<b>96</b>	<b>4,525</b>
<b>2007</b>								
EIB own resources under EU / Member States'	1,366	820	17	362	63	131		2,758
EIB own resources under own risk facilities	1,131	185		74			288	1,678
EU and Member States Budgetary resources		27				396		423
2007 TOTAL	<b>2,497</b>	<b>1,032</b>	<b>17</b>	<b>436</b>	<b>63</b>	<b>527</b>	<b>288</b>	<b>4,859</b>

Source: EIB internal data

As **proportion of GNP**, it is noteworthy that lending commitments are highest for countries nearest the EU, that is for pre accession and Mediterranean countries. ACP and South Africa are in an intermediate position, and the lowest ratios are for Asia and Latin America, as well as for Eastern Neighbours and Russia.

These changes in lending to non-member states can also be reviewed by **risk category**. The majority of the increase in lending in 2009 was in the form of EIB lending under EU and member state guarantees. EIB own risk facilities<sup>1</sup> actually declined from €2.0 to €1.5 billion or by 25% from 2007 to 2009 and in 2009 reached €1.8 billion, still below 2007 levels. (See Figures 10, 11 and 13) This pro-cyclical risk response will be discussed in the following sections.

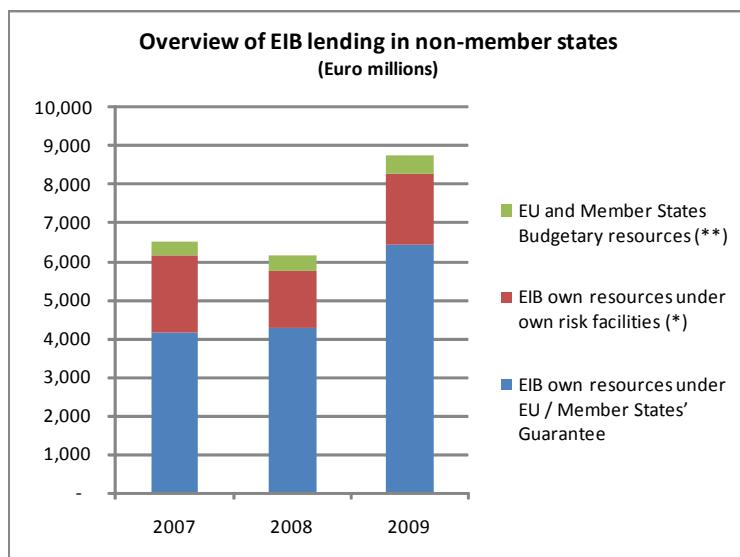
Figure 12: Commitments as a percentage of GNP for non-member states reflect similar patterns to overall lending with concentration in Pre-accession and Mediterranean countries including responses in the 2008/9 crisis.



Source: EIB internal data and IMF October 2009 Statistical database

<sup>1</sup> The EIB own risk facilities include: (i) Pre-Accession Facility: financial envelope of €19.5bn for the period 2000-2010; (ii) Mediterranean Partnership Facility II: €2bn for 2007-2013; (iii) Facility for Energy Sustainability and Security of Supply: €3bn for 2007-2013. Eligible regions include ACP, Mediterranean countries, Eastern Europe, Southern Caucasus, Asia, Latin America and South Africa; (iv)EFTA Facility: €3.3bn until 2013; (v) Eastern Partners Facility: €1.5bn authorised in December 2009 until 2013

Figure 13: EIB Lending Commitments to Non Member States 2007 to 2009 by Risk Category



Source: EIB internal data

When examined by sub-region, lending was focused in **pre-accession countries**, reflecting the EU policy of supporting pre-accession countries through the EIB. These countries received 50% or €4.3 billion of the 2009 lending commitments to non member states although the slow disbursements in this sub-region was notable with no increase in disbursements from 2007 to 2008 and a decline in disbursements to 2009 of 10%. This meant that there was an increase in the "commitment gap", defined as the funds committed but not actually disbursed, in the given time period for the sub-region.

**Mediterranean countries** received another 18% of the 2009 total commitments, with a 24% increase year on year in commitments and with the EIB remaining a leading development lender in the region with an €1.6 billion of lending in 2009 and 70% of 2009 signatories were with co-financing operations in the region. (7). Disbursements were down by 11% from 2007 to 2008 but up a large 50% from 2008 to 2009 thus showing a net increase in disbursements from 2007 of 33%. Interestingly this meant that the Mediterranean region saw a narrowing of its "commitments gap" during the crisis with increases in funds being disbursed (See Figure 15 below). This may be linked to good administrative capacity in the region (From interview material).

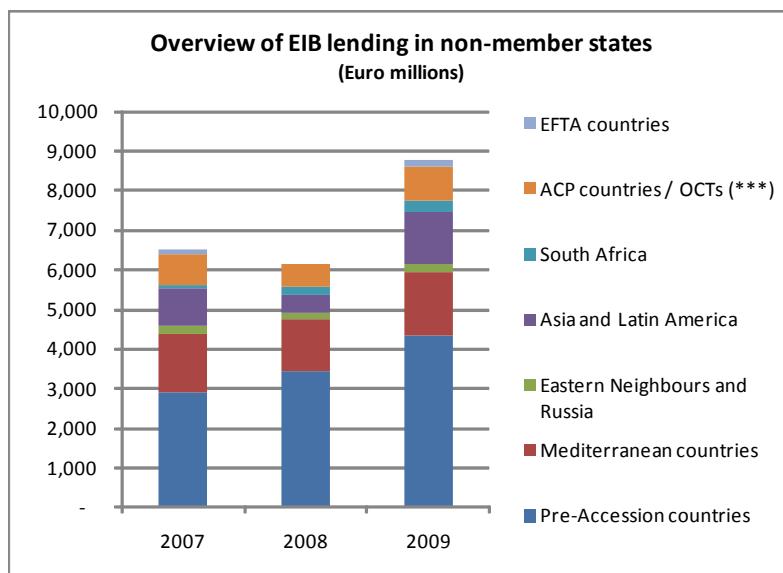
In **Asia and Latin America** in 2008 lending commitments and disbursements were €0.5 billion and 7.6% of the total respectively, reflecting a decrease in commitments but stable disbursements at €0.4 billion for both years. In 2009 as the crisis response gathered pace lending commitments were increased by an impressive 175% but in absolute terms the increase remained small with a total lending commitment in 2009 of €1.2 billion and disbursements failing to match pace with an increase of only €0.3 billion which however implied an impressive growth of 76%. The current EU mandate gives caps for lending to the regions of €2.8 billion for Latin America and €1.0 billion for Asia. This is seen as too restrictive by EIB staff, as future lending will soon be restricted by the total envelope of 2007-2013 mandate, even though demand is high for good projects. Consideration should be given to possible expansion of this mandate. 2009 Lending was made to 9 projects, all with facilities of €100 million or above. The recipient countries include China, India, Pakistan and Vietnam in Asia and Argentina, Columbia, Panama and Colombia in Latin America.

**ACP** showed a very similar pattern to Asia and Latin America with the response in 2008 actually showing a decline in both commitments and disbursements of 25% and 10% respectively and low absolute

amounts of both. Similarly in 2009 commitments increased by a material 54% but the absolute amount remained small and disbursements failed to keep pace with a decrease in the same period of 15%. This is developmentally serious, as many LICs were quite seriously foreign exchange constrained, which slowed down developmentally crucial projects. This is a source of particular concern. 2009 EIB lending commitments were €1.1 billion in 2009 and included €280 million for 4 projects in South Africa plus a further €864 million for 29 development projects across the region, giving an average project lending of €30 million. 72% of projects were also co-financed with other IFIs. This is a positive feature. Projects included a focus on the private sector and financial sector with the latter including microfinance and local investment funds. SME support includes venture capital and the GroFin Africa fund.

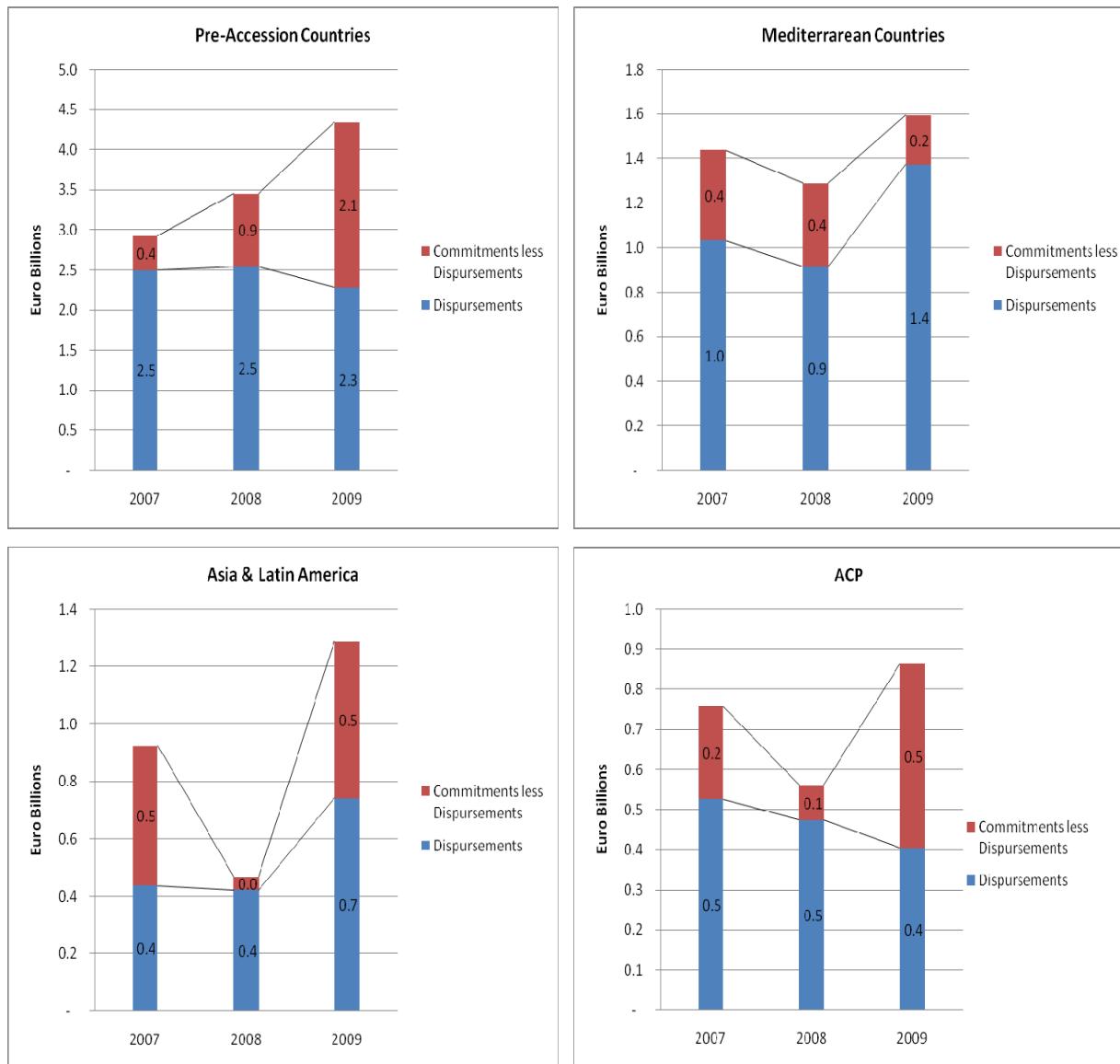
These figures are illustrated in figure 14 and 15 below.

Figure 14: EIB Lending Commitments to Non Member States 2007 to 2009 by Region



Source: EIB internal data

Figure 15: EIB Lending Commitments and Disbursements, showing the commitment to disbursement "Gap": 2007 to 2009 for Selected Countries and Regions



Source: EIB internal data

#### 1.4 Comment on the MDB & EIB Responses

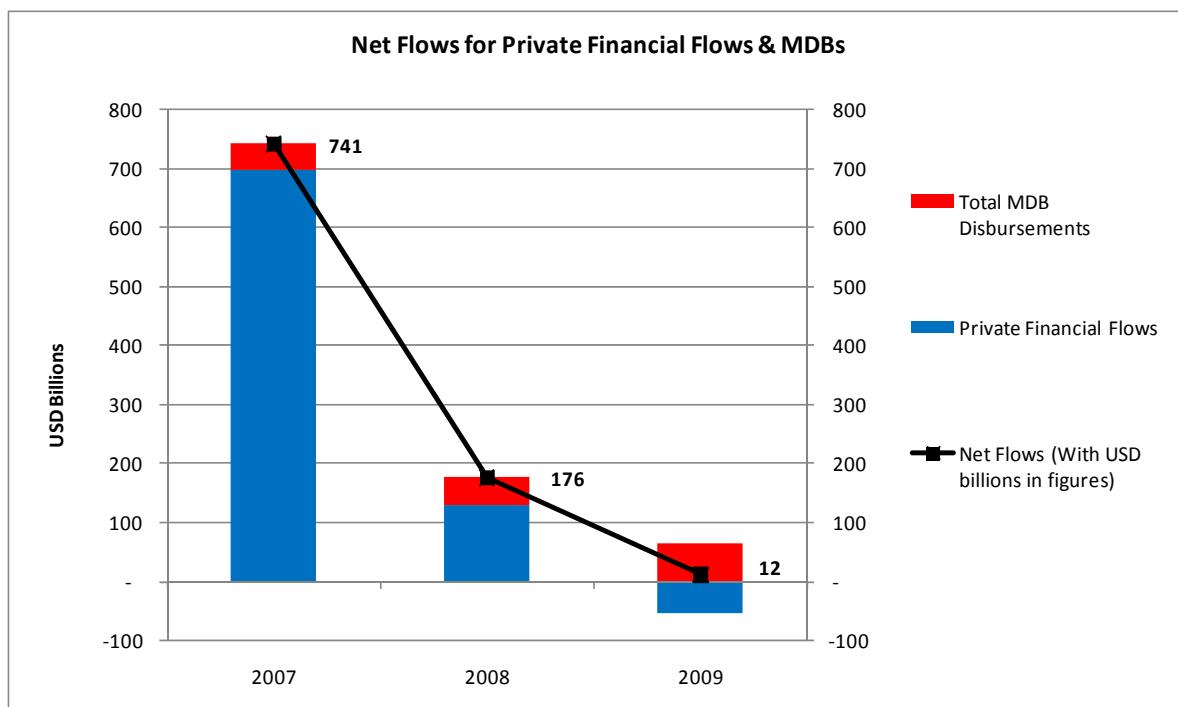
However despite this active response from MDBs including the EIB, a number of issues can be raised. Firstly, despite some MDBs responding by significantly increasing lending commitments in 2008 and retaining or increasing them through 2009, the sheer **scale of private sector financial flows** collapse dwarfed their response, and partly neutralised their valuable anti cyclical response. Figure 16 below illustrates this point in more detail.

In addition the response of MDBs **focused on MICs**. This was partially driven, as noted in the earlier section, by linkage to global financial markets and the composition of trade so MICs were more heavily impacted by the crisis, whereas LICs were apparently less affected, though in terms of impact on poverty the effect can be higher. In addition immediate support was offered to the financial sector and this was focused in MICs. Nevertheless many LICs and the poorest people in MICs, who have the greatest need, were severely impacted by the crisis which worsened chronic issues already existing.

**EIB** responded to the crisis mostly through additional lending in Europe. Increased lending that was to developing countries from the EIB was largely to MICs (See figure 12). MICs include countries that were most, rather than least, able to raise capital flows independently. For example, China, India, and South Africa are all large economies, at the upper end of the scale in their integration and standing within global capital markets but received substantial financing from the EIB. **EIB Lending to LICs remained small** with only €1.6 billion<sup>2</sup>, that is less than 20% of 2009 non-member country lending going to LICs.

Figure 16: Multilateral Development Banks & Private Financial Flows (2007-2009)

The below figure shows disbursements, the difference (the "gap") to commitments for lending and guarantees, as previously shown in figure 7, as a total for all MDBs (the World Bank, the EIB lending to Non-member States, the Asian Development Bank, the African Development Banks and the Inter American Development Bank). Private Financial flows are then added where positive and subtracted where negative. The figure then shows a "net flow" for the two elements, the pro-cyclical private sector flows and the anti cyclical MDB disbursements and commitments. As can be seen, the large scale of private financial flows, both at the 2007 peak of the cycle and the trough of the 2008-2009 crisis, dwarf the combined anti-cyclical lending of the MDBs. Only in 2009 did MDB lending provide a proportional response to private financial flows and mainly because the latter were small and negative.



Source: IMF, Annual Reports of the named MDBs. Estimated unpublished 2009 data for the African and Asian Development Bank's benchmarked against the G-20 Finance Ministers Communiqué in September 2009.

Similarly many MDBs focused on **sectors** that were relatively more able to assist themselves. Financial sector support was substantial from many institutions and although this may have fairly reflected immediate concerns about wide spread collapse of the financial systems at that time of the most acute phase of the crisis in late 2008, other sectors heavily impacted and more chronically impacted by the huge decreases in liquidity and availability of financing and the increases in cost were not supported in

2 Estimated based internal EIB data and EIB Annual Reports and uses ACP, Asia and Latin American lending less lending to China, South Africa and Argentina.

sufficient scale. Such sectors included the SMEs, innovative technology and infrastructure and similar sectors requiring stable long-tenor financing.

The weaknesses in providing an effective anti-cyclical role was also impacted by the limited ability of institutions like the EIB to act sufficiently quickly, pushing actual disbursements into 2009 and 2010. The ability to act with **speed** as well as scale is also an important part of providing an anti-cyclical response. As noted in the previous section, disbursements lagged commitments.

At the EIB commitments in 2008 to non-member states actually fell by 7% and disbursements by 6% versus 2007. However in 2009 commitments rose 43% but **disbursements continued to lag** with a rise of only 15%. Although increased commitments are welcome, disbursements are critical especially during a crisis period. Some countries for example experienced strain on foreign exchange reserves and required immediate disbursements for lending to be effective. Similarly there were examples of rapid deepening of extreme poverty<sup>3</sup> in some LICs which required immediate responses to be effective.

The reasons for delayed disbursements was due to a number of factors, including **absorption capacity**, also linked to more limited administrative capacity in some developing countries. However there were also other important constraints that varied by institution. Some institutions, such as the ADB, were **restrained by capital**. The EIB however, despite raising additional capital in 2009, does not seem to have been constrained by their capital base due to its EU shareholders. This strength meant that there was limited capital driven constraints on lending or on the terms or ability to raise external funding in the financial markets at an appropriate AAA spread.

MDBs were also internally restrained by issues such as the mandate, internal requirements and risk management. As noted some MDBs sought to reduce these constraints through mechanisms such as fast tracking facilities and reducing conditionality. In regard to these constraints the **EIB** seems to have fared less well than in capital constraints. The **external mandate** under which the EIB operates external to the EU<sup>4</sup> was restricted by multiple and diverse requirements, which varied by region. These include regional lending ceilings, requirements to focus on specific regions, memorandums of understanding with other RDBs and, requirements to show consistency and support of EU policy<sup>5</sup>. The latter are naturally important, but may be time consuming. For example, financing requires significant review and has a lengthy process of approval including by the EIB board and through agreement by the European Commission, which needs to confirm that particular loans are eligible to be made by the EIB. As pointed out, the fact that the EIB only lends to projects tends to slow down disbursements. Where loans are co-financed with other RDBs, other complications and delays can arise. The same issue arises where there are memorandums of understanding with other RDBs that may either slow down or even restrict the EIB's ability to lend to certain regions. There is also a process of borrowing country level ratifications, which can be quite lengthy in some countries, as loans are approved by Parliaments<sup>6</sup>. Similarly the ACP-EU Partnership agreements (the Cotonou Agreement) have procedural requirements that need to be demonstrated and approved.

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3 For example the experiences in some LICs of food shortages as commodity price inflation and volatility impacted basic food supplies.

4 Pre-Accession, Neighbourhood and partner countries, Asia, Latin America and South Africa

5 In general the activities of the EIB are required to be consistent and supportive of EU policy including environmental protection and energy security for example. In July 2009 the EP and the EU Council introduced a requirement that EIB financing operations should also contribute to EU "development cooperation" objectives.

6 The time to complete In-country ratification varies greatly by country and can be very lengthy. For example, according to internal EIB sources, Serbia takes on average up to four months and Bosnia one year.

These requirements slowed the response of the EIB and contributed to the slowing of lending commitments and especially disbursements. This included in 2008 when the crisis was at its most acute, but continued into 2009, especially for disbursements. Finally, another factor that may have slowed down EIB lending commitments and disbursements may have been that staff working on non member countries were shifted into lending to EU countries, which grew very rapidly in the crisis. This makes it very desirable that the number of dedicated staff to lending to non member countries is increased, and are not shifted from that activity in crisis times.

It is a source of concern that the EIB is less able to increase disbursements quickly than other MDBs (see figure 8). A more detailed study of the barriers to this in the EIB, as well as positive lessons from other MDBs and RDBs seems urgent to establish what specific measures could be taken to overcome this problem.

The EIB also **reduced own risk lending** (see figure 13), probably reflecting highly conservative internal risk management and appetite. The EIB in the pre 2007 period had been active in using own risk to leverage private sector funds. For example the EIB provided venture risk capital, equity and mezzanine funding. It has also been active in co-financing although much of this is done through guarantees rather than own risk. This pro-cyclical contraction in risk appetite, although understandable from a viewpoint of protecting the EIB's own capital, was problematic from the perspective of increased lending.

## **2 THE EIB AND THE FINANCIAL NEEDS OF DEVELOPING COUNTRIES**

As reviewed above, the financial crisis highlighted important barriers to Developing Countries accessing financing from public sources, showing both successes and weaknesses of MDB's, including the EIB, in responding to them. As the global economy moves beyond the acute phase of the crisis into the post-crisis environment a new set of challenges present themselves. In particular there is a need to assess lessons learnt for both crisis and non-crisis economic circumstances and adapt to them and to be able to do this in an environment where there may be a need to "do more with less"<sup>7</sup>. We will discuss these issues and our recommendations in this section, including especially in relation to the specific EIB focus on SMEs. This would also be relevant in relation to Climate Change and Infrastructure.

As we have discussed, the scale of the private sector lending in many developing countries dwarfs the IFIs, MDBs and RDBs but is characterized by important **market gaps and failures**. These are reflected in the short maturity, poor availability and high cost of financing in private markets. In certain countries and sectors, no private flows are available at any time (e.g. financing of infrastructure in very poor countries). These issues are structural and exist across the business cycle including in a non-crisis environment. There is here a permanent role for institutions like the EIB, to replace nonexistent private flows. MDBs and RDBs can try to crowd in private flows, but where such attempts are not successful, then their role remains. In addition private sector flows, where available, are highly **pro-cyclical** and the level of pro-cyclicality is greater with a greater level of integration into the global financial system. Both structurally and in the recessionary phase of the economic cycle there is also a strong tendency for "marginalization of the weakest" through a differential impact in the private sector on selected countries, often the poorest, and sectors.

As such the **key roles** for MDBs, including the EIB in its development financing, is to seek to function to close directly structural market gaps and failures, crowd in the private sector to those gaps where feasible and to provide an anti-cyclical role, especially during and after crisis. In the 2008-09 crisis the majority of MDBs attempted having a major countercyclical impact through increasing lending,

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<sup>7</sup> As per the Mid term Review

loosening criteria and conditionality to speed approvals and disbursements and creating special liquidity and sector specific facilities. However we would comment that although these actions were welcome, the scale and speed of them was not adequate to be sufficiently anti-cyclical, especially as regards disbursements.

In the Mid Term Review, the “**business model**” of the EIB is described as based upon its AAA credit rating, lending as its main activity and focused on administrative costs coverage. Further in dealing with activities outside the EU the EIB benefits from an EC guarantee, focuses on blending of grants and loans and is heavily reliant on the Commission and other EU institutions for policy definition and dialogue. If the EIB were to adopt the roles noted above it is possible that some of these **core features of the business model** may need to be adjusted. Issues relating to the achievability of this are discussed further below.

## 2.1 A Need for Greater Risk Taking

As part of extending developing country financing we recommend greater EIB **risk taking** to both **support incomplete and failed markets and to crowd-in the private sector** so the real economy can be supported. Not only would this potentially create “leverage” to reach for greater scale to address structural issues and to provide an anti-cyclical role, but would also enable the EIB to achieve greater results with less resources.

We would note that there has been some concern about such an increase of risk internally at the EIB due to guardianship of its **AAA credit status**. We would fully recognise the considerable benefits this brings, not least in funding cost which can be passed to borrowers, especially in developing countries where reasonably priced and long term financing is lacking. However we also believe that risk taking could be extended quite significantly in ways that could increase the development impact of the EIB, without threatening the credit standing of the EIB given its current exceptional capital base and shareholder support, as well as its excellent record of loan repayments.

Increased risk can be considered in a number of forms. Overall **exposure and activities to developing countries** needs to be extended as the most important aspect of increased risk taking. As discussed in the prior section, as a **proportion of GNP**, lending is concentrated in countries nearest the EU, that is for pre accession and Mediterranean countries with ACP and South Africa in an intermediate position, and the lowest ratios are for Asia and Latin America, as well as for Eastern Neighbours and Russia. The two latter regions therefore seem good candidates for an expansion of EIB lending, especially where this is consistent with EU development or broad policy objectives. A good example of furthering development objectives would be to introduce EIB lending to SMEs in Asia and Latin America (“ALA”), which is currently not allowed in the EIB mandate. This would have an important employment and development effect. It would require also an increase in the overall lending envelope to ALA.

Such an increase would imply **greater balance between EIB lending to different regions**, which would correspond well with its’ new, far more explicit development mandate. However, lending to LICs needs also further expansion, with special attention given to mechanisms that can accelerate disbursements; this could include more flexible conditions in bad times, as well as higher technical assistance; more generally sector loans could be considered.

However increased risk taking can also be undertaken through extension of partnerships with the private sector, increasing activities in certain higher risk sectors and by adopting different risk instrument characteristics such as increased tenor and moving towards the equity end of the debt-equity spectrum, for example by greater support of venture capital.

To date the EIB has already had **successes** in these areas with the EU and pre-accession countries. In particular, there have been a wide variety of successful public-private partnerships and the EIB has extended its range and risk of instruments to include equity, mezzanine debt and venture capital funding. Examples include the EIB policy of financing a maximum of 50% of investment cost and makes co-financing a key feature of all EIB operations. The Mid Term review in particular highlights the EIB's success in a key market gap of lending large amounts with long tenors and at attractive terms to the infrastructure sector. Similarly special vehicles such as JEREMIE and JASMINE<sup>8</sup> have been set up to provide equity and mezzanine financing as well as lending to SMEs and Microfinance institutions with co-financing from financial intermediaries. These successfully executed examples demonstrate the potential of such an approach.

We would suggest more broadly extending these roles to developing countries. We would encourage the **partnerships and co financing arrangements** that the EIB has completed to be extended into development financing further, by for example extending the range of instruments including further involvement in equity and mezzanine financing, extending further into non-EU countries including LICs and with a greater range of partners, such as local financial institutions in MICs and LICs, microfinance institutions and specialist investors, would also be areas to review. In addition, we would consider that the percentage of **co financing should be flexible** within the lifecycle of individual facilities in order to ensure longer term financing and an anti-cyclical role. For example the EIB should consider taking 100% financing on larger scale in SMEs and venture capital investments and varying percentages of co-financing across the business cycle by, for example, providing full initial financing in times of crisis. The policy reportedly pursued by the EIB during this crisis of increasing its co-financing during bad times (observation based on interview material) is to be welcomed and extended.

In addition to extending the EIBs current successful approaches into developing countries, we would also recommend the EIB considers a more active role in new areas. In particular, as discussed there are significant market gaps which are reflected in a **lack of financial depth<sup>9</sup> and a high level of informal finance** (Honohan 2007). Typical gaps include illiquidity, lack of critical mass of financial sector participants and an inadequate range of instruments, all of which interact in the development of the real economy. For example the lack of secondary capital markets impedes the development of longer tenor financing or innovative financing such as GNP linked bonds as capital providers cannot rebalance their risk portfolios during the term of a loan or bond. The lack of secondary markets and hedging instruments in foreign exchange and money markets impeded the development of local currency futures, options, bonds and loans as participants seek to avoid unmanageable currency exposure and favour hard currency instruments. Similarly in financing for individuals and SMEs the lack of financial service providers and the limits of their instruments, often for example in Microfinance institutions limiting access only to loans with inflexible characteristics, drives use of informal finance (Collins 2009).

In challenging these issues the EIB can fill these gaps directly as noted above by providing finance. However the EIB also has a role to play in stimulating the **deepening of the financial markets indirectly** through development of intermediary participants and markets. Options to act for the EIB are wide and many remain in preliminary stages of exploration with other MDBs and development

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<sup>8</sup> JEREMIE mandates have been signed in a number of countries including Romania, Latvia, Lithuania, Slovakia and Bulgaria. JASMINE has been operational within Europe. The EIB have also been involved in a number of transactions in the ACP to provide equity and quasi equity to existing and new MFIs. This has included such innovative transactions as the AfriCap Microfinance Fund, a commercial microfinance equity fund dedicated to Africa.

<sup>9</sup> Banking depth is typically measured by deposit mobilization or by extended credit as a ratio to GNP. Intermediation is typically measured by capitalization and liquidity

agencies and we recommend a feasibility study to examine the most effective and efficient way for the EIB to act. However examples might include acting as market-maker for key financial instruments, financing of private sector or semi-private agents who are entering these types of markets or providing insurance and guarantee instruments. Before expanding guarantee instruments, it may be desirable to analyze why guarantees, even if allowed, have been used so little in developing countries, for example in ACP, where they have been allowed via the Investment Facility; would for example greater technical assistance help in ensuring their greater use. In relation to market making we would for example recommend examining a greater role in local currency loans (where the EIB has been active) to help develop further local currency capital markets.

In the case of lending to SMEs and Microfinance Institutions ("MFIs"), this requires EIB lending in **local currency** only where local banks that lend EIB loans do not have sufficient local currency deposits or by having subsidiaries in many countries, can diversify currency risk themselves (From interview material). It is crucial that for lending to SMEs and MFIs which have local currency revenue, the EIB makes sure that the loans which it makes to intermediaries are lent in local currency, to avoid damaging mismatches, harmful both at a micro and macro level during devaluations.

Furthermore, the EIB should consider lending, especially to the public sector, in loans whose **debt servicing is linked to the economic cycle**. Precedents for this exist, for example, in some loans that the Agence Francaise de Development has made to developing countries. Similarly EIB loans could require higher debt servicing when economies were growing more rapidly and lower debt servicing (or no debt servicing), when economies grew little or not at all. This would facilitate countercyclical fiscal policies, both in good times and bad ones, as well as reduce the risk of default. As in the case of local currency loans, such growth linked loans by the EIB could facilitate the creation of a domestic private market in growth linked bonds as confirmed by World Bank, IADB and Initiative for Policy Dialogue studies (Griffiths [www.ipd.org](http://www.ipd.org)).

**Counterparties in the private sector** could be expanded, to include private sector agents such as most critically, MFIs seeking to expand the range of services beyond loans to deposits and micro insurance. Guarantee and insurance instruments could, for example, include an expansion of the range of MICs and LICs covered by the current EU political risk insurance, reinsurance for selected areas in LICs such as micro insurance in health, education and agriculture and macro level insurance similar to, for example, the World Bank's recent Caribbean Catastrophe Risk insurance facility. These are also areas where the EIB should consider a key role in **technical assistance** to both private sector participants and governments.

As noted, these types of activities would in some cases modify the existing business model of the EIB, particularly its conservative approach to **risk management**, as they would require potentially additional risk taking by the EIB on an own risk basis. However we believe that with the correct internal environment and with an acceptance of the need to increase risk taking, these issues are manageable. For example, risk management could use current techniques the EIB and its affiliate's use, such as portfolio diversification with a careful management of risk including across countries, sectors and risk categories.

It is also possible for the EIB to consider using securitization to reduce risk, although such techniques need to be carefully designed so as to take account of the negative experience of such financial engineering in increasing certain risks and in lowering transparency in the financial markets, factors which contributed quite significantly to the 2007/2008 crisis. The EIB, if it lent for example in local currency to a number of countries, including both developed and developing could create a basket of loans, which it could then sell on to private investors, whose risk would be reduced by the

diversification of currency risk across a variety of countries. As the EIB is the only RDB that lends to a variety of countries, it could provide the most diversified portfolio of any MDB or RDB, by having high income, middle income and low income countries.

## 2.2 Tailoring the Mandate and Lending Criteria for Developing Countries

As noted in our discussion, the EIB was constrained in its responsiveness by its mandate and internal requirements. The Midterm review also examines the mandate constraints and the reliance on the EU for policy definition and dialogue and comments in relation to the external EIB mandate “we recommend establishing a **streamlined EIB mandate with high level EU objectives**” (MTR 2.1, page 2). We would fully support such a recommendation of streamlining the EIB mandate and we also would include ensuring the mandate is tailored to developing countries’ needs.

In relation to **tailoring the mandate for developing countries** we would emphasise that the environment in which financing is completed and the considerations in relation to project assessment and monitoring are complex, especially in relation to LICs. The institutional environment is typically much weaker and the absorption capacity an important issue. Consequently we would recommend a **high degree of flexibility and EIB level discussion** in the mandate to adapt it to different country environments.

In addition we would make the following specific recommendations in relation to the Midterm review;

- We would recommend greater **oversight by the European Parliament**, especially as regards the development criteria for, and impact of, EIB loans. This should include such broad issues as scale of lending, mandates and sector priorities for lending, as well as avoiding lending to activities that imply tax evasion or avoidance. However, EP oversight would be best and most effective at these broad sector levels, avoiding oversight of individual loans. The EP’s role in oversight is pioneering in that no other MDB or RDB has such an oversight; it therefore needs to be developed carefully, as there is no precedent. It may in its turn offer precedents later for other institutions
- As part of the Midterm review streamlining, we would recommend considering a **specific crisis mandate** including revision of internal procedures and conditionality to allow acceleration of disbursements including for generalised purposes, such as fiscal support or more sector lending. It would also be appropriate if a separate subsidiary or mechanism is created for developing country finance to include a provision for increasing capital, especially rapidly in crisis conditions. Such a mandate would need careful drafting to include such issues as definition of a “crisis” and to retain appropriate controls and approvals. In addition such crisis planning could also develop a strategy for coordination and cooperation with other IFIs. The advantage of this was apparent during the recent crisis, where joint major initiatives and actions between RDBs and MDBs reportedly increased significantly and a more formal and pre-planned cooperation would add to future effectiveness.
- The Midterm Review recommends “**priority objectives** for specific regions” (MTR page 3). We would recommend for MICs and LICs introducing this initiative **at the country level**, reflecting the great diversity and country specificity of the environment for financing. However, for all countries, these are likely to include goals relating strongly to the Millennium Development Goals, broader development goals and to mitigating, as well as adapting to climate change. In this way the excessively ad hoc approach, that encourages/allows certain activities in some developing regions, but not in others, needs to be overcome.
- Relating to MDGs, the Mid Term review comments “there may be opportunities for EIB financing in social sectors, such as **health and education** ... but these are likely to be exceptions” (MTR p3). In relation to LICs we would recommend that social sectors are made a core part of the LIC

lending mandate, even though we agree that priority should be given to sectors such as SMEs, infrastructure and clean energy, where the EIB has very valuable expertise and clear comparative advantages.

- The mandate would also ideally include a **blending** of grants and lending with a high percentage of grants for LICs. Appropriate consideration should be given to sourcing of EU funding for such grants. The issue of criteria to maximize the development impact of grants needs to be carefully studied and rigorously applied. For example to what extent should grants be used to facilitate more risky lending (either to countries or sectors), to subsidize loans especially to make their products or services accessible to poorer people, subsidize institutions that grant such loans or provide technical assistance?
- As regards **additional development standards and conditions**, especially where consistent with EU developing national development strategies, need to be introduced, particularly as an explicit EIB development mandate has been approved. For this purpose, additional staff, with expertise on development issues and in developing countries, needs to be hired, and devoted exclusively to lending to developing countries. However, this should be done in a gradual way, so they do not slow down excessively or make too much more costly EIB loans, and especially do not slow down further the ability of the EIB to respond counter cyclically in times of crisis. This is particularly the case as other IFIs and RDBs are lowering and streamlining conditionality. We do not believe that development conditions of EIB loans should be more intense than those of other MDBs or RDBs.
- To help evaluate development effects of EIB loans, it is important that the EIB introduces a mechanism for evaluating development impact of its loans. This important role, which is not at present being carried out, would facilitate the analysis by the European Parliament and the European Commission (as well as others like the developing countries' governments and civil society) of the effectiveness of EIB lending in meeting its development mandate.
- We would recommend that the main aim of EIB lending to developing countries is development. However, another very important aim is to finance **investment in climate change mitigation and adaptation**, area where the EIB has great expertise. Other aims may be important in specific countries, such as helping meet the *acquis communautaire* in pre-accession countries. But pursuing purely EU aims such as promoting European FDI or securing energy for EU countries should only be pursued by the EIB loans, if they are consistent with recipient countries development. This would become easier if the EIB has separate institutional arrangements for developing countries.
- We would also recommend that where EU policy objectives, such as environmental and climate change standards, are set as part of a project assessment that consideration is given to adjusting standards to a developing country's level of development and administrative capacity and to set that standard separately for each country as part of the "priority objective" settings. In addition, although we would expect policy to require an eventual long term convergence on full EU standards, we recommend examining the possibility of using **relative standards**, not absolute standards, and **assessing progress** towards, rather the achievement, of those standards. This is especially the case for LICs' where absolute standards may be unachievable and inappropriate in the short to medium term. On the other hand, for pre-accession countries, EIB support through loans and technical assistance for helping meet the *acquis communautaire*, for example in environment standards, or procurement procedures, may be particularly valuable.

### **2.3      Need for Greater & Specialist Resources**

A key concern should a revised mandate and lending criteria be adopted is that such an extension of developing country financing, especially in a context of higher risk taking and greater discretion for EIB

staff, requires a different level of **expertise and knowledge**, as well as **greater staff numbers**. This is especially true in the context of LICs where institutional assessments and technical advice are key parts of a financing projects success. In assessing issues from country level priorities to detailed assessment and monitoring of individual projects, a high level of specialist knowledge and an intensity of resources are required. For risk taking activities an increase in risk management specialists within the current EIB teams is likely to be needed to manage and control the extensions of developing country risk.

Based on the Midterm Review (MTR Appendix 3, Table 4), only 524 staff in the EIB are dedicated to developing countries and of that only 8% of staff are located in 13 field offices. This contrasts with other MDBs such as the World Bank with over 11,000 staff, 56% of whom are located in its 120 field offices. Consequently the EIBs' **level of staffing** would need to be increased and a **local presence** in developing countries would be required. As noted in the Midterm Report the current business model of the EIB is "its lean and efficient set-up" (MTR page 26). It also includes an existing body of very experienced and valuable staff in key areas that could be leveraged directly such as infrastructure, climate change and SMEs. However the required resourcing model for developing country financing, especially with the range of risk and activities the Mid Term Review and this report are recommending, is an **innately more cost and personnel intensive** operation and the EIB needs to assess the requirements to ensure success.

We would also recommend that resourcing is a key area where the EIB might seek further **cooperation with other MDBs** such as the World Bank, regional and sub-regional development banks. Within these institutions there is much accumulated expertise in the knowledge and execution of developing country finance including significant field offices and local presence. A partnership with such institutions would allow the EIB to extend developing country financing in a way that is both appropriately assessed and monitored but also cost efficient. Greater collaboration with bilateral development European institutions should be further developed. Similarly, far greater partnership with financial institutions in individual developing countries, such as national development banks, or regional ones (such as the Andean Development Corporation) can offer similar very valuable advantages.

Finally, we would confirm our support for the Midterms Review for a **feasibility study** into the possibilities for a new subsidiary and, in the interim, a dedicated internal organization. We consider that a ringfenced structure would allow the required focus and specialisation needed for developing country financing to be successful.

In addition we would make the following points to be considered;

- Regardless of the organizational or legal structure, **additional capital** of the EIB needs to be dedicated to developing country finance in order for any substantial improvements by the EIB in the field to be achieved. This is particularly true were a **separate subsidiary** to be created as discussed in the MTR.
- The importance of the EIB **AAA credit rating** in enabling it to offer lowered interest rates remains a critical part of its "value add" in developing country financing. Any structure considered in the feasibility study needs to ensure this is unthreatened. An issue to consider is how to **mitigate** the impact of **increased risk** on that credit rating. Risk will be increased both through the increased risk of developing vs. developed country risk as well as any greater risk taking. We note this issue was solved by the EIF structure which has allowed a similar advantage as the EIB extended activity into the higher risk SME sector including through equity, mezzanine and securitization programs. A similar or alternative structure to this could be considered with due consideration to the impact of some of these techniques during the financial crisis.

- Within the EIB there is a great depth of **knowledge and experience** including in specialist sectors such as SMEs, infrastructure (especially at a regional level, where the EIB has such a distinguished and long experience at European level) and preventing as well as adapting to Climate Change. As noted, any structure needs to ensure “cross pollination” of that experience on an operational level into the new organizational structure.
- **EU policy guidance and support**, such as grants and funding also need to be developed as part of the new structure considerations to ensure the high levels of blending in financing to be executed effectively.
- We would strongly recommend **representation** from developing countries in such a feasibility study and high level representation, such as on the board of any future subsidiary, of appropriate persons from developing countries especially LICs.

## 2.4 Applying these Recommendations to Developing Country SMEs & MFIs

To date the EIB has been very active and successful in the SME sector in the EU and Pre-Accession countries including through the EIF, its specialist SME financing vehicle. This has implied a number of innovative programs including most notably JEREMIE, which has sought to provide a broad range of instruments including equity and mezzanine finance via partnerships with financial intermediaries, and JASMINE in microfinance. The EIF has also been active in venture capital and guarantees.

An optimal approach would be to extend this strong track record to developing countries as the SME sector is a “primary driver for job creation and GDP growth” including through formalizing an economy and the MFI sector as a key path to directly alleviating poverty and assisting the poorest in the developing countries. SME and MFI financing has been one of the fastest growing areas of developing country banking as commercial banks seek to enter the sector and microfinance institutions continue to grow their operations. (Honohan 2007)

However key barriers for SME development remain **access to finance**. Issues include access to local currency finance, high interest rates, and poor availability of funds, short maturities and collateral requirements. Informal financing remains common. The EIB engagement in this sector, given its expertise especially in EU countries, could be a significant contribution to development financing.

In assessing how the EIB can improve its performance in developing country SME financing we would refer back to the principles which we set out in prior sections. In particular we would highlight the following points and recommendations:

- In several regions, such as Eastern Europe, Asia and Latin America the EIB has reportedly not had a mandate to lend to SMEs. A first step in **broadening the EIB mandate** is that in all regions as discussed in the MTR where it lends the EIB is allowed to lend to SMEs, area where the EIB has such **highly valuable experience** in Europe. Similarly lending to municipalities needs expanding, but made consistent with broad national government lending targets.
- The SME sector in developing countries may not be able to meet the usual conservative criteria required by the EIB. For example collateral or guarantees and equity or other venture capital may be very limited or non-existent. This is a key area for **greater risk-taking** including where a high level of equity and mezzanine financing may be an appropriate method. An area where the EIB can play a larger role in SME financing is to support more venture capital and new SMEs more broadly, with special emphasis on incorporating new technology where appropriate. This can be done via support for research and development (perhaps financed more through grants), as well as innovation and commercialization, that can be done through loans or equity. Blending of loans and grants will be particularly valuable there. Similarly another key area for greater risk taking is

extending the tenor for such investments including by using a "warehousing" ability on balance sheets of the EIB.

- **Risk management** to assist and mitigate greater risk taking may include through dedicated funds, both internal and external, so that risk is mitigated via portfolio diversification and securitization programs, again taking into consideration the impact and weaknesses of these techniques revealed during the financial crisis.
- The continued importance of **partnership with local financial institutions**: This approach has been successful in JEREMIE and other programmes (via on lending through financial institutions) and has provided both crowding in of the private sector and local expertise and monitoring. We would suggest that a similar approach is taken in developing countries given the number of commercial institutions, including especially local financial institutions, entering the sector. Selection of partners needs to be carefully assessed in this environment to ensure that capability and integrity is appropriate. But we believe there are sufficient candidates for this to be done successfully including in LICs.
- Also important in this area is the **loosening of the mandate and conditionality** such as discretion in applying conditions and standards and to focusing on progress rather than absolute standards in criteria and monitoring. It is suggested that this should be a key approach for SMEs. This would include in relation to collateral and external guarantees.
- As noted a key barrier is the cost of financing for SMEs. It is essential that the EIB strives to reduce the cost of capital for SMEs. We suggest a **higher than average level of grants** in blending and concessional finance is appropriate especially for LICs. As for JEREMIE the EIB also need to ensure that such benefits are fully passed on to end user when disbursed via intermediaries.

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