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COMMISSION STAFF WORKING PAPER

"Shaping support for private sector development in the Mediterranean"

Extended Impact assessment

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Executive summary

i. Over the last decade economic growth in the Mediterranean Partner countries ("the Mediterranean") has been insufficient to absorb a growing workforce. The lack of private sector development is seen as a key factor explaining this situation, which deteriorated further over the last two years. Enhancing the role of the private sector in the region should therefore be a key objective for the medium and the long term. This requires in the first place a more business friendly environment. In this context, a comparison between current investment needs and the characteristics of the supply of financial capital in the Mediterranean also points to a mismatch between supply and financing needs, **long term investment finance** being difficult to mobilise. SMEs in particular need to be provided with the appropriate financial products to support their investment needs.

ii. In order to address these needs, in March 2002 the Ecofin and European Council in Barcelona decided to enhance the **existing activities of the European Investment Bank (EIB) in the Mediterranean** through the creation of a Facility within the Bank. Private sector development was considered a key priority. The Bank has proceeded rapidly with the setting up of the Facility for Euro-Mediterranean Investment and Partnership (FEMIP). FEMIP started its operations on 1 September 2002 and was officially launched at a meeting held in Barcelona on 18 October 2002.

iii. The Ecofin and European Council nevertheless considered that the question of whether to **incorporate this facility into an EIB majority-owned subsidiary** should be considered one year after the launching of the Facility. The review requested by the Ecofin and the European Council one year after its creation is subsequently scheduled to take place in Autumn 2003.

iv. In order to prepare the ground for the line to take in this review, the Commission decided to conduct an **Extended Impact Assessment**[1]**.**

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1 Commission Work Programme 2003, Ref. COM(2002) 0590, Annex 2.

Impact Assessments

Impact Assessments are used by the Commission as a tool to improve the policy development process and are to be carried out for all major initiatives[2]. Impact Assessments examine the main choices in view of a policy decision to be made and outline their potential impacts, from an ex-ante perspective. They identify the likely positive and negative impacts of proposed policy actions, enabling informed policy judgements to be made and to identify trade-offs in achieving competing objectives.

Preliminary draft assessments may be prepared in the early stage of the process. Extended impact assessments - as in the present case - are meant to be prepared before the key decision intervenes.

v. **Options**. Two schematic policy options have been considered for this impact assessment. For the sake of comparison in the present assessment, certain assumptions have been made in order to define each of these options. This schematic approach should not be seen as prejudging their ultimate design. Another possible option where the current Facility would stay in place without being further enhanced is considered as the baseline case forming the starting point for these two options.

vi. The **first option is defined as a further development of the newly established Facility** (Developing FEMIP, referred to as the "FEMIP" option in this report), with a private sector development mandate. This would entail possible adjustments in the Bank's financial policies, and more specifically as regards its operations in the Mediterranean. Under this option, FEMIP would remain a department within the Bank, operated by EIB staff as presently, potentially increasing their number. FEMIP would thus continue its operations and develop its products as far as possible under the general umbrella of the EIB, notably its statute and financial policies. The Facility would continue to operate mainly under Council lending mandates, for the time being with the Community Budget guarantee, and with the contribution of the EC budget mainly for technical assistance support to its operations, risk capital operations and interest rates subsidies for environmental projects. Operations would remain centrally managed from Luxembourg, with a few regional or country offices.

vii. The **second option is defined as the establishment of a majority-owned EIB subsidiary** ("subsidiary"). Under this option, part or the totality of the Bank's portfolio of assets in the Mediterranean would be incorporated in the subsidiary. The new subsidiary would have its own staff, statute, and financial policies and be entrusted, like FEMIP, with a private sector development mandate. Staff would be substantially increased in order to enable the resource-intensive development of its private sector operations. The new subsidiary would offer a broad range of financial products. It would have a profile close to that of multilateral development banks, in particular a financial standing and a capital base aimed at securing a best creditor status and a Triple A rating. Operations would be centrally managed from its headquarters, with an important role devoted to local country offices. The assumption is that, while the Bank would retain a majority shareholding position in the subsidiary, its capital would be opened to Member States, the European Community and also

[2] Communication of the Commission on Impact Assessment. 5.6.2002 COM(2002) 276.

possibly to Mediterranean Partners. Its governance would reflect this opened shareholding structure.

viii. In order to conduct an assessment of the two options a number of **impact criteria** were defined. These include the **effectiveness** of options in achieving policy objectives and their **efficiency** taking into consideration resource mobilisation. The impact on private sector development has been a core benchmark in assessing the options. Furthermore, consistent with the conclusions of the Gothenburg European Council of 15-16 June 2001, impact criteria have been examined in the present report covering a broad **sustainable development** perspective, including the economic, financial, employment and environment dimensions.

ix. **Consultation of stakeholders**. Commission services have maintained close contacts with the EIB services in the course of the present assessment. Mediterranean Partners were consulted as the main stakeholders in this process. While a number of Mediterranean Partners' representatives enquired on the features of each option and the nature of the choice to be made, those which expressed a view recognised that the creation of a subsidiary would allow for more ownership and would be seen as a strong and visible political commitment. Some in particular inquired on the costs of the products to be offered by a subsidiary and how they would compare with the current terms available under FEMIP. Enterprise confederations which were also consulted emphasised SME[3] financing needs and called for a reinforcement and a diversification of the supply of finance. Commission services also had a number of informal contacts with the European Investment Fund (EIF), the World Bank, the International Finance Corporation (IFC), the African Development Bank and the European Bank for Reconstruction and Development (EBRD).

x. **Effectiveness**. As regards effectiveness - mainly in meeting the core objective of supporting private sector development - the estimated impact of the two options is not invariant to the underlying assumptions. Nevertheless, it is clear that each option has a distinct impact on meeting private sector investment needs of the region and contributing to growth. A number of other objectives have also been assessed, namely the capacity of supporting local financial sector development, addressing local SME needs and financing key transnational infrastructure projects as well as public-private partnerships.

xi. As a baseline case, FEMIP has, owing to the strong commitment of its dedicated staff, quickly become operational. It benefits from the EIB corporate environment, its logistic, infrastructure and experience. Under the FEMIP option, private sector operations can be increased from their current modest level, using local financial institutions to channel loans to local firms, notably SMEs. However, developing the private sector orientation under this option is a real**,** although not impossible, **challenge** given the need to adapt a number of the EIB's statutory provisions and standing practices for this purpose across the Bank, in the absence of any similar private sector mandate for the remainder of EIB operations.

[3] Small and Medium Sized Enterprises (SMEs). EC usual definition: enterprises of less than 500 employees

xii. The subsidiary option could be **more effective** than the FEMIP option in meeting the private sector development mandate by adopting a less **risk-averse profile** than the EIB, developing a pro-active institutional capacity through a **high level of staff resources** dedicated to private sector banking, ensuring more **proximity** to local operators, pursuing **market-oriented pricing policies** to cover both enhanced risk taking and higher operating costs, as well as offering the **full range of state-of-the-art financial products** geared to private sector finance for which the local supply is presently limited.

xiii. **Efficiency**. Under the baseline *status quo*, the current FEMIP instrument is, as it stands, very efficient in terms of costs and leverage as regards the Bank's own resource operations. It benefits from the EIB's low cost borrowing conditions and of synergies with the Bank's other activities and departments. It provides low cost loans to Partner Countries and has a high leverage on other sources of finance raised on the market to carry out its operations. In terms of **proportionality** of means mobilised to implement lending operations the FEMIP option can be considered as providing a higher leverage as regards its own resource operations than a subsidiary. This comparison is hampered by the fact that under the current statutes, the FEMIP option would rely on external funding for its risk capital operations.

xiv. Under the subsidiary option, operations would need to be secured with **capital reflecting the risk profile,** and may –subject to the risk profile retained- require a lower capital-to-operations gearing ratio, which may have to be reduced from the current 2.5:1 EIB overall ratio. The percentage of paid-in capital, to secure the subsidiary with an adequate working capital, would need to be higher than the current EIB 5% paid-in capital. The counterpart would be the capacity to develop a broader offer of financial products and to conduct risk capital operations independently from external funding.

xv. Assuming that the Community and Member States take a direct participation, they will have to contribute to its capital. The extent of this support would be subject to the eventual features of the subsidiary and be compensated to a greater or lesser degree by **savings from the EC budget** since MEDA[4] risk capital support and the provisioning of loans in the Guarantee Fund for external lending would no longer be needed, at least in part.

xvi. For Mediterranean Partners, the enhanced features of the subsidiary option compared to FEMIP would imply correspondingly higher interest rates and a possible capital contribution if they were offered a stake in the institution. These potential cost implications are the counterpart of increased ownership of the instrument and additional benefits in terms of private sector development.

xvii. **Subsidiarity** will continue to be better ensured by retaining a Community instrument - FEMIP or a subsidiary- than through a multiplication of national financing schemes. A Community direct stake in a subsidiary can already be financed under the current **Financial Perspective** and would moreover contribute to enhancing

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[4] The MEDA programme established under Council Regulation (EC)1488/96 is the principal financial instrument of the European Union for the implementation of the Euro-Mediterranean Partnership. The programme offers technical and financial support measures to accompany the reform of economic and social structures in the Mediterranean partners.

cooperation with other Community instruments such as MEDA and securing consistency with the policy objectives of the Community in the Mediterranean. Any choice of extension or reconsideration of the EC budget guarantee as regards the subsidiary's lending operations would also need to be made consistent with the current **Mid-Term Review** of the Bank's external lending mandates.

xviii. **Sustainable development**. Assuming that a subsidiary would broadly adopt the EIB's existing environmental policies and continue its operations in this area, the options have been found to be **neutral in terms of environmental impact**. While it has not been possible to identify a quantified impact of the existing EIB operations on employment in the Mediterranean, a subsidiary is estimated to be potentially **more effective** over the long term in contributing to **employment creation**, mainly because of its higher effectiveness in stimulating private sector development. Adapting and developing FEMIP would however have a positive impact as well.

xix. **Partnership** with Mediterranean Partners eligible to FEMIP operations is currently ensured through their presence in FEMIP's consultative board, the Policy Dialogue and Coordination Committee (PDCC). This board only has a consultative role and FEMIP's governance, being subject EIB rules, does not ensure any co-decision with Mediterranean Partners. The **subsidiary option would enhance ownership** if the beneficiaries of its operations were offered a stake in the new institution. They would thus participate in its governance as full partners.

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Introduction

1. The Laeken European Council of 14-15 December 2001 invited the Council and the Commission to examine the setting up of a Euro-Mediterranean Development Bank. Following this request the Commission on 27.2.2002 adopted a report to the Council on “A new Euro-Mediterranean Bank”. The report, having considered different options (a facility based on EIB existing lending instruments, a budget fund, a new bank or an incorporation into an EIB subsidiary of the bank's activities in the Mediterranean) favoured the establishment of an EIB majority-owned subsidiary which would incorporate its activities in the Mediterranean. A parallel report on a number of options was also prepared by the Economic and Financial Committee (EFC) and finalised on 4 March 2002.

2. There was a consensus among the Commission, Member States and the EIB that the **lack of private sector development and investment** in the Mediterranean was a core impediment to higher growth rates and to the region's long term economic development, and that the **priority of EU investment support to the region should go to private sector projects**. Among the set of considered options, a majority of Member States opposed the setting up of a new institution.

3. It was subsequently decided in the March 2002 Ecofin and European Council in Barcelona to enhance the EIB's existing activities in the region through the creation of a Facility within the Bank. The Ecofin Council and European Council nevertheless concluded that a decision on the incorporation of this facility into an EIB subsidiary should be considered again after one year. In its 14 March 2002 conclusions the ECOFIN states that "*On the basis of the evaluation of the Facility performance, and taking into account the outcome of consultations with our Barcelona Process Partners, a decision on the incorporation of an EIB majority owned subsidiary dedicated to our Mediterranean Partner Countries will be considered and taken one year after the launching of the Facility*".

4. The Facility started its operations on 1 September 2002 and, at a meeting held in Barcelona on 18 October 2002 (which a number of Finance Ministers of the EU Member States, Commissioner Solbes, and Mediterranean Economy and Finance Ministers of the Mediterranean Partners attended), the EIB’s new Facility was officially launched. The meeting provided the opportunity to establish the Policy Dialogue and Co-ordination Committee (PDCC), a consultative board which will also be a discussion forum on the private sector investment environment and meets twice a year. Member States, the Commission, but also Mediterranean Partners and International Financial Institutions (IFIs) are represented in the PDCC. The second meeting of the PDCC was held on 3 April in Istanbul.

5. The review requested by the Council in March 2002 is now expected in the Autumn of 2003, i.e. one year after the launching of FEMIP. To Facilitate this review the Commission decided to launch the present Extended Impact Assessment (EIA) on the FEMIP, which was subsequently scheduled in the Commission's 2003 work programme[5]. This EIA provides an analysis of policy options and is meant to facilitate the establishment of a Commission position for the Fall review.

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[5] Ref. COM(2002) 509

6. The main purpose of this report is to assess the sustainable development and social and economic policy impacts of the Facility recently established within the EIB and to compare them with those expected under the option of the conversion of the Facility into an EIB subsidiary.

7. Given the fact that this is a cross-cutting exercise, an inter-departmental group was set up within the Commission under the chairmanship of the “lead” Directorate General (ECFIN) which co-ordinated the exercise (see members of the group in annex 1). The group agreed on a set of impact criteria to be examined in the present assessment, notably with regard to the **effectiveness** of options in achieving policy objectives and their **efficiency,** taking into consideration resources mobilisation. Consistent with the Gothenburg European Council's conclusions, impacts have been examined in the present report from a broad **sustainable development** perspective.

8. Close contact with the EIB was maintained throughout the exercise. The EIA procedure also as foreseen by the Commission[6] included consultations with a number of interested parties ("stakeholders"), namely the EIB itself, Mediterranean Partners and enterprises through their Federation in Europe UNICE (Union of Industrial and Employers’ Confederation of Europe) and the Mediterranean UMCE (Union Méditerranéenne des Confédérations d'Entreprises) which is the UNICE counterpart organisation in the Mediterranean Partners. In the context of this assessment, Commission services also had a number of informal contacts with the EIF and with IFIs, namely the World Bank, the International Finance Corporation, the African Development Bank and the European Bank for Reconstruction and Development[7].

9. The present report of the Commission services does not intend to draw any policy conclusions. It is meant, in line with the aim of Extended Impact Assessments, to provide facts and analysis on the design of options and their impact, so as to clarify the implications of policy choices to be made. While Commission services are aware that the Bank has now proposed a number of changes to its statute, which remain to be approved by the IGC and ratified, the present report does not prejudge the outcome of these proposed revisions and the analysis made remains based on the existing statute. Mutatis mutandis, the same goes for a number of changes developed by the Bank for the operation of FEMIP. The Commission is expected to define its position on the possible incorporation of FEMIP into a subsidiary in full knowledge of this impact analysis. This report will also in due course be sent to the Council (and made available publicly), in view of Council conclusions expected by the end of 2003 on whether to incorporate FEMIP into an EIB majority-owned subsidiary.

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6 Communication of the Commission on Impact Assessment. 5.6.2002 COM(2002) 276.

7 The European Bank for Reconstruction and Development is not as such a stakeholder in this context, since it is not active in the Mediterranean. Its experience with regard to private sector finance was however considered relevant for the purpose of the policy choice to be made in the Mediterranean.

Section I - What is the problem ? The private sector's financing needs

I.1 A declining growth performance.

10. Mediterranean Partners' **growth performance** was characterised by an average growth rate of 4.1% in the last decade (EU: 2.0% on average per year), which however needs to be considered against the background of relatively high population and labour force growth rates (2.2% and 3.0% on average per year, respectively). Macroeconomic stabilisation efforts, some progress in structural reforms and more favourable commodity prices lifted the average growth rate above 5% in the period 1994-96 before falling back towards the 3% level at the end of the decade. Individual country performances varied significantly, ranging from 1.2% per year in Algeria to 5.6% in Lebanon.

11. This long term trend has worsened over the recent period. In the past two years, the regional growth rate declined substantially to below 2%. In addition to sluggish international demand for their exports, the events of September 11th 2001 weighed heavily on growth in several countries. In particular, its impact on tourism and economic activities has been felt in Morocco, Tunisia and Egypt, where growth rates decreased noticeably. Israel and West Bank and Gaza again recorded a reduction in their income level, as economic activities remained severely affected by continuing violence, while Egypt's growth performance was also affected by difficulties in exchange rate management. Algeria, owing to a favourable oil price and Jordan which demonstrated a strong export performance were expected to counter these negative developments and to post a moderate increase in growth rates in 2002. The situation in the region worsened over the first half of 2003, which was dominated by the events of the Iraq war.

I.2 Investment in the Mediterranean

12. Macro-economic stability has progressed across most countries of the Mediterranean region with low levels of inflation and improved fiscal and external positions. This is key to supporting investment and private sector development by providing stability and lowering risks. Openness, especially to trade, and the political willingness to promote competition and productivity have increased and much has been achieved in the region. However, the geo-political situation, including slow progress with the Middle East Peace Process (MEPP), the war in Iraq and social tensions in Algeria are major destabilising factors and provide strong disincentives for investment.

13. Countries in the region have been slow to shift the emphasis from the State to the market with the State still heavily involved in the real and financial sectors in many countries, in particular, Syria, Algeria and Egypt, discouraging investment. Privatisation has generally proceeded slowly, although this is only one aspect of private sector development. Existing enterprises, especially SMEs, are not well prepared to face growing international competition and will need to undertake important investments to increase their level of productivity. New entrepreneurs find it difficult to enter markets and the reform process is delayed or stalled. In the Mediterranean region much needs to be done to modernise company law, investment codes and customs and tax regulations. Weak legal frameworks (contract enforcement and property rights) contribute to uncertainty and lower investment.

14. Similarly, the regions' investment performance has also recently weakened. Notwithstanding country differences, after growing quickly in the 1970s (particularly the oil exporters Algeria and Syria) gross fixed capital formation as a percentage of GDP has remained steady over the last two decades, averaging around 23%, before falling to 20% at the end of the 1990s. This is below the average of their peer group of lower middle income countries which averaged around 28% over the 1990s and far below the countries of East Asia with an average ratio of 33%. (Chart 2, Annex)

15. Data on the split of public and private investment is not readily available by country for the Mediterranean region. IMF data[8] up to the mid-1990s show that for the MENA[9] region public sector investment has continued to dominate fixed capital formation accounting for approximately one half of total investment. The ratio of public investment to GDP is one of the highest in the world peaking at more than 16% of GDP in the early 1980s before falling back to 10% in the mid-1990s. This is still higher than for developing countries at around 6-7%. At the same time private sector investment at around 10% of GDP in the first half of the 1990s remains lower than for developing countries (17-18%) and Asian countries (21-22%). (See chart 3 in Annex).

16. The level of foreign direct investment (FDI) to the Mediterranean has been low by international standards and has not kept pace with the global expansion in international capital flows. UNCTAD data on FDI shows that the average annual FDI inflows over the period 1997-2001 were $5.5bn[10]. This is equivalent to broadly 1% of GDP. The share of FDI in total investment is low relative to developing country peers. For developing countries as a whole, FDI averaged broadly 12% of gross fixed capital formation over the period 1998-2000, while for the Mediterranean countries the level is only 5%.

I.3 Capital Markets and Financial Intermediation in the Southern Mediterranean

17. Mediterranean financial systems have been gradually reformed over the last decades although most countries only began serious reforms in the 1990s. There are significant variations between countries and the overall pace of reform lags behind reforms in many other regions. The region is still at an early stage in the process.

18. Financial systems in the Mediterranean countries are bank-based, rather than capital market based. Nevertheless, penetration of banking systems in the economies of the region remains relatively low. Banking sector assets to GDP averaged around 130% in the Mediterranean compared to the around 250% in the Eurozone countries at the end of 2001. Banking sector asset volumes range from over 250% of GDP in Lebanon to a 50% of GDP in Algeria.

19. The distribution of bank lending is also indicative of the structure of Mediterranean economies and the heavy involvement of the state sector in many. Table 1 (Annex) shows the bias towards bank lending to the public sector in Algeria, Syria, Turkey

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8 Investment, Growth in the Middle East and North Africa, WP/96/124, November 1996

9 The MENA region comprises: Algeria, Djibouti, Egypt, Iran, Iraq, Jordan, Lebanon, Morocco, Syria, West Bank and Gaza, Tunisia, Yemen, Bahrain, Kuwait, Libya, Malta, Oman, Qatar, Saudi Arabia, and the United Arab Emirates, Malta. Note that classifications and data reported for geographic regions are for low-income and middle-income economies only, this excludes the Gulf countries.

10 Excluding Israel

and Lebanon. In Syria it reflects the large proportion of bank funding allocated to public enterprises. In Lebanon it reflects lending to the central government to finance large fiscal deficits.

20. Over the 1990s most countries in the region made progress towards liberalising interest rates (Algeria, Egypt, Jordan, Morocco, Tunisia) which generally followed a declining trend. Market based interest rates have been relied upon to a greater extent to conduct monetary policy, except in Syria where interest rates remained controlled and direct instruments are used for monetary operations.

21. There are several reasons explaining the features of financial systems in the region and for the relatively low level of bank intermediation. One important factor is the difficult geo-political and security situation which contributes to high levels of uncertainty and high levels of political and economic risk. The uncertainty created by this environment does not favour domestic or external confidence which reduces lending, borrowing and investment. These risks are reflected in the low level of sovereign credit ratings for countries in the region. Other institutional features and structures also contribute to the low levels of investment and bank lending.(Table 2, Annex).

22. Heavy state involvement in financial sectors (particularly in Syria, Algeria and Egypt) prevents the development of competitive and efficient markets. Governments have traditionally set interest rates on deposits and lending, and credit has been directed towards state-owned companies or used to finance government deficits. This has led to high levels of non-performing loans and the crowding-out of private sector finance. As a consequence, SME access to finance, especially to long-term instruments has remained very limited. Furthermore competition has been limited by restrictions on entry by local and foreign banks in many countries. State involvement, including in some cases in setting interest rates, leads to the misallocation of credit and inefficient intermediation. The quality of the institutional environment including bureaucracy, the judicial system and contract enforcement are generally poor in the region. The enforcement of property rights remains weak which limits the level of bank lending to SMEs and companies without long borrowing records. This results in lending being biased towards short-term, trade-related projects and not long-term productive lending needed by start-ups and SMEs.

23. Equity or bond markets are not real alternatives to unsatisfactory supply of bank long-term lending. Stock markets are generally underdeveloped and lack innovation and trading volumes are low. Insurance, pension and investment fund markets also remain underdeveloped. Bond markets are dominated by governments. Corporate bond markets are virtually non-existent with only a few major corporates in the region able to issue long-term bonds. With very few issuances there are no liquid secondary markets. The fact that many large companies are in public hands has led to low repayment rates, and that has impeded the development of efficient, deep and liquid bond markets.

I.4 Private sector development: FEMIP's core objective.

24. The lack of development of the private sector means that it makes little contribution to growth and a lot remains to be done to support its long term development. Current investment levels remain low with too much credit directed towards the state sector rather than the private sector. In terms of private sector development the needs and the characteristics of the supply of financial capital in the Mediterranean point to an inadequacy of supply, with long term investment finance being difficult to mobilise. SMEs in particular need to be provided with the appropriate range of financial products to support their investment needs and financing conditions which are adapted to their smaller size and their simpler structure. This also requires a more business friendly environment.

25. The Ecofin Council[11] stated the need to stimulate private sector development in the Mediterranean, in order to facilitate a higher level of economic growth consistent with the growth of the labour force in the region. The Commission has also, since the very beginning, considered FEMIP's private sector mandate as crucial. Support to private sector development was already considered the key priority in its 27 February 2002 report to the Council.

26. The Bank has acknowledged this priority and taken important steps to increase its private sector operations. It recently established a private sector development division within FEMIP. In a paper tabled at the PDCC's inaugural meeting on 18 October 2002, it indicated that it will "*not only expand considerably its level of intervention over the next four years, but will also refocus its activities and widen the range of instruments at its disposal to better adapt its intervention to the requirements of its new mandate*". The Commission will in due course take this priority into consideration when assessing the Facility's implementation. While the quantitative impact of the instrument on private sector investment may be difficult to measure, the size and proportion of its operations devoted private sector finance are expected to provide a useful indicator in this respect.

27. FEMIP should further play an important role :
- in supporting the local financial sector through intermediated loans and risk capital operations; such operations can facilitate the transfer of know-how and management skills to local banks and encourage them to introduce new products;
- in facilitating SME development and entrepreneurship in the region through the provision of SME targeted finance, including risk capital;
- in financing infrastructure, particularly in sectors which are being liberalised and transnational networks.

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[11] Conclusions of the 14 March 2002 Ecofin Council meeting.

Section II. Main Features of EIB-FEMIP operations in the Mediterranean Region. Experience from other instruments or institutions.

II.1 Own-resource lending operations.

28. The EIB lends under its own resources to Mediterranean Partners beneficiaries within the scope of lending envelopes entrusted to it by the Community, a number of which benefit from the EU budget blanket guarantee[12] as well as within the framework of the Euro-Mediterranean Partnership financing facility (Nice envelope) launched by the EIB itself following the Nice European Council (December 2000).

II.1.1. Lending guaranteed from the EC Budget.

29. The current guarantee system has two components: a blanket guarantee and a risk-sharing element.

30. **Blanket guarantee**. From 2000 onwards, the EC has agreed to provide the Bank with a global guarantee restricted to 65% of the aggregate amount of the credits opened (signed), plus all related sums[13]. Within this aggregate ceiling, defaults on individual loans are, in effect, covered to the extent of 100 %. The Guarantee Fund is provisioned with 5.85% (i.e. 9% provisioning rate x 65% blanket guarantee coverage) of each loan's amount. The guarantee covers the commercial risk not underwritten by risk-sharing arrangements (see below) as well as the political risk in all cases. It refers to the total amount guaranteed without distinguishing between regions. The EIB external lending mandate, included in the Council Decision, presents an overall ceiling of the credits opened equivalent to € 6 425 million[14] for the Mediterranean region[15], and covers a period of seven years from 1 February 2000 until 1 February 2007. The legislation on the EIB external lending mandate and on the Guarantee Fund[16] requires a review of its application, in the context of the accession of new countries to the EU. The EIB and Commission services are currently preparing the mid-term review of the EIB's external lending mandate.

31. **Risk sharing.** Risk sharing is an important element of the EIB's overall private sector operations in the region. The risk-sharing element separates the commercial and political risks. The EIB is required by Article 18 (3) of its statute[17] to be covered by "adequate guarantees" for all its loans. In order to limit the exposure of the EC budget, which acts as guarantor of last resort, EIB loans benefiting from individual non-sovereign guarantees are covered only for defined political risks by the EU blanket guarantee, thus limiting the EC budget exposure ("risk sharing mechanism").

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12 Council Decision EC 2000/24 of 22 December 1999, OJ L9, 13.1.2000, p 24 and subsequent amendments.

13 Interest rates, commissions, charges, expenses, etc. as defined in the "Contract de Cautionnement".

14 Under the current Mid-Term review it is envisaged to increase the ceiling to € 6520 million (without Tukey) instead of € 6425 million (with Turkey). Turkey, while remaining eligible to FEMIP, would be dealt with under another lending envelope (for South-eastern neighbours).

15 The countries covered are: Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, Syria, Turkey, and Gaza-West Bank.

16 Council Regulation 1149/1999 of 25 May 1999 amending Regulation 2728/94.

17 Article 18 (3), EIB statute : When *granting a loan to an undertaking or to a body other than a Member State, the Bank shall make the loan conditional either on a guarantee from the Member State in whose territory the project will be carried out or on other adequate guarantees.*

32. The Council Decision invites the Bank to cover the commercial risk on at least 30% of its lending from non-sovereign guarantees on an overall mandate basis and as far as possible on an individual region basis. As at 31 December 2002, the risk-sharing achieved on mandate and assimilated mandate was around 15% in the Mediterranean region, compared to 80% in ALA. However, given the fact that most risk sharing operations in the Mediterranean actually took place in Turkey, without Turkey the current share of risk sharing operations is actually only around 4% of the total. This points to particular difficulties in developing the Bank's risk sharing operations in the region, owing to the poor investment climate, the lack of FDI and to the Bank's current requirement of an A2+ rated guarantee for its investments. The effective level of risk sharing in the Mediterranean is however expected to rise as lending under the Partnership Facility comes on stream and as FEMIP works up to its full level of activity.

II.1.2. Lending without EC budget Guarantee : the Euro-Mediterranean Partnership financing facility (Nice Envelope)

33. The Euro-Mediterranean Partnership financing facility set up after the Nice 2000 European Council (hereafter the "Nice Envelope") provides for a lending package of up to € 1 billion for a period of seven years starting from January 2000 (same period as the general lending mandate). This envelope was created in support of major trans-regional transport, energy and environmental projects. Projects funded with this financing facility are not covered by the EC budget guarantee. Up to now, the approved projects amount to€ 255 million committed. However, none of these agreed projects have yet been signed. The Bank now expects to sign in the coming months a € 225 million loan under this envelope for an important project in Egypt. The prospect was, and is still, to fully utilise this envelope, which will require active implementation from 2003 onwards (on average some € 200 to 250 million per year until 2006). Signatures under this facility will increase the risk sharing on mandate and assimilated mandate.

II.1.3. Financing Facilities offered by the bank under FEMIP.

34. The EIB offers various financial services under own resources to support projects in the Mediterranean region, depending on eligibility and project category. ***Direct loans*** (or "individual loans") are credits made available directly by the EIB to promoters in both the public and private sectors, including banks. The bank normally takes up to 50% of the investment cost. The bulk of EIB own resources lending in the region is provided through direct loans. ***Global loans*** (Loans for SMEs through an intermediary) are credit lines made available to banks or financial institutions, which on-lend the proceeds for small or medium-scale investment projects meeting the Bank's criteria. To complement the EIB financing, the intermediary also provides co-financing in support of the projects concerned. Beneficiaries can be local authorities or SMEs.

II.1.4. Recent developments of Bank lending in the Mediterranean.

35. In spite of a slight downward trend in 1998 and 1999, the total amount of EIB signed loans under own resources in the region has increased over the recent years. Table 3 (annex) shows a breakdown of lending projects for Mediterranean Partners (including Turkey SAP and TERRA) signed, for the period 1997-2002 and by country. Loan signatures have been increasing since 2000, and disbursements have

followed a comparable trend and were close to € 1 billion per year over the last three years.

36. For the whole period considered, the energy, communication and environmental sectors received the bulk of EIB loans, representing respectively 25%, 23% and 23% of total lending. A large share (around 90%) of funded environmental and energy projects are water related, water being a critical resource in the region. Regarding the communications sector, while most projects were in the roads sector, ports and airports projects were however important. The Bank did not finance any telecom or railways projects in the Mediterranean (Chart 4, Annex).

37. Projects financed with "global loans" as well as risk capital operations contribute to private sector development to the extent that SMEs are the main final beneficiaries, even if intermediary financial institutions are public-owned banks. Global loans are an additional source of EIB funds to private sector projects (even if channelled through public banks) and represented 13% (6% excluding Turkey) of total EIB loans signed in the region (period from 01/01/1997 to 31/03/2003).

38. Altogether, in addition to equity and quasi-equity investments which are financed by the Bank using risk capital resources from the EC Budget (MEDA), and managed under mandate from the Commission, a fair account of the Bank's private sector own-resources operations in the Mediterranean can be given by looking at combined corporate private sector operations and global loans which altogether represent over the beginning of the current mandate period (2000-2002) around 30% on the average. The Bank's Business Plan for the Facility (see below) had foreseen a very progressive shift of operations towards the private sector. The initial business plan's expectations were that by 2005-2006 private sector operations would still represent a minority of the Bank's annual operations. However since FEMIP was launched in October 2002 and until 31 August 2003, the EIB performed well since a majority (63%) of new commitments went to private sector development (corporate lending 41%, global loans 22%, risk capital 1%). The latest developments since FEMIP's creation are thus favourable –even though they remain to be confirmed over the medium term as this percentage is contingent on just a few operations- and tend to show that the Business Plan's conservative assumptions on the shift to private sector can be exceeded.

39. Past and recent experience, nevertheless, tend to confirm that it is a challenging, although not impossible, task for any IFI to develop activities in the Mediterranean on private sector development.

II.2 Financial instruments funded from the EC budget

II.2.1 Interest rate subsidies

40. The Bank matches some of its own resources lending with EC budget subsidies to reduce the level of its interest rates. Under MEDA financing (since 1997), the interest rates subsidies have been restricted to EIB loans in the environmental sector, with a maximum of 3 percentage points of interest rate subsidy. Since FEMIP was created, there has been no change in this respect (see data, table 4).

II.2.2 Risk capital operations

41. Article 20(2) of the EIB Statute does not allow the Bank to engage in equity operations, which is the most conventional form of risk capital finance[18]. Article 18(3) which applies to own resources lending requires the Bank to secure guarantees from third parties and in practice means that the Bank cannot either commit another form of risk capital finance, conditional loans, from its own resources. The Bank's risk capital activities can thus not be financed from its own resources owing to these statutory limitations. They are funded from the EC Budget and are thus off-EIB balance sheet. The Bank is remunerated with a fee (1% to 5%) for investing on behalf of the EC. The payback obtained from risk capital operations goes directly to the EC budget. While in view of the long payback period, funds returned to the EC have so far been very low, repayments have improved over the last 2-3 years (about € 22 million per year).

42. Risk capital funds have been made available from the EC budget for a number of years and this activity of FEMIP is expected to continue. The amount of outstanding signed risk capital operations since 1995 represents a total of € 138.8 million (as of 01/01/2003). In June 2002 the Commission pledged a package of € 150 million of risk capital funds financed from the EC budget for the period 2003-2006, i.e. more than 30 million per year on average. The operations take the form of conditional loans (most of them) and equity finance. Conditional loans are long-term "reimbursable facilities" channelled to beneficiaries through Financial Intermediaries (FIs) (domestic and foreign) to finance equity or quasi-equity investments in SME projects. They allow FIs to adapt the remuneration and repayment conditions to the performance of the financed project, normally in the form of shares of profits, dividends or capital gains.

43. In order to involve FIs more directly in the performance of operations, since 1995 the EIB has been requesting them to contribute up to 50% in the form of risk capital, i.e. becoming a partner of the company. The EIB also takes equity participations, on behalf of the Community, in the capital of banks or businesses. These are normally minority stakes of a temporary nature which are usually invested in financial companies, such as venture capital funds. The Bank limits the EC's participation in any specific company to 30%.

II.2.3 Technical assistance

44. One of the main changes in the context of the establishment of FEMIP is now the availability of significant EC budget grant resources to finance technical assistance operations. In June 2002, Commissioner Patten pledged on behalf of the Commission a package of € 105 million in support of technical assistance linked to FEMIP instruments, over the period 2003-2006 (€ 25, € 25, € 25 and € 30 million, respectively). This package implies a considerable increase of funds devoted to technical assistance (from € 3 million before FEMIP[19]) to € 25 million annually under FEMIP. To cope with such a radical increase, the Bank needs to establish and

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[18] Article 20 (2), EIB Statute: *It* (*the* Bank) *shall neither acquire any interest in an undertaking not assume any responsibility in its management unless this is required to safeguard the rights of the Bank in ensuring the recovery of funds lent.*

[19] This amount was managed by the METAP (Mediterranean Environmental Technical Assistance Programme) and technical assistance was devoted exclusively to environmental projects.

to progressively develop its absorption capacity. To implement this package, a new Framework Agreement between the EIB and the EC, which establishes the rules for EC budget assistance under MEDA to support the Bank’s Mediterranean operations, was signed on 25 May 2003. A new Fund established under this Framework Agreement will be used as a vehicle to channel EC technical assistance support to the Bank's operations. A similar agreement has been signed on 30 July 2003 as regards technical assistance in favour of Turkey.

II.3 Experience from other instruments/institutions entrusted with a private sector mandate.

45. The **European Bank for Reconstruction and Development** (EBRD) was created in 1991 to foster the transition process in former Central and Eastern European Countries and the Former Soviet Union. The EBRD is not active in the Mediterranean but shares with FEMIP a private sector mandate : according its statute, the Bank has to commit at least 60% of its operations in the private sector.

46. The EBRD can commit both loan and equity resources. It does not have any statutory requirement to secure third parties guarantees on its private sector operations and does not benefit from any form of budget guarantees from the EC or its bilateral shareholders. The Bank defines a strategy for each of its countries of operations and develops its portfolio of projects with intensive human resources input: it has a total staff of 1,144 (2002 data) out of which 237 are posted in its countries of operations. In 2002 the EBRD approved 102 projects worth € 3.9 billion.

47. The counterpart of these human-resource intensive activities is a pricing policy characterised by substantially higher lending interest rates. The EBRD has a cost of borrowing which compares with that of the EIB owing to its triple A rating. In order to secure balanced accounts, the EBRD charges lending margins which are considerably higher than that of the EIB. They reflect both the higher risk taken on projects given the fact that the EBRD's statute do not require guarantees from third parties on its operations, as well as higher operating costs, mainly related to human resources. The business model developed by the EBRD, although in another region with a different business environment, has demonstrated that private sector development banking was possible under a difficult environment, provided the appropriate resources and financial instruments are put in place and linked to the degree of reforms in the beneficiary countries.

48. The **International Finance Corporation** (IFC) is the private sector arm of the World Bank. According to its statute beneficiaries from IFC operations can only be private sector projects (with the exception of public companies in the case of privatisation operations). The IFC is active in the Barcelona Partner Countries with a team of around 70 staff, a large part of which is located in the region. In 2002 and 2003[20] the IFC approved respectively USD 433 and 213 million new financing in Mediterranean partner countries. The IFC provides a large range of financial products and services, notably loans, equity and quasi-equity, and loan guarantees.

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[20] Fiscal Year, ends on 30 June.

49. IFC priorities are to primarily focus on "frontier markets", i.e. countries where there is little or no foreign capital flow, or areas and sectors within a country where there is little or very limited capital availability. The IFC also puts some emphasis on "high impact sectors" - the financial sector and infrastructure- and SME finance. Over the years the share of the IFC in IFI finance to the private sector has diminished overall in the world and in the Middle East and North Africa region as well. The IFC notes that it is not competitive in a number of regions against institutions such as the EIB which offer lending rates considerably lower than its own. It however considers that there is room for improved cooperation with institutions like the EIB, and that other IFIs resources can be used to leverage the expertise and resources of the IFC and commercial lenders[21].

50. Like most IFIs, the EBRD and IFC only intervene on a share of projects costs and co-finance a large part of their portfolio of projects with other IFIs or banks. They can syndicate a loan, by negotiating the loan and only taking a share (the "A loan") on their books, the remainder being financed from commercial banks ("the B loans"), which leverages their interventions.

51. The apparent productivity of the EIB, the EBRD and the IFC, defined on the basis of the ratio between turnover (amounts approved or signed) and staff, differs considerably, which suggests substantially different business models (see table 6, Annex). One factor is the difference in project size: the EIB's higher apparent efficiency in this respect is to some extent attributable to the size of its projects, due to the important share of sizeable infrastructure projects in its portfolio. This points to high economies of scale on preparation and management of the largest projects. However, the ratio of staff per number of projects approved which neutralises the difference in project size (but not in project type, i.e. private sector or public sector projects) is also very different among the three institutions: obviously, the IFC and the EBRD follow a business model which requires human resources about threefold that of the EIB's staff required for each single project approved, irrespective of its size.

52. The **"Cotonou Facility"** is a recently established EU development instrument, in the context of the 9th European Development Fund approved in 2000 and managed by the EIB. The Investment Facility, with its € 2.4 billion endowment, including € 200 million of interest subsidies, is the main EC cooperation instrument in ACP countries for private sector development, one of the priority areas of the Cotonou Agreement.

53. The Facility will deploy a series of financial instruments such as loans, equity participation, and guarantees, focussing on fields of intervention and operations which cannot be financed sufficiently from private capital or by local financial institutions. One major difference vis-à-vis FEMIP is that it will function as a *revolving* fund (i.e. reimbursements of funds invested by the Facility will remain within the Facility and will be reinvested in other projects, they will not return to Member States' budgets, whereas reimbursements from risk capital operations in the Mediterranean cannot not be reinvested on other projects by the EIB and have to be

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21 IFC Strategic Directions, March 2003, p 3-4.

returned to the EC Budget). Given the recent creation of the Cotonou investment Facility, no evaluation of its impact is yet available.

Section III - Policy options to achieve the objectives

54. Under the present section key features of policy choices to be made are presented:

- i./ *Current instrument.* The main institutional and financial characteristics of the EIB-FEMIP instrument are recalled, although the baseline instrument as such is not being retained as an option owing to a number of limitations in achieving its private sector mandate (section III.1);

- ii./ *Developing FEMIP*, i.e. a continuation of FEMIP with a limited number of changes to increase its focus on private sector development (section III.2); and

- iii./ *A subsidiary*, i.e. an incorporation of all or part of FEMIP operations into an EIB majority-owned subsidiary (section III.3).

A number of indicative elements on the costs of the latter two options are briefly presented (section III.4).

III. 1 Current Features of the EIB-FEMIP instrument

55. Given the fact that FEMIP is currently not incorporated into a legal entity but a facility established within the EIB, its main features reflect Bank broader features, particularly with regard to statutory provisions and financial policies pursued. Its business plan has been designed taking these EIB institutional features into account.

56. The first ***Business Plan*** of FEMIP for the period 2003-2006 was presented and broadly supported at the 18 October 2002 PDCC in Barcelona. It is foreseen (see table 7 in annex) to gradually increase the Bank’s core lending activities in the MPCs to some € 2 billion per year, compared to a level of some € 1.4 billion by the end of 2001 (i.e. already an increase against average annual commitments of € 1.1 billion in 1997-2000). By 2006, € 120 million additional lending would be expected to go to the private sector (annual amount), out of a very significantly increased total. Private sector operations would under the existing business plan still represent in 2006 a minority of the Bank's operations.

57. ***Capital and gearing ratio***. FEMIP loans are, as any EIB own resource operations, supported by the Bank’s capital. The capital of the Bank is subscribed by Member States and amounts to € 150 billion (as of 1.1.2003). Only 5% of the subscribed capital is paid-in (by Member States). For lending using EIB own resources, the gearing ratio (capital to loans) applied is 1:2.5. Combining the gearing ratio and the paid-in capital implies a 50 multiplier effect on resources provided from EC Member States budgets. FEMIP, as well as generally EIB operations, benefits from this high multiplier effect on own resource operations. The multiplier effect in relation with budget costs is however lower if one takes into consideration EC budget provisioning costs of the Bank's external lending under guaranteed mandates.

58. ***Governance and ownership.*** The management and control structures are the ones already existing within the Bank. Projects in the Mediterranean are approved by the board, the same as for any EIB lending projects. The PDCC established in 2002 meets twice a year, has a consultative role and allows for beneficiary countries to express their views on operations and priorities.

59. ***Staff***. Currently there are 25 people working exclusively on FEMIP (and roughly another additional 25 full time staff involved inside the Bank by providing support assistance). The Bank expects to recruit between 12 and 18 additional staff and to reach a total staff of around 40 persons working only on FEMIP by end 2003 (these increases in personnel are currently being reassessed). This compares to previous estimates provided in early 2002 of possibly staff of 75 in 2003 rising to 125 after five years.

60. ***Operating costs. Cost coverage***. The present FEMIP portfolio amounts to around € 10 billion (out of which around € 6 billion is disbursed) and revenue from this portfolio roughly covers current internal FEMIP operational costs. In the coming years, the Bank expects extra costs due to the newly arriving staff and the creation of the new regional office(s). In early 2002 the EIB had estimated administrative cost of the Facility in the range of € 20 million per year initially, rising to € 35 million after five years, including the cost for one or two local representative offices in the region. Article 19(1) from the Bank's statute requires the Bank to operate at cost coverage[22] and will over time require FEMIP's revenue to cover its costs.

61. ***Risk profile.*** The Bank's statute includes provisions which have wide ranging effects with regard to the bank's risk profile***. Article 18(3)*** requires the bank to cover its operations with adequate guarantees. This means that the inherent risk of the Bank's operations is normally *externalised*[23]. This is a unique feature of the EIB compared to rules of operations of IFI's and commercial banking practice. One of the core features of banking is normally risk assessment, which has a bearing on interest prices charged: the higher the risk, the higher the interest rate. The EIB owing in part to its current statute has so far not been subject to this constraint and this relationship between risk and price on most of its operations. The Bank has recently proposed statutory changes which might eventually lead to a modification of this currently low risk profile.

Extract from the EIB statute.

Article 18 (3)

When granting a loan to an undertaking or to a body other than a Member State, the Bank shall make the loan conditional either on a guarantee from the Member State in whose territory the project will be carried out or on other adequate guarantees

Article 20 (2)

It (the Bank) shall neither acquire any interest in an undertaking nor assume any responsibility in its management unless this is required to safeguard the rights of the Bank in ensuring the recovery of funds lent.

NB: The Bank has recently proposed a number of changes to its statute, yet to be approved by the IGC and ratified. These changes if approved would notably relax existing constraints under Articles 18(3) and 20(2). The present analysis does not prejudge the outcome of these proposed revisions nor the extent to which this would in practice modify Bank policies on its external lending operations.

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[22] Article 19(1), EIB Statute: "*Interest rates on loans granted by the bank and Commission on guarantees shall be adjusted to conditions prevailing on the capital market and shall be calculated in such a way that the income therefrom shall enable the bank to meet its obligations, to cover its expenses and to build up a reserve fund as provided for in Article 24."*

[23] However the Bank accepts "single signatures", i.e. without third party guarantee, from well rated borrowers incorporated in the EU or a number of OECD countries.

62. This ***specific risk orientation*** also affects the nature of operations which the bank can undertake. Art. 20(2) of the EIB's Statute does normally not allow the Bank to take a direct equity participation in the beneficiary which has up to now implied that risk capital operations had to be financed from outside resources (from the EC budget), instead of from the EIB's own resources.

63. ***Pricing policy.*** The current pricing policy reflects the Bank's conservative risk profile and its low administrative costs. The EIB applies to its operations a standard mark-up (on top of its cost of resources), which equals 13 basis points within the EU (and accession countries) and 40 basis points for external lending in most other countries. This flat price structure makes the Bank's loans the cheapest on the market, and significantly below IFI prices which charge lending margins on their loans up to 550 basis points, depending on the level of risk. However the Bank decided in July 2001 to charge fees for private sector operations (up-front charge of € 40 000 per operation). Given the fact that the risk is externalised, in case of risk sharing the real cost of the bank's loans for the borrowers is the sum of the interest rate charged by the Bank and the risk premium charged by the guarantor.

64. ***Provisioning***. Another consequence of the Bank's risk profile is the quasi-absence of provisions. While other banks and IFIs *internalise* project risks and carry them on their accounts in the form of provisions, the fact that EIB statutes require the risks normally[24] to be *externalised* (through guarantees) means that the Bank has the lowest possible level of provisioning of any banking institution in the world. For loans under mandate, which are guaranteed by the Community (or by Member States in ACP countries), the Bank does not make any provisions except in the case of risk sharing operations, for which provisions are made in line with the Bank's general provisioning policy. By the end of 2002 the total stock of provisions was very low compared to operations and amounted to € 1.1 billion[25] on the total EIB lending (€ 205 billion outstanding loans on the Bank's own resources). The amount provisioned by the Bank in 2002 was € 25 million.

65. ***Co-financing policy.*** The Bank does not finance more than 50% of a project's cost. The current EIB practice regarding co-financing is to contact other IFIs or other banks (domestic and foreign) and to encourage them to participate in investment projects in the region. This takes place on a case-by-case basis. The EIB does not syndicate loans.

66. ***Intermediation policy***. In order to reach a wider range of companies in the Mediterranean from its Luxembourg headquarters, the Bank has pursued a policy of intermediation with local financial institutions. "Global loans" from the Bank's own resources (about 13% of its lending operations and 6% without operations in Turkey) and "risk capital" funds from the EC budget are the only intermediated operations. The need for the Bank to request guarantees for its own resources loans however has a strong influence on the profile of intermediated operations. Most intermediated loans are channelled through public sector banks that benefit from a government guarantee. In a small number of cases, when the parent - or holding - company of a local private bank can provide a guarantee for its subsidiary, and provided this parent/holding company is at least rated investment grade, the bank can engage own resources for global loans with local private banks.

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[24] Except in Single Risk cases already mentioned.

[25] Amount of the Fund for General Banking Risks

67. ***The Bank's environmental policies and procedures.*** The EIB's environmental policy has been defined in response to evolving and more demanding EU policy objectives, taking also into account the objectives and constraints incorporated in its statute, and a need to be accountable to its stakeholders.[26] Environment is considered throughout the life cycle of all projects. This requires an environmental assessment[27] which, in areas outside the EU and Candidate Countries, is to be carried out in the light of local regulations and circumstances, taking as a guideline the principles and standards of EU environmental policy and law. According to the Bank, in some cases Mediterranean Partners' local environmental standards have been found to be even higher than the European ones. The conclusions and recommendations of the assessment form part of the overall appraisal report and, where appropriate, are carried through to the loan agreement. The EIB works closely with the European Commission[28] and maintains contacts with other EU institutions. The majority of environmental related lending in the Mediterranean concerns projects in the areas of water, waste water and solid waste.

III.2 Option 1 : Developing FEMIP

68. Under the first option it is assumed that the existing FEMIP instrument would be retained and enhanced. The Bank would *develop intermediated operations*, along the lines of what is currently being done in the context of "global loans" and risk capital operations. This would enable a population of private sector SMEs which are out of direct reach from Luxembourg with FEMIP's limited staff to nevertheless benefit from the Bank's financial support. FEMIP's development would benefit from the very substantial EC budget support already pledged.

69. FEMIP would be expected to develop *wholesale banking* products with the local banks, that would match EIB loans with their own. The Bank would remain *hands-off* from most of the final beneficiaries of its operations (except for a few large sized operations, notably in the context of FDI investments, privatisations etc.) but the successful development of this option would require a *hands-on* relationship with the financial intermediaries. This would imply a limited increase of staff resources currently already active within FEMIP. Given the core role expected from local banks under this option, the FEMIP would need to contribute to a *pro-active financial sector strategy* in line with the objectives of the Barcelona process and in close cooperation with the MEDA programme.

70. A focus on intermediated operations is in line with the Bank/FEMIP's existing experience. Taking into consideration local firms – and notably SMEs - financing needs, global loans have over the past been developed as a matter of necessity, given the impossibility to address SME needs from Luxembourg on a case-by-case basis with scarce human resources. The extension of this wholesale banking approach could usefully be pursued within FEMIP and contribute to accelerate the shift to private sector support. However, a **number of actions** should be examined in this context in order to **ensure FEMIP's increased private sector focus**:

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[26] The EIB's environmental objectives have been consolidated and are presented in the Bank's "Environmental Statement", which includes an outline of the eligibility criteria for environmental projects.

[27] (Environmental Impact Assessment or EIA, Directive 85/337/EEC as amended by 97/11/EC),

[28] See document "Working procedures between EIB and EC (DG ENV and DG ECFIN) in the consultation of the Commission under Article 21 of the EIB Statute.

71. - i./ As indicated in the first section of the present report, what the private firms in the region need is not capital *per se* but an adequate supply of long term investment finance. This requires a different behaviour from local banks resulting in the supply of long term loans or venture capital in appropriate size and conditions. Improving the local banks' management and expertise to provide long term investment finance to private sector operators is crucial. The EIB, which cannot take any stake in local institutions and in this way influence the local bank's governance, only relies on ***technical assistance*** linked to its own instruments under FEMIP to improve local banks' management. The funds already pledged from the EC budget should enable the Bank to provide targeted technical assistance support to the banking sector of the region. This would come in addition to larger technical assistance programmes funded under MEDA, in areas such as financial sector reform and private sector development.

72. - ii./ The absorption capacity of local banks – a number of which are small institutions - and final borrowers to increased exposure to hard currency liabilities is limited and may hinder the development of intermediated loans. In order not to increase the local borrower's hard currency exposure beyond their capacity, the Bank should actively investigate the possibilities for local currency lending, which implies ***local currency borrowing*** in the form of bond issues (in order not to transfer the currency risk to the Bank). It could also help to facilitate the development of local capital markets but this also requires further structural reforms in financial markets regulations and the active cooperation of the beneficiary countries' authorities.

73. - iii./ Current ***guarantee requirements*** under the Bank's financial policies bias the choice of financial intermediaries and trigger a tendency to choose public financial intermediaries which can benefit from a sovereign guarantee. Pursuing the current policy of global loans on a wider scale could enhance the position of local public banks against local private ones, the majority of which cannot be backed by high rated guarantors. Under the present statute the Bank could review its current policy to require a guarantee from investment grade rated guarantors (normally banks), with the aim of broadening eligibility criteria of guarantors (and thereby of eligible beneficiaries of FEMIP wholesale products). A somewhat higher risk profile in this respect may also call for a review of provisioning and pricing policies applied under Bank/FEMIP operations.

74. A number of complementary improvements could be investigated in order to diversify the Bank's financial products on offer and adapt them to SME needs. The Bank could usefully draw on the experience of the EIF to review and possibly diversify its risk capital operations in the region, notably in the area of seed capital. The EIF could further provide its expertise in the area of SME guarantee schemes. A coordinated approach between the EIF and FEMIP in Turkey where both have risk capital funds available for investment appears warranted.

III.3 Option 2 : Subsidiary

75. The second option examined in the context of the present impact analysis is the establishment of an EIB majority-owned subsidiary, incorporating FEMIP's operations. The purpose of this incorporation could be to have a more dedicated institution, tailor-made to the needs of the region, in particular private sector finance.

76. The rationale for incorporating FEMIP within a subsidiary lies in achieving what is difficult to achieve under FEMIP. A dedicated subsidiary would arguably need to be tailor-made to pursue an extensive private sector development strategy. The priority in the institutional design of the subsidiary option should be to enable it to have a high effectiveness in private sector development by:
- i./ adopting a ***risk profile*** different from the current one, widening the scope of eligible private sector projects and thereby enhancing the instrument's impact;
- ii./ developing a pro-active institutional capacity through ***high input of staff resources*** dedicated to private sector banking;
- iii./ ensuring more ***proximity*** to local operators;
- iv./ evolving towards ***market oriented pricing policies;***
- v./ aiming at ***increasing the leverage*** on other sources of project finance;
- vi./ offering the ***full range of state-of-the-art financial products*** geared to private sector finance and adapted to SME financing needs;
- vii./ opening the possibility for a ***high degree of ownership*** of the new financial cooperation instrument.

Under this option, a hands-on approach to private sector operations would be pursued and not restricted only to the financial sector. It would therefore obtain a profile close to that of multilateral development banks such as the EBRD and the IFC.

77. ***Risk profile.*** The Bank's current low risk profile, reflected in limited amounts of provisions[29], would have to be reconsidered. The new subsidiary would abandon the current Article 18(3) statutory requirements, along the lines of other development banks with similar mandates. This would widen the spectrum of private sector projects eligible to its financing and serve the purpose of its private sector mandate.

78. The extent to which the subsidiary would benefit from the existing Community guarantee under the current EIB external lending mandate in the Mediterranean should also be examined. If the current regime were to be maintained, including low lending rates, a substantially higher involvement of the subsidiary in the Mediterranean, notably regarding private sector operations could have crowding out effects on commercial lenders and IFIs active in the region as they would not operate on an even playing field with the subsidiary. It would go against the objective of additionality of the EC financial cooperation in the region.

79. Technically and legally speaking, eliminating the EC budget guarantee is however not feasible for already signed operations: it could only possibly be envisaged for the subsidiary's new operations, as of its creation. Moreover, under the Mid-Term review of the Bank's external lending mandates, no changes in the current provisions on the EC budget guarantee in favour of the EIB are foreseen. In any case, there is an eligibility issue to solve, as, according to the Council Decision 2000/24, the guarantee is

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[29] Apart from EC budget Guarantee Fund provisions.

applicable to the EIB itself only. A subsidiary is therefore not eligible under the current legal basis.

80. Different approaches can be taken in order to address the above mentioned shortcomings of a full guarantee of the bank's operations:
- not extending in any form the current guarantee arrangement to the subsidiary; this would mean that the new subsidiary's operations would not benefit any more from the EC budget guarantee (which would only continue to apply to operations signed before the incorporation of FEMIP into the subsidiary); this solution would require a significant review of existing provisioning and pricing policies in order to enable the subsidiary to cope with corresponding higher risks;
- an extension to the new subsidiary of an EC budget guarantee covering only political risks[30]
- an extension to the new subsidiary of an EC budget guarantee covering only public sector operations (i.e. mainly infrastructure operations).

81. In addition, a minimum threshold for private sector operations - for instance at least 50% of annual commitments - may need to be set ex-ante, particularly if the latter approach is retained, in order for the eventual guarantee regime not to act as a dis-incentive to the institution's private sector development mandate[31].

82. The capital coverage of a subsidiary should aim at securing its financial standing with a best creditor status and a triple A rating. The gearing ratio (capital-to-operations) which is currently 1 : 2.5 for the EIB and which (notionally) applies to FEMIP operations reflects the EIB's overall low-risk orientation and would, under a dedicated subsidiary, have to be brought in line with its specific risk profile. In case of a discontinuation of the EC budget guarantee, a new risk profile would over time, along the precedent of multilateral development banks, warrant a lower gearing capital-to-operations ratio of 1 : 1 and hence higher capitalisation needs for the same level of business. In case of an intermediate approach associated with a partial EC budget guarantee (on political risks or public sector operations) the gearing ratio would need to be set between the two latter reference values. The percentage of paid-in capital should also be set consequently.

83. A ***high input of private sector dedicated staff resources*** would enable the Bank to have a more active role. Private sector development requires highly qualified staff with merchant banking experience, able to play a key role in the project development phase. This includes extensive market search, due diligence including risk assessment, but goes much beyond this and requires capacities of technical advice to overcome local impediments to project development in a frequently unfriendly business environment. More staff would however trigger substantial additional operating costs for which equivalent revenue streams would need to be secured.

84. ***Proximity***. On-site teams in each of the countries of operation would facilitate the identification of projects and their development and remain in close contact with the local firms and the administration. More than under the FEMIP option, the Bank would be able to decentralise a significant part of its staff in the Mediterranean.

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[30] Currently defined as risks arising from currency non transfer, war, expropriation or civil disturbance. A possible revision of this definition is currently being considered.

[31] A precedent of such a threshold exists : the EBRD, according to its statute, has to commit at least 60% of operations in favour of private sector projects.

85. ***Evolving towards market oriented price policies***. The development of private sector resource-intensive banking operations warrants adequate pricing policies to cover the higher staff and operating costs as well as, subject to choices to be made on the extent of coverage of the EC budget guarantee, potentially significantly higher risks on operations. Lending rates closer to market rates would contribute to ensure that the new institution operates on an even playing field with IFIs active in the region. As other IFIs, the new subsidiary would have a triple A rating owing to its preferred creditor status, ensuring minimal borrowing cost conditions.

86. ***Increasing the Bank's leverage on project finance raised***. A dedicated subsidiary would be expected to pursue co-financing policies at least as actively as the EIB currently does, and would not have any impediments to do so. Moreover, the EIB has not so far pursued any syndication policies: syndication has been used by a number of IFIs (notably the IFC and the EBRD) to limit their individual project exposure (particularly in the case of large projects) and to act as a catalyst to attract more funds in the relevant beneficiary countries. The IFI "lender of record" which syndicates the loan raises additional finance by calling commercial banks to provide part of the financing which its negotiates with the recipient. Under syndicated loans (also referred to as B-loans, the lender of record providing the A-loan), participating banks provide their own share of the financing and take their own commercial risk but do not enter into any contractual relationship with the recipient.

87. Syndication has advantages for all the parties:
- from a commercial bank perspective, it protects the B loan lender from rescheduling (the current practice is not to include IFIs syndicated loans in reschedulings); in case of litigation, the commercial bank will fully rely on the IFI (the only one to have entered into contractual arrangements with the beneficiary) and will benefit from its favourable negotiating position with the recipient. Reduced risks also allow, in a number of countries, for lower provisions to be passed on to bank participants in IFIs syndications. The commercial banks further benefit from the IFIs due diligence of the project and may thereby reduce their project costs;
- from a recipient perspective, syndication enables attracting new providers of investment finance in the country; it is particularly appropriate in countries rated as risky;
- eventually, from an IFI perspective, syndication enables leveraging the impact of the IFI's financing and thus improves the institution's efficiency. It further creates a market.

88. While syndication could usefully be pursued by a subsidiary to increase the leverage on other sources of finance raised, this would however only be an option if the subsidiary carries the full risk of all or some of its operations on its own balance sheet and can thus call on other banks to co-finance a number of them on similar terms ("pari passu").

89. Offering the ***full range of state-of-the-art financial products*** geared to private sector finance and adapted to SME financing needs. While the Bank can provide own resource loans and issue guarantees, it cannot commit equity for its own resource operations and for this particular purpose currently relies on EC budget funds.

90. The capacity to invest in equity is important for a number of reasons:
- equity finance has a higher leverage on financing than loans and would enable the bank to increase its leverage and efficiency in this respect;
- venture finance in the Mediterranean is scarce;
- a number of investment projects require the provision of a blend of equity and loans;

the capacity to provide both would enable the bank to have a higher impact on private sector investment;
- equity is in particular a key tool with regard to SME creation or development, notably in the form of seed capital;
- channelling a number of funds through financial intermediaries requires a capacity to influence their management and governance; while technical assistance enables management to be improved, governance issues can normally better be addressed by taking a stake in the institution and participating in its governance;
- investing in equity on a dedicated subsidiary's own balance sheet rather than with EC budget funds managed by the Bank could provide additional sound banking incentives and stimulate accountability.

91. Enabling the subsidiary to provide equity would thus represent significant progress in effectiveness and this possibility would therefore be part of this option, provided this increase in the Bank's current risk profile is adequately addressed in the institutional setting. It would ensure the long term sustainability of the risk capital instrument which currently relies exclusively on annual EC budget allocations. A subsidiary could also play a useful role in adapting the range and size of financial products to specific SME needs including loans, equity participations, guarantees and other products.

92. ***Opening the possibility for a high degree of ownership.*** The EIB would have at least 50% + 1 share of a majority-owned subsidiary's capital. While a number of EU Member States could take a participation in the new institution, as well as the European Community, Mediterranean Partners could also be offered a stake in the new institution and thus become full members with a role in its governance.

93. ***Corporate governance***. Corporate governance would reflect the dedicated subsidiary's shareholding. While increased staff dedicated to private sector operations would inevitably translate in higher operating costs, governance costs should be minimised in order not to increase any further and unnecessarily the subsidiary's lending rates. Opting for a non-paid board of directors would allow for significant savings in this respect.

94. ***Variant of the subsidiary option***. Rather than a full incorporation of FEMIP into a subsidiary, other scenarios can be envisaged, for instance the setting up of a ***private-sector-only*** subsidiary : under this alternative scenario, EIB-FEMIP public sector loans in the Mediterranean (i.e. the bulk of the current portfolio) would not be incorporated into the subsidiary and EIB activities could be split into two parts, public sector operations retained within FEMIP and private sector operations within a new subsidiary, starting from a very low level of operations, and hence with more limited initial capital needs. This scenario could be investigated further if deemed necessary.

III.4 Potential costs for the EC, EU Member States and the Mediterranean Partners

95. ***Operating costs*** have not been examined thoroughly in the present Extended Impact Assessment. While operating costs would proportionately be much higher in the case of a dedicated subsidiary along the identified model, the basic assumption is that any choice – FEMIP or a dedicated subsidiary - will need, under adequate pricing policies, to ensure sustainability of the instrument which would over time post balanced results. The Bank, which is better equipped than Commission services to estimate such costs, is expected to report on this matter.

96. The assessment has focussed on “external costs”, i.e. mainly potential budgetary costs for the EC and Member States. Both options have a potential impact on budgetary requirements for the EC and MS. With regard to beneficiary countries, potential costs need to be compared with potential benefits. Since benefits are difficult to estimate, and not only quantitative, this is a more complex analysis. A number a preliminary indications can be provided in this respect.

III.4.1 Budgetary costs under option 1 (Developing FEMIP)

97. **The Bank's capitalisation**. Under the existing instrument a first component of budget costs involved is related to the EIB's capitalisation. The FEMIP option does not imply any additional needs in terms of capitalisation. The EIB's capital has been increased on 1.1.2003 by incorporating reserves and is now € 150 billion, allowing for a volume of operations of € 375 billion across the whole institution. FEMIP current activities are covered under this capital umbrella. Given the EIB gearing ratio and paid-in capital, FEMIP is not costly in terms of capital and budget resources (notionally) used. The combined gearing and paid-in ratio imply a 50-fold multiplier effect between capitalisation needs and operations. For instance, a € 25 billion volume of operations over the long term would correspond to **€ 500 million** paid-in capital (in nominal terms) from EIB shareholders (Member States).

98. **EC budget guarantee costs**. A second budgetary cost component of FEMIP is related to the Community budget guarantee which has a budgetary cost in the form of Guarantee Fund provisioning. A € 1.5 billion to € 2 billion annual lending volume under guaranteed mandates[32] requires € 87.75 million to € 117 million annual provisions. Under a number of conventional assumptions the cost of provisions over 30 years related to guaranteeing external lending in the Mediterranean can be estimated in net present value terms at up to € 1.9 billion (in terms of gross amounts). After deducting possible estimated repayments from the Guarantee Fund (to Member States), the net cost of provisioning EIB loans can be estimated in net present value terms up to € 440 million. Experience since 1998 suggests that the current provisioning rate (9%) may be higher than necessary to meet the Fund's liquidity requirements. However this needs further review and it is not currently envisaged to modify this provisioning rate.

99. **EC budget support**. Furthermore, FEMIP currently benefits from substantial EC budget support (mainly from MEDA) to finance risk capital activities, technical assistance and interest subsidies for environment projects in the Mediterranean. The € 255 million package pledged by the Commission[33] (risk capital activities, technical assistance) and possible amounts of interest subsidies over the period 2003-2006 imply that under the current arrangements EC budget funds of an average € 94 million could annually be allocated to FEMIP activities (see table 8). Under the conventional assumption that this co-operation would continue at a comparable level in real value terms over the next 30 years, budget EC appropriations can be estimated at a net present value of about **€ 1.5 billion**[34].

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[32] This excludes non guaranteed loans under own resources (currently "Nice" envelope). The conventional relationship between guaranteed loans amounts and provisioning is the following:
provisions = loan amount * 9% provisioning rate * 65% blanket guarantee coverage.
In addition the Guarantee Fund covers Macro-Financial Assistance and Euratom lending.

[33] 18 June 2002 letter from Commissioner Patten.

[34] Assuming a 2% annual inflation and 30 years bonds interest rates of 4,5%. Potential repayments from risk capital operations are included in this assessment. The assumption is that the pay-back of the risk capital

III.4.2 Possible budgetary costs for the EC and MS under a subsidiary

100. **Capitalisation.** The two main elements to take into consideration in assessing capitalisation needs of a subsidiary are its volume of operations and its gearing ratio. A long term volume of operations of € 25 billion would imply capitalisation needs of € 25 billion if the gearing capital-to-operations ratio is brought to 1 : 1, against € 10 billion capital needs if the present 2.5 : 1 gearing ratio were retained.

101. The creation of a subsidiary requires a number of assumptions to be made. Indicative costing elements can be proposed based on some conventional assumptions. It concerns only indicative figures which cannot not be considered as a forecast.

102. **Costing elements.** By definition, the share which the EIB would take in the new majority-owned subsidiary has to be of a minimum of 50%. It would be influenced by the total capital amount deemed necessary and by the value of its lending portfolio in the region. This value would have to be audited by independent auditors. The incorporation of the EIB's portfolio into a subsidiary would normally imply that these assets are transferred to the subsidiary together with liabilities. An economic price remunerating the Bank would also be attached to the net future cash flow (also to be reviewed by independent auditors) generated by this portfolio of assets and liabilities.

103. Assuming that the total capital deemed necessary over the long term amounts up to € 25 billion (corresponding to maximum capital needs in case of a 1 : 1 gearing ratio), the EIB could take a 60% stake in the subsidiary (up to € 15 billion), thereby retaining a majority control of the new entity.

104. Under these assumptions new shareholders (the EC, a number of Member States and possibly Mediterranean Partners) would need to subscribe up to € 10 billion. The direct budgetary cost of capitalisation would be linked to the level of the paid-in capital and the possible subscription of capital by Mediterranean Partners. Even under the assumption of an opening of the capital to Mediterranean Partners, the bulk of these capital payments would be expected to be at the expense of the EC and Member States' budgets. Assuming a paid-in capital between 10% and 25%, additional capitalisation costs would amount up to between € 1 billion and € 2.5 billion in nominal terms for minority shareholders (i.e. non EIB shareholders).

105. Additionally, as in the case of FEMIP, a subsidiary would have a notional capitalisation cost for EC Member States related to the use of the EIB's capital notionally "allocated" to the subsidiary. Assuming a nominal capital subscription of € 15 billion in the subsidiary by the EIB fully covered by the Bank's capital, the notional capital cost for Member States would be up to € 750 million.

106. Possible savings. Compared to FEMIP, the subsidiary option could however allow for: - i./ savings from the current EC budget support for risk capital. Assuming that the new subsidiary would be enabled to commit equity from its own resources, risk capital funded from the EC budget would cease. This would imply savings from the MEDA/EC budget of some € 300 million in NPV terms (deprogramming risk capital support). The EC budget support would be limited to technical assistance costs and, under the

takes place on a nominal amount on the tenth year following the year of disbursement. This estimate does not prejudge any EC long term budgetary pledge : indications beyond the current Financial Perspective, i.e. beyond 2006, are not possible at this stage.

assumption that they are maintained, interest rate subsidies;
- ii./ possibly, if new loans signed under the subsidiary do not benefit from the EC budget guarantee at all, savings from provisioning the Guarantee Fund of up to € 1,9 billion in NPV terms (gross amount) over the next 30 years, or up to some € 440 million NPV in net amounts; if the EC budget guarantee were extended partly to a subsidiary, these savings would only partly materialise.

107. From a pure perspective of the Community Budget the net impact of FEMIP's incorporation could - subject to the level of EC participation, the share of the capital which is released and assumptions on the extent of coverage of the EC budget guarantee- over time either be negative or positive. Capital subscriptions would generate extra-costs for Member States, and from a consolidated EU perspective the net outcome of FEMIP's full incorporation would under all assumptions, be negative in case of a 1 : 1 gearing ratio. Under a 2.5 : 1 gearing ratio (thus assuming the full continuation of the EC budget guarantee) the net consolidated EU budgetary outcome of FEMIP's full incorporation would be negative as well. All costing scenarios for the subsidiary - assuming it would incorporate all FEMIP operations- would generate additional budgetary costs.

108. Additional EC budget expenditure related to a subsidiary's capitalisation would have to remain compatible with the current ***Financial Perspective***'s tight budgetary margins. On an indicative basis, in case of a full incorporation of FEMIP already in 2004 and assuming a € 25 billion long term portfolio of operations:
- with a 2:1 operations-to-capital gearing ratio, an EC 10% participation in the new institution, and a 10% paid-in capital released over 10 years, the Community Budget would have to contribute with annual payments of € 12.5 million in 2004, 2005 and 2006;
- with a 1:1 gearing ratio, an EC 10% participation in the new institution, and a 20% paid-in capital released over 10 years, the Community Budget would have to contribute with annual payments of € 50 million in 2004, 2005 and 2006.

109. Such amounts may already be fully or to a large extent secured from savings realised from MEDA (deprogrammed risk capital support as of 2004; some 122 million over 2004-2006) and appear compatible with the Financial Perspective. The range of possibilities as outlined in the table below is however broader, pending assumptions to be made on the main parameters (gearing ratio between 1 and 2.5, EC participation between 5% and 25%, paid-in between 10% and 25%). Assuming a release of capital contributions over 10 years, this could imply annual budget payments between € 5 and 156 million in 2004, 2005 and 2006.

110. A partial incorporation of FEMIP (for instance under the "private-sector-only" alternative mentioned above) would be less costly and would be compatible with the Financial Perspective. On an indicative basis, assuming a € 7.5 billion portfolio of operations, a 1:1 gearing ratio, an EC 10% participation in the new institution, and a 10% to 20% paid-in capital released over 10 years, the Community Budget would have to contribute with annual payments of € 7.5 to 15 million in 2004, 2005 and 2006.

111. Any choice of extension or reconsideration of the EC budget guarantee as regards the subsidiary's lending operations would also need to be made consistent with **the Mid-Term Review** of the Bank's external lending mandates due to be examined by the Council at the same time as the FEMIP review.

Table: indicative budget costs for the EC and Member States under various options.

Comparison: FEMIP and a subsidiary

(million)	FEMIP	EIB 60% subsidiary (full incorporation of FEMIP)		Dual option EIB : public lending Subsidiary : private
		gearing 1:1	gearing 2,5:1	
Notional EIB paid-in capital use	**500**	**750**	**750**	**537**
Additional capitalisation needs				
EC paid-in contribution (*)	0	125 to 1562,5	50 to 625	37,5 to 469
MS paid-in contribution (**)	0	500 to 1875	200 to 750	150 to 562
total EU contribution (***)	**0**	**625 to 2500**	**250 to 1000**	**187 to 750**
EC Budget costs in NPV	**1940**	**1210**	**1650**	**1520**
provisioning guarantee fund (net)	440	0	440	310
technical assistance	600	600	600	600
risk capital	290	0	0	0
interest rate subsidies	610	610	610	610
Indicative total (****)				
for the EC	**1940**	**1335 to 2772**	**1700 to 2275**	**1557 to 1939**
for Member States	**500**	**1250 to 2625**	**950 to 1500**	**687 to 1099**
for the EC and MS	**2440**	**2585 to 4460**	**2650 to 3400**	**1974 to 2807**
for the EC and MS, central value	**2440**	**3520**	**3025**	**2390**

Basic assumption: long term 25 billion operations.
(*) lowest value: 5% capital share, 10% paid in
highest value: 25% capital share, 25% paid-in
(**) lowest value: 20% capital share, 10% paid-in
highest value: 30% capital share, 25% paid-in
(***) lowest value: 25% capital share, 10% paid-in
highest value: 40% capital share, 25% paid-in
(****) Indicative in the sense that these values do not strictly add up (NPV EC budget costs are compared with nominal capitalisation needs).

NB: the notional EIB paid-in capital use does not require any new cash payments from Member States. Additional capitalisation needs do, as well as EC budget support costs.

112. The above indicative budget costs do not include EIB own costs or Mediterranean Partners' possible costs. The assumptions of this indicative costing estimate are **conservative**:
- FEMIP direct budget costs have been estimated on the basis of current recurring costs. Additional costs to operate FEMIP may have to be covered by donors, in particular Member States which so far have not contributed, notably related to the establishment of a donors' Trust Fund which has been envisaged by the Bank. Any defaults on guaranteed operations in the region would also increase the estimated cost of the EC budget guarantee, which in the above estimate only includes net provisioning costs assuming a zero default situation;
- capitalisation requirements of a subsidiary have been estimated on the basis of a portfolio of operations of € 25 billion (against some € 10 billion currently). This would allow for operations of € 2.5 billion per year (against some € 2 billion under the current FEMIP business plan's targets for 2006), assuming a 10 year average maturity of loans. A sensitivity analysis shows that, assuming a capital increase after 15 years to allow for a corresponding increase in operations of € 10 billion (i.e. up to a total of € 35 billion), the additional budget cost to bear for EU shareholders (assuming they subscribe to a combined stake of to 40%) could be nominally between up to € 400 million and € 1 billion (assuming a 1:1 gearing ratio and a paid-in capital between 10% and 25%), or, in 2003 net present value terms, comprised between up to € 200 million and € 500 million.

III.4.3 Possible cost for Mediterranean Partners

113. With regard to Mediterranean Partners the additional cost of setting up of a Bank subsidiary would be related to:
- a possible stake in the subsidiary. For instance, a 10 % participation (altogether for Mediterranean Partners) in the institution associated with a 20% paid-in capital could imply budget needs of up to € 500 million for all the participating Mediterranean Partners (assuming a capital of €25 billion and a 1:1 gearing ratio);
- over the long term, a possible higher cost of interest rates to be paid on the bank's loans, in particular private sector projects which are not secured with sovereign guarantees. On the short and medium term these costs would however be minimal owing to the large part of the Bank's portfolio in the region already contracted at low interest rates.

Section IV - SUSTAINABLE DEVELOPMENT IMPACT ANALYSIS

IV.1 Effectiveness impact criteria

114. In general, an assessment of effectiveness should answer the question whether the effects of an intervention correspond with its objectives. In the context of this ex-ante analysis, it can be understood as an assessment of the capacity of the two options to achieve these objectives.

i./Meeting private sector investment needs and contributing to growth in the Mediterranean Partners

115. The baseline scenario (FEMIP unchanged) shows that the shift to private sector development is challenging. Under the *status quo*, which has not been retained as an option, FEMIP's impact on private sector development in the Mediterranean would be positive but limited. FEMIP's impact can however be improved by introducing a number of enhancements under the "Developing-FEMIP" option. A first set of improvements can be considered in terms of guarantee policies, work with financial intermediaries, and local currency operations. Such measures would facilitate the development of private sector operations. Provided such issues can satisfactorily be addressed FEMIP could deliver increased private sector support, without a radical overhaul of the Bank's financial policies or any substantial increase in human resources allocated to FEMIP operations.

116. Further changes could also be considered. None of the main features of a more private banking orientated institution is *a priori* impossible to attain under FEMIP within the EIB: the Bank's statute and financial policies could be changed, in particular its risk, provisioning and pricing policies; the EC guarantee coverage on external lending could be modified or even lifted; new financial products such as equity participations could be introduced by amending the EIB statute; and a different corporate culture could be introduced over-time.

117. However, while a number of these changes may be possible individually, implementing these extensive and ambitious changes altogether would affect the whole EIB corporate identity and mission, and appears uncertain in the absence of a comparable private sector strategy for EIB operations more generally. The case for such an institution-wide change seems not to have been made clearly until now and the sum of policy and corporate identity changes involved in trying to adapt the Bank to FEMIP's private sector mandate may not be realistic in the context of a discussion purely limited to the Bank's Mediterranean operations.

118. The primary responsibility for the current private sector situation and its future developments lies with Mediterranean Partners. They need to foster private sector development by establishing business friendly environments and streamlining the often bloated public sector. However the difficulties of local private sector firms make it even more relevant to have an instrument -from the supply side of finance- able of meeting the challenges of a difficult environment. As indicated in the above analysis, establishing a tailor-made subsidiary would in particular enable to adjust its risk profileto private sector finance needs, to increase staff resources dedicated to private sector development with more proximity to local operators, to have a more consistent pricing policy, and to offer the full range of state-of-the-art financial products geared to private sector finance. Just waiting for a change on the demand side may not materialise

in any rapid results. The EU and its Mediterranean Partners should aim at a dynamic instrument and relationship, able to support private sector operations through the provision of hands-on private banking advice and finance. The often unfavourable private sector environment in the region makes the case for an appropriate private sector development instrument even more compelling.

119. For this reason a **tailor-made EIB dedicated subsidiary** in the Mediterranean is considered over the long run to be **more effective** than FEMIP in meeting the private sector development mandate.

ii./ Capacity to support local financial sector development

120. The current policy under FEMIP is to channel a significant share of private sector operations through local financial intermediaries, and this report argues that this policy could be enhanced and made more effective. It is possible to pursue and develop this policy both under FEMIP and under a dedicated subsidiary.

121. Local intermediaries' governance is however more difficult to influence materially without a stake in the institutions, which requires a capacity to take equity participations. If this can be possible under both options - FEMIP or a subsidiary - the choice will remain neutral. Unless a change of article 20 of the EIB statute which prohibits equity participations in operations can be approved, the **choice** between the two options would also have an impact on the capacity of supporting local financial sector development **and a dedicated subsidiary would be better equipped to influence the local financial intermediary's governance**. The current requirements under article 18(3) of the EIB statute and the low credit rating of banks in the region also make it difficult for the Bank to channel its global loans through private sector banks. An enhanced FEMIP under revised financial policies may allow to channel a larger share of these funds through private banks. An enhanced FEMIP under revised financial policies may allow to channel a larger share of these funds through private banks. A subsidiary would however be freed from this constraint and would **less rely on public sector banks** to channel its intermediated financial products. To this extent also, the choice of **a subsidiary may also have a higher impact**.

iii./ Addressing local SME needs

122. As regards the provision of lending to SMEs, FEMIP, or a subsidiary, will need to pursue decentralised policies already initiated by the EIB in the Mediterranean, and to channel loans through local financial intermediaries, in particular through "global loans". It will need to develop a good understanding of SME needs, and to propose financial services such as micro-credit or leasing schemes meeting such needs. Given the importance of decentralisation and close work with financial intermediaries, the choice between the two options could however have an impact for the reasons indicated under the previous question.

123. Unless Article 20 of the Bank's statute is amended, SME risk capital needs which can currently only be addressed with EC budget funds would be better addressed under FEMIP-subsidiary, through the provision of equity from the new subsidiary's own resources.

124. Furthermore, cooperation with the EIF could provide valuable expertise as regards SME finance and could enable the Bank to widen its offer of financial services, notably

insurance schemes. This can be done either under FEMIP or under a subsidiary and the options are neutral in this respect.

iv./Financing key transnational infrastructure projects in the Mediterranean **and Public-Private-Partnerships.**

125. Even assuming a diversification of the portfolio of projects in a wider range of activities, infrastructure which currently represent FEMIP's core business will remain an important activity, and trans-national projects should be supported, in line with Community policies in this area[35] to promote both south-south and north-south links in order to establish Euro-Mediterranean networks. Both options are expected to have comparable impacts in this respect.

126. While the role of the State or local authorities is expected to remain important in a number of infrastructure projects financed by the Bank, a particular way for FEMIP or a subsidiary to serve its private sector development mandate in this area would be to give a particular priority to Public Private Partnerships. Projects such as Build-Operate-Transfer (BOT) operations could become an interesting way to match the Bank's know-how in the field of infrastructure finance with the private sector mandate. The Bank's low interest rate loans under FEMIP are very effective as regards public infrastructure projects. Unless a change of Article 20 of the EIB statute which prohibits equity participations in operations can be approved, the choice between the two options would also have an impact as a subsidiary able to match loans and large equity stakes may be better suited to support private sector promoters of infrastructure projects or private sector companies engaging into Public-Private-Partnerships.

IV.2 Efficiency impact criteria

127. In general, an assessment of efficiency should answer the question whether objectives have been reached at "reasonable" cost, i.e. whether resources mobilised are strictly proportionate to the result obtained. In the context of this ex-ante analysis, it can be understood as a broad assessment of cost/effectiveness.

v./ Leverage on other external resources raised to meet the same objectives

128. Both the options' characteristics and the choice of option have a potential impact on the leverage of the instrument. As already indicated under Section III, the leverage of the instrument is the combined result of a number of features and policies: the gearing ratio, the paid-in capital, as well as co-financing policies pursued. Setting up a subsidiary could reduce the EIB's existing favourable leverage related to its gearing ratio and paid-in capital: the gearing ratio may need to be reduced if the institution's risk profile is modified, and the proportion of paid-in capital may have to be increased. A number of design parameters - such as lowering the subsidiary's exposure on each project or pursuing active syndication policies - could however contribute to limit this reduction in the instrument's leverage. However, if it is eventually decided to establish a subsidiary institution and to depart from the Bank's current conservative risk profile, the global leverage capacity of the instrument is expected to decrease materially.

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35 See Communication from the Commission to the Council and the European Parliament on the development of a Euro-Mediterranean transport network. COM(2003) 376, 24 June 2003.

129. A special mention should nevertheless be made in this context of *risk capital operations*, for which the situation is different. These operations are not funded from the Bank's own resources as long as they are provided from the EC budget, and remain off-balance sheet. Unless Article 20 of the Bank's statute can be amended, only a subsidiary would be able to commit equity funds. The capacity to commit equity increases the institution's leverage because from the perspective of the beneficiaries, additional funding in the form of equity considerably increases the capacity to raise borrowing. The options' characteristics or choice can therefore have a material impact in this respect.

vi./ Cost of capital and in particular the pricing of loans for beneficiaries

130. Under the baseline scenario -*status quo*- FEMIP loans would remain cheap and provide the lowest interest rates lending conditions available to Mediterranean Partners. Developing FEMIP with a high degree of wholesale banking would probably imply a continuation of the Bank's current low interest rate policy.

131. Following a different model with a dedicated subsidiary having higher operating costs and a higher risk profile may have implications on its lending rates. Subject to choices to be made on the extent of coverage of the Community Budget guarantee, prices of loans -or of some loans, notably private sector loans- could progressively be brought closer to market rate levels to cover both higher risks and increased operating costs (see section III.4).

vii./ Complementarity with IFIs active in the region

132. *World Bank* and *African Development Bank* projects are mainly sovereign lending operations and would not be directly affected by an increase of EIB operations in favour of the private sector, under either option. The IFI for which the setting up of FEMIP or of a subsidiary with a private sector mandate has - or could have - the most direct impact is the *International Finance Corporation* (IFC): the IFC is the World Bank Group's private sector arm and is active in the Partner Countries. The IFC only finances private sector projects and extends its loans at market-based conditions : its prices and lending margins reflect country and projects risks, which means that its interest rates are much higher than EIB rates.

133. This means that an active policy to develop FEMIP's private sector portfolio could, under a no policy change assumption as regards interest rates, have *a crowding out effect* on a number IFC lending operations in the region. However, as both institutions limit their exposure on total project costs, some room of manoeuvre for complementarity through co-financing would remain. If FEMIP is incorporated into a subsidiary and if its prices are brought closer to market prices, price competition will cease to be an issue.

viii./ Budgetary requirements for the EC and Member States

134. Both options have a number of budgetary implications. FEMIP operations will remain "notionally" covered by a share of the EIB's capital, 5% of which is paid-in (Member States budget contributions). Moreover, FEMIP is rather costly for the EC budget (provisioning costs, EC budget support). An indicative assessment of these costs on a long term basis is provided in section III.4.

135. FEMIP's incorporation into a subsidiary would imply;
- direct capitalisation costs which would be higher than equivalent "notional" capitalisation costs of the EIB if its risk profile is different from the current low risk profile of the EIB;
- possible savings of provisioning costs from the EC budget if the Community budget guarantee is fully or partially lifted;
- possible savings from the EC budget. To the extent that a subsidiary would not be constrained by current limitations of the EIB status; the subsidiary would be able to commit risk capital from its own resources instead of from EC budget funds.

136. The conclusion of this comparison is that, while all options have a cost, assuming that the EC and Member States take a significant stake in a new subsidiary, FEMIP's full incorporation into a subsidiary could be more costly from a consolidated EU perspective than retaining the Facility, in spite of a number of possible savings related to de-programming risk capital support from MEDA or to the reduction or cancellation of provisioning EIB own resources loans. Seen from a more restricted EC budget perspective the impact of a full incorporation of FEMIP into a subsidiary could pending assumptions be positive, negative or neutral (see section III.4, table). A partial incorporation of FEMIP limited to its private sector operations would be cheaper for the EC and Member States' budgets and compare more favourably with the costs of FEMIP.

ix./ Complementarity with local and regional resources

137. The choice between FEMIP and a subsidiary is expected to have a limited impact on complementarity with local or regional resources. A policy of borrowing in local currencies, if successfully pursued, -this could be done under both options- would increase the complementarity with local and regional resources.

138. In the event of the creation of a new subsidiary, an opening of its capital to Mediterranean Partners (and possibly to regional funds) would increase the local financial stake in the institution.

IV.3 Other sustainable development and policy impact criteria.

x./Sectoral distribution of projects

139. The current sectoral distribution of projects (chart 4, annex) is influenced by the structure of the economies of the region and the strong public infrastructure pattern of the EIB's existing portfolio in the Mediterranean. Both options, FEMIP and a subsidiary, are expected to have an impact on the sectoral distribution of projects, and to translate into a sizeable shift towards private sector projects, which means that the relative share of public infrastructure projects should decline. Sectors such as manufacturing (broadly), as well as a number of services, notably in the tourism industry, financial services or trade services could, over time, be better represented in the Bank's portfolio of projects. The option choice may influence this trend to the extent that it may facilitate and accelerate it. A detailed forecast of the sectoral breakdown of projects under each option is not feasible under the present exercise as this remains contingent upon a series of factors, in particular the existence of – not yet identified - good bankable projects in relevant areas.

140. On a number of countries Bank sectoral priorities will need to be closely coordinated with the EC policy and sector priorities, in order to ensure consistency and to maximise the impact. For instance, as regards Turkey, given its status as a candidate country to the European Union, and the commitment taken by the European Council in Copenhagen in 2002 to enhance the support for Turkey’s pre-accession preparations, EC priorities, beyond private sector development, focus on acquis related projects and institution-building. To the extent that bankable projects can be identified in these areas, the EC and the Bank could have an important joint impact, under both options.

xi./ Technological development and innovation in the region

141. There is *prima facie* no direct channel of impact of the option’s choice on the Mediterranean Partners' innovation capabilities. The options' characteristics could influence the capacity of innovation and its dissemination to the extent that technology would be included in the project selection criteria, which is not currently considered a priority, notably given the overall scarcity of good bankable projects in the region. Also, to the extent that private sector development could be conducive to an accelerated dissemination of technology and innovation, the choice of the option most conducive to private sector growth may have an indirect contribution to technological development and innovation in the Mediterranean. These are hypothetical and indirect impacts which cannot be precisely identified or quantified at this stage.

xii./ Employment creation in the region

142. Even on an ex-post basis, the impact of Bank projects on employment is a difficult question. Commission services have inquired in their bilateral contacts with Bank services whether the Bank was in a position to estimate the employment impact of its already existing projects in the region. The Bank confirmed that it was currently not in a position to provide such estimates. To the extent however that a dedicated subsidiary would over the long term be better suited to private sector development, and given the importance of private sector development for long term growth, the latter option could over the long term have a higher contribution to employment creation than FEMIP.

xiii./ Job contents, qualifications and local expertise

143. The provision of technical assistance to enhance local capabilities and increase the absorption capacity for investment finance could have a certain impact on job qualifications and local expertise. To the extent that EC technical assistance budget support currently provided to FEMIP is not made contingent upon the option’s choice, the options are expected to remain neutral in this respect.

144. To the extent that a dedicated subsidiary would be more effective in supporting private sector development, job contents related to private sector business activities could be positively affected.

xiv./ Education, training and culture

145. In spite of their importance, education, training and culture do not belong to the priorities of EC investment support in the region. The EC has a core instrument, MEDA, of a concessional nature, which is more appropriate to address such needs.

146. In its FEMIP business plan the Bank indicated its intention to pursue a limited number of operations in the area of training and education. However such activities would

normally have difficulties meeting bankable project requirements with a stream of revenue enabling the projects' sustainability. Given the non concessional character of FEMIP -nor of a subsidiary- it is expected that these activities will only represent a small share and number of projects in the region, and both options will have a limited impact on training and education. A direct impact on cultural activities is not expected.

xv./ Social exclusion and poverty, and distributional implications (effects on the income of particular groups of the population, sectors)

147. Direct distributional effects on particular groups of the population are not prima facie expected, neither under FEMIP, nor under a subsidiary. To the extent that a dedicated subsidiary would be more effective in meeting private sector development objectives, and given that growth is expected to be fuelled by private sector development, the choice of option could have a secondary – not measurable - impact on social exclusion and poverty.

xvi./ Gender balance in the region

148. The EIB has a policy of non-discrimination towards individual groups of society. To the extent that it would pursue similar policies under a subsidiary the option's choice is expected to remain neutral with regard to gender balance.

xvii./ Social and labour legal framework and standards

149. The options are not expected to produce direct appreciable impacts in this respect, since project finance operations are not policy loans, compared with for instance World Bank adjustment credits.

xviii./ Support to environmental projects, and addressing some of the region's key environmental needs; and, in particular, sectoral distribution of "environmental projects"

150. Support to environmental projects is to a large extent influenced by interest rates subsidies to the Bank's environmental operations, which are funded from the EC budget. These subsidies have contributed to the Bank becoming a major actor in the region in areas such as water treatment. To the extent that the decision whether to continue with the current subsidies policy is completely independent for the current choice to be made, and assuming that a subsidiary could adopt the EIB's existing environmental policies, the choice of option is not expected to have any material impact on environmental projects. The success of any future support will be linked to the momentum and success of EU and international environmental initiatives to which FEMIP or the subsidiary could participate.

151. The impact of a choice between FEMIP and a subsidiary on the sectoral distribution of environmental projects is expected to be neutral.

xix./ National environment policy frameworks and standards

152. According to the Bank, its policies have spill-over effects whereby it influences national regulations and standards on environment. In a number of cases, disbursement conditions require changes in local regulations regarding environmental issues. The policy of the Bank is, however, to put the emphasis on the procedures (including public

consultation) at least as much as on the standards. The choice of option is expected to be neutral in this respect, as long as a subsidiary would follow EIB environment policies.

153. Work towards greater harmonisation with EU environmental standards, and towards better integration of environmental aspects into other policy areas will mainly depend on the speed of implementation of international initiatives regarding environment, which pursue the harmonisation of environmental regulations in the region with international standards. The choice of option is also considered as neutral in this respect.

xx./ Meeting EC environmental policy objectives in the region

154. EC environmental policies foster a consideration of the environmental dimension from the very early stage of project programming and of the whole development process. The adoption of an integrated strategy is considered of paramount importance. EC policy objectives support ensuring the respect of horizontal environmental policy principles such as the “polluter payer principle” and the “precautionary principle”. EIB environment policies can play an important role in supporting these broad policy objectives and the choice of option is considered to be neutral in this respect.

155. Furthermore, FEMIP or a subsidiary can be an important instrument supporting EC environment policies in the Mediterranean. The first five years of implementation of SMAP[36] (1997-2001) lead to conclude that: (i) delays in processing and implementation of the SMAP regional projects do not yet allow an assessment of the results; (ii) much more could be done to achieve the SMAP objectives through National Indicative Programmes if the benefits of a sustainable development approach were taken into account when setting priorities. As indicated in the present assessment, the EIB is particularly active on environment projects in the Mediterranean and can act in complementarity with EU policies/initiatives in this field. FEMIP or a subsidiary can contribute the implementation of SMAP and possibly speed it up. The choice of option is also expected to be rather neutral in this respect.

xxi./ Degree of complementarity with EC cooperation programmes, in particular with MEDA, the core EC co-operation instrument with Mediterranean Partners

156. The three main areas of MEDA’s cooperation with the EIB are technical assistance, risk capital funds and interest subsidies, all financed under the EC MEDA budget [37]. Cooperation in the area of technical assistance is being secured through regular contacts between services and a recently signed Framework Agreement between both institutions. Under the assumption that *technical assistance* support from the EC budget would continue under both scenarios, the choice of option would not have any significant impact on complementarity with MEDA. The same applies to cooperation in the environment field in the form of *interest rates subsidies,* under a similar assumption.

157. The main area directly affected by the options characteristics or choice would be cooperation in the area of *risk capital*. If FEMIP is kept in its present form there will not be any immediate and important effect on cooperation with MEDA. If however it were feasible to amend Article 20 of the Bank’s statute, it would become possible under FEMIP to invest equity funds in ordinary operations from the bank’s own resources.

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[36] Short and Medium Term Priority Environmental Action Programme.

[37] With the exceptions of funds allocated to EIB operations in Turkey which come from a different budget line.

The rationale for a continued support from the EC budget with "risk capital" funds - to circumvent the current Bank's current statutory limitations - would cease. The same applies under a dedicated subsidiary enabled to commit equity on its operations. In both cases - a revision of Article 20 under FEMIP or its incorporation into a dedicated subsidiary enabled to invest equity resources – one of the important impacts would be to de-programme the current budget appropriation of risk capital funds within the MEDA budget in favour of the bank.

158. Cooperation with technical assistance programmes funded under MEDA , especially in areas such as financial sector reform and private sector development, would be expected to continue -and possibly to be enhanced- under both options. The same applies to cooperation with EC programmes on Turkey, which do not fall under MEDA and which focus on institution building, adoption and implementation of the acquis and investment support. Turkey is also eligible for funding under the Bank's pre-accession facility[38].

xxii./ EU-MED partnership and co-operation objectives (including the recent context of the "Wider Europe" initiative). And in particular "ownership" of financial cooperation by Mediterranean Partners

159. With regard to Partnership, there are significant differences between the two options. Mediterranean Partners are not shareholders of the EIB and have a consultative role in FEMIP's supervisory board (the PDCC). Under a subsidiary, they could be offered a stake and a full shareholder role. This would ensure a higher degree of ownership by the beneficiary countries and would reflect the political priorities expressed in the Community's recent "Wider Europe" initiative.

xxiii./ Interaction with local economic reforms.

160. A subsidiary with a dedicated private sector banking staff more important than currently under FEMIP, providing a hands-on due diligence of private sector projects, would be superior in interacting with local economic reforms. Mediterranean Partners' directors in the subsidiary's board -provided they subscribe a share of the capital- could also play an important role in this respect. This dynamic interaction could facilitate the establishment of more business friendly legal and economic environments.

xxiv./ Distribution of funds among beneficiaries

161. The regional distribution of funds among beneficiary countries is to a large extent the outcome of absorption capacities. Even before the adoption of the private sector development priority in 2002, there were quite significant discrepancies in the country allocation of projects which reflect both the business environment and the investment's dynamism. As shown in chart 10 (in Annex), Tunisia and Syria, with respectively 4% and 8% of the actual beneficiary countries' population, have (respectively) been allocated 16% and 4% of EIB own resources projects in the region over the 1997-2002 period. Turkey, the largest recipient country with Egypt, has a share of EIB projects in line with its population but below its GDP share in the total.

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38 Turkey may participate in horizontal and multi-country EC 'Phare' programmes, where its participation is financed from the EC national pre-accession programme for Turkey. The EC programmes have also been providing co-financing with the national budget to enable Turkey to participate in selected Community programmes and agencies since 2001 and this will continue in 2004.

162. The priority on private sector development means in practice that countries which have facilitated private sector development by establishing a favourable business environment, facilitating FDI and pursuing privatisation policies will most probably obtain the highest share of the FEMIP or a subsidiary's support in this area. To the extent that the option of a subsidiary is expected to have the highest efficacy with regard to the promotion of private sector development, the options may not be fully neutral and the choice could affect the regional distribution of projects financed.

xxv./ Subsidiarity.

163. Subsidiarity of FEMIP and of a subsidiary versus any comparable scale financial cooperation instruments split among the EC Member States, or any mandate given to one or several private sector financial institutions, is ensured given the important economies of scale of a unique instrument, the advantageous conditions of borrowing and the creditor status associated with a triple A rated IFI, the facilitated liaison of an official cooperation instrument with other ODA instruments, and last but not least the leverage and possible articulation with recipient countries' policies .

164. Developing FEMIP or establishing a subsidiary is however neutral with regard to subsidiarity, as both benefit or would benefit from the above mentioned features.

Section V. Monitoring and evaluation.

165. The Bank is expected to provide PDCC bi-annual meetings with progress reports on the implementation of FEMIP. The Commission will closely monitor FEMIP’s –or a subsidiary’s- operations. It will actively participate in PDCC meetings in order to review and discuss FEMIP activities. Should a subsidiary be created, and assuming that the Community takes a participation in the institution, the Commission would be represented in its board and actively monitor the new institution's development and operations. A number of monitoring indicators will be defined in close relationship with the objectives assigned to the instrument. The Commission will grant a special attention to compliance with the private sector mandate.

166. Consistent with Article 27(4) of the Financial Regulation[39] and Article 21 of the Commission regulation laying down the rules for its implementation[40], a Community subscription in the capital of a new subsidiary would be the subject of an evaluation at least every six years. It is furthermore worth noting that the Bank's evaluation department has programmed an evaluation of Bank-own resources operations in the Mediterranean and expects to conclude this evaluation by the end of 2004. Its findings would provide valuable input for any subsequent exercise, notably the renewal of external lending mandates beyond 2006, as well as subsequent Commission evaluations of the instrument.

167. Should the Council review on FEMIP conclude that it should be incorporated into a subsidiary the Commission would assess, in collaboration with the Bank, actions needed, including the need for a legislative proposal. Any change related to the current guarantee regime applying to EIB external lending mandates would need to be made consistent with the Mid-Term review of external lending mandates until January 2007.

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[39] O.J.C.E. L248/12, 16.9.2002.

[40] O.J.C.E. L357/1, 31.12.2002.

Section VI. Stakeholders' consultations

168. Mediterranean Partners, which are the beneficiaries of FEMIP operations, are the main stakeholders with regard to the policy choice examined in the present assessment. Commission services consulted them and held a meeting with their representatives in Brussels on 13 June 2003. Subsequently, a number of them submitted written comments. Mediterranean Partners’ representatives considered the supply of SME finance, notably access to long-term funds from local banks, as essential. FEMIP (or a subsidiary) could play an important role in this respect with “global loans”. Moreover, risk capital was needed. They also noted the importance of technical assistance to implement FEMIP’s projects. The role of the Policy Dialogue and Co-ordination Committee was considered as very positive. Overall, while a number of Mediterranean Partners' representatives enquired on the features of each option and the nature of the choice to be made, those which expressed a view recognised that the creation of a subsidiary would allow for more ownership and would be seen as a strong and visible political commitment. Some in particular inquired on the costs of the products to be offered by a subsidiary and how they would compare with current terms available under FEMIP.

169. Enterprises representatives were also consulted, namely the “Union Mediterranéenne des Conféderations d’Entreprises” (UMCE) and its European counterpart, “Union of Industrial and Employers’ Confederation of Europe” (UNICE). UNICE and UMCE emphasised the importance of micro and SME finance and the possible complementarity with MEDA in this respect. Leasing, guarantee schemes and venture finance should be developed further. The EIB played a positive role but large infrastructure projects still absorbed an excessive large share of its operations. UMCE mentioned the need to support joint ventures and infrastructure geared to support economic integration. Investment finance should according to UNICE be matched with technical assistance and grants. According to UNICE, while the rationale for the incorporation of FEMIP into a subsidiary was considered difficult to evaluate at this stage, it could play a positive role if it involves a reinforcement and a diversification of the supply of finance, and provided overlaps with existing institutions can be avoided. UMCE supported the setting up of a subsidiary to promote private sector development, diversify financial investment tools and insure increased ownership of Mediterranean Partners.

170. Commission services also had a number of informal contacts with the World Bank and the IFC. World Bank and IFC representatives in particular concurred with Commission services that, while capital resources were widely available in the regions, the supply of long-term financing to private sector investments was inadequate. Commission services also met EIF staff and examined possible complementarities between FEMIP and the EIF in the Mediterranean. While not operating in the region, the EBRD's experience was also considered relevant because of its private sector mandate and a number of informal meetings were arranged in its headquarters in London. African Development Bank services were also contacted and confirmed the limited share of its operations devoted to private sector development.

Section VII. Summary of impacts.

Summary Table		
EFFECTIVENESS IMPACT CRITERIA	Developing FEMIP	Subsidiary
i) Meeting private sector investment needs and contributing to growth in the Mediterranean region	+	++
ii) Capacity of supporting local financial sector development	+	++
iii) Addressing local SMEs needs	+	+
iv) Financing key transnational infrastructure projects in Mediterranean Partners and Public-Private-Partnerships	+	+(+)
EFFICIENCY IMPACT CRITERIA		
v) Leverage on other external resources raised to meet the same objectives	++	+
vi) Cost of capital and, in particular, on the pricing of loans for beneficiaries	(=)	+(+)
vii) Complementarity with IFIs active in the region	=	+
viii) Budgetary requirements for the EC and Member States	+	+(+)
ix) Complementarity with local and regional resources	(+)	(+)
OTHER SUSTAINABLE DEVELOPMENT AND POLICY CRITERIA		
x) Sectoral distribution of projects	+	+
xi) Technological development and innovation in the region	n.i.	n.i.
xii) Employment creation in the region	+	+(+)
xiii) Job contents, qualifications and local expertise	= /+	= /+
xiv) Education, training and culture	=	=
xv) Social exclusion and poverty, and distributional implications (effects on the income of particular groups of the population, sectors)	=	=
xvi) Gender balance in the region	=	=
xvii) Social and labour legal framework and standards	=	=
xviii) Support to environmental projects and addressing some of the region's key environmental needs? And, in particular, as regards the sectoral distribution of "environmental projects	=	(=)
xix) National environmental policy frameworks and standards	=	=
xx) Meeting EC environmental policy objectives in the region	=	=
xxi) Degree of complementarity with EC co-operation programmes, in particular with MEDA, the core EC co-operation instrument with Partner Countries	=	+
xxii) EU-MED partnership and co-operation objectives (including the recent context of the "Wider Europe" initiative)? And, in particular, as regards "ownership" of financial co-operation by Partner Countries	=	(+)
xxiii) Interaction with local economic reforms	(=)	(+)
xxiv) Distribution of funds among beneficiaries.	+	+
xxv) Subsidiarity	+	+

Notes :
+ + Important impact = Neutral impact (+) Impact subject to a number of assumptions
+ Significant impact n.i. Not identified impact

GLOSSARY

Basis points	Interest rate or lending margin measure (100 basis points equals 1%).
Blanket guarantee	EC budget guarantee restricted to 65% of the EIB's aggregate amount of the credits opened (and related sums) on external lending mandates.
Capitalisation	Provision of equity funds by its shareholders to a new or existing institution
Commercial risk	Risk of default on a project arising from business related events (i.e. excluding "political risk" factors, see definition of political risk).
Conditional loans	Long-term reimbursable facilities channelled by the EIB to its beneficiaries through financial intermediaries to finance equity and quasi-equity investment in SMEs' projects
Corporate governance.	The system according to which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs (OECD, 1999)
Direct loans/Individual loans	Credits made available "directly" by the EIB to promoters in both the public and private sectors, including banks.
Extended Impact Assessment	Ex-ante evaluation exercise used by the Commission as a tool to improve the policy development process.
External Lending Mandate.	Lending authorisation entrusted to the EIB by the Council with the benefit of the blanket guarantee.
Guarantee Fund	EC Fund created to protect the EC budget against risks of default on guaranteed external lending operations.
Gearing ratio	Operations-to-capital ratio. A 2.5:1 gearing ratio enables operations of € 250 million on the basis of a € 100 million capital. A 1:1 gearing ratio requires a capital of € 100 million for operations of the same amount.
Global loans	Credit lines made available to banks other financial institutions, which on-lend the proceeds for small or medium-scale investment projects meeting the EIB's criteria.

Intermediated operations	Operations according to which the main lender (the Bank) channels its financial resources via financial intermediaries (mainly commercial banks) to the final beneficiaries.
Leverage	Capacity to raise/attract additional resources.
Mark-up	Additional price charged on top of cost of funds (spread)
Paid-in capital	Amount of capital actually disbursed by shareholders.
Pari passu conditions	Similar financing conditions (price, securities…) among several co-financing parties.
Political risk	Risk currently defined due to currency non transfer, expropriation, war or civil disturbance (definition under review).
(Bank) Pricing policy	Policy that establishes the interest rate and fees to be charged to borrowers.
Provisioning policy	Policy that establishes the amount of money that should be allocated and registered under the heading "Provisions" in the balance sheet of any enterprise in order to cover for any contingency it could happen related to its day-by-day business (provisions are contingency reserves).
Risk profile	Set of characteristics that describes the type of response to risk of an agent (adverse/favourable to risk).
Risk sharing mechanism	Under the risk sharing mechanism, the EIB requires non-sovereign guarantees from well rated guarantors to cover commercial risks associated to its lending, and the EC budget exposure is limited to the political risk.
Sovereign guarantee	Guarantee provided by the State of the recipient country. Sovereign guarantees are normally extended for public sector projects.
(EIB) Subsidiary	Bank entity owned by the EIB.
Syndication operation	Co-financing operation under which the IFI "lender of record" only takes a share of a lending operation on its books (A-loan) and calls on commercial banks to provide the remainder (B-loan).

ACRONYMS

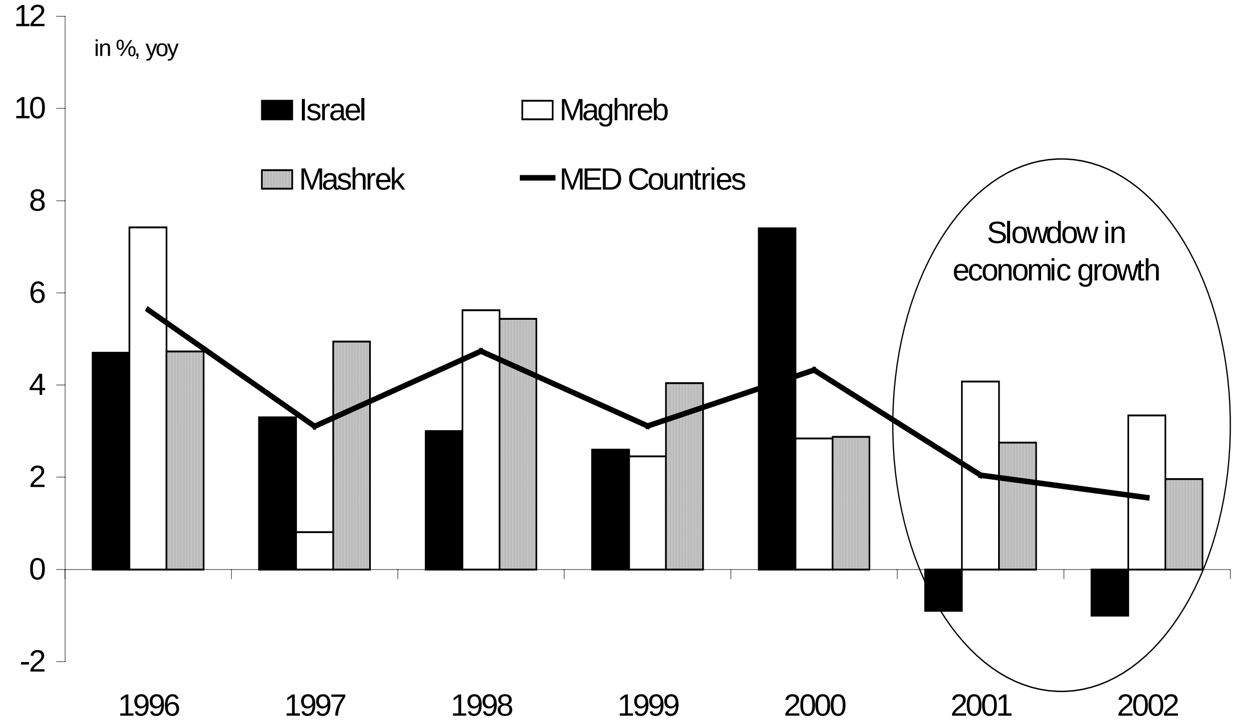
ACP	Africa, Caribbean and Pacific countries
BOT	Build, Operate and Transfer project (public-private partnership in the form of a concession, used for utilities, motorways etc..)
DG ECFIN	Directorate General - Economic and Financial Affairs
DG ENV	Directorate General - Environment
EBRD	European Bank for Reconstruction and Development
EC	European Community
EIA	Extended Impact Assessment
EIB	European Investment Bank
EU	European Union
Europe Aid (DG AIDCO)	European Co-operation Office
FDI	Foreign Direct Investment
FEMIP	Facility for Euro-Mediterranean Investment and Partnership
FIs	Financial Intermediaries
GDP	Gross Domestic Product
IFC	International Finance Corporation
IFIs	International Financial Institutions
IMF	International Monetary Fund
MED	Mediterranean region
MEDA	The MEDA programme is the core EC cooperation instrument for the implementation of the Euro-Mediterranean Partnership. As a grant-based instrument MEDA offers support measures to accompany the reform of economic and social structures in the Mediterranean partners
MENA (World Bank)	Middle East and North Africa : Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Malta, Morocco, Oman, Qatar, Saudi Arabia,

	Syria, Tunisia, the West Bank and Gaza, and Yemen
MENA (IFC)	Algeria, Egypt, Jordan, Lebanon, Tunisia, Morocco, Syria, Gaza West-Bank, Bahrain, Oman, Kuwait, United Arab Emirates, Yemen, Saudi Arabia, Iran and Afghanistan
MEPP	Middle East Peace Process
METAP	Mediterranean Environmental Technical Assistance Program
MPC	Mediterranean Partners: Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, Syria, Turkey, and Gaza West-Bank
MS	Member States.
NPV	Net Present Value.
PDCC	Policy Dialogue and Co-ordination Committee.
PPP	Public Private Partnership
SAP	EC/Turkey Customs Union Special Action Programme.
SME	Small and Medium Enterprises.
TERRA	Turkey Earthquake Reconstruction and Rehabilitation Action.
UMCE	Union Méditerranéenne des Confédérations d'Entreprises.
UNICE	Union of Industrial and Employers' Confederation of Europe.
UNCTAD	United Nations Conference on Trade And Development.
USD	United States Dollar.

Annex 1: Members of the Inter-service Group

Mr. P. Schellekens, DG SG-C1 Mr. J. Duynhouwer, DG AIDCO-B3 Mrs.I. Schwaiger, AIDCO-B3 Mr. J. Rivière y Marti, DG COMP-A Mr. J-L. Stephany, ELARG-D3 Ms. P. Widen, DG BUDG-A4 Mr. U. Eiteljoerge, DG MARK-B3 Mrs. J. Pinto-Antunes, DG ENV-E1 Mr. F. Donatella, DG FISH-B1 Mrs. A. Bournoville, DG TREN-A3 Mr. A. Traore, DG DEV-B2 Mrs. V. Kotsoni, DG REGIO-A2 Mr. B. Martens, DG RELEX F/1	Mr. A. Italianer, DG ECFIN-D (chairman) Mrs. B. Kauffmann, DG ECFIN-D4 Mr. C. de la Rochefordière, DG ECFIN-D4 Mr. I. Hoskins, DG ECFIN-D4 Mrs. Pilar Blanco-Rodríguez, DG ECFIN-D4 Mr. K. Williams, DG ECFIN-R3 Mrs. A. Melot, DG ECFIN-L1

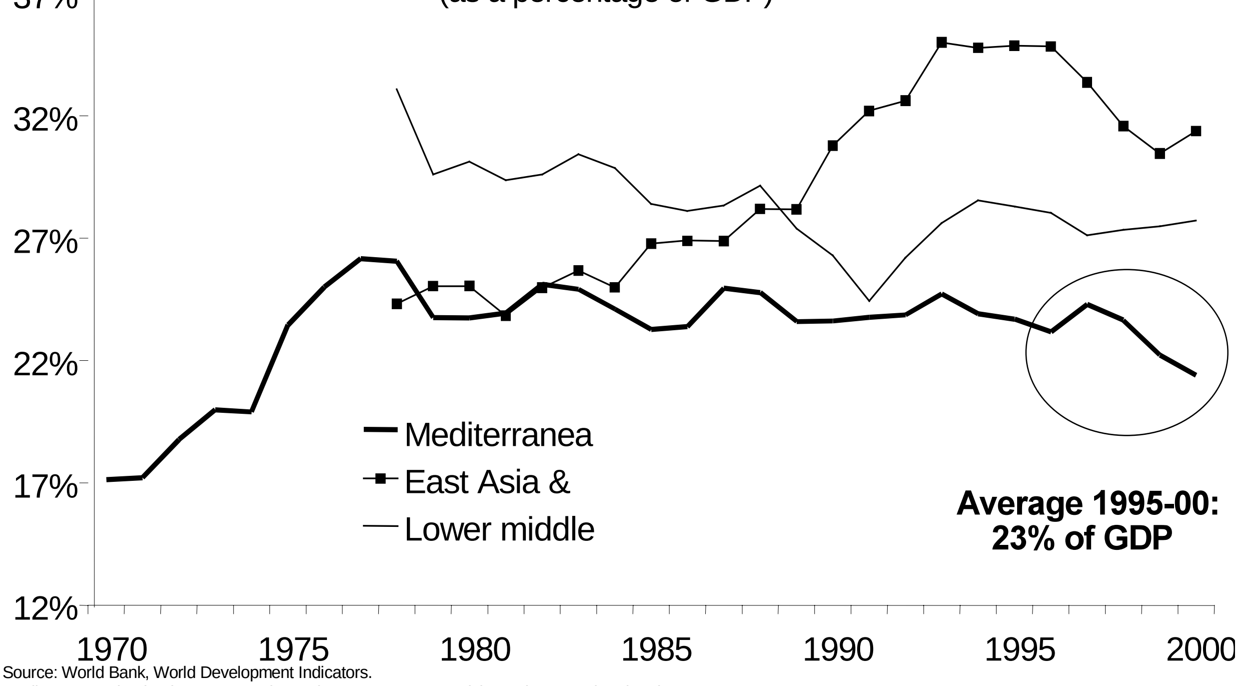
Chart 1. Real economic developments in the MED region



Source: IFS, national statistical offices

Chart 2. Gross fix capital formation

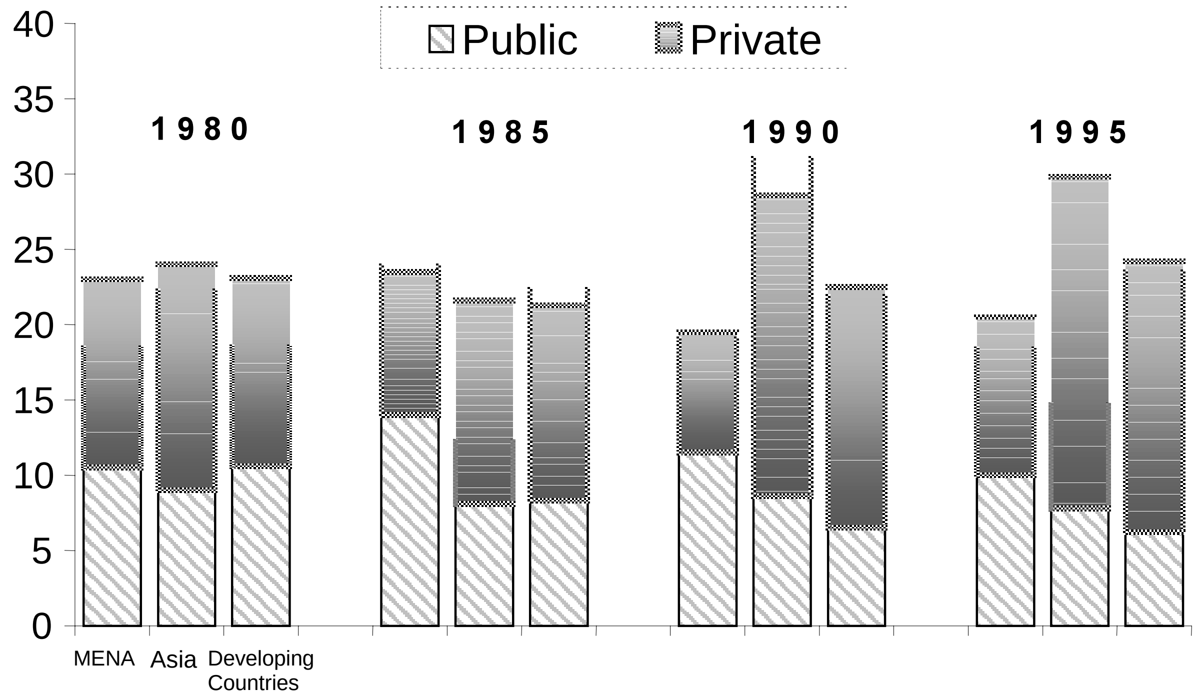
(as a percentage of GDP)



Source: World Bank, World Development Indicators.
"Mediterranean" is Algeria, Egypt, Jordan, Lebanon, Morocco, Tunisia, Turkey, Israel and Syria.

Chart 3: Proportion of public and private

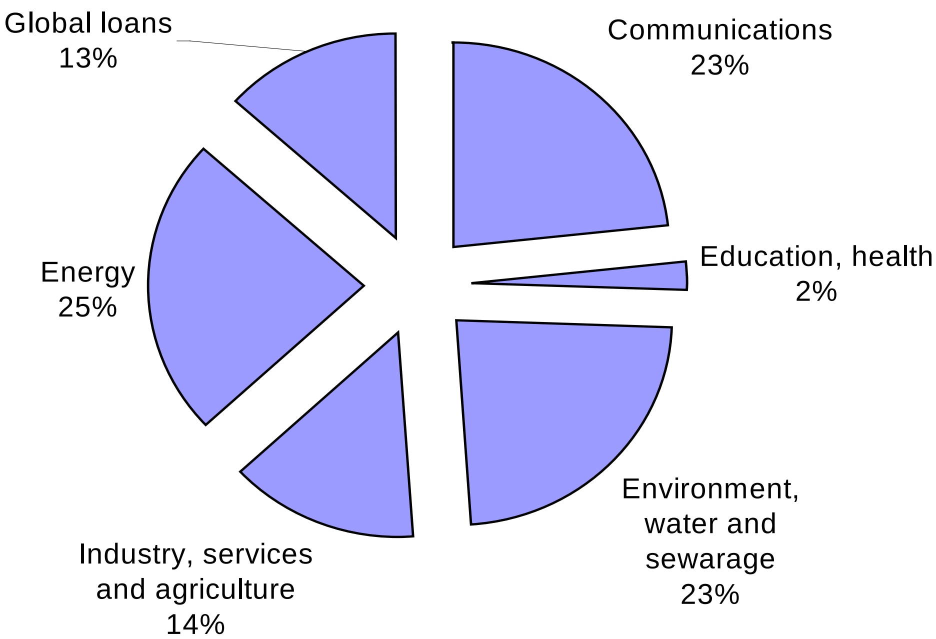
(gross fixed capital formation in percentage of GDP)



Source: IFS, national statistical offices

Chart 4: Own resources lending by sector

Mediterranean region (1997-2002)



Source: EIB Data.

Table 1: Bank lending by sector

(in % of total lending)

	Government and Public Enterprises	Private Sector	Total
Algeria	82%	18%	100%
Syria	77%	23%	100%
Turkey	62%	36%	98%
Lebanon	51%	49%	100%
Egypt	32%	66%	98%
Morocco	23%	66%	89%
Jordan	16%	84%	100%
Israel	9%	91%	100%
Tunisia	8%	92%	100%

Source: IMF IFS

Table 2: Credit Ratings
Mediterranean Region

(April 2003)

	Moodys	S&P
Algeria	Not rated	Not rated
Egypt	Ba1	BB+
Israel	A2	A-
Lebanon	B2	B-
Morocco	Ba2	BB
Tunisia	Baa2	BBB
Jordan	Ba3	BB-
Syria	Not rated	Not rated
Turkey	B1	B-

Credit ratings in European countries can reach (in average) A3 or AAA levels.

Source: Moodys' and S&P websites.

Table 3: EIB's Signed Contracts - Own Resources

(million)

	1997	1998	1999	2000	2001	2002	**Total**
Algeria	335,0	30,0	0,0	140,0	225,0	220,8	950,8
Egypt	131,0	225,0	188,3	100,0	180,0	200,0	1024,3
Gaza-Cisjordania	14,0	97,0	10,0	10,0	0,0	0,0	131,0
Jordan	60,0	83,0	80,0	60,0	0,0	0,0	283,0
Lebanon	131,0	30,0	30,0	0,0	0,0	45,0	236,0
Morocco	135,0	137,7	261,0	83,0	280,0	140,0	1036,7
Syria	0,0	0,0	0,0	75,0	115,0	100,0	290,0
Tunisia	130,0	165,0	98,1	150,0	225,0	290,0	1058,1
Turkey (1)	95,0	32,0	78,0	575,0	370,0	555,0	1705,0
Total	1031,0	799,7	745,4	1193,0	1395,0	1550,8	6714,9

(1) The programmes "Turkey Earthquake Reconstruction and Rehabilitation Action (TERRA)", and "Turkey Customs Union Special Action Programme (Turkey SAP)" are also included

Source: EIB Data.

Table 4: Interest Subsidies to EIB lending
Mediterranean Region

(million)

	1997	1998	1999	2000	2001	2002-2003[1]	**Total**
Total	n.a.	33,06	33,20	18,44	28,90	38,95[2]	152,61

[1] From 01/01/2002 to 31/03/2003

[2] 22,65 million in 2002 and 16,36 million in 2003.

Source: EIB Data.

Table 5: Risk Capital Operations[1]

Contract amounts by protocol and MEDA I and II

(million)

	2nd Prot[2]	3rd Prot[3]	Off-Prot[4]	1997	1998	1999	2000	2001	2002[5]	**Total MEDA**
Algeria	4,0	0,0	0,0	0	0,0	0,0	3,0	0,0	6,0	9,0
Egypt	11,0	16,0	0,0	6,5	25,0	0,0	0,0	0,0	25,0	56,5
Gaza-Cisj.	0,0	0,0	6,0	1	5,0	8,0	3,0	0,0	0,0	17,0
Jordan	2,0	2,0	0,0	10	1,4	0,0	9,8	0,0	0,0	21,2
Lebanon	1,0	3,0	0,0	0	0,0	0,0	0,0	0,0	0,0	0,0
Morocco	11,0	20,0	0,0	0	45,0	2,0	0,0	0,0	0,0	47,0
Syria	0,0	0,0	0,0	0	0,0	0,0	0,0	0,0	0,0	0,0
Tunisia	6,0	15,0	0,0	15	10,0	34,3	4,8	0,0	0,0	64,1
Turkey [1]	0,0	0,0	0,0	0	0,0	12,0	0,0	0,0	6,0	18,0
Med. Reg.	0,0	0,0	0,0	0	0,0	0,0	0,0	6,0	0,0	6,0
Total	35,0	56,0	6,0	32,5	86,4	56,3	20,6	6,0	37,0	236,8

[1] Data includes global loans amounts provided from EC budget.

[2]1982-1986; [3]1987-1991; [4]1992-1996

[5] Data from 01/01/2002 to 31/03/2003.

Source: EIB

Table 6: Comparative EIB-EBRD-IFC indicators

2002 data	EIB (total)	EIB Med[1]	EBRD	IFC[2]
Number of projects approved	340,0	19[3]	102,0	204,0
Projects approved (million)	52824,0	1551[3]	3899,0	3100,0
Average project size (million)	155,0	70,5	35,0	15,0
Total staff	1113,0	50[4]	1144,0	2053,0
Staff (notional) per 100 million committed	2,1	3,2	29,0	66,0
Staff (notional) per project approved	3,3	2,6	11,2	9,8

[1] Data from 01/01/2002 to 31/03/2003. Base on "signed projects".

[2] Data FY 02.

[3] Only lending operatios.

[4] FEMIP direct staff and estimated staff input from other bank's departments, as of end 2002.

Source: Various IFI's data base.

Table 7: The FEMIP Business Plan

(million)

	Instrument	Historical 1999-2002	Year 1 2003	Year 2 2004	Year 3 2005	Year 4 2006	Total 2003-2006
Core lending activity	loans	5120	1560	1600	1670	1670	**6500**
Additional activities for private sector development	loans		102	142	232	337	**813**
Lending to private sector	loans		30	50	80	120	**280**
Lending to complementary activities	loans		72	92	112	157	**433**
Risk Capital	equity	138	22	28	80	120	**250**
of which additional	equity		0	0	40	60	**100**
Technical Assistance and investment	grants	167	55	52	25	30	**162**
of which additional			25	25	25	30	**105**
Total operations		**5425**	**1739**	**1822**	**1967**	**2097**	**7625**
of which additional			**127**	**167**	**257**	**367**	**918**

Source: EIB Data.

Table 8: Current EC budget support

(mainly from MEDA)

(million)

	2003	2004	2005	2006	**Total**
Risk capital activities	28,0	22,0	40,0	60,0	150,0
Technical assistance	25,0	25,0	25,0	30,0	105,0
Interest subidies (indicative possible amount)	30,0	30,0	30,0	30,0	120,0
Total	83,0	87,0	95,0	120,0	375,0

Source: Europpean Commission.

Table 9: Distribution of projects per country

(Regional comparison)

	1997-2002 projects[1]	Distrib. A %	Population (million, 2002)	Distrib. B %	Nom. 2002 GDP(US$ bn)	Distrib. C %	Index A/B	Index A/C
Algeria	950,8	14,0%	31,2	14,0%	55,0	13,0%	1,0	1,1
Egypt	1024,3	15,0%	66,7	29,0%	81,8	19,0%	0,5	0,8
Gaza-Cisj	131,0	2,0%	3,0	1,0%	4,9	1,0%	1,5	1,7
Jordan	283,0	4,0%	5,3	2,0%	9,5	2,0%	1,8	1,9
Lebanon	236,0	4,0%	3,6	2,0%	17,8	4,0%	2,2	0,9
Morocco	1036,7	15,0%	29,7	13,0%	38,8	9,0%	1,2	1,7
Syria	290,0	4,0%	17,7	8,0%	20,9	5,0%	0,6	0,9
Tunisia	1058,1	16,0%	9,8	4,0%	22,0	5,0%	3,7	3,1
Turkey	1705,0	25,0%	62,7	27,0%	183,1	42,0%	0,9	0,6
Total	6714,9	100,0%	229,7	100,00%	433,8	100,0%	1,0	1,0

[1] Own resources/signed contract amounts.

Source: EIB Data.