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Assessment of the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) and Future Options

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INTRODUCTION

In line with the European Council conclusions of December 2003[1], the European Commission in close cooperation with the European Investment Bank has conducted a review of the Facility for Euro-Mediterranean Investment and Partnership (FEMIP). This Communication summarizes the main findings of the review and presents options for the future. More detailed and technical information is provided in the Commission services' working document attached to this communication.

FEMIP was created in October 2002, following the conclusions of the Barcelona European Council in March 2002 that private sector development in the Mediterranean region[2] should be stimulated, to facilitate a higher level of economic growth. FEMIP combined EIB loans with EU-budget resources to provide technical assistance, risk capital and interest rate subsidies for environmental projects. Furthermore, a dialogue structure between EU- and Mediterranean Partner Countries was created.

In November 2003, the Council, on the basis of a Commission assessment, carried out a first review of FEMIP's activities and decided to reinforce the Facility with new features: creation of a Special FEMIP Envelope for loans with a higher risk profile, establishment of a donor Trust Fund, reinforcement of the dialogue structure and further extension of FEMIP's local presence in the region. It agreed as well to increase the amount of Community guarantees for loans to the region – an increase which was formalized in December 2004, in the context of the mid-term review of EIB external mandates.

The European Council also invited the Ecofin Council to conduct another review in 2006, after consulting the Mediterranean Partner Countries. The consultation process involved a direct exchange of views amongst Ministers, the Commission and the EIB in the FEMIP Ministerial meeting in June 2006, bilateral discussions between the EIB and authorities in Mediterranean countries in the first half of 2006 and consultations with FEMIP stakeholders through both targeted and internet-based questionnaires.

The results of the consultation process were used, together with a selection of EIB evaluations and economic data, to assess FEMIP's performance in meeting its primary objectives of fostering economic growth and private sector development.

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[1] Conclusions of the Brussels European Council, 12-13 December 2003: 'The European Council welcomes the ECOFIN Council decision to develop further the FEMIP facility by reinforcing the FEMIP within the European Investment Bank. In line with the Barcelona European Council remit, the decision was taken on the basis of the performance of the FEMIP, which was evaluated positively, and consultation with Mediterranean Partner Countries. The European Council invites the ECOFIN Council to assess the incorporation of an EIB majority- owned subsidiary dedicated to the Mediterranean partner countries in December 2006, on the basis of an evaluation of the reinforced Facility's performance, taking into account the outcome of consultations with the Barcelona process' partners.'

[2] This covers the Barcelona process countries: Morocco, Algeria, Tunisia, Egypt, Gaza-West Bank, Israel, Lebanon, Syria, Jordan and Turkey.

1. ASSESSING FEMIP IN THE LIGHT OF THE ECONOMIC NEEDS OF THE MEDITERRANEAN REGION

1.1. Fostering support to investment and economic growth in the region

Recent economic growth in the Mediterranean region, while significant (4.8% in 2005), has continued to lag behind the average of comparable middle income countries. It has proved insufficient to reduce unemployment, with officially-reported rates ranging from 9% to 23%. In addition, the percentage of people living below USD 3 a day remains high, with rates varying from 20% (Tunisia, Jordan), 35% (Algeria) to 70% (Egypt).

Investment patterns in the region remain subdued, notably outside the oil producing countries, and the level of FDI inflows stands relatively low compared to other regions; only 3% of net private capital flows to developing regions is directed towards the Mediterranean region. This is basically explained by a weak business environment associated with a high political and economic risk perception. This also translates into high real interest rates, which indicate deficiencies in financial markets and regulatory environment and a lack of integration of the region into world capital markets.

Although considerable progress has been made in improving the business climate, the region still scores below the world average on important determinants for the ease of doing business, such as access to finance, registering property, investor protection, and administrative procedures for starting a business, dealing with licences, etc. Further reforms to improve the business climate are needed to facilitate the creation and development of new companies, job creation and economic growth.

Access to finance in particular remains problematic for private enterprises, especially for smaller companies (SMEs). Although on average Mediterranean banks seem to have sufficient capital and liquidity, their behaviour is very risk averse. This is partly due to the fact that the percentage of non-performing loans is already high. Banks therefore charge relatively high interest rates, provide loans with short maturities and require high collateral from their borrowers. Access is further limited by underdeveloped delivery channels and organisational weaknesses within banks. Government ownership of banks is widespread, and in some countries a large part of the loans are directed towards the public sector and allocated on non-commercial criteria. The result is that bank credit available for the private sector remains scarce and only covers between 4% and 20% of private sector investment needs.

Small enterprises have even less access to credit than the private sector as a whole, even though in many Mediterranean countries they constitute more than 95% of all businesses and 50-70% of employment. The main reasons why SMEs face more difficulties than larger enterprises are that they tend to be undercapitalised, that they lack collateral and are not sufficiently transparent in the information they provide. Furthermore, the costs to banks of providing small loans are relatively higher than for larger loans.

Micro-finance institutions and less resource-intensive, standardised instruments could help solve the problem for the smallest companies. Although the availability of micro-finance is growing fast, it currently covers less than 0.5% of the population, leaving a large potential unfulfilled.

1.2. FEMIP has significantly contributed to investment in the region

In this context, FEMIP intervention is of particular importance since it finances high quality and productive infrastructure and private sector investments under attractive conditions.

FEMIP has been instrumental in channelling substantial funding to the Mediterranean region. The EIB is the largest provider of loans to the region and its activities in the Mediterranean have grown substantially since the establishment of FEMIP; signatures increased from EUR 1.6bn in 2002 to EUR 2.2bn in 2005 (including Turkey[3]). Around one third of the FEMIP projects were co-financed with other institutions.

In the period October 2002-end 2005, 77 operations were signed for an amount of EUR 7.2bn, corresponding to a total project volume of more than EUR 25bn. With borrowers from Turkey, Egypt, Tunisia and Morocco receiving the largest share of loans, it is foreseen that the Euro-Med II loan mandate will be fully exhausted before the end of 2006.

FEMIP has contributed to economic growth through support to investment in infrastructure (60% of all loans) and private companies. Loans to local intermediaries, for on-lending to SMEs (global loans), have grown substantially over the past few years, reaching more than 20 % of total loans provided in 2002-2005. Total financing of private operations by FEMIP almost has tripled in absolute terms, from EUR 0.3bn a year in 2000-2002 to an average of EUR 0.9bn a year in 2003-2005.

In complement to these lending activities, EIB operations have included risk capital and technical assistance financed by EU budget resources[4]. Risk capital has mainly been used for participations in private equity funds, microfinance institutions and an SME loan guarantee scheme. With EUR 350m in commitments (of which more than EUR 200m of risk capital is disbursed and still outstanding (i.e. not yet reimbursed or written-off), the EIB has become the largest international provider of risk capital to the region. The use of this instrument has been mainly concentrated in a few countries (Morocco, Tunisia and Egypt), which reflects market developments (legislation, presence of qualified staff, etc) and the size of the economies.

Technical assistance (TA) proved to be very useful for project-identification, preparation, implementation and evaluation. The technical assistance concept and approach is positively received in all target countries and supports effectively the transfer of know-how to beneficiary countries. So far less than 30% of technical

3 Due to Turkey's recognition as a candidate for accession to the EU, lending in this country (which previously represented on average over one third of FEMIP activities), has been transferred to a different loan mandate since 2005. Accordingly, in the future, operations in Turkey will no longer be accounted for under FEMIP, though Turkey will continue to be involved in institutional aspects of FEMIP (such as FEMIP meetings.)

4 The current EIB statutes restrict the EIB's capacity to finance such operations from its own funds.

assistance has been used for the private sector, though it could further support the development of local financial intermediaries and SMEs.

A FEMIP donor Trust Fund was created at the end of 2004, to finance technical assistance for sector and thematic studies and risk capital activities which could not be financed under existing EIB-managed EU-budgetary funds. This started operating at the beginning of 2005; twelve technical assistance operations and one risk capital operation had been approved by August 2006.

1.3. But FEMIP could do more to foster private sector development and especially SMEs

While FEMIP has succeeded in providing substantial amounts of loans suitable to large long-term investments, and has made efforts to cater for the needs of smaller companies, it has proved difficult to reverse the public-private sector balance in a sustainable way and bring FEMIP's support to private companies up to more than 50% of its activities.

Global loans to financial institutions for on-lending to SMEs are mostly used by larger, export-oriented SMEs, as the local intermediary banks have to fully bear the SME risk and EIB loans to these intermediaries are made in foreign currency. These loans have therefore been less instrumental in targeting smaller enterprises within the private sector. The EIB has made a considerable effort to offer loans in local currency, but these efforts have often been hampered by insufficient cooperation by Mediterranean authorities to allow the issuance of EIB local currency bonds in their markets.

Two EIB evaluation reports on EIB activities in the Mediterranean region and consultations with stakeholders show that the main obstacles are the business environment and particularly financial sector reform, insufficient cooperation from Mediterranean governments to facilitate EIB private sector operations in their countries, and also the insufficient adaptability of FEMIP's instruments to the needs and risk profile of private sector projects in this region. The strict security and guarantee requirements as well as the foreign exchange risk attached to the EIB loans have made it difficult to cater for smaller scale private sector needs. The evaluation reports also showed that some opportunities to provide value added have been missed, by not sufficiently defining EIB's role in countries and sectors and by not placing enough emphasis on institutional issues and cooperation with the local authorities, the Commission and other donors.

The introduction of the Special FEMIP Envelope (SFE) somewhat lowered the security requirements in some cases. As of end 2005, the SFE had been used only twice (partly due to the fact that certain Mediterranean countries have started to question the applicability of the Framework Agreements with EIB to private sector operations), but the list of projects in the SFE pipeline shows a promising take-up.

Addressing the shortcomings identified in FEMIP financial instruments would require that the Facility as it stands be fine-tuned and diversified.

2. THE WAY FORWARD

2.1 The future of the European Neighbourhood Policy (ENP)

The introduction of the European Neighbourhood Policy in 2004 has created a new political environment that needs to be taken into account when assessing the future of FEMIP. Starting in 2007, EC cooperation with neighbouring countries will be governed by the European Neighbourhood and Partnership Instrument (ENPI) which is a policy oriented instrument. This new instrument foresees specifically the need to ensure coherence with the EIB.

In this context, the Commission has put forward a proposal for the 2007-2013 EIB external mandate that would substantially increase the loan resources available for ENP countries. Such proposal also contemplates that the consistency of EIB external actions with the external policies and objectives of the European Union shall be strengthened.

With regard to the further development of ENP, it is expected that a comprehensive debate will take place within the EU in the course of next year. This could lead to a more ambitious and comprehensive approach in a wider ENP framework.

2.2 The options

Three options, representing three levels of ambition, are next considered for the future of FEMIP[5]:

1. A first baseline option consisting of no changes in instruments, an increase in the volume of loans and stronger links with the European Neighbourhood Policy;
2. A second option including: fine-tuning and diversification of FEMIP's financial instruments, while reinforcing partnership and local presence, so as to further improve FEMIP's effectiveness and value added for private sector development;
3. A third option upgrading FEMIP into a fully fledged Euro-Mediterranean EIB subsidiary.

2.3 Option 1: Maintain the reinforced FEMIP and improve its linkages with the ENP

Under this baseline option, the volume of lending to help meet the region's investment needs would increase, in line with the forthcoming Council decision on the EIB external mandates[6]. According to the Commission proposal, the increase in the regional ceiling would allow lending resources available to the region to grow by 2% per year in real terms, hence helping to match the investment needs.

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5 A more detailed presentation of these options can be found in the Commission services working document.

6 In the Commission's proposal for the 2007-2013 EIB external mandates, the loan resources available for Mediterranean countries would increase from EUR 6.5bn for 2000-2007 to EUR 10bn for 2007-2013 (guaranteed by the EU budget). In addition, an envelope without EU-budget guarantee of EUR 2bn is foreseen.

The external mandate proposal also envisages strengthening the linkage between EIB priorities and EU policies under the European Neighbourhood Policy (ENP) to deepen economic integration between the EU and its neighbours through further trade liberalisation, joint transport and energy networks and regulatory approximation to open up markets and overcome barriers to trade and investment.

A better integration of the EIB into the EU country strategies and ENP framework (notably relevant sections of the Action Plans), together with enhanced coordination between the EIB and EU activities, would reinforce the consistency and impact of EIB lending in a broader sector and economic reform perspective. Such an approach would be achieved by further association of the EIB in the Commission's programming process (e.g. country or regional strategy papers, indicative programmes and action programmes), and by close cooperation in the upstream identification and implementation of FEMIP projects. In this context, FEMIP could finance a series of projects in a specific sector, linking the loan with a sector reform or strategy, in cooperation with the Commission and where relevant other multilateral/bilateral institutions. In particular, an increased EIB involvement in the extension of Trans-European Networks to the Mediterranean region will be sought.

Risk capital and technical assistance are and will continue to be financed from EU budget resources. Over the period of the next Financial Perspectives, the Commission plans to propose under the ENPI regional programme for the Mediterranean region an envelope of € 32m per year in grant contribution to FEMIP, subject to the coming into force of ENPI and the relevant comitology procedures. In addition, the Commission foresees a revision of the EIB-Commission agreement governing the management of financial assistance to Mediterranean countries, and in particular the use of reflows of risk capital and special loans from past operations under MEDA estimated at € 35m per year, in view of adding these resources as a contribution to FEMIP. The reflows, both from past Protocols and Mandates and from future operations, would be used for new risk capital operations. This should enable FEMIP to aim for a volume of around EUR 50m a year in new risk capital operations (corresponding to the 2005-2006 average) and commit around EUR 20m a year for technical assistance[7]. Furthermore, the amounts available in the donor Trust Fund at the end of 2006 could be carried over into the new programming period, to finance additional technical assistance and risk capital operations. Interest rate subsidies will remain available for selected projects, on request by national authorities and financed by the ENPI country allocations.

To handle the larger volume of loans and increased integration of EIB activities into the ENP and EU sector and country strategies, the EIB broadly estimates it would need to reinforce its staff to around 110 operational staff by 2013, from approximately 70 operational staff members as of end of 2005. The number of staff would still remain small compared to other International Financial Institutions. Under this scenario, according to the EIB, administrative costs would still outweigh

[7] Given the difficulty in forecasting the stream of reflows, the figures of EUR 50 and 20m are indicative. As a consequence, some flexibility would be considered in the relative allocations of technical assistance and risk capital in a given year.

current revenues, although FEMIP cost coverage would progressively improve over time[8].

This baseline option would be the least costly. However, it would not address the identified current pitfalls as regards private sector development.

2.4 Option 2: In the framework of the ENP, adjust FEMIP to enhance support for SME development and increase partnership

This option aims to improve FEMIP's ability to realise more of its potential in targeting private sector needs and overcome its shortcomings. In addition to the features under Option 1, Option 2 proposes to fine-tune and broaden the range of FEMIP instruments and to strengthen the EIB presence at local level. This would help to better meet private sector (and notably SME) needs. The creation of an advisory committee is also proposed, to reinforce the partnership with Mediterranean countries and increase their ownership.

Better matching private sector needs through a wider range of financial instruments and services with added focus on SMEs

A more proactive policy, **better catering for SMEs'** needs, could include better allocation of risk between FEMIP, local financial intermediaries and local businesses, as well as actions to improve the risk-management capabilities of all actors involved.

Increasing EIB risk-taking could be achieved through a more active use of the Special FEMIP Envelope to alleviate the strict security requirements in some cases, both for direct loans to private companies and provision of guarantees, and to widen the range of global loans to financial intermediaries. In this respect, cooperation from Mediterranean countries is needed to fully implement the bilateral framework agreements with EIB for private sector projects.

The currently risk-averse attitude of local **intermediaries** could also be overcome through more competition for global loans, and explicit provisions in global loan agreements to focus on smaller SMEs. Besides these improvements in lending activities, technical assistance should be further developed to help financial institutions develop systems to assess credit risks better, to streamline procedures, and to introduce new products for SMEs. In this field, FEMIP could also support the development of SME loan guarantee schemes (lowering the SME risk for the local bank). This would be further supported if measures contemplated in the ENP country action plans aiming at progress in structural reform of the banking sector are implemented.

Besides the use of risk capital resources, **alleviating the risks borne by SMEs** through own resources could be achieved first by providing local currency loans, thus making them available also to companies and projects that generate less or no export income. This requires that regulatory authorities in beneficiary countries clear

8 As a reference point, over the last few years FEMIP cost coverage by current revenues was around 80%. For more details please refer to the Commission services working document.

all the necessary steps for EIB to issue local currency bonds in local markets or develop other hedging instruments.

Technical assistance could also be provided to further **enhance the quality of SMEs' investment projects** and reduce their risk. FEMIP could support the development of business services to smaller SMEs in order to assist them with drafting business plans, improving reporting skills and overall transparency, thus making them more 'bankable'. Trade finance instruments (by providing global loans or guarantees to local financial institutions for this purpose) could also be further developed, to enable Mediterranean companies to make better use of the 2010 Euro-Mediterranean Free Trade Area.

Furthermore, directing more **risk capital resources** to SMEs is seen as particularly important, since this instrument has the advantage of delivering resources in local currency without large collateral requirements. Further developing micro-finance activities and private equity funds in a wider range of countries would serve this purpose. If FEMIP were to undertake more and larger operations (such as participations in companies that are being privatised or joint equity investments with loans for large private sector projects), the financing requirements for risk capital activities could certainly exceed the level of EUR 50m a year foreseen under Option 1 (an EIB estimate points to a minimum of EUR 80m per year for 2007-2013). To fill the financing gap, either EU Member States and Mediterranean countries or the EIB itself (through its reserves or alternative financing arrangements) could provide additional funds.

Increasing partnership and local interaction

To increase Mediterranean partner countries' involvement in, and ownership of FEMIP, and thus better link FEMIP activities to the ENP process, the dialogue structure could also be improved. In the FEMIP Ministerial meeting in June 2006, various countries showed interest in replacing the current bi-annual expert meetings by an **advisory committee**, which would meet 2-4 times a year. This committee would include representatives from Mediterranean countries, Member States and the European Commission, and possibly invite outside experts. Besides discussing sector topics, sector reforms and issues related to the overall business climate, as the experts meetings currently do, this committee could also discuss FEMIP strategy, priorities and results (for example a FEMIP business plan, the FEMIP annual report and use of various instruments) and hurdles encountered by the EIB in conducting operations in Mediterranean countries. In this way, FEMIP would also become more responsive to needs on the ground. The advisory committee would also prepare the ground for the yearly FEMIP Ministerial Meeting.

EIB **local presence** could also be reinforced. The experience of the EBRD has shown how important this element is for a successful coverage of the private sector. So far, the EIB operates 3 local offices, employing 7 EIB staff members in total[9]. Due to their small size, these offices mainly function as representative offices. To further improve FEMIP's visibility and proximity to its beneficiaries in the

[9] Excluding local staff, currently used for non-conceptual administrative tasks only (e.g. reception, security, cleaning, maintenance, etc).

Mediterranean countries, the existing EIB local offices could be slightly expanded, not only to facilitate contacts with authorities and borrowers, but also to improve EIB's integration in wider strategies and donor cooperation, to facilitate the identification of new projects, to improve monitoring of existing operations and to transfer more EIB knowledge and experience to the country.

Consideration should also be given to expanding the number of local offices, if justified by operational and business needs; this would also render the EIB more visible and give a political signal of long-term commitment to the host country. In establishing new offices, synergies with the EC and/or bilateral development agencies should be favoured.

Under Option 2, EIB estimates that it would need an increase in operational staff working directly on Mediterranean operations to a total of approximately 130 staff by the end of 2013, to cope with the strengthening of staff-intensive risk-capital operations, the broadening of the role of local offices and the creation of an Advisory Committee. This would translate into higher costs than those incurred under Option 1. According to the EIB, administrative costs would outweigh current revenues, although FEMIP cost coverage would progressively improve between 2007-2013.

Under Option 2, the private sector's needs would be better served, EIB would come closer to its customers and other stakeholders, and Mediterranean countries would become more involved in FEMIP's strategy and results. It would also increase the intensity of FEMIP's support to SME creation and development.

2.5 Option 3: The establishment of a fully fledged Euro Mediterranean Bank

The more ambitious option of creating a fully fledged separate institution (Euro-Mediterranean Bank) has been considered.

A Euro-Mediterranean Bank would operate in the Mediterranean partner countries (currently 9 countries)[10]. Shareholders could include other Mediterranean countries, notably candidate and potential candidate countries, in addition to EU member states, the EIB (majority) and the European Community.

The subsidiary would use at least the same variety of instruments to provide flexible financing as considered under Option 2, including lending, equity, guarantees etc, but with a higher focus on higher risk products. Like FEMIP and most multilateral banks, the subsidiary would also be looking at attracting and catalysing funds from external donors (i.e. the EU, Member States, and other shareholders) for grant-funded activities, such as technical assistance and subsidies.

It is expected that reaching higher business volumes would be facilitated by the greater involvement of Mediterranean countries in the subsidiary's governance and extended local presence, which enable more private sector activities to be supported. According to EIB estimates, based on an assessment of current absorption capacity, lending activities could go beyond the levels contemplated for FEMIP, reaching EUR 1.8bn in 2009 and then a cruising speed of EUR 2.6bn by 2013.

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10 Due to Turkey's recognition as a candidate for accession to the EU, new operations in Turkey would remain within the EIB, though Turkey would be invited to become a shareholder of the new bank.

However, the range of instruments expected from a Euro-Mediterranean subsidiary would also be more resource-intensive, even in the hypothesis of a subsidiary relying heavily on EIB-support services against payment of a fee. For illustrative purposes, the EIB estimates that the 'Euro-Mediterranean Bank' would need 195-390 staff members in 2009, growing to 270-540 by end of 2013, depending on the extent to which the subsidiary can share support services with the EIB. This would imply either a strong increase in administrative mark-up levels for some or all products, or a high paid-in capital by shareholders to generate substantial treasury income.

A Euro-Mediterranean bank could take a variety of forms, each of which would have different operational and financial requirements. The EIB estimates[11] that the institution would need around EUR 22bn in capital to cover the period until 2013 (assuming that the EIB-portfolio in the Mediterranean region at the time of creation would be transferred to the new institution), to be put in by the shareholders.

The main advantages of this option would be to increase ownership, by including Mediterranean countries in the decision making process and shareholding. Compared with Option 2 it would promote a more risk-taking attitude and greater flexibility in instruments.

However, this option would entail additional costs for shareholders. Unless the subsidiary continued to benefit from EU budget guarantees, its restricted country basis compared with the EIB would call for a capital base at least as strong as other multilateral banks (gearing ratio of 100% as opposed to 250% for the EIB). A higher paid-in capital ratio (i.e. 20%) would also be necessary so as to generate sufficient treasury revenues to guarantee coverage of the higher costs linked to increased staff levels[12].

The time needed to establish such an institution has to be considered. To create a subsidiary, EIB statutes (article 30) would need to be amended; as these are part of the EC treaty an ad-hoc intergovernmental conference would be needed, followed by signature and ratification by each Member State. International negotiations to determine the statutes, capital structure and working methods of the new institution are also likely to be lengthy.

3. CONCLUSION

The analysis suggests that FEMIP has been successful in channelling funds for investment to the Mediterranean region, but that its ability to influence economic reforms and private sector needs can be improved by: 1. increasing its strategic focus, through better linking EIB operations to EU policies for economic reform, 2. broadening and fine-tuning the range of FEMIP instruments to better match private

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11 In the Staff working paper attached to this Communication, a scenario for such a Euro-Mediterranean bank is provided, based on various assumptions.

12 Every additional EUR billion of loans provided by EIB requires EUR 0.4bn of capital, of which 5% needs to be paid-in by EIB shareholders. In the case of a Euro-Mediterranean subsidiary with its own capital base, full coverage of loans by capital would be needed (every additional billion of loans would require 1bn of capital), on which a higher paid-in ratio (20% under the assumptions contemplated) would apply to fully cover administrative costs.

sector needs and 3. strengthening FEMIP's presence at local level, to better identify and respond to the needs of Mediterranean countries.

Further adapting FEMIP within the current institutional setting (maintaining it as a facility within the EIB, as per Option 2), by introducing sizeable improvements in instruments, local interaction and strategic focus, appears to be the most cost- and time-efficient option. This adaptation will take place in the context of the adoption of ENPI and of the future development of the European Neighbourhood Policy.