EUROPEAN PARLIAMENT

DIRECTORATE-GENERAL FOR EXTERNAL POLICIES

POLICY DEPARTMENT

BLENDING GRANTS AND LOANS IN THE LIGHT OF THE NEW DCI

DEVE

EN

2012

DIRECTORATE-GENERAL FOR EXTERNAL POLICIES OF THE UNION

DIRECTORATE B

POLICY DEPARTMENT

STUDY

BLENDING GRANTS AND LOANS FOR FINANCING THE EU'S DEVELOPMENT POLICY IN THE LIGHT OF THE COMMISSION PROPOSAL FOR A DEVELOPMENT COOPERATION INSTRUMENT (DCI) FOR 2014-2020

Abstract

For the next Multiannual Financial Framework for 2014-2020 the European Commission proposes to introduce loan and grant blending facilities into the Development Co-operation Instrument (DCI). These facilities have succeeded in leveraging considerable development finance from development banks and other financiers in the countries embraced by the EU Neighbourhood policy, the Balkans and Sub-Saharan Africa. There are justified concerns, however, that these blending facilities are not appropriate to address many development needs and that the assistance in the form of concessional loans can put heavily indebted countries at risk. Nevertheless, the use of blending facilities in the DCI can be beneficial if well devised. They should be used to complement but not substitute for traditional development finance. Furthermore, care is required to ensure that blending instruments are effectively oriented towards poverty reduction, avoiding a return to a focus on investment. To ensure that the blending facilities expand the effectiveness of development finance, the governance and coherence of the instruments need to be reviewed, with the aim of retaining the positive elements of flexibility, but keeping the risks for the beneficiaries low and ensuring a poverty reduction approach.

EXPO/B/DEVE/FWC/2009-01/Lot5/29 June 2012

PE 433.784 EN

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

AUTHORS:

Dr Jorge NÚÑEZ FERRER, Associate Research Fellow, CEPS, BELGIUM
Dr Pedro MORAZÁN, SÜDWIND INSTITUTE, GERMANY
Tobias SCHÄFER, SÜDWIND INSTITUTE, GERMANY
Dr Arno BEHRENS, Research Fellow, CEPS, BELGIUM

Coordination provided by Ecologic Institute.

ADMINISTRATOR RESPONSIBLE:

Fernando, GARCÉS DE LOS FAYOS
Directorate-General for External Policies of the Union
Policy Department
WIB 06 M 077
rue Wiertz 60
B-1047 Brussels

Editorial Assistant: Györgyi MÁCSAI

LINGUISTIC VERSIONS

Original: EN

ABOUT THE EDITOR

Editorial closing date: 28 June 2012.

Printed in Belgium

ISBN: 978-92-823-3769-1
Doi: 10.2861/90202

The Information Note is available on the Internet at
http://www.europarl.europa.eu/activities/committees/studies.do?language=EN

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LIST OF ABBREVIATIONS

ADB	Asian Development Bank
AECID	Agencia Española de Cooperación Internacional para el Desarrollo
AFD	Agence Française de Développement
AIF	Asia Investment Facility
AfDB	African Development Bank
AusAID	Australian Agency for International Development
BDEAC	Banque de Développement des Etats de l'Afrique Centrale
BIO	Belgian Investment Company for Developing Countries
BDEAC	Banque de Développement des Etats de l'Afrique Central
BMZ	German Federal Ministry for Economic Cooperation and Development
CBR	Cost Benefit ratio
CCW	Climate Change Window
CMZB	Czech-Moravian Guarantee and Development Bank
CEB	Council of Europe Development Bank
CIF	Caribbean Investment Facility
COFIDES	Compañía Española de Financiación del Desarrollo
CPIA	Country Policy and Institutional Assessment
DAC	Development Cooperation Directorate
DG CLIMA	Directorate General Climate Action
DG DEVCO	Directorate General Development and Cooperation
DG ELARG	Directorate General for Enlargement
DG ECFIN	Directorate General for Economic and Financial Affairs
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
EBFI	European Bilateral Financial Institution
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EDF	European Development Fund
EEAS	European External Action Service
EIB	European Investment Bank
EP	European Parliament
EU	European Union
EWBJF	European Western Balkans Joint Fund
FEMIP	Facility for Euro-Mediterranean Investment Partnership
FIEG	Financial Inclusion Experts Group
FIG	Finance Institutions Group
FINNFUND	Finnish Fund for Industrial Cooperation Ltd.
HIPC	Heavily Indebted Poor Countries
IFCA	Investment Facility for Central Asia

IFI	International Finance Institution
IFP	Investment Facility for the Pacific
IPA	Instrument for Pre-Accession Assistance
ITF	Infrastructure Trust Fund for Africa
JGF	Joint Grant Facility
KfW	KfW Bankengruppe
LAIF	Latin America Investment Facility
LDC	Less Developed Country
LGB	Loan and Grant Blending
LGBF	Loan and Grant Blending Facilities
LIC	Low income country
LMIC	Low Middle Income Country
MDG	Millennium Development Goals
MFB	Hungarian Development Bank
MRI	Mutual Reliance Initiative
MS	Member States
NIB	Nordic Investment Bank
NIF	Neighbourhood Investment Facility
NIPAC	National IPA Coordinators
NZAID	New Zealand Aid Programme
ODA	Official Development Assistance
ODI	Overseas Development Institute
OECD	Organisation for Economic Cooperation and Development
OeEB	Oesterreichische Entwicklungsbank AG
PCD	Policy Coherence for Development
PFG	Project Financiers Group
PIA	Policy Institutional Assessment
PIDG	Private Infrastructure Development Group
SID	Slovenian Investment bank
SIMEST	Societa Italiana per le Imprese All'Estero
SOFID	Sociedade para o Financiamento do Desenvolvimento, Instituíção Financeira de Crédito, S.A.
SSA	South Saharan Africa
UMIC	Upper Middle Income Country
UNFCCC	United Nations Framework Convention on Climate Change
WB	World Bank
WBIF	Western Balkan Investment Framework

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EXECUTIVE SUMMARY

The European Commission has launched a proposal for the Development Co-operation Instrument (DCI) in the next Multiannual Financial Framework (MFF) 2014-2020. This proposal envisages to introduce to the countries benefitting from this support the use of loan and grant blending facilities (LGBF), instruments which have been successfully introduced in a number of other geographical programmes.

These instruments link EU budget grants – sometimes topped up with Member State grants – with loans from international, regional and European bilateral financial and development Banks and agencies. These LGBF are considered by some development practitioners as a good example of an effective translation into action of EU aid effectiveness objectives.

These new instruments have improved EU donor coordination, increased the leverage of EU development finance and enhanced the effectiveness and efficiency of the financiers' operations.

While it is true that blending facilities have had a positive effect in increasing the leverage of EU funds for development finance considerably, concerns exist that those instruments do not fit well the needs of the poorest. Loans are by nature debt obligations and need to be linked to revenues capable to recover the loan capital and interests. While such instruments are clearly welcome to explore new development programmes and to better discriminate between assistance for non-revenue generating investment from those that can recover the loans, there is a justified fear that necessary grant assistance is reduced under the justification that loans expand development aid at lower cost to the exchequer. In times of strong austerity and considerable budgetary cuts, this is a credible risk.

This study has analysed the operations of the facilities and reached some key messages and conclusions:

Key messages

- The blending facilities have a very large leverage effect, the size of which will depend on the local needs and characteristics and the type of projects undertaken. In more risky regions and for infrastructures the Africa Investment Trust Fund (ITF) has a leverage ratio of funds raised from development financiers of approximately 7. Adding the finance from other sources for the total value of projects we reach 12 to 13. In the middle income countries of the western Balkans and Eastern Europe the leverage effect is much higher. In the Neighbourhood Investment Facility (NIF) leverage ratios are 15 and 33 respectively. For the Western Balkans Investment Framework we reach 25 and 45.

- The facilities have been modestly funded, with an EU budget contribution of €1.3 billion over the whole period of the 2007-2013 financial framework, EU budget and EDF funding together and some member state additional grant contributions. A yearly average of less than €200 m compared to an EU total ODA expenditure of €53.8 bn (2010). The whole EU budget and EDF development budget amounted to €14.5 bn in 2010.

- The LGBF use the grant assistance for a number of different formats depending on needs, guarantees, interest rate subsidies, technical assistance grants, specific grants for part of projects, etc. This allows calibrating the balance between loans and grants to the levels deemed necessary to achieve the objectives.

- Financiers accredited to access the grants have a development-oriented mission, which reduces considerably the risk of moral hazard by financiers. The governance structures have been developed to ensure that the investments are in line with the EU development strategies and are monitored by the Commission. Furthermore, the objectives and policy formulation of the facilities is undertaken by a steering committee that includes representatives of the EU member states and the beneficiary countries.

- LGBF are debt instruments, even if they may offer softer terms to the beneficiary than pure loans, these need to be repaid. Thus LGBF need to follow a financially sound decision-making and can only focus on projects that generate positive revenues sufficient to cover the loans. The use of LGBF require particular attention if used in highly indebted countries. The governance of the facilities gives some guarantees in this respect, but there is yet no formal method to treat those cases.

- LGBF mechanisms cannot substitute pure grants in many areas of development finance and should be seen as an additional instrument to enhance development, not a substitute to grants. The LGBF can assist the EU to reach the millennium development goals and the pledges to development countries in the climate finance agreements on support to mitigation and adaptation.

- LGBF help to differentiate between projects with revenue generating potential from those which do not. This allows for a better focus on grant support where it is needed, increasing the quality of targeting.

- The EU instruments have many qualities, but have been developed ad hoc, without a solid legal basis and by different Commission services. This has led to some unjustified differences between the facilities. The same financiers are treated differently in different facilities and the reporting varies between the facilities, reducing transparency.

- Blending instruments can have a significant leverage effect and are supporting the visibility of EU development cooperation. Due to the existing OECD/DAC guidelines on ODA accountability, blending is not going to increase the ODA quotas of EU member states. It is also important to note that loan repayments are recorded as negative ODA if the loan was declared as assistance.

- There is a possibility of increasing tied aid in the course of blending packages. Formal regulations do not point in this direction, but in some cases donor institutions could use their additional resources to foster tied aid practices. There is a clear tension between untied aid and the interest of the EU to promote specific areas and to use development policy as an instrument to influence structural reforms.

- Quite often, no direct links between blending and poverty reduction can be observed. Blending facilities are focusing on growth incentives through investments in infrastructure, energy and transport. Impacts on poverty cannot be taken for granted, which is why transmission channels need to be identified for stakeholders to directly or indirectly pursue the MDGs and other goals.

Recommendations

There are a number of recommendations emerging from the report:

- LGBF are a useful addition to the EU's development policy, but they cannot replace traditional grant based support to developing countries. While expanding LGBF can be recommended, traditional development aid should not be reduced.

- In order to safeguard the poverty focus of blending instruments, ex ante poverty impact assessments should be compulsory for the screening process of eligible projects. Investments in infrastructure with private sector involvement are not necessarily to the benefit of the poor. Primary transmission channels need to be identified for blending to ensure significant influence on target groups and poverty eradication. Furthermore, a comprehensive stakeholder analysis could help to mitigate risks.

- The size of the grant elements should be based on a more thorough analysis than the financial criteria and the EC's objective to generate the largest multipliers.

- The EU has stated the objective to phase out pure grants in middle-income developing countries to replace them with blending facilities. This movement seems to disregard the fact that in middle income countries inequalities tend to be higher and that the very poor could get increasingly marginalized. Decisions of this type need to be taken based on the situation of the groups targeted and needs of the programmes, blending facilities cannot handle a large number of projects generating public good, in particular of social nature.

- While there is a relatively good governance structure in place for each facility, there is a lack of overarching structure to set minimum standards and improve coherence.

- The expansion of mutual recognition agreements between financiers should be promoted to facilitate management of projects for the EU and the beneficiaries.

- Leveraged resources (i.e. loans) of blending packages should have the character of additional flows. ODA crediting of blending instruments needs to comply with established OECD/DAC requirements. Thereby, the amount of ODA qualifying grant elements should be made transparent.

- We recommend setting up the platform with two specialised steering groups, one on policy and one on technical implementation. The steering group should include representatives of civil society.

- The EU platform for Cooperation and Development should define clear rules and procedures for all LGBF, in particular:

    1. Rules for monitoring and reporting, coherence in reporting standards,
    2. Rules on the treatment of financiers (eligibility, remuneration, required minimum reporting standards),
    3. Rules that spell out clearly the obligations of financiers requiring proof of financial control,

4. Offering for transparency a combined report of projects and actions of all LGBF in external action, clarifying amounts, if the finding comes from the EU budget or the EDF,
5. Developing a clear methodology on measuring the state of Heavily Indebted Countries and the approach to take with the instruments.
6. Terms on links to structural reform conditionalities need to be set. A clarification of the rules on tied aid for LGBF need to be given.

- The decisions of the platform should focus on minimum standards, but leaving enough flexibility to allow tailoring the operations to the realities on the ground.

- The LGBFs have a commendable structure, with a steering committee, operational board and financiers groups. There is a need to define better the role of the steering committee and open it to the participation of beneficiary country civil society at this level. Transparency in project tendering can also help avoiding tied aid.

- The impact of blending facilities on the poor needs to be better studied and integrated to the blending instruments, using recognized criteria. In order to safeguard the poverty focus of blending instruments, ex ante poverty impact assessments should be compulsory for the screening process of eligible projects. Investments in infrastructure with private sector involvement are not necessarily to the benefit of the poor. Primary transmission channels need to be identified for blending to ensure significant influence on target groups and poverty eradication. Furthermore, a comprehensive stakeholder analysis could help to mitigate risks.

INTRODUCTION

The European Commission has launched a proposal for the Development Co-operation Instrument (DCI) in the next Multiannual Financial Framework (MFF) 2014-2020. This proposal envisages to introduce to the countries benefitting from this support the use of loan and grant blending facilities (LGBF), instruments which have been successfully introduced in a number of other geographical programmes.

These instruments link EU budget grants – sometimes topped up with Member State grants – with loans by the International, Regional and European Bilateral Financial Institutions such as EIB, EBRD, CEB, NIB, AFD and KfW. These LGBF are considered by development practitioners as one of the few examples globally of an effective translation into action of the aid effectiveness commitments the EU has agreed to (Paris Declaration on Aid Effectiveness (2005), the Accra Agenda for Action (2008)[1] and the European Code of Conduct on Division of Labour in Development Policy (2007)). These new instruments have improved EU donor coordination and increased the leverage effect of EU development finance. It has in the areas it intervenes enhanced the effectiveness and efficiency of financiers operations.

While it is true that blending facilities have had a positive effect in increasing the leverage of EU funds for development finance considerably, concerns exist that those instruments do not fit well the needs of the poorest. Loans are by nature debt obligations and need to be linked to revenues capable to recover the loan capital and interests. While such instruments are clearly welcome to explore new

[1] Texts published by the OECD (2008), "The Paris Declaration on Aid Effectiveness and the Accra Agenda for Action", OECD, Paris

development programmes and to better discriminate between assistance for non-revenue generating investment from those that can recover the loans, there is a justified fear that necessary grant assistance is reduced under the justification that loans expand development aid at lower cost to the exchequer. In a time of strong austerity and considerable budgetary cuts, this is a credible risk.

Nevertheless, a rejection of LGBF in favour of a grant only approach would close the door to developing countries from the benefits those instruments can offer, including the positive externalities from greater cooperation between aid agencies, international financial institutions, the European Union and the beneficiary countries. There is no doubt that due diligence is needed, and excessive indebtedness of less developed countries has to be avoided, but the LGBF that have been developed take into account the need to have an appropriate governance structures and have the potential to increase the impact of development finance. Existing LGBF have also introduced novel decision-making practices which are designed to safeguard the quality of the assistance provided and also involve the beneficiary countries in the decision-making process within the instruments.

Given the pledges of the EU to developing countries to mobilise additional finance for climate change adaptation and mitigation and the existing gap between the millennium development goals and actual aid levels, LGBF should be seen as a tool to complement and better manage aid and not to substitute grant support.

It is the aim of this report to assess the performance of the existing instruments and analyse how to safeguard the focus of aid on the poorest, avoiding the over-indebtedness of the development countries.

1. RATIONALE, STRUCTURE AND LEVERAGE OF THE EU BLENDING FACILITIES

Blending grants and loans is an acknowledged practice in international development finance, practiced also by national development banks of the EU (such as KfW, AfD). EU aid assistance also combined loans and grants to a limited extent, such as financing technical assistance which led to a project financed by loans or offering guarantees for the EIB to extend loans. The new LGBF have brought blending to a new dimension, because:

a) it brings together public and private financiers other than the EIB to jointly finance projects supported by an EU grant.

b) It thus allows for larger projects to develop which one financier alone would not undertake, or the joining of related individual projects of separate financiers into a larger more coherent project.

c) it has opened the door to the pooling of development funds for blending by contributions of the member states which are not part of the EU aid budget.

d) It has set up decision making structures which bring together development banks, EU member states *and* beneficiary country authorities in the decision-making process to guarantee a sound strategy and to defend the interest of all parties.

The first LGBF was set up for Africa in 2007, thus they are relatively new, in evolution and limited in size.

Table 1. presents the LGBF which have been established since 2007. They are, however, already considered quite successful to enhance the three objectives that the European Commission targeted:

a) to increase the leverage of EU grant support, i.e. attract additional funding to combine with the grant to achieve larger development objectives;

b) to increase aid effectiveness by enhancing coherence, cooperation and coordination;

c) to increase the visibility of EU development aid.

The aim of the facilities is to leverage more funding for development as well as increasing efficiency, ownership, impact and visibility of EU development cooperation. The grant facilities can multiply the level of development finance compared to separate grant and loan assistance. The need to have such instruments can be justified by the following:

a) There is an increasing demand for development funding, needed to meet the Millennium Development goals (MDG and to find the additional resources to offer developing countries assistance for adaptation and mitigation to climate change as agreed at the UNFCC negotiations in the Copenhagen Agreement.

b) The increasingly limited budgetary resources of donors due to the public deficit crisis in Europe and thus their unwillingness and inability to increase the development budgets.

c) The important economies of scale, effectiveness and coherence this approach generates as a result of improved coordination and pooled resources.

Table 1. Brief overview of EU blending facilities

Name of facility Region covered:	Launch date	Allocation of funds	Participating financiers
ITF: Infrastructure Trust Fund for Africa 47 African Countries[2]	2007	Grant funds allocated: €308,7m from 10th EDF + €64m from MS budgets (as of 31 Dec. 2010)	AFD, AfDB, BIO, COFIDES, EIB, FINNFUND, KfW, Lux-Development, MoF Greece, OEeB, SIMEST, SOFID, PIDG
NIF: Neighbourhood Investment Facility Countries eligible for ENPI[3]	2008	€700m for 2007-2013 from EU budget + €64.4m from MS budgets (as of 31/12/11)	AECID, AFD, CEB, EBRD, EIB, KfW, NIB, OeEB, SIMEST, SOFID
WBIF: Western Balkan Investment Framework Western Balkans[4]	2009	€166m from EU budget + €10m EIB, €10m EBRD, €10m CEDB + €47.6 m in grants from MS budgets (+ Norway) (as of 31/12/11)	CEB, EBRD, EIB, World bank Group, KfW, MFB, CMZR, OeEB, SID
LAIF: Latin America Investment Facility Latin Am. Countries[5]	2010	€125m 2010-2013 from EU budget	AFD, BCIE, IDB, CAF, EIB, KfW, NIB, OeEB
IFCA: Investment facility for Central Asia Central Asian countries[6]	2010	€20m 2010 from the EU budget	NIF accredited institutions can participate.
Asia Investment Facility Asian Countries[7]	2011	€30 m from the EU budget	EIB, EBRD, NIB, ADB, AfD, KfW, OeEB, SIMEST, SOFID
Caribbean Investment Facility ACP Caribbean countr.[8]	2012	€40 m 10th EDF	EIB, NIB, CDB, IDB, others joining
Investment Facility for the Pacific ACP-Pacific countries[9]	2012	€10 m	EIB, AFD, KfW, AusAID, ADB, NZAID, WB

[2] Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo Brazzaville, Democratic Republic of the Congo, Eritrea, Ethiopia, Djibouti, Gabon, Equatorial Guinea, São Tomé & Principe, Ghana, Togo, Guinea-Bissau, Republic of Guinea, Côte d'Ivoire, Liberia, Kenya, Somalia, Lesotho, Swaziland, Madagascar, Malawi, Mali, Mauritania, Mauritius, Comoros, Seychelles, Mozambique, Namibia, Niger, Nigeria, Rwanda, Senegal, Cape Verde, Gambia, Sierra Leone, Sudan, Tanzania, Uganda, Zambia, Zimbabwe.

[3] European Neighbourhood and Partnership Instrument countries: Ukraine, Belarus, Moldova, Armenia, Azerbaijan, Georgia and Russia and Ukraine, Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestinian Authority of the West Bank and Gaza Strip, Syria and Tunisia

[4] Albania, Croatia, Bosnia and Herzegovina, Kosovo, Montenegro, FYROM, Serbia

[5] Argentina, Bolivia, Brasil, Colombia, Costa Rica, Cuba, Chile, Ecuador, El Salvador, Guatemala, Honduras, México, Nicaragua, Panamá, Perú, Paraguay, Uruguay, Venezuela

[6] Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan

[7] Afghanistan, Bangladesh, Bhutan, Cambodia, Chine, DPR Korea India, Indonesia, Laos, Malaysia, Maldives, Mongolia, Myanmar, Nepal, Pakistan, Philippines, Sri lanka, Thailand et Vietnam

[8] Antigua & Barbuda, Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, Saint Kitts & Nevis, Saint Lucia, Saint-Vincent and the Grenadines, Suriname, Trinidad & Tobago

[9] Cook Islands, East Timor, Fiji, Kiribati, Marshall Islands, Micronesia, Nauru, Niue, Palau, Papua New-Guinea, Samoa, Salomon Islands, Tonga, Tuvalu, Vanuatu

1.1 Economic rationale

The advantages of grants and loans are manifold and include improved financial viability of projects, increased financial leverage, economies of scale and lower transaction costs through donor coordination, increased financial discipline and ownership compared to exclusively grant funded alternatives, and generally higher effectiveness of projects.

As regards the financial viability of projects, it is rather obvious that loans at concessional rates, additional grants and/or risk guarantees improve the feasibility of projects or investment programmes by reducing overall project costs (incl. interest costs) and financial risk. This can improve the benefit-cost ratio (BCR) of development projects to such an extent that implementation becomes financially feasible in cases where it might not be without the grant element. Beneficiaries can thus gain access to funds that might not be available under 'normal' market conditions. This is particularly relevant for projects that fail to attract sufficient investments at normal market rates. It also helps to contain the level of debts, e.g. in already heavily indebted poor countries, HIPCs. In addition, the grant element can help to accelerate project progress, e.g. by an early start of the feasibility study.

A second economic argument in favour of blending instruments is their ability to leverage additional (public and private) funding for EU development policy objectives. The grant component helps to gain financial and qualitative leverage and can thereby help to increase the impact of EU development policy. In times of increasing austerity in EU member states and other donor countries, blending can thus help to limit public spending, while increasing the impact of development grants. The latter is achieved through the pooling of funds, which allows for the funding of large-scale development programmes that single donors would not be able to finance or implement. In addition, significant economies of scale can be achieved through the combination of resources of different donors and lenders, which on the donor side allows for a better alignment of funding with EU development policy thus improving effectiveness and impact. This also leads to reduced transaction costs for beneficiaries, which only need to deal with a single (larger) counterpart and common procedures instead of multiple donors with different procedures.

Blending also raises the financial sustainability of projects. First, beneficiaries gain ownership in terms of project selection allowing them to focus on their own development priorities. Second, the enhanced use of loans should positively impact on financial discipline compared to pure grant projects, also in view of the fact that beneficiaries need to repay loans and contribute own funds. Finally, blending may allow for a better allocation of funds, putting more emphasis on loans where repayment capacities exist while preserving grant funding where necessary.

1.2 Political rationale

In addition to economic benefits, blending can also raise the political effectiveness of development projects, both in partner countries and in the EU. The EU LGBF increase cooperation and coordination between different EU and non-EU actors (EC, member states, partner countries and DFIs) thus increasing overall EU aid effectiveness as well as the visibility of EU development and external policy. Similarly, the joint appearance of EU development actors as common, financially strong and coherent partners for beneficiary countries increases the influence of the EU especially with respect to structural reform dialogues (e.g. on economic, financial and political reform). The beneficiaries can participate in the strategic decisions of the LGBF, the coordination of EU donors and financial institutions increases the influence of the EU on sectoral policies. In addition, the EU LGBF can influence lending activities in the EU's interest based on regional strategies, e.g. by altering the rules on what types of projects can be funded and by calibrating the grant size.

Another benefit is the improved quality of interventions through closer collaboration of financing institutions and the EC within the LGBF. Sharing expertise, skills, practices and lessons learnt also encourages innovative ideas to further enhance cooperation and coordination mechanism on the operational level. An excellent example is the AFD-EIB-KfW Mutual Reliance Initiative (MRI)[10], which supports division of labour between financing institutions on the implementation level by reciprocally delegating project management tasks to one of the three institutions acting as Lead Financier in joint co-financing on the basis of mutually agreed minimum standards.

1.3 Type of grants provided

There is yet disagreement on what kind of grants should the EU offer to the blending facilities. There are a number of different grant instruments that can potentially be used in the framework of the LGBFs. A list of possibilities was provided by the ECOFIN council in 2009 in a report on the additionality of grants and loans in the framework of the blending mechanisms (European Commission, 2009). The list presented the following:

a) Technical Assistance and studies
b) Direct Investment Grants
c) Conditionality / performance related grants
d) Interest rate Subsidies
e) Loan Guarantees
f) Structured Finance – first loss piece
g) Risk Capital
h) Insurance premia

The function of each grant element is listed in Annex I.

- One additional grant that is used, but may be categorised as a "direct investment grant" are capital cushions and equity for mezzanine loans for local financial institutions to expand their lending to SMEs. These are listed by the WBIF as "incentive payments to financial intermediaries (risk capital)".

- The present EU blending instruments do not use all of the options listed, and the combinations vary from instrument to instrument. To some extent the differences are based on the regional criteria and operational needs, but often it seems not to be based on those, but on the ad hoc manner the instruments were set up and experimented with by different Commission Directorate Generals responsible.

- From the large palette of grant instruments which have been identified as potentially important for the LGBF, only five are effectively permitted and not every instrument uses them (Table 2).

[10] More details on the MRI can be found in Chedanne P. (2009), 'Mutual Reliance Initiative ADF – KfW – EIB', presentation, Brussels, 16 October 2009

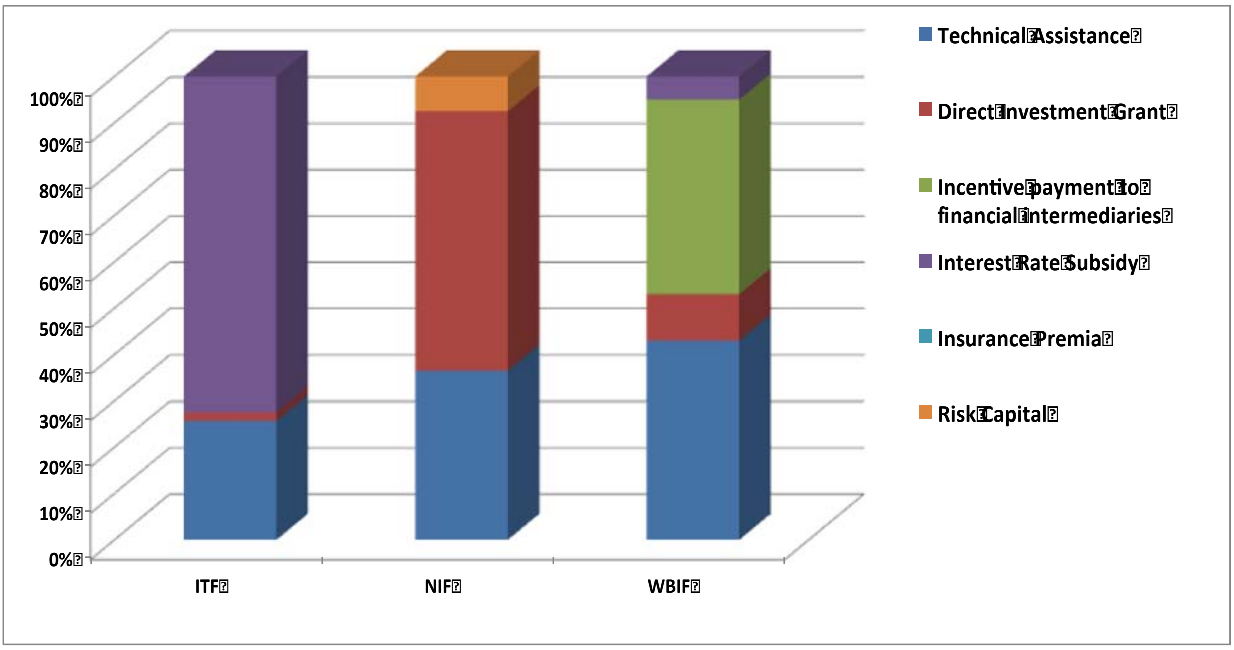
Table 2. Grant instruments available in the blending facilities

ITF	NIF	WBIF	LAIF, IFCA, AIF, CIF, PIF, CIF
Technical Assistance Direct investment grants Interest rate subsidies Insurance premia	Technical Assistance Direct investment grants Interest rate subsidies Risk capital	Technical Assistance Direct investment grants Incentive payments to financial intermediaries (risk capital) Interest rate subsidies Insurance premia	Technical Assistance Direct investment grants Loan guarantee cost Interest rate subsidies Risk capital

Source: Núñez Ferrer et al. (2011) and Commission information

The type of grants used in the facilities up to date varies considerably amongst the facilities. This is due to the strategy for the regions and the type of projects selected. It is interesting to note how some grant types have not been used at all in some facilities. IRS are the main grant element on the ITF, which is understandable given the mandate of the facility to concentrate on projects of regional (i.e. cross-border) importance, which are in general large infrastructure projects in the areas of water, energy and transport. IRS are also deemed more appropriate in poor regions where financial markets are weak. Thus in addition to needs on the ground, this 'mandate limitation' of the ITF also may explain the lower levels of grants in the ITF compared to the NIF. NIF focuses on a wider range of projects compared to ITF, including social, which are financially less bankable.

Figure 1. Types of grant by facility, % usage



Data: ITF (2007-2010), NIF (2011), WBIF (2009-2011)

1.4 Leverage effect of the blending facilities

The reports of the LGBFs by the European Commission show promising positive results[11] and recent reviews concord on their positive contribution[12]. The LGBF are at the moment modest in size. The financial allocation to all the facilities has been very or of approximately €1.3 billion over the whole period 2007-2013, EDF, EU budget and EU Member State donors all together. In comparison, the total Official Development Assistance (ODA) by the EU and the Member States has been estimated at €53.8 billion in 2010[13] (0.43% of EU's GNI). EU spending from the EDF budget and from other development funding of the EU budget amounted to €14.5 billion in 2010.

Thus, despite the limited funding, the final financial impact of the facilities has been high, attracting funding for projects by EBFIs, the EIB, other IFIs and other funding sources (including from the partner countries themselves). The very different role of the funds and area of intervention is reflected by the number of projects and their size.

The **ITF** has approved 19 projects between 2007- March 2011 with a grant value of €176 m, leveraging close to €1.3bn in loans from EBFI and IFIs for a total project cost value[14] of €2.2 bn[15].

For **NIF** we have an accumulated grant value of €417,7m for 52 projects, leveraging close to €6.3 bn in loans from EBFI and IFIs for a total project cost value of €14 bn for 2008-2011.

The **WBIF** approved 112 projects for a grant value of €220 m and financier loans of €5.5 bn mobilising a total investment of €10 bn between December 2009 and end December 2011.

Only partial information has been published for **LAIF**. The grant funding mobilised has been of €35 m for a total project value of €1.6 bn. The subdivision between loans by the accredited financiers and other loans and donor funds has not been made public yet.

The other facilities have not yet started operations.

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[11] EC (2012), "NIF Neighbourhood Investment facility, Operational Annual report 2011", European Commission, Brussels.
EC (2010), "WBIF Western Balkans Investment Framework – 2010 Annual report", December 2010, Brussels
EIB (2010a), "European Investment Bank's external mandate 2007-2013 Mid- Term Review – Report and recommendations of the Steering Committee of wise persons". Luxemburg, February.
Stepanek P, C. Gofas, M. Cingolani, E. Göksu, L. Herrera (2010), "Review of the Western Balkans Investment Framework", 02/12/2010, EIB.

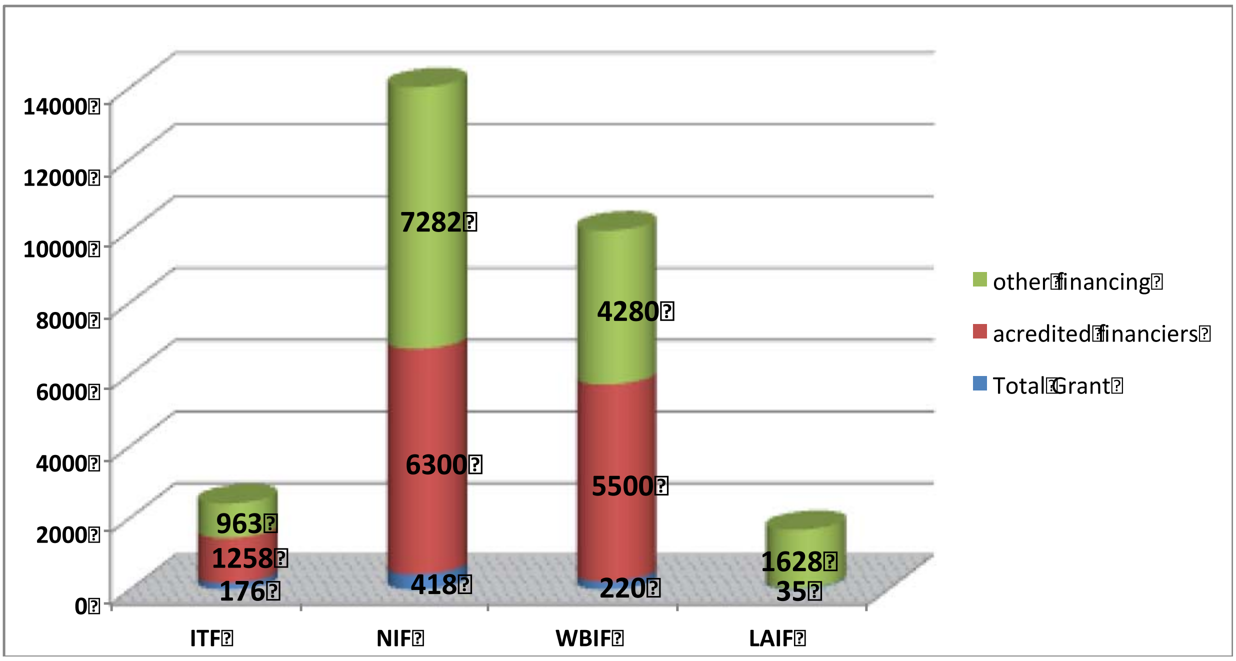
[12] Núñez Ferrer, J., C. Egenhofer,, A. Behrens (2011), 'Innovative approaches towards EU blending mechanisms for development finance, CEPS Special Report, May 2011
Overseas Development Institute (2011), 'EU Blending Facilities: Implications for Future Governance Options', European Think Tanks Group.

[13] IP/11/410, Brussels, 6 April 2011.

[14] The total project cost value is equal to the total cost summing the grant, loans by the accredited financial institutions and other sources of finance.

[15] As of 24 March 2011.

Figure 2. Grant, Financier's Loans and Other Funding in the LGBF, € million



Source: Data from annual reports. The ITF figures only list projects which are under an investment phase as at 24.03.2011 while for the other facilities it presents the figure for all approved projects until 31.12.2011. The LAIF figures are from the DG DEVCO website: http://ec.europa.eu/europeaid/where/latin-america/regional-cooperation/laif/projects_en.htm

It should be noted that leverage and multiplier effect are recorded with a different definition, which is not helpful. For ITF project preparation TA is not considered as eligible for the purpose of estimating leverage and multiplier effect. This is however the case in the other facilities, which inflates strongly the 'EU grant leverage impact'.

2. BENEFITS AND RISKS OF LGBF COMPARED TO GRANTS

When the question is put if pure grants or blending the grants are a better system to finance development finance, the answer is clearly that "it depends". The best development policy is one that uses the best mix of instruments given the objectives to be reached, the type of investment to be financed and the economic situation of the beneficiary, i.e. the capacity of the beneficiary to service the loan.

Blending of grants and loans is to be used in projects with a potentially positive internal rate of return (IRR), but where the risks level is too high for development financial institutions to intervene without a capital cushion or financial support, i.e. covering some of the risks or expenditures and making the project "bankable". The blending facilities also create an institutional structure that facilities cooperation between different financiers and thus make larger projects realisable.

While the lending levels increase with the facilities, it is likely that the governance structures reduce the risk of countries becoming over indebted. This may sound paradoxical, but the facilities bring together donors, financiers and beneficiaries thus allowing for all participants to assess the situation of the beneficiary country and the needs of the target investment. Development Banks acting in isolation will not have the same overview of the commitments of the beneficiary to other financiers. Nevertheless, there are no formal procedures and more needs to be done as will be presented later.

Table 2 lists the pros and cons of EU LGBF vs. grants on a number of categories. This table takes into account the governance rules of the blending facilities, it is not comparing 'blending' in a general theoretical setting as has been usually done in most documents. This is no longer relevant, as the blending instruments now have some well-established practices.

Table 3. EU LGBF vs. development grants by the EU

	Positive	Negative
Financial criteria	The blending facilities are able to leverage large levels of development finance where financiers would otherwise not have acted due to the risk mitigation effect. Blending facilities are more flexible in their operations and financiers can better assess the needs of projects and payment schedules than pure grant systems. Project quality tends to increase as project developers need to develop and operate correctly the output (e.g. power infrastructure) to service the loan element.	Loan and grant facilities only will operate where financiers find an interest to invest their resources. Even if projects are realised that pure loans would not cover, LGBF are not well suited for many development operations, such as food aid, small infrastructures, social programmes, and many areas of public service provision. The loan element of LGBF and the interest needs to be repaid, thus infrastructures and services provided through LGBF will need to be linked to a revenue stream, either through user charges or from taxation. In the case of some key infrastructures, such as water, the resulting charges may affect access to the poor. This needs to be factored in the project preparation and follow up. For donors it will be more difficult to follow up on the use of the grant elements and impacts, as the project management will be in the hands of financial institutions. (it is, however, highly questionable if grants managed by public authorities or NGOs offer more transparency guarantees). The European Commission's objective to maximise the leverage effect may lead to very low grant levels and higher indebtedness than necessary.
Economic Criteria	LGBF, like is the case for pure loans, reduce the levels of market distortion that grants can generate. The process of project selection can lead to a better valuation of projects. The cooperation of different donors can lead to better coordination and higher economies of scale. Higher investment if well targeted should result in higher economic results that the LGBF can generate due to the leverage and thus larger scope of projects compared to limited grant funding. The coordination of development banks and	The LGBF can increase the level of indebtedness of the beneficiary countries as it mobilises more loan funding. There is a risk that grant funding is over time reduced in exchange for 'cheaper' blending facilities leaving important areas which are not 'bankable' underfunded.

	the use of blending also has the opposite effect, reducing the number of more expensive independent loans.	
Political and strategic criteria	The pooling of resources and the coordination of financial institutions increases the impact of EU development aid and thus the influence of the EU in the beneficiary country. The governance structure which involves all donors, financiers and beneficiaries ensures a stronger and more coherent say on the development strategy of the beneficiary. The European Union wins visibility. The use of pooled resources and the increased coordination between financiers potentially increases transparency compared to separate individual EU operations.	The individual donors lose some control over the funds pooled and their individual visibility. The blending faculties are complex, making transparency and governance difficult. However, this has to be balanced with separate operations by EBFIs and other IFI and regional financiers without EU level overview.
Operational criteria	The projects will be selected and managed by financial institutions which results in speedier projects and often higher quality. The financiers have to be transparent in their operations in the beneficiary country, reducing overlaps and improving their understanding of the economic situation of the beneficiary. The LGBF have increased the coordination between donors and lenders, improving knowledge transfer and adoption of best practices. Including a better transfer of expertise form lenders to beneficiaries in project management. LGBF can lead to a better distribution of risks between the EU taxpayers, the financial institutions and the beneficiaries.	The objectives of the Financiers and the European Commission on the use of grants are not related to a proper poverty assessment and to the needs of the beneficiary. The increasing role of non-European financiers has implications on the accountability of the institutions in terms of standards of monitoring and evaluation.

2.1 What is the risk of increasing debt dependency in developing countries?

Blending instruments are influencing the debt situation of partner countries since they promote public borrowing for development investments with grant support. Especially low revenue projects tend to jeopardise debt sustainability. Blending strategy papers opt for financially sound projects only, yet, at the same time blending is supposed to allow for social projects and public goods that would otherwise not be viable. It is difficult to draw the exact line and this precisely constitutes the risk for unsustainable debt dependencies. One also has to keep in mind that financial institutions such as AFD or KfW have access to concessional resources on their own. In order to avoid adverse consequences, blending operations should only be implemented after a debt sustainability analysis has been conducted and if respective risks are estimated to be reasonable. Currently, the Debt Sustainability Framework (DSF) elaborated by the IMF is the basis for Low-Income Countries (LICs) to avoid future debt problems.[16] Generally, three indicators are considered for the assessment of debt sustainability:

– Public debt in relation to GNI
– Public debt in relation to annual export revenues
– Debt service in relation to annual export revenues

With these three indicators a country's liquidity and solvency can be estimated. Annual export revenues are the benchmark for liquidity, whereas the total economic performance (GNI) is taken as a point of reference regarding solvency.

In the context of the HIPC initiative the IMF has defined threshold values for these indicators. Also, World Bank and IMF have introduced the DSF in April 2005 as an analytical tool for implementing debt sustainability analysis (DSA) in LICs. This country specific DSA is reviewed periodically. It is crucial to put the risk analysis of economic policies in indebted countries into relation with their financial liquidity.

Table 4. Debt Burden Thresholds under the DSF

	NPV of debt in percent of			Debts service in percent of	
Policy / Indicator	Exports	GDP	Revenue (fiscal)	Exports	Revenue (fiscal)
Weak Policy	100	30	200	15	18
Medium Policy	150	40	250	20	20
Strong Policy	200	50	300	25	22

Source: http://www.imf.org/external/np/exr/facts/jdsf.htm

Based on the World Bank's Country Policy and Institutional Assessment (CPIA) index, World Bank and IMF divide countries into three categories (strong, medium, weak) and adapt the indicative thresholds according to these policy assessments. In order for developing countries to have access to international financial markets, DSA are conducted annually and are included as an annex to Article IV consultation reports. However, large and temporary shocks have not been considered thoroughly enough by this stress testing.

The current blending practice in this regard is similar to the social standard screening process for eligible blending projects: LGBFs do not provide operational procedures themselves on how debt sustainability needs to be analysed, but rely on respective assessments of involved financial institutions. They generally evaluate debt risks based on macroeconomic data and internal country rankings. Hence, they differ in their estimations and their willingness to assume risks. The envisaged coordinating platform might also contribute to harmonise debt analysis among European financial institutions and present some kind of operational guidelines in order to ensure comprehensive risk mitigation.

Loan absorption capacities of partner countries can be fragile due to changing market economy parameters such as interest rates and financial crises. Through blending, poor countries are more directly linked and exposed to unstable international financial markets (Griffiths 2012: 10). Moreover, political scenarios like social unrest and changing public spending priorities can weaken debt capacities (CONCORD 2012: 15). These risks can be mitigated by ensuring that debt burdens are not decided upon by ruling elites. Democratic ownership should be emphasized and local civil society needs to be

[16] cf. http://www.imf.org/External/np/pp/eng/2005/032805.pdf

included in project assessment instead (CONCORD 2012: 15). Again, transparency in project planning and implementation is likely to increase public support and, thus, willingness to shoulder long-term debt burdens.

Clearly, country debt levels and flows have to be monitored in decision processes of blended investments. This is already taken into account and even described as an advantage of LGB since HIPC lending requirements and DSF thresholds can be met through increasing concessionality levels (EC 2009: 12). On the other hand, blending incentives and the availability of supports might stretch debt-dependencies of receiving countries beyond reason. In some cases, IDA or other highly concessional loans or stand alone grants "might be more cost effective and suitable than LGB" (EC 2009: 7).

Another important criterion concerning debt is the grant-loan ratio. Generally, the smaller the grant element, the higher the risk of stretching the limits of indebtedness. Within NIF and ITF, the average grant share amounts to 2.3% and 2.28% respectively (Gavas et al. 2011: 22). In addition to the grant size, which in these facilities is fairly small, one has to take into consideration the grant type and the lending conditions. Interest rate subsidies, for instance, can play a crucial role to lower debt burdens and are mainly used in ITF projects (80 %) (Nuñez Ferrer et al., 2011: 21). Including concessionalities and additional IFI's grant resources, the grant share of the overall finance value is 5.2% (NIF) and 13.7% (ITF) (Gavas et al. 2011: 6). Even though the idea of blending is to leverage additional (private) resources (i.e. loans), in terms of debt sustainability there needs to be a **reasonable ratio of loan and grant elements**. At the moment there is no specific rule on the grant size, it is generally based on the assessment of financiers and the opinion of the EC. Financiers claim to seek a 'necessary' grant size to operate, while the commission has the interest to increase the multiplier to a maximum, and tends to reduce the grant element to a minimum. These are considerations removed from a needs assessment based on the situation of the recipient country.

3. GOVERNANCE AND STAKEHOLDER PARTICIPATION IN THE FACILITIES

Depending on the lead DG of the EC and the budget, the investment facilities have been developed based on three "templates". The LGBFs for the DCI are chaired at the strategic level by the EEAS and follow what will be referred to as the "NIF model". Thus LAIF, IFCA, AIF and new facilities in development CIF and IFP are based on the same logic, with differences based on regional specificities. ITF run by DG DEVCO is similarly structured, but has important operational deviations. The WBIF run by DG ENLARG has a very different structure, because as potential candidates for accession to the EU or at least for strong integration, the facilities also provide assistance closely resembling the EU's own internal debt and equity innovative financial instruments.

This section is going to present the functioning of the NIF. This will be used as a basis to present potential reforms of the system and any additional strategic and coordination needs.

3.1 Governance structures of blending facilities

The LGBF are treated as an additional tool to finance the operations of the EC in different geographical areas, with the particularity that grants are combined with other MS grants (in some cases) and with loans from EBFIs and IFIs. There is yet no overarching dedicated structure above the facilities although this may change with the proposed *EU platform for Cooperation and Development* incorporating the Commission, Member States and European financial institutions.

It is important to underline that the role of the facilities is not to tell the project financier which projects to finance, but to offer grants to enhance their activities. It is for the financial institutions to propose projects after consultation with the respective partner country/-ies. Grants will be offered for areas of specific interest defined in the strategies of each facility based on the regional EU policy. Project financiers will apply for the grants for specific projects, if those are compatible with the eligibility criteria of the grants. It is possible for grants not to be used, if those cannot be used in bankable projects. The LGBF are all based on a three-tier structure of governance, with the exception of the WBIF, which has two[17]. Those are:

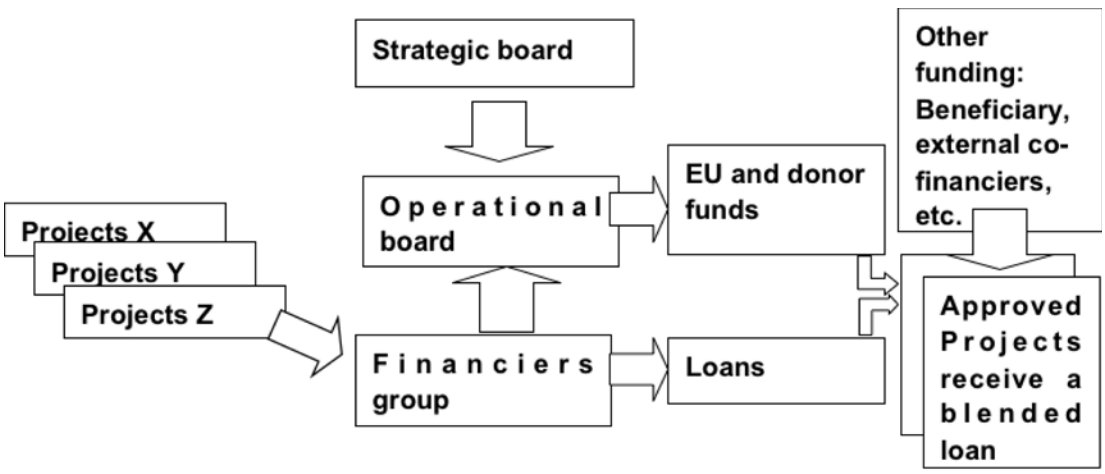
– A strategic board[18]
– An operational board[19]
– A finance Institutions group (FIG)[20]

The strategic board composed of the Commission, donor countries and beneficiary countries sets the strategic goals of the facilities; the operational board decides on the financing of projects which the FIG presents. Figure 4 shows the process.

The strategic board decides on the strategy of the blending facility. The FIG selects projects based on guidelines and financial sustainability and proposes them to the operational board for approval. Projects that are vetted will then be financed by blended EU (and possibly MS) grants and loans by the financiers.

The rules of procedure in the different facilities are described in agreements on the funds. For the ITF and NIF models the rules are laid down in agreements between the EC and the donors, and in the ITF also with the European Investment Bank (EIB), as it acts as fund manager for the EU budget funds (EC 2007 and 2008). For the WBIF the Terms of Reference of the Joint Grant Facility present the rules, as there is a different structure to the funding sources (EC 2009b). The structure and composition of the facilities is presented in Annex II.

Figure 3. Basic structure of NIF, LAIF, IFCA, AIF, CFI, PIF



Source: Núñez Ferrer et al. (2011) adapted

[17] The strategic and operational boards are merged, because of the introduction of shared management principles in the pre-accession funds, e. i. the delegation of management of programmes to national authorities.
[18] steering committee in ITF and WBIF
[19] executive committee in ITF
[20] Project Financiers Group (PFG) in the WBIF and ITF

3.1.1 Role of the strategic boards / steering committees in LGBFs

This body has the task to set the overall strategy of the financing facility, meeting in principle once a year including representatives of the beneficiary countries. The strategy for the facilities is in line with the wider EU policy orientations for the region which are determined by:

- For the NIF: The Neighbourhood Policy;
- For the LAIF: The EU regional strategy for Latin America and the EU-Latin America partnership ("Global Players in Partnership");
- For the IFCA: The EU regional strategy for Central Asia ("Strategy for a New Partnership with Central Asia")
- For AIF: The Regional Strategy for EU-Asia Co-operation;
- For CIF: The Joint Caribbean-EU Partnership Strategy;
- For IFP: EU relations with the Pacific Islands - A strategy for a strengthened partnership
- For the ITF: The EU-Africa Strategic Partnership;
- For the WBIF: The EU Pre-Accession Strategy for the Western Balkans;

There are marked differences between the "NIF stile" facilities and those for the WBIF and ITF concerning the level of participation of beneficiaries. This is due to the different relations between the European Union and the beneficiary countries and the different scope and type of projects financed. The chairmanship of the EC in all facilities at the level of the steering committee guarantees that the strategy of the instruments and the project selection are based on the wider EU development objectives.

This is important when drawing the line between the theoretical pros and cons of "blending" as a tool and the practice of implementation. The EU has set up a complex decision-making procedure to ensure that development objectives are achieved. It is also at this level that donors and other stakeholders can monitor the facilities. Many of the drawbacks of the facilities are overcome due to the existence of this body. The debt situation of the beneficiary countries for example, will be fed into the decision-making. The actions by financiers are under strong policy control.

3.1.2 Role of the operational board

The operational board of the LGBFs is responsible for the approval of grant operations which are presented by the FIG. Projects are screened to see if those are eligible according to the criteria of the blending facility.

There are important differences between the LGBFs in the composition of the boards and the rules of eligibility for projects. Some differences are clearly necessary due to the very different needs of the beneficiaries and diverging objectives of the European Union in the regions, but this does not justify all variations. Stakeholders have called for more coherence between the facilities and the envisaged platform should provide an answer.

The operational board has a fund or funds manager for the EU budget contributions and other donor contributions to the grant element. The ITF has a single "trust fund" bringing together the EDF funds and Member State contributions. The NIF does not have such a trust fund, the additional donor contributions are managed separately by the ITF Secretariat based in the EIB. This is because the member states do not want their contribution to be pooled to the EU budget contribution directly, as this would be formally equivalent to an expansion of the EU budget (which is already made up of contributions to the EU budget). For the newest financial instruments no trust funds exist yet.

Guarantees and grants which the EBFIs exert further complicate the matter. They are de facto enhancing the size of the grant. Their influence is opaque. To be able to count the grants as ODA in line with the OECD definition there is a need for transparency, including those often embedded in the EBFIs loans provided by their national governments. This is important to appropriately record all ODA flows.

3.1.3 Role of the Financial Institutions Group

Financial institutions can participate in the facilities and benefit from the grants if accredited. Presently the financial regulations do not specify who can be in the FIG, it is de facto restricted to financiers with a development mandate. Other financiers are welcome to co-finance the projects separately, but can neither benefit from the grants directly nor manage projects.

The accredited financing institutions undergo an assessment by the EC in order to be eligible to implement EC funds. Accreditation is required to allow the financial institutions to handle EU grants, it guarantees that the financiers' procedures fulfil EU budgetary control requirements.

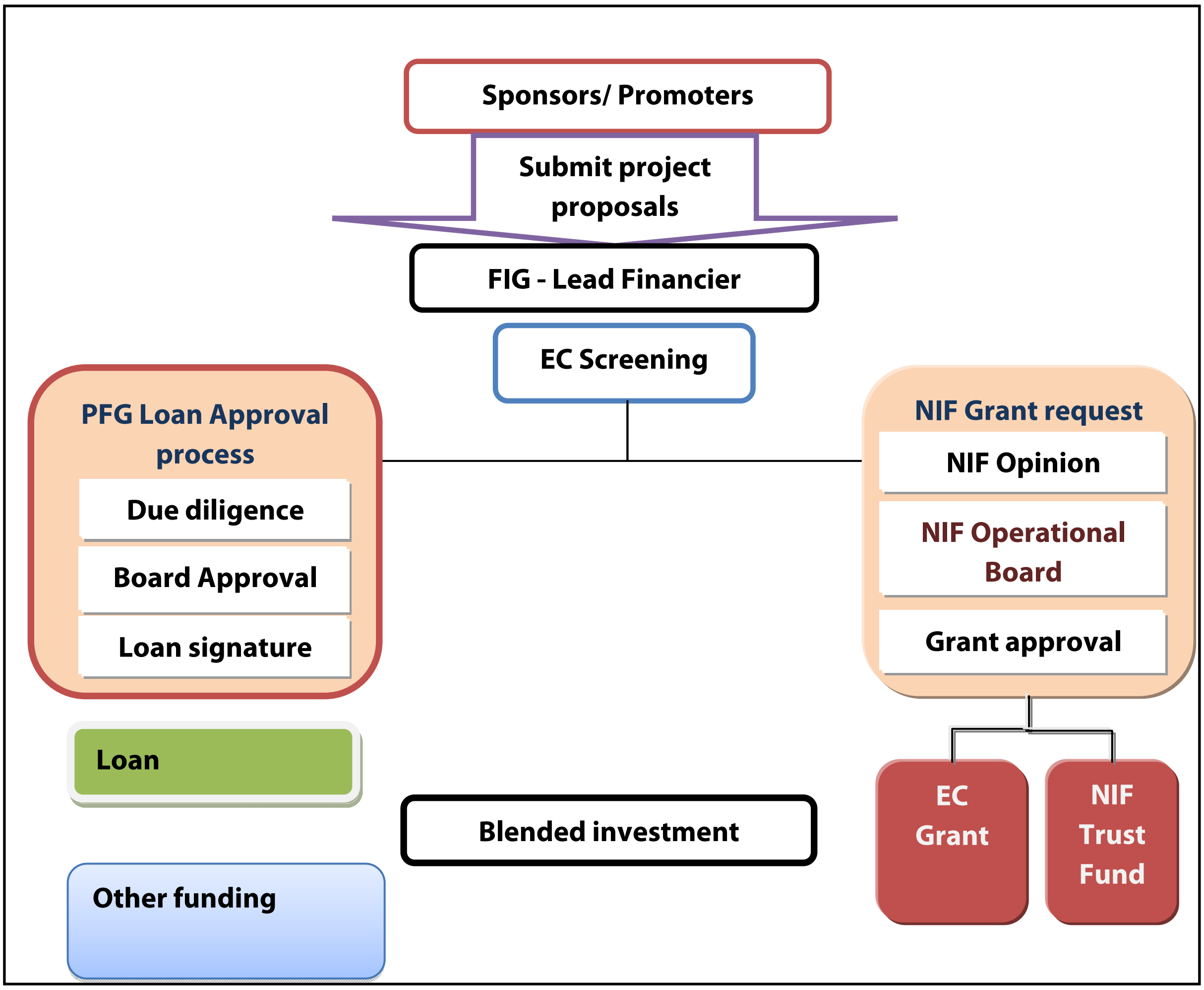
The composition of the FIG (see Annex II) will depend on the number of EBFIs active in the region and specific agreements with some IFIs and regional development banks. The EBRD, WB, CEB, AfDB, IDB, AusAID, NZAID are members for some of the facilities, due to their importance in the regions and existing collaboration with the EU and Member States. For the CIF the Caribbean development Bank (CDB) will also be accredited. Other external financial institutions, public and private, can participate as co-financiers in projects.

A central characteristic of the facilities is that the financiers establish one common project pipeline which simplifies the process for recipients. The facilities are primarily designed to encourage co-financing by more than one financier. There is no rule obliging several financiers to collaborate in all projects, an idea that has been floating in policy discussions, but there are many projects not suitable for multiple fund sources (Stepanek et al., 2010),

The selection of projects that will be presented to the operational board rests in the hands of financiers, which will also determine the grant size and type and the complete financial package based on their own financial assessment criteria. The EC is present at the FIG and may participate informally in the project selection, e.g. by pre-screening ideas based on the national strategies and information from the delegations in beneficiary countries.

The development of the project pipeline is based on a bottom up approach led by the financiers. This ensures that projects selected for consideration in the financial facilities are financially sound.

Figure 4. Project approval pipeline, NIF model



Source: Updated from Núñez Ferrer et al. (2011)

The LGBFs have encouraged collaboration between the institutions. An example of the increasing donor coordination which sets a precedent for the future of the LGBF is the Mutual Reliance Initiative (MRI) which the AFD, EIB and KfW are piloting. This initiative aims at recognising each other's project management procedures, i.e. project appraisal, tendering, due diligence and monitoring procedures, so that the institutions avoid duplication of tasks. This MRI process if expanded can facilitate the coordination of financing institutions in blending operations and also other collaborative projects outside the facilities considerably, improving the situation for the beneficiaries by lowering transaction costs.

4. THE FUTURE OF BLENDING FACILITIES

The EU has established quite successfully blending facilities for development finance with very limited resources and high leverage and multiplier effect. There is certainly scope to increase the size and reach of the facilities, but with due care of ensuring that this increases the effectiveness of the EU development policy and ultimately reaches the objectives of bringing the poorest out of poverty.

Blending is to be seen as an additional instrument alongside more traditional grant based assistance. It can identify those projects which can be undertaken mainly through loans, freeing grant resources for core development activities.

4.1 Possibilities and appropiateness to expand the use of blending

Type and size of grant: One of the questions often raised is which kind of grant instrument should the EU budget allow and what share of he investment should the grant cover or guarantee. Presently the types of grant offered are limited, while the size of the grant has to be justified to the financiers, with the European Commission having to agree on the request. In all facilities, the choice is relatively open within the permitted tools available, but the stakeholders are not unanimous on the kind of grants needed.

Given that accredited financiers are institutions with a public good and a development mandate, moral hazard risks are limited. Given the governance structure of the facilities it can be argued that the palette of grant tools available should be as large as possible to allow more and more targeted assistance. From the point of view of flexibility, effectiveness and development impact, the wider the palette of options the better.

The facilities ensure that the European Commission has the ultimate say in the approval process and requires the financial institutions to present a '*project fiche'* justifying for the need of a grant element and the kind of grant requested. The guidelines give rules regarding the information to be supplied, but those are rather open to interpretation. The EC's own method to reassess the grant needs of projects proposed is in turn put into question by some financiers, which view the Commissions' decisions as unclear. This needs to be addressed in future.

There are clear differences in opinion between stakeholders, different departments of the EC and financiers on which grant instruments should be eligible. According to financiers, the kind of grant to be used should depend on the specific needs of the projects and not determined by decree. All of the facilities should offer a wide palette of grant instruments proposed by the working group set up by ECOFIN in 2009 and listed in Annex I.

For stakeholders there is also the problem of visibility. The wider the palette of options the more difficult are investments to monitor. There is therefore a tendency to favour TA or investment grants over other tools. Visibility of EU actions is valuable for the EU. However, the tools should be developed with aid effectiveness in mind and restricting the palette of options based on the difficulty to follow the grant instrument is not a good argument. Monitoring of grant impacts is more valuable than ex-ante restrictions.

For transparency much can be achieved by imposing a unified presentation for all projects under the blending platform for external action. Reporting needs to be comparable and use the same terminology. Presently, not only the format, but even basic terminology such as leverage are presented differently in the annual reports.

Expanding the scope of the financial instruments – the case of climate change

Of the €1,3 million committed in EU grants to the investment facilities, more than 50% support climate change-related projects. An additional €1 billion should be made available in grants to climate financing until the end of 2013. To ensure better tracking and visibility of climate actions within the investment facilities, specific Climate Change Windows (CCW) have been set up in all of the regional investment facilities over the last two years. The aim of the CCW is to allow for transparent tracking of climate change projects in strategic areas like energy, transport, environment, forests, water, sanitation and support for the private sector. Funds for the CCW will target projects with the principal objective to contribute to mitigation and/or adaptation (i.e. Rio marker 2). If properly implemented, the CCW may encourage EU member states to add funds to the investment facilities, especially earmarked for the CCWs.

Expanding the financial allocation to grants: At this stage the financial allocation to the financial instruments is very limited and there is much space to expand the grant facilities. The expansion should occur seeking a good balance between loans and grants.

Looking for the optimal grant size: At present there are no clear guidelines on grant size. All the blending instruments mention that financiers have to justify the grant size and analyse of the leverage ratio, but there are no clear guidelines presented.

4.2 Governance and role of different stakeholders on the blending facilities

This section explores the role the different stakeholder could potentially have in the future governance of the blending facilities, within the facilities and at the level of a Platform for Cooperation and Development.

4.2.1 What role for European and International Financial Institutions?

At the level of the facilities:

The rules determining the obligations of financial institutions to be accredited to the blending facilities, which means to be allowed to be lead financiers and manage projects which benefit from EU grants. At the moment the obligations on reporting and monitoring are unclear and vary from facility to facility. The kind of grants different kinds of financiers have access too after accreditation also varies without any stated rule as there is no legal framework. Differences will depend of a combination of preferences by the lead Commission Directorate General responsible, realities on the ground, the importance of the financial institution or the shareholder status of a member state in a regional development bank.

The way lead financiers are treated between the facilities differs, even, for example, on the rules of remuneration. These differences are not justifiable and should be amended, the absence of clear rules of remuneration also creates an indirect barrier for smaller development financiers participate and take the lead in projects. The financial regulation for the EU budget and those for the EDF should clarify eligibility criteria and determine some minimum standards across the board.

A problem to address is on accountability of the institutions to the EU. It is clear for example that it is difficult to require EBFIs to be accountable to the European Parliament and the European Court of Auditors, such as is the case for the EIB. However, as structures form member states some common

European standards can be expected. However, it is clearly impossible to demand accountability to the EU for regional development banks and IFIs. There is, however, the need to ensure that their standards and due diligence procedures are in equivalent with the standards of the EIB. Sanctions for violating such standards, by revoking the institutions accredited status need to be defined with clear criteria and procedures to follow across the facilities. The objective is to have financiers which are at equal footing, in rights as well as obligations. This is also a prerequisite for the expansion of mutual reliance across financiers.

4.2.2 What role for the private sector and private financial institutions?

Supporting private enterprises does not automatically lead to poverty reduction. Private sector investments should only be supported if improved opportunities for the poor are ensured. According to this approach, the EU Agenda for change stated that the "EU should develop new ways of engaging with the private sector, notably with a view to leveraging private sector activity and resources for delivering public goods."

In order to support donor's efforts in increasing the impact of private sector development on poverty reduction the OECD/DAC[21] has developed a Guidance that could be a common basis to harmonize bilateral approaches with the strategy objectives of the Agenda for Change.

Differentiated approaches for LICs and MICS have to consider peculiarities and weaknesses of private sector involvement. This refers to the following aspects (amongst others): incentives for SME, productivity, value chains and international economic linkages, market access, risk and vulnerability.

Private EU financiers with a string development commitment are already allowed to become accredited institutions. A the level of the beneficiary country the involvement of private financial institutions is allowed by the facilities as co-financiers. This is important and has to be encouraged, for the following reasons:

- to expand their role in the national development.
- because the blending facilities should not be there to substitute local finance.
- because the LGBF are good vehicles to increase human capital of the local financial institutions.

4.2.3 What role for EU national authorities and civil society?

The national authorities of the member states involved in the different blending facilities are represented through in the strategic board of the committees, while the development policy is of course decided in broader regional development strategies in which the Council has the highest decision making influence.

The main weakness is the absence of civil society of EU member states and partner countries in any of the structures. Civil society could be integrated in decision-making structures and monitoring at the strategic board level, either in the individual blending instruments or in the potential EU Platform for Cooperation and Development. A possible structure is presented in section 5.6.

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[21][21] "This guidance is based on an analytical framework report, "Accelerating Pro-Poor Growth through Support for Private Sector Development", as well as work on a series of important topics. These are: *i)* removing barriers to formalisation; *ii)* implementing competition policy; *iii)* promoting the supply-side response; *iv)* the financial sector's contribution to pro-poor growth; *v)* enhancing women's market access; and *vi)* constructing inclusive public-private dialogue" see: http://www.oecd.org/dataoecd/43/63/36427804.pdf

The civil society organizations have raised important concerns and can be part of the process to find solutions. Those concerns include:

- Subsidising private sector: ODA might not all end up in beneficiary countries (CONCORD 2012); may cause market distortion (ECDPM 2011);
- lack of transparency, accountability and detailed criteria that justify engaging in blending; lack of assessment of impact on poverty reduction (CONCORD 2012)
- Opportunity costs: using public resources for blending means those resources cannot be used elsewhere (Bretton Woods)
- Moral hazard: Investors take greater risk because they assume they will not bear the full costs in case of failure (ibid.)
- Risk of debt overload of beneficiaries/ partner countries
- Limited development experience within the EIB (ECDPM 2011)

The envisaged Platform for Coordination and Development could leave some space for CSOs to articulate their concerns and to give advise regarding country context and specific social and poverty related needs. The blending instruments already offer in the steering bodies a place for stakeholders to offer their views, but CSOs are not yet represented. This possibility should be envisaged and the composition and methods of communication of these bodies should be reviewed to ensure proper participation of key stakeholders.

4.2.4 Democratic scrutiny and accountability, the role of the EP?

The most important action for the blending facilities is transparency and consistency in reporting, which is not fully the case at the moment. There is also a need of monitoring performance and impacts, without, however, hampering the work of the financiers or limiting the operability of the instruments.

For the European Parliament to have a better overview of the functioning of the facilities, it should be represented in the Platform for Cooperation and Development, as well as in the strategic boards (steering committees) of all facilities. Participating in these bodies would allow the European Parliament to understand better the blending instruments and improve its capacity to oversee and influence their structure through the normal channels of budgetary control and development policy formulation. This is clarified in the next section.

4.2.5 Increasing transparency, democratic accountability and involvement of civil society

The governance structures of the blending facilities are being reviewed for the next MFF. This section will present how the EU Platform for Development and Cooperation can play a crucial role in better governance of the facilities, and how the governance structures of the individual blending facilities can be improved.

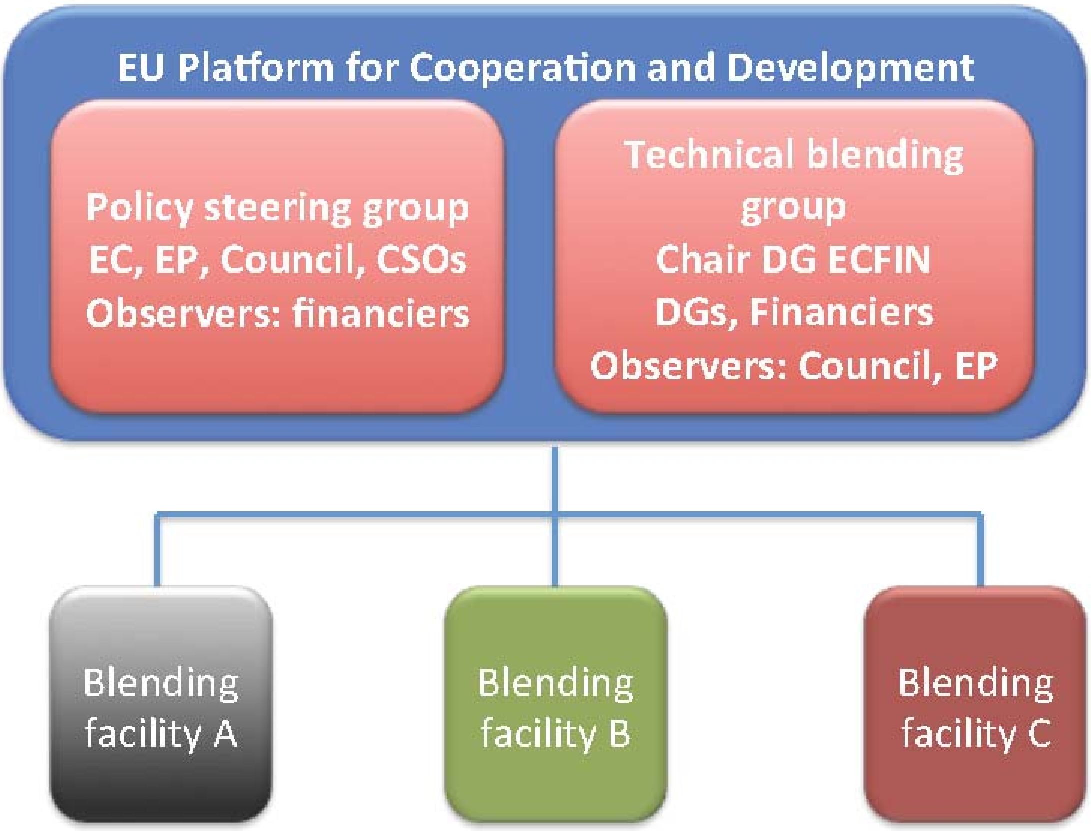
There is no doubt that there is a need for a better coordination of the facilities. While efforts are being undertaken to consolidate the governance for the facilities within the respective DGs, there is still a problem to bring coherence across the DG DEVCO, EEAS and DG Enlargement. This is the point where the Platform for Development and Cooperation can play a central role.

The platform should have two arms, a policy and a technical arm. It is important that those are handled differently. While the objectives of the facilities are decided at political level, the implementation of the blending facilities needs to follow the financial logic.

It is recommended that the Platform is not chaired by any DG directly involved in individual facilities except in cases where the only ones discussed are under the control of one DG. Overall oversight of the platform should be left to DG ECFIN, this would also ensure further coherence with the internal EU financial instruments. For internal policies, DG ECFIN already chairs the Financial Instruments Inter-services Expert Group (FIEG) and is involved in assisting the development the external financial instruments. The EIB could also take this role, but as a participation financial institution it would have conflicting roles. The operational structure, risk profile and needs differ considerable form other EBFIs or IFIs (EBRD, CEB, etc.).

In the policy arm of the platform, the Council, European Parliament and CSOs should be present, with accredited financiers as observers. Beneficiary countries are represented in the strategic board of the blending facilities and should not be present at this level. In the technical group, the Commission and the accredited financiers should set up the rules for the implementation in the blending facilities, with the Council and European Parliament invited as observers. It is important that decisions at this level are not undermining the more detailed work in the regional blending facilities, where rules need to reflect regional specificities. Here the lead DGs will have the strongest say and chair the strategic boards (steering committees), but need to implement the overall standards decided at the level of the platform.

Figure 5 Possible structure for the Platform for Cooperation and Development



5. BLENDING AND OECD/DAC REQUIREMENTS FOR ODA

Blending grants and loans "to boost the financial resources for development" – as stated in the Agenda for Change – poses the question of compliance with the OECD/DAC requirements for ODA.[22] The regulation of the European Parliament and of the Council for establishing the DCI states in article 2, that "actions under geographic programmes shall be designed so as to fulfil the criteria for ODA established by the OECD/DAC" (EC 2011a: 18). As defined by the DAC, ODA is the key measure used in practically all aid targets and assessments of aid performance. In the following it will be examined, how compliance of the total financial assistance (i.e. grants and loans) of a blending facility with OECD/DAC requirements for ODA can be guaranteed, how blending packages influence the ODA levels of member states and whether there is a risk that blending mechanisms contribute to de-facto tied aid.

5.1 The OECD/DAC Definition of ODA

As a member of the Development Assistance Committee (DAC) the EU aligns its development policies to the mandate and the criteria established by this organization. This also implies to "monitor, assess, report, and promote the provision of resources that support sustainable development (…) by collecting and analysing data and information on ODA and other official and private flows" (OECD 2010: 3).

Box 1. Definition of ODA

The DAC defines ODA as "those flows to countries and territories on the **DAC List** of ODA Recipients and to **multilateral development institutions** which are:

i. provided by **official agencies**, including state and local governments, or by their executive agencies; and

ii. each transaction of which:

   a) is administered with the promotion of the **economic development and welfare of developing countries** as its main objective; and

   b) is **concessional in character** and conveys a grant element of at least 25 per cent (calculated at a rate of discount of 10 per cent)."

The boundary of ODA has been carefully delineated in many fields, including:

- **Military aid:** No military equipment or services are reportable as ODA. Anti-terrorism activities are also excluded. However, the cost of using donors' armed forces to deliver humanitarian aid is eligible.
- **Peacekeeping:** Most peacekeeping expenditures are excluded in line with the exclusion of military costs. However, some closely-defined developmentally relevant activities within peacekeeping operations are included.
- **Nuclear energy:** Reportable as ODA, provided it is for civilian purposes.
- **Cultural programmes:** Eligible as ODA if they build the cultural capacities of recipient countries, but one-off tours by donor country artists or sportsmen, and activities to promote the donors' image, are excluded.

[22] The DAC is the Development Assistance Committee of the OECD. It was established in 1961; members: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Korea, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, the United States and the European Union.

Source: OECD/DAC 2008

Even though the EU is a DAC member, as a multilateral institution it cannot provide ODA on its own account. Member states submit ODA to multilateral institutions like UN bodies, IMF, World Bank, EDF and EU budget. Therefore, EU ODA flows are added to MS figures according to their share in the EU development budget.

5.2 The commitment to increase ODA

Attempts to increase ODA flows to development countries are not new.[23] The commitment of the EU to increase its ODA level to 0.7% of GNI by 2015 is the first attempt, however, to actually realise a respective action plan: In 2002, in the wake of the UN international conference 'Financing for Development', EU-15 Member States agreed to achieve a collective ODA level of 0.7% of GNI by 2015. To achieve this goal, an interim target of 0.56% ODA/GNI was set for 2010. In addition, EU-12 Member States committed to provide 0.33% of their GNI as ODA by 2015 and agreed to an interim target of 0.17% for 2010. Also, during the UN World Summit in 2005 and the G8 meeting of Gleneagles it has been emphasized that this target is crucial for the achievement of the MDGs. However, despite improvements made especially within the EU between 2001 and 2008, the process has been reversed in the last two years.

Due to the current financial crisis, the 0.7% goal appears to be rather unrealistic in near future. According to OECD statistics the total net ODA by all 27 EU member states in 2011 was USD 73.6 billion, which indicates a decrease from 0.44% of the combined GNI in 2010 to 0.42%. The EC has acknowledged that the intermediate goals of the twelve-point EU action plan in support of the MDGs cannot be achieved anymore. Therefore, new and innovative instruments such as blending facilities are required that might help to meet financial targets as well as to contribute to aid effectiveness regarding the OECD-DAC process.

5.3 ODA eligibility of blending operations

In order to clarify to what extent funds provided by blending could be reported as ODA, the following aspects need to be highlighted:

- Beneficiaries need to have the status of eligible development countries[24] and operations need to take place in qualifying sectors. Flows to countries like Greece do not count as ODA, the same applies to loans or grants for military purposes or defensive measures, even though in eligible developing countries.

- Within national / bilateral blending instruments, allowances can be made through grants or concessional loans. Loans need to have a minimum grant element of 25 % in order to be counted as ODA (OECD/DAC 2008). For LDCs or HIPCs the required grant element can be as high as 35 %.

- As soon as debtor countries begin to accomplish principal and interest repayments to creditors, those repayments are subtracted from EU member state's ODA-figures. Therefore, they have a negative impact on the ODA/GNI target. Thereby, only cash flows are considered, whereas

[23] Since 1969, as the Pearson Commission – in its report Partners in Development – proposed a target of 0.7% of donor GNP, this goal has been established within the OECD. It was supposed to be reached "by 1975 and in no case later than 1980" (OECD 2012). This suggestion was based on the DAC's 1969 definition of ODA and was taken up in a UN resolution in 1970. In the past, DAC members generally accepted the 0.7% target for ODA, at least as a long-term objective.
[24] The DAC List of ODA Recipients approved in October 2011: http://www.oecd.org/dataoecd/32/40/43540882.pdf

project outcomes and success rates are not relevant. Miscalculated projects which fail to reimburse loans remain ODA-compatible in contrast to loans for successful (self-carrying) operations.

- Blending has the potential to contribute to the mobilization of additional resources for development financing. However, unlike concessional loans on bilateral level, loans provided through EU facilities cannot be counted as ODA in total. Only the grant elements of blending operations in eligible countries are counted as ODA, distributed according to the overall share of MS to the EU budget. For many national development financing institutions, this could even be a disincentive to participate in EU-blending operations. Accounting EU-Blending operations as additional ODA would be a duplication, because such contributions have already been declared as ODA from bilateral donors (MS) to a multilateral institution (EU). A change in the guidelines giving the opportunity to declare (multilateral) loans as ODA could cause a crowding out effect in respect of grants.

The challenge for blending instruments is to support EU development aid to be in line with ODA criteria according to the OECD/DAC definition. It is important to assure additionality of development resources and not to soften ODA requirements in order to achieve the 0.7 % objective. It should be noted that additionality has two dimensions: loans and grants. Within blending, loans are displayed as additional resources (leverage effect), but their additionality is of limited duration since loans need to be reimbursed. An effective increase in ODA needs to target the grant elements. If the grants used for blending and concessional loans would be of additional nature, it could be ensured that there is no crowding out of other development measures. As illustrated above, EU blending can hardly be used to increase ODA. Therefore, not the quantity of leveraged finance should be considered but first and foremost the quality and effectiveness of ODA-flows with regard to poverty reduction.

Blending packages can help to avoid problems and shortcomings of pure grants and/or pure loans, and might even contribute to the improvement of ODA effectiveness. Possible improvements cannot be estimated by now due to the lack of comprehensive blending evaluation. The envisaged differentiation in the proposal of the new DCI (EC 2011a) requires a greater focus on LICs and, thus, might lead to a higher compliance of blending with ODA criteria. However, the impacts of pure grants and loans (as independent instruments) do not disappear once they are blended (see Table 3). On the contrary, the risks of unintended side-effects persist and should be controlled by strong governance structures.

5.4 Blending and tied aid

According to the DAC "tied aid describes official grants or loans that stipulate that procurements with those funds must be used to purchase services, goods or works from companies in the donor country or in a group of donor countries" (DAC 2010: 17).

Thus, tied aid is perceived to be inefficient since recipient countries do not have the chance to choose the most cost-effective or context-fitting option for implementing development operations. In order to increase the effectiveness and to strengthen the ownership and responsibility of partner countries, the OECD/DAC formulated the 2001 "DAC Recommendation on Untying ODA" (DAC 2008). On the one hand, the independent OECD/DAC peer review evaluation points out some progress in this regard: Several European donor countries have untied all their aid (Denmark, Sweden, etc.) or most of their aid (Germany, Netherlands, etc.) to LICs and HIPCs. From 1999-2001 to 2008, the proportion of untied bilateral aid rose progressively from 46% to 82%.

On the other hand, the OECD report on Untying Aid shows that the effort to enhance the visibility of EU development cooperation may even be a driver for tying aid (Edward et al 2009). This is especially relevant as the peer review states that "the EU institutions' approach to untying only partially meets the 2001 DAC Recommendation" (OECD/DAC 2012: 84). According to the DAC definitions, EDF and DCI are tied aid instruments since they are limited to specific geographic and thematic programmes.

In the course of additional blending facilities and private sector involvement the risk of tied aid is increasing. Blending facilities are supporting development objectives. Thereby, explicit regulations tend to favour those projects that allow for close linkages with EU businesses and investments.[25] This corresponds to the objectives of the Agenda for Change but contradicts international commitments made by MS concerning tied aid.

In their proposal for establishing a "European Infrastructure Blending Instrument for Sub-Saharan-Africa" (EIBSSA), the European International Contractors (EIC) are strongly lobbying to soften existing directives concerning untying aid: "To the extent that EIBISSA cannot be tied to European contractors, EIC would suggest to introduce a rigid pre-qualification process in connection with the application for funds which should be coherent with the European Union's wider policy objectives in the fields of protection of the environment, health and safety as well as corporate social responsibility to the extent that only those bidders may participate in the competition that can demonstrate their ability to comply with the European Union's environmental, ethical and social policy objectives. EIC is fully prepared to detail its respective proposals further."[26] The strong competition of China in the infrastructure market worldwide and especially in Sub-Saharan Africa could pressure the Commission to change existing standards concerning tied aid.

6. FOCUS ON POVERTY ERADICATION

6.1 The rationale of poverty eradication

The Treaty of Lisbon in its basic framework for EU external policies outlines poverty eradication as the primary target of development cooperation. Thereafter, the Union pursues common policies and actions in order to "foster the sustainable economic, social and environmental development of developing countries, with the primary aim of eradicating poverty" (Lisbon Treaty Article 21, 2d). This strategy is reflected in the European Consensus on Development which emphasizes the UN MDGs as a focal point of European development cooperation activities and – even further – stresses the non-interference of EU external policies with the MDGs in what is known as Policy Coherence for Development (PCD). Moreover, in the Agenda for Change as well as the EC proposal for establishing a financing instrument for development cooperation (EC 2011a) the poverty focus is acknowledged, but also the obvious failure to accomplish the MDGs is discussed.

It seems as if blending operations (such as infrastructure, energy, communication) are targeting indirect poverty reduction mainly. Therefore, a multidimensional poverty concept that covers absolute as well

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[25] All assets and services financed by the Trust Fund must follow stringent procurement procedures: "The Lead Financier for each Project shall ensure that all assets and services financed either by a loan from the institution or by funds made available from the Trust Fund shall be procured in a manner compliant with the institution's procurement rules and procedures which in turn conform to internationally accepted standards open at least to all enterprises established in either an EU Member State or a member of the African, Caribbean and Pacific Group of States and including the award of contract to the tender offering the best value for money, in compliance with the principles of transparency and equal treatment for potential contractors." cf. http://www.eu-africa-infrastructure-tf.net/procurement/index.htm

[26] http://www.eicontractors.de/media/uploads/attachment/draft-eic-position-on-eibissa_1.pdf

as relative aspects as outlined in the DAC guidelines on poverty reduction is more appropriate for assessing blending operations (OECD/DAC 2001: 37/38). In contrast to measuring poverty by income only (e.g. people living on less than USD 1.25 a day / World Bank), this holistic approach leaves more space for LGB to target poverty drivers.

The vast majority of blending projects addresses economic development in general. Eventually, the overall economic improvement is supposed to reduce poverty (trickle-down effect). This assumption, however, cannot be taken for granted. Blending to facilitate access to water and sanitation or in the social sector is more likely to have a direct poverty impact, but this link is not mandatory either. A general dilemma of using blending for development projects persists, since the financial viability of blending operations seems to be antipodal to the degree of social and poverty-related ambitions. Apparently, private investors at times lack sensitivity regarding pro-poor-growth and social responsibility. Risks are taken in order to achieve financial returns, not to comply with social and environmental standards. This also poses the question of additionality and crowding out of sectors. Consequently, the use of grant resources for blending needs to be assessed very carefully and should consider side effects and opportunity costs.

In order to safeguard the underlying poverty focus of EU development cooperation within LGB projects, an ex-ante poverty relevance evaluation needs to be conducted that critically assesses three core issues:

A. <u>Stakeholder analysis</u>: On top of the financial institutions involved, who are the additional investors and primary grant beneficiaries (state institutions, state owned enterprises, private corporations)? How do they influence the decision making process and what are their medium and long-term objectives?

B. <u>Poverty focus</u>: Which poverty dimension is addressed? Who is the target group and what are the expected outcomes? Clear objectives should be defined and respective indicators need to be provided for evaluation procedures.

C. <u>Transmission channels</u>: What is the interrelation of investment and poverty impact? How is the envisaged project going to stipulate the indicated poverty dimension and what is the advantage of a particular undertaking in comparison with other spending alternatives (opportunity costs)?

Many times, economic development and growth is accompanied by increasing disparity and "only weakly correlated with poverty reduction" (Wiggins/Higgins 2008: 2). Even though certain poverty dimensions or capabilities are in the focus of LGB and respective improvements can be observed in total (country level), reducing poverty means improving the situation of a specific group, i.e. the most vulnerable and underprivileged people. Thus, an ex-ante poverty relevance evaluation needs to consider a comprehensive pro-poor approach. It remains controversial, to which extent the situation of the poor needs to improve for growth to be defined as pro-poor (Wiggins/Higgins 2008: 1). In terms of development budget spending, the poverty reduction agenda should be emphasized. Pro-poor growth could then be described as a condition, where the capabilities of the poor improve faster than the capabilities of the better-off (in the targeted dimensions).

6.2 Key countries, objectives and eligibility criteria

Country preference:

Concerning the current discussion on country differentiation the question arises, whether the best way to tackle poverty reduction in MICs is the implementation of new finance Instruments like blending, and whether such instruments can have the same relevance in LICs. The proposed new European development strategy is following the rationale of primarily targeting LICs and "for some countries this may result in less or no EU development grant aid and the pursuit of a different development relationship based on loans, technical cooperation or support for trilateral cooperation" (EC 2011b: 10).

Bearing in mind that today the majority of the world's poor people live in countries classified as MIC, NGOs and scholars stress the need to differentiate development instruments rather than countries in order to explore appropriate methods to accelerate poverty eradication in an all-inclusive way. Development countries face diverse challenges and, thus, need different approaches to address country specific underdevelopment and poverty causes. Against this background LGB can be regarded as an opportunity to facilitate customized solutions in respect to the situation concerned in a partner country.

The EC in its 2009 blending mechanisms report states that poverty level "can have a considerable impact" on the design and financing of projects. Thereafter, LICs are more likely to deserve external financing, but taking disparity of MICs into account, LGB instruments should "not be excluded in these countries if a core objective of a project is poverty reduction" (EC 2009: 12). A screening of ITF blending projects shows, that out of 43 approved grant operations in the ITF that can be located in specific countries (one operation might target up to four countries at the same time), 46 times a (Low Income Country) LIC was targeted, 22 times a Low Middle Income Country (LMIC) and 7 times an Upper Middle Income Country (UMIC). This corresponds more or less to the overall share of LICs, LMICs and UMICs in SSA. Thus, no focus of LGB activities in respect to Income / World Bank classification of countries can be identified within the ITF framework. Also in terms of grant scope (Technical Assistance, IRS etc.) no preference can be seen regarding any country income class. 70% of ITF projects are supported via technical assistance grants, 26% via interest rate subsidies and 4% are composed of direct grants. The countries that are most involved in LGB are Ghana (LMIC), Namibia (UMIC) and Zambia (LMIC), which to some extent points towards the direction that MIC tend to be more suitable for LGBF operations.[27] For the LAIF a similar analysis is of no use since there is only one LIC (Haiti) and the number of accessible projects is very limited. One also has to keep in mind that LGBF are very often applied in regional settings and cross-border projects.

The DAC in its 2012 peer-review report of EU development co-operation points out that, in the course of phasing out of some MICs, blending instruments and private finance could help these countries to bridge funding gaps. Also, it could give the EU the chance to engage strategically with MICs on global challenges (OECD/DAC 2012: 19). The German KfW is thinking along similar lines and considers blending to be an instrument for investments in UMICs mainly. In principle, grants are provided for LICs only and for MICs in case of direct poverty impacts.[28] MICs are supposed to be more likely to have a political and financial stable environment to shoulder liabilities derived from blending loans. Financial institutions have their own debt sustainability criteria in this regard (chapter 3). Still, one has to keep in mind that these countries very often show high disparity and, thus, high poverty rates despite solid GNI growth. Hence, a comprehensive poverty focus analysis is just as important as in LICs. In order to

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[27] Based on ITF web data: http://www.eu-africa-infrastructure-tf.net/activities/index.htm

[28] Interview with KfW representatives in Mai 2012.

combine blending with poverty eradication, an ex ante poverty impact assessment should identify transmissions channels and sectors with higher potential for poverty reduction.

Key objectives and criteria:

In its annual report the ITF points out that the regional dimension of a project is among the eligibility criteria. National projects need to have an impact on at least two more eligible African countries. Another prerequisite are "sound sustainable development principles such as poverty reduction, contribution to economic development, trade and environmental and social best practice" (ITF 2010: 15). The LAIF Action Fiche expects projects to contribute to better transport infrastructure, improved energy infrastructure, increased protection of the environment, improved social services (i.e. health care and education) and growth of SMEs and employment (LAIF 2009: 4/5). A similar document dealing with the 2010 established Investment Facility for Central Asia (IFCA) is composed of the same objectives. It remains unclear in what way poverty reduction is considered by LGBFs, what the transmission channels are and to what extent positive impacts on poverty are required for operations to be eligible.

Other LGBFs in poverty-stricken areas (Caribbean/CIF, Asia/AIF, Pacific/IFP) have just recently been / are going to be launched and respective documents and/or project lists are not available so far. In a rather broad sense project eligibility criteria also refer to regional EU strategy papers (e.g. EU-Africa partnership Strategy, EU Strategy for Central Asia), above that there is little information on which conditions have to be met for a project to qualify (Gavas et al. 2011: 26).

Poverty-focus in blending practice:

IFIs who are involved in blending operations apparently apply their own eligibility criteria and social and poverty related standards and guidelines. EIB, KfW and AFD, in this respect, even launched a mutual reliance initiative in order to agree upon collective principles concerning the implementation of blending instruments. In the end they committed to operational guidelines; despite considerable similarities there are some different focal points. The more financial institutions are involved in a blending project, the more extensive are eligibility procedures because all institutions insist on their respective standards. According to the KfW, a number of projects have been dismissed due to non-compliance at this early stage.[29] Development institutions of MS provide guidelines for assessing the poverty orientation of development projects which have to be considered by implementing agencies and development banks in ex-ante project auditions. According to these guidelines, four main criteria are applied to evaluation which are compatible with DAC Guidelines:

- Are the poor part of the target group?
- Does the project improve living conditions of the poor and does it enhance their productive potentials?
- Are the poor involved in the project?
- Is the project embedded in a poverty-focused environment?

A variety of sub-categories and characteristics are available to define the overall poverty orientation of a development operation which needs to comply with certain minimum standards to be approved.

The European blending facilities do not have to rely on implementing IFI's efforts when it comes to poverty reduction measures. Respective provisions could also be made compulsory for blending operations. Especially in respect of private sector involvement, binding obligations concerning

[29] Interview with KfW representatives in Mai 2012.

universal service improvements can be requested. Such regulations could include additional responsibilities for (non-blending) development projects, agreements on minimum taxation levels or other mechanisms to ensure services to the needy or general social betterments.

Concerning the focus on poverty eradication the LGBF documents at hand suggest that direct poverty eradication is not a key target of blending operations but – if at all – only one issue among others and to some extent interchangeable. In opposition to this loose rationale it needs to be reemphasized that poverty eradication is the leading principle of European development strategies. Even though IFIs adopt national poverty focus standards and additional EU-regulations might complicate eligibility processes, clear objectives need to be formulated that highlight the poverty focus of blending facilities. Also, more transparency on how social standard evaluations are realized in project screening might contribute to ease civil society concerns in this respect.

6.3 Evaluation and Monitoring

LGBFs consist of different governance levels and bodies that influence the admission process of blending projects. These include strategic bodies, decision groups and technical groups. Within the ITF, there is a Steering Committee (composed of 29 representatives from EU and AU each) that "provides strategic guidance" but "does not intervene in the choice of grant operations" (ITF 2010: 12ff.). This power vests with the Executive Committee whose voting participants are EU donors only (EC and MS). Their responsibility is to examine and approve grant operations according to agreed terms and procedures. Below the Executive Committee there is a Project Financiers Group that is responsible for project assessment, evaluation and eligibility check. These Lead Financiers are mainly national financial institutions with development expertise that are appointed by the donors.

LGBF steering committees ensure that facility strategies are in line with overall EU policy orientations for a country / region (Nuñez Ferrer/Behrens 2011: 10). However, poverty impact analyses of the facilities are not provided, but left to the Lead Financier institutions to provide. Their assessments, however, do not necessarily imply poverty reduction to be a main goal. Also, participation of target groups and CSOs is usually not provided, it would be an asset to improve transparency and efficiency in that respect.

In compliance with a multidimensional poverty concept that leaves space for LGB to have a considerable impact on poverty reduction, the EU could provide operational guidelines for LGBF Committees and Lead Financiers. Poverty impact assessments, such as the PIA evaluation provided by the OECD, are not only to be conducted ex-ante but can also serve as an assessment tool during and after implementation of operations. If such assessments are carried out by Independent expert groups, the credibility and acceptance of blending in development contexts could also be strengthened. Evaluation outcomes of completed blending operations can serve as a basis for future decision making processes.

Based on existing qualitative and quantitative data and within a time frame of 2-3 weeks, PIA first observes a country's poverty situation and existing strategies. Then, respective stakeholders and institutions involved in a project are examined according to their pro poor agenda. Eventually, this allows for identifying the appropriate transmission channels and impacts on stakeholder groups, especially those targeted by the project. In the end, predictable outcomes of the intervention regarding MDGs and other goals can be identified (OECD 2007: 13ff).

If such assessments and evaluation processes were to be compulsory in LGBF decision making for envisaged LGB projects, poverty reduction (in all its dimensions) could be addressed more implicit than previously. There is no necessity for a complete change of project sectors and instruments, but respective stakeholders and decision-makers should be sensitised to poverty impacts. Concerning this matter, the new blending platform could also serve as a coordinating body for poverty impact assessments.

7. CONCLUSIONS AND RECOMMENDATIONS

The blending facilities are an important new addition to the arsenal of financial assistance mechanisms for development. However, the blending facilities are ultimately a debt instrument for revenue generating projects, and cannot be used in many development programmes. LGBFs cannot replace grant financing but complement it. We also have identified important needs to improve the functioning of the facilities which should be incorporated in the expected EU Platform for Cooperation and Development.

We identified the need to make the facilities more coherent and backed with an appropriate legal basis. We also identified the need to develop mechanisms to ensure appropriate democratic scrutiny and that operations are in line with poverty eradication objectives.

The blending instruments have been created independently from each other which has led to many unjustifiable differences in the operations of the LGBFs. There is a need of an overarching body which ensures appropriate standards and the participation of EU and beneficiary state civil society representatives in decision making. This report proposes to introduce policy and technical steering groups in the platform, taking as a point of departure the structure offered by the FIEG for innovative financial instruments of the EC.

The platform also should develop standards on reporting and methodologies on monitoring and evaluation to assess the impacts of the policies. In order to safeguard the poverty focus of blending instruments, ex ante poverty impact assessments should be compulsory for the screening process of eligible projects. Investments in infrastructure with private sector involvement are not necessarily to the benefit of the poor. Primary transmission channels need to be identified for blending to ensure significant influence on target groups and poverty eradication. Furthermore, a comprehensive stakeholder analysis could help to mitigate risks.

The envisaged Platform for Cooperation and Development needs to develop common standards for all blending facilities. We recommend that at the core a structure similar to the FIEG for internal innovative financial instruments chaired by DG ECFIN is developed. It is important that a specialist service *not* directly running a facility takes an overall view and steering role. The platform should have two bodies steering, one for steering the policy, one for technical implementation matters. The first should ensure that there is a good representation by the budgetary arms of the EU, which includes the EP and civil society. The technical group should include the financiers to develop minimum standards on poverty assessments, grant size determination and monitoring and reporting.

The EU platform for Cooperation and Development should define clear rules and procedures for all LGBF, in particular:

- Rules for monitoring and reporting, coherence in reporting standards. For transparency, we recommend that there should be a single consolidated reporting template with common terminology.

- Rules on the treatment of financiers (eligibility, remuneration, required minimum reporting standards).
- Rules that spell out clearly the obligations of financiers requiring proof of financial control.
- Offering for transparency a combined report of projects and actions of all LGBF in external action, clarifying amounts, if the finding comes from the EU budget or the EDF.
- Developing a clear methodology on measuring the state of Heavily Indebted Countries and the approach to take with the instruments.
- Terms on links to structural reform conditionalities need to be set. A clarification of the rules on tied aid for LGBF need to be given.

The decisions of the platform should focus on minimum standards, but leaving enough flexibility to allow tailoring the operations to the realities on the ground.

The existing governance structures at regional level are well devised, but there is a need to open the door at steering committee level for local civil society organisations involved in development programmes. The present structure is to some extent rather top down.

The EU has stated the objective to phase out pure grants in middle-income developing countries to replace them with blending facilities. This movement seems to disregard the fact that in middle income countries inequalities tend to be higher and that the very poor could get increasingly marginalized. Decisions of this type need to be taken based on the situation of the groups targeted and needs of the programmes, blending facilities cannot handle a large number of projects generating public good, in particular of social nature.

In order to safeguard the poverty focus of blending instruments, ex ante poverty impact assessments should be compulsory for the screening process of eligible projects. Investments in infrastructure with private sector involvement are not necessarily to the benefit of the poor. Primary transmission channels need to be identified for blending to ensure significant influence on target groups and poverty eradication. Furthermore, a comprehensive stakeholder analysis could help to mitigate risks.

Leveraged resources (i.e. loans) of blending packages should have the character of additional flows. ODA crediting of blending instruments needs to comply with established OECD/DAC requirements. Thereby, the amount of ODA qualifying grant elements should be made transparent.

Thus LGBF need to follow a financially sound decision-making and can only focus on projects that generate positive revenues sufficient to cover the loans. The use of LGBF require particular attention if used in highly indebted countries. The governance of the facilities gives some guarantees in this respect, but there is yet no formal method to treat those cases.

Budgetary control by the European Parliament is guaranteed for the facilities financed by the external action budget of the MFF, but much less for the instruments financed by the EDF funds. Nevertheless, the strategy of the blending facilities needs to conform with the EU development strategies. In future the EP could be represented in the steering committees of the facilities. Other stakeholders could also be represented at his level.

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ANNEX I. GLOSSARY

This text originates from Núñez Ferrer et al. (2011):

a) Technical Assistance(TA) and studies

TA grants are one of the main instruments in the facilities. They are considered successful to improve project preparation and planning, accelerate the start of projects, project and implementation and management as well as the sustainability of the investment. A number of complex projects would most likely never have seen the light without TA support. This support also is important to prepare the appropriate financial package which may be of further grant and loan blended support and speed up the start of projects.

b) Direct investment grants

Investment grants can be used to cover specific parts of a project, which can be highlighted as items needing grant support. It helps to reduce the overall cost of a project in a transparent manner. Grants can be used in particular for specific social or environmental aspects of projects, aspects which are necessary to the success of a project. Investment grants can be used upfront to accelerate projects giving them a kick-start, or at closure so as an incentive to the beneficiary to keep to the loan contract terms. The format of a grant should depend on the project.

c) Conditionality / performance based grants

Those are grants linked to conditionalities, such as Output Based Aid as defined for ODA. Ex-ante conditions are defined which the beneficiary needs to fulfil to obtain the grant or grant elements based on service level or performance targets. This enhances the efficiency of project implementation and increases the alignment of the interests of the beneficiaries with the development objectives pursued by the donors. Those conditionalities are particularly important in countries where governance is weak.

d) Interest rate subsidies

Interest rate subsidies (IRS) help bring down the costs of borrowing, making projects more bankable and less onerous. The overall effect is not much different to investment grants, but can be less visible than an investment grant. Only ITF and WBIF currently use interest rate subsidies while the NIF, LAIF and IFCA do not apply them in practice. IRS can play an important role to make the financing terms of development options favoured by donors more attractive than alternatives. This can be important in specific areas, such as in the case of energy, where under normal loan conditions "dirtier technologies" are more advantageous.

In theoretical terms investment grants or interest rate subsidies are equivalent in value, but the impact on implementation is different, as the motivation by the beneficiaries can be affected. The IRS has the advantage to the beneficiary that there is one single contract and contract partner; hence reducing the transaction costs on the partners' side. The use of interest rates rather than investment grants will depend on the project and the potential market distortions.

e) Loan guarantees

Loan guarantees offer the lender a protection in cause of default. Loan guarantees are an insurance of importance in underdeveloped markets. It is a risk sharing mechanism, where the LGBF offer a protection with grant funding serving as guarantee. It reduces also the risk of projects and thus the interest rate charged to the borrower, mimicking an interest rate subsidy. Loan guarantees can be combined with other kinds of grant, such as investment grants. Loan guarantees only in case of default lead to real disbursements. Due to this reason, they can contribute to increase the development financing volumes without charging scarce EU budget to the same extent.

f) Structured finance – first loss piece

First loss financing is similar to a guarantee, but is used to invest in the highest risk tranche of a project to leverage funding from IFIs, EBFIs and private banks.

g) Risk capital

Risk capital grants are equity or quasi-equity investments for high risk projects. The projects are by nature profitable if successful, but no investors or financiers are ready to participate in developing the project due to their risk level. Risk capital can be an important tool for development projects, because underdeveloped markets of developing countries require higher risk premia than developed markets. Risk capital can be offered for particular risks in a project or pari-passu for the whole project[30], i.e. where the fanciers and investors are willing to bear the risks but only up to a specific level. The difficulty when offering risk capital is to determine the right level of support and avoid excessive risk coverage, biasing investment incentives. The best areas for intervention with risk capital operations are investments in SMEs and for infrastructure.

h) Insurance premia

Curiously absent from the working group's report on blending were the insurance premia, which can play an important role. These provide initial insurance cover offering a risk-mitigation necessary to launch projects.

[30] Risks is only partially covered by the grant and the remaining adeguately shared between all the financiers.

ANNEX II. GOVERNANCE OF BLENDING FACILITIES

<table>
<tr><th></th><th>ITF</th><th>NIF, LAIF, IFCA, AIF, CIF, IFP</th><th>WBIF</th></tr>
<tr><td>Strategic Board or Steering Committee</td><td>Steering Committee

Co-chaired by the EC (DG DEVCO) and the African Union Commission. It is composed of all member states, the EC, the EIB, 29 African Members (the members of the conference bureau - Transport, energy & ICT (19 African states), the Regional Economic Communities, the Economic Commission for Africa, the AfDB, the NEPAD and the African Union Commission). EU Finance institutions and international Development Agencies attend the meeting as observers. Administrative support is financed by the EDF budget for technical assistance.</td><td>Strategic Board

Chaired by the EC (EEAS) and composed of all member states. Beneficiary countries and finance institutions attend meeting as observers. The secretariat is handled by EEAS.</td><td rowspan="2">Steering Committee (and also operational board)

Co-chaired by the EC (DG ELARG) on a permanent basis and by the rotation Chair of the Assembly of Contributors to the European Western Balkans Joint Fund (EWBJF) on a rotating basis every 12 months. Other members of the Steering committee are member states not contributing the EWBJ, beneficiary countries, other stakeholders, the Regional Cooperation Council and partner IFIs (EIB, EBRD, CEB). Other EBFI attend as observers. In contrast to other LGBFs, the steering committee also operates as an operational board.

When acting as executive body for the selection of projects, voting rights projects are based on the status of member states as donors, only those contributing to the fund can vote. Other stakeholders in the steering committee can be observers but not vote. The expert advisers of the lead IFIs can attend for projects of their competence. Interestingly, projects cannot only be presented by the Finance Institutions, but together with the beneficiary countries.</td></tr>
<tr><td>Executive or Operational body</td><td>Executive Committee

It is chaired by the European Commission (DG DEVCO), with the possibility not yet used of EU member states which have donated more than €5 million to the Trust Fund to chair it. It is composed of the European Commission and all member states which have contributed to the fund at least € 1 million. The EIB attends as manager of the Trust Fund, as well as the secretariat without voting power. Other member states, EBFI and development agencies may attend as observers if invited by the relevant donor.</td><td>Executive Committee

It is chaired by the EC (DG DEVCO), and is composed of all member states. Finance institutions attend meeting as observers. The secretariat is handled by DG DEVCO. In LAIF, due to the reduced presence of EU financiers and the need for close collaboration with regional development banks, those are invited as observers too. This is likely to occur in LAIF.</td></tr>
</table>

			Administrative support is offered by the EC (DG ELARG) and the co-chairing EWBJF contributor.
PFG/FIG	Project Financiers Group Chaired by the financier hosting the PFG meeting. Each donor to the ITF nominates one financier to the PFG. Current members are AFD, EIB, KfW, BIO, OEeB, Lux-Development, MoF Greece, SIMEST, COFIDES, SOFID, AfDB, PIDG. In this facility, the AfDB is of particular interest, as it is not an EBFI. The UK nominated AfDB as its representative to the PFG. Its member ship was agreed due to the important role it plays in the region and the existing collaboration of this development Bank with European Banks and member states. PDIGE also not an EBFI – but nominated by the Netherlands due to special know how.	Finance Institutions Group NIF model: The FIG is chaired by the European Commission (DG DEVCO). The members of NIF are AECID, AFD, CEB, EBRD, EIB, KfW, NIB, OeEB, SIMEST, SOFID. LAIF: AFD, BCIE, IDB, CAF, EIB, KfW, NIB, OeEB AIF: EIB, EBRD, NIB, ADB, AfD, KfW, OeEB, SIMEST, SOFID CIF: EIB, NIB, CDB, IDB, others joining IFP: EIB, AFD, KfW, AusAID, ADB, NZAID, WB	Project Financiers Group Chaired between the European Commission (DG ELARG) on -a permanent basis and by accredited IFIs on a 6 monthly rotating basis. Members are CEB, EBRD, EIB, KfW. Discussions are on-going on the possibility to include the World Bank.
Fund management	The ITF has only one Trust Fund, combining the EU and member states contributions. The Trust Fund is managed by the ITF Secretariat. Decisions on the Trust Fund are taken by consensus and otherwise by double majority (2/3 majority of those with voting rights and 2/3 of donors).	Depending on the facility there can be one fund from the EU budget or the EDF or two, where the second one is composed of a Trust Fund with the MS' contributions managed by the EIB. Members normally take decisions by consensus or vote according to the rules of the ENPI for NIF. The European Commission has a veto right. For the Trust Fund, voting rules of the Trust Fund are applied, only MS which have contributed to the fund can vote.	The WBIF has five funds: one derives from EU budget resources (€130m) and is managed by the European Commission, the second is a European Western Balkans Joint Fund (EWBJF) with the contribution of donor member states (€20m) and the three others – a marked difference to other LGBFs – come from €10m grant contributions each by the EIB, EBRD and CEB, which are earmarked for their own operations. Each fund has its own voting rules.
Secretariat	ITF Secretariat, based in EIB	European Commission	European Commission

Source: Updated from Núñez Ferrer et la. (2011)

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ISBN 978-92-823-3769-1

ISBN 978-92-823-3769-1
doi: 10.2861/90202

Publications Office