

Erforth, Benedikt; Kaplan, Lennart

Research Report

The future of European development finance: Institutional reforms for sustainable solutions

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The Future of European Development Finance – Institutional Reforms for Sustainable Solutions

Summary

Climate change, migration flows, security – growing challenges like these are calling for new responses from EU development policy. Achieving the Sustainable Development Goals (SDGs) by 2030 will in itself require additional financial resources of up to USD 2.5 trillion every year in middle- and low-income countries. Although the European Union (EU) and its Member States are already the biggest donors worldwide, the amount of public funds available is not enough to reach the SDGs. In their search for solutions, therefore, state and non-state actors are focusing squarely on linking public- and private-sector funding.

Faced with ambitious climate targets and China's growing involvement in development finance, the current debate on the EU's future external financing is centred around reforming the institutional architecture. Such reforms are intended to boost green energy and employment in the partner countries and communicate a coherent European model of socioeconomic development to the outside world. While all actors agree that the EU's external financing architecture should be simpler, more visible and more efficient (European Commission, 2018), views on how this

could actually be achieved vary widely. This led the Council of the EU to task a high-level *Wise Persons Group* with formulating various scenarios for creating an EU Development Bank.

EU development financing is plagued by conflicting national and supranational interests and often sees institutional concerns prioritised over matters of content. Against this backdrop, we argue that institutional and content-related interests need to be better aligned if development financing is to be made more efficient and more sustainable. In particular, a reformed architecture for the EU's external financing has to do more to reconcile European sustainability and development goals with the needs of partners. Measuring impact against uniform standards will both help to achieve overarching objectives and convey a successful European development model. Given the importance of private capital for development finance, a reformed financial architecture should also consider the interests and rationales of the private sector. However, this will only be a winning formula if social, environmental and human rights standards do not take a back seat.

The European system of development finance

In its current form, Europe's financial architecture is characterised by a multitude of actors and instruments, giving the EU considerable expertise across a range of sectors and regions. However, this diversity requires strong governance to ensure that the Union presents a clear and coherent image of itself. The ever-growing importance of emerging powers, particularly China, is fuelling the belief amongst European decision-makers that being a visible provider of development finance serves the Union's geostrategic and economic interest.

One key actor is the European Investment Bank (EIB). As a European institution, it grants loans under official EU mandates. However, the world's largest multilateral development bank only deploys ten per cent of its financing outside the Union. Another key actor is the European Bank for Reconstruction and Development (EBRD). Unlike the EIB, however, it is not an official EU institution, counting countries such as the US, Japan, Canada, Switzerland, Russia, China and India amongst its shareholders. Besides these two financial institutions, development finance in Europe is also provided by 19 national development banks and development finance institutions (DFIs) plus the Member States themselves and the EU Commission. The individual actors can access EU guarantees and funds to support their activities to varying degrees under specific mandates.

Amongst the bilateral promotional banks, France's Agence Française de Développement (AFD) and the German banking group Kreditanstalt für Wiederaufbau (KfW) have the most financial clout. The two institutions have been partners for many years. For example, they work together to develop innovative approaches for digital impact measurement (e.g. using satellite data) and co-finance infrastructure projects such as the world's largest solar power plant in the Moroccan city of Ouarzazate. Yet even institutions like AFD and KfW are reliant on additional co-financers to carry out major projects, which is why they work closely with the EIB in several countries. To this end, each has agreed to recognise the other's procedures and audit results.

However, cooperation between the bilateral development banks and the EIB is being hampered by institutional differences and competition. Firstly, unlike the EIB, AFD and KfW see themselves more as development banks, leading them to assess risks differently. Secondly, AFD and KfW have more branch offices in their partner countries, allowing them to support structural measures. Thirdly, the three actors sometimes compete in markets with limited capacity for financial absorption. Fourthly, they also differ in how they can access EU guarantees, which are needed in particular to mobilise private capital and can exert a significant leverage effect.

The EIB is keen to retain its priority access to EU guarantees for external financing as they are its only means for investing outside the EU and in high-risk projects without burdening its balance sheet. In the interests of an open financial architecture, the bilateral development banks and the EBRD favour free access to EU funds. This thinking is in line with that of the Commission.

The EU Commission: a signpost in development financing

In view of the inter-institutional conflicts of interest and inefficiencies in the current system, the European Commission's proposed instrument for "Neighbourhood, Development and International Cooperation" (NDICI) is geared towards ensuring a simplified and coherent architecture for the EU's external financing (European Commission, 2018). A comprehensive external instrument is to be created in the EU's next Multiannual Financial Framework (MFF) to meet these requirements. The EU Commission also intends to improve coherence by strengthening political governance.

Amongst other things, these objectives need to be seen in the context of the EIB's increasing autonomy. In particular, the operational freedom afforded to it under the existing Guarantee Fund for External Actions is a thorn in the side of Commission decision-makers. It is no coincidence that questions have been raised over these mandates. According to internal Commission data, it is not a question of putting an end to the bank's activities outside Europe. Rather, the

Table 1: Comparison of key figures for the EIB, AFD, KfW and EBRD (data correct as of 2018)

	EIB	AFD	KfW	EBRD
AAA rating	Yes	No	Yes	Yes
Funds pledged	EUR 64.19bn	EUR 11.4bn	EUR 75.5bn	EUR 9.5bn
of which:				
- outside the EU	EUR 8.1bn	EUR 11.4bn	EUR 10.6bn ¹	EUR 6.7bn
- in Africa	EUR 3.3bn	EUR 5.3bn	EUR 5.21bn	EUR 1.4bn
Employees²	2,900	2,650	6,376	2,600
Branch offices	50 (27 outside the EU)	66 (outside the EU)	63 (outside the EU)	53 (39 outside the EU)

¹Total funds pledged by KfW Development Bank and DEG for 2018.

²All employees of the banking group, not just those primarily working in the development sector.

Source: Own compilation, data from the individual institutions.

aim is, on the one hand, to prevent it from enjoying a monopoly position and, on the other, to scrutinise the instruments currently in use before the next MFF is adopted.

Building on its experience with the existing EUR 1.5 billion guarantee under the European Investment Plan, the Commission is convinced of the added value offered by an open financial architecture that promotes competition. As well as believing that greater competition for public funds amongst national and multilateral development banks encourages innovation, the Commission is also hoping that this approach will generate synergy effects between the various actors' areas of expertise, thus boosting the EU's global influence.

Several options for creating a European Development Bank

Given the complexity of the issue and the persistent lack of consensus, the Council of the EU tasked a *High-Level Wise Persons Group* with preparing the issue for the next stage of negotiations and identifying the main problem areas. The group was asked to analyse potential overlaps between the EIB's and EBRD's remits and assess the capacity levels of Europe's financial architecture. In its final report, the *Wise Persons Group* concluded that the system is highly fragmented, and activities should be better coordinated. It also devised various scenarios (1-3) for creating a central European Development Bank.

Scenario 1: the EBRD could be developed as a European Climate and Sustainable Development Bank, with the EIB discontinuing its non-European activities. A strong external structure would enable the EBRD to instigate and support projects and implement structural measures. However, this capacity would have to be built from scratch for sub-Saharan Africa. This would pose a challenge, as the bank has so far only had limited experience in fragile and low-income countries. It must also be borne in mind that the London-based bank is not an EU institution, meaning that additional shares would have to be acquired in order to strengthen the European nature of its governance. But its particular shareholder structure could represent an opportunity if (especially following Brexit) long-term cooperation with non-EU actors in a multipolar world becomes the order of the day.

Scenario 2: an autonomous EU Development Bank could play a key role in the EU's development finance system, whether as a separate institution or a mixed-ownership entity with multiple shareholders. As a newly created EU body that was not yet affected by any institutional path

dependencies, the bank could take greater account of partners' concerns and thus boost the positive image of EU development finance. However, any reservations on the part of Member States concerning centralisation and a potential monopoly would have to be dispelled. The decision about what powers a bank like this should have and where it should be based could be expected to trigger some tough negotiations.

Scenario 3: a further option, which was proposed as far back as the Camdessus Report of 2010 and discussed repeatedly by the EIB since then, would be to set up a subsidiary of the EIB. The direct access that it, as an EU institution, enjoys to other European actors as well as the efficient structures of the investment bank could be put to use at this subsidiary for its lending activities. Although it would have a global mandate, such an entity would focus on Africa. However, this would require the EIB to become more willing to take on risk, particularly with regard to poor and fragile states. From the *Wise Persons Group*' perspective, therefore, this would require a major shift in corporate culture and a clear separation from the EIB's core activities within the institution itself.

Setting up a mixed-ownership entity with multiple shareholders (Scenario 2) could significantly improve system coordination. However, the existing institutions and mandates would have to be completely restructured. Assuming sufficient capital, both creating an EU Development Bank and pooling external mandates in the EIB or EBRD (Scenarios 1 and 3) would establish a counterweight to China, other BRICS countries and other multilateral development banks. Yet scenarios 1 and 3 also risk giving birth to an institution with excessive powers that would sideline the national development banks. All three scenarios, particularly the creation of a new mixed-ownership entity, would entail significant capital requirements that would have to be weighed up against the potential benefits and that would hinder implementation in the event of any doubt.

Scenario 4: besides the scenarios put forward by the *Wise Persons Group*, there remains the option of retaining the existing structures but improving coordination and demarcating the boundaries between their regional or sectoral mandates more clearly. The interaction but also the competition between the EIB, the EBRD and the national DFIs allow the Commission to harness the comparative advantages of the individual actors. This complementarity should be borne in mind when deciding whether to maintain the status quo or opt for a restructure. National

Box 1: Scenarios for creating a European Development Bank			
Scenario 1	Scenario 2	Scenario 3	Scenario 4
Creating a European Climate and Sustainable Development Bank based on the EBRD	Creating a European Climate and Sustainable Development Bank via a mixed-ownership entity	Creating a European Climate and Sustainable Development Bank as a subsidiary of the EIB	Maintaining the existing structure but coordinating matters between national and multilateral development banks more efficiently

actors would be able to contribute their expertise and networks while an EU Development Bank identified potential synergy effects between the national executing agencies. Staff exchange schemes between national and European DFIs could boost informal dialogue and coordination, with national development banks promoting the acceptance of development cooperation in the Member States.

In the negotiations over the next MFF, therefore, the Council and Parliament should carefully consider to what extent reforms open the door to increasing efficiency and paying greater attention to partners' concerns. Proposals for reform should be more closely aligned with questions of content rather than chiefly serving institutional interests. In particular, the deliberations should not focus primarily on the quantity of investments and take into account that the opportunities for investment are already limited in some partner countries. Thus another criterion should be: which scenario is best placed to mobilise private-sector actors, and which arrangement is best suited to creating a favourable investment climate together with the partner governments. Competitive and financially viable green infrastructure projects will also have to be developed at local level if the climate targets are to be met. As far as the partners are concerned, swift implementation and efficiency considerations will play an especially important role alongside social rights and climate change mitigation. In particular, any

conflicting aims that could arise, e.g. when resettling communities during major infrastructure projects, must be prevented by applying transparent, uniform standards. Inconsistencies in content must also be avoided in order to preserve the EU's credibility. The recent push by the Council of the European Union to drop all fossil fuel funding is a step in the right direction in this regard. Going beyond this, a strong EU body would be required to coordinate matters with the national DFIs and development banks in order to harness their expertise for innovative project proposals. A well-coordinated, evidence-based EU development policy would enhance the visibility and effectiveness of Europe's development finance architecture. "Effectiveness" has multiple dimensions in this context. As well as targets for reducing poverty and combating the causes of forced displacement, greater prominence should also be given to human rights and environmental concerns. The impact assessment and accompanying research by a group of think tanks that the *Wise Persons Group* is proposing could make a fundamental contribution in this regard. In addition, the comparative advantages of EU development policy should also be highlighted in the international debate through a consistent narrative that showcases the benefits of European development finance. This would allow Europe with its socioeconomic model to position itself more clearly in the international cooperation arena.

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Dr Benedikt Erforth
Researcher
"Inter- and Transnational Cooperation"
German Development Institute / Deutsches
Institut für Entwicklungspolitik (DIE)



Dr Lennart Kaplan
Researcher
"Inter- and Transnational Cooperation"
German Development Institute / Deutsches
Institut für Entwicklungspolitik (DIE)

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