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Maximising EU Concessional Finance for Greater Leverage and Impact

An Options Spread

MIKAELA GAVAS · SAMUEL PLEECK · ANDREW ROGERSON · SAN BILAL · KARIM KARAKI

Abstract

Already constrained by the economic aftershocks of COVID-19, the impact of the war in Ukraine, and the food and climate crisis, low-income countries and lower-middle-income countries now face a combination of soaring debt and high interest rates. Confronted with insufficient liquidity to respond to these challenges and unable to access capital markets, they need additional concessional finance, in the form of grants and soft loans. The European Union (EU) already provides concessional finance, but it is not nearly enough to respond to their growing needs. With European budgets under more strain than ever, this paper puts forward the case for finding ways to maximise the overall efficiency and impact of European concessional finance and in doing so, better articulating and combining grants and concessional loans in its support and investment toolbox. To remain relevant and maintain relationships and influence with partner countries–even more in a world characterised by the polycrisis and geopolitical fragmentation–the EU will have to step up its game when it comes to providing more strategic concessional finance. The paper sets out six complementary and non-mutually exclusive options for maximising EU concessional finance with a view to a strategic set of decisions to be made for the next EU Multiannual Financial Framework.

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Maximising EU Concessional Finance for Greater Leverage and Impact: An Options Spread

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1. Introduction and scope

This paper aims to provide a better understanding of EU concessional finance and how it could be optimised to respond to the urgent needs of emerging market and developing economies (EMDEs), especially low-income countries (LICs) and lower-middle-income countries (LMICs).

Financing needs for urgent development priorities are huge and continue to grow, especially for low-income and highly indebted countries. Recent estimates find that EMDEs, excluding China, will need to invest an additional USD 3 trillion (10 percent of their gross domestic product) per year by 2030 compared to pre-pandemic (2019) levels to get on track to low-carbon, equitable, resilient, and rapid economic growth.[1] With their fiscal space constrained by the economic aftershocks of the COVID-19 pandemic, the impact of the war in Ukraine, and the food and climate crisis, EMDEs now face a combination of soaring debt, rising interest rates, and inflationary pressures, limiting access to and/or increasing the cost of finance. They cannot address this financing gap alone. External funding from developed country governments will be key, particularly on concessional (below-market or "soft") terms.

The vast majority of concessional finance needs are in LICs and LMICs, particularly in social sectors, including health and education. It is estimated that LICs and LMICs should annually invest an additional USD 2 trillion by 2030, of which around half would be needed for social sectors.[2] The external financing gap for upper-middle-income countries (UMICs) is estimated at USD 950 billion. Domestic finances in UMICs tend to be stronger and they can also absorb proportionately more of their lower public external gap on market-based or "hard" loan terms. For the same two reasons—their greater domestic fiscal space and better access to financial markets—more advanced developing economies are also less likely to be "nudged" into major policy reforms by relatively modest amounts of additional external funding, even on improved terms.

The augmented risk of debt distress in a volatile global environment (hit by multiple energy, supply chain, and interest rate shocks) increases the need for grants—or at least loans with a high grant element—particularly for LICs, countries transitioning from LIC to LMIC status, and fragile LMICs. At the same time, there are other LMICs and UMICs that have a much greater capacity to take on additional debt if that can be sourced at affordable, sufficiently concessional rates. For example, with a moderate share of government debt to gross domestic product (GDP) of 71 percent in 2022 and the ability to borrow from international capital markets, Morocco could benefit from additional concessional loans to finance strategic investments.

With European budgets under more strain than ever, this paper makes the case for finding ways to maximise the overall efficiency and impact of European concessional finance and in doing so, better

1 G20 Independent Experts Group. (2023, October 13). *The Triple Agenda: A Roadmap for Better, Bolder and Bigger MDBs*. https://www.cgdev.org/publication/triple-agenda-roadmap-better-bolder-and-bigger-mdbs.

2 Ibid.

articulating and combining grants and concessional loans (Box 1) in its support and investment toolbox. We are particularly interested in how the EU could make more strategic use of the toolkit of ***policy-based finance***, be it general budget support or sectoral policy-based support, including "results-based" finance, which can leverage external assistance well beyond the impact achievable by any series of standalone projects, especially for sectors which are not typically cash generating for public investors, like public education and health.

We set out six complementary and non-mutually exclusive options for maximising EU concessional finance. While we recognise that this may not be the moment to enact change in the short term, our objective is to set the scene for a strategic set of decisions to be made for the next EU Multiannual Financial Framework (MFF). In doing so, we assume a constant EU budget for external action in real terms. Therefore, the overall impact of the chosen options should be roughly cost neutral.

Disclaimer. Improved incentives—including concessional loans—also play a key role in persuading developing countries to invest more in global public goods (GPGs), like mitigating climate change. These GPGs, by definition, deliver major cross-border benefits that are not captured by the investing country, which therefore cannot be expected to fund them only or primarily on market terms. This imperative massively widens the concessional finance agenda. It also creates potential trade-offs between country groups, to the extent that opportunities for climate change mitigation investments at scale, for example, also tend to be concentrated in less-poor developing countries. How to balance such competing claims on scarce international assistance—as highlighted, for example, by the Bridgetown Agenda and the World Bank's Evolution Process—is, however, beyond our scope here.

BOX 1. What are concessional loans, and how do they leverage budget contributions?

By "concessional" loans, we mean how much their terms improve on what the market can offer. This is typically represented by a loan's grant element (GE), within the range of zero, for fully market-based, "hard" or "non-concessional" terms, to 100 percent, for a pure grant.

A package (or "blend") of, say, EUR 100 million, combining a stream of EUR 20 million of pure grants and one of EUR 80 million of market-based loans (so, an overall GE of 20 percent), theoretically allows a development bank (or the European Commission) to deliver five times as much financing up-front, compared to a standalone grant of EUR 20 million. Put another way, the fiscal cost of delivering the whole EUR 100 million is a fifth as much as if the entire package was delivered on a grant basis.

Loans, even if fully non-concessional, are not costless, of course. But public lending institutions with a solid repayment record and backed by the full faith of one or more top-rated (AAA or similar) government owners, like the large national and multilateral development banks in Europe, can raise funds at, or sometimes slightly below, relevant market cost benchmarks, like Libor or Euribor.

They might then pass the proceeds on to borrowers at similar or slightly higher rates, i.e., at minimal or no immediate net financial cost to themselves, ignoring non-repayment risk, of course. Any additional tax-funded subsidy, if the lender receives one, helps cover their costs and risks, as well as soften average on-lending terms.

From sovereign borrowers' perspective, market access may already be limited or non-existent, so the alternative interest rates they face may be significantly higher than this, and likewise the effective grant element of the terms offered by these public banks. Typical concessionality measurement formulas, like the Organisation for Economic Co-operation and Development's (OECD) eligibility test for official development assistance (ODA) loans, try to capture this feature by assigning a higher discount rate to lower-income (and usually less creditworthy) country groups, and vice versa.

The GE, which captures the degree of concessionality of any loan, also depends on the actual repayment schedule. For example, a Special Drawing Rights (SDR) loan fixed at 0.75 percent, repayable in level semi-annual instalments over 38 years with six years of grace, compared to an assumed 5 percent market reference rate, works out at a GE of 53 percent, well over the IMF concessionality threshold of 35 percent. These were, until recently, the regular International Development Association (IDA) loan terms (see footnote 6). They easily clear the ODA eligibility threshold of 45 percent, at its much higher (9 percent) discount rate.

2. The EU's current concessional finance toolkit

Although the EU does not have its own concessional finance facility on the scale of the World Bank's International Development Association (IDA) or the African Development Bank's African Development Fund (ADF), the EU and its Member States have been active in this field, with several concessional finance-related instruments and approaches in place.[3] **We argue, however, that the EU can do more to optimise the use of its resources and improve its concessional finance to deliver greater and more transformative impact.**

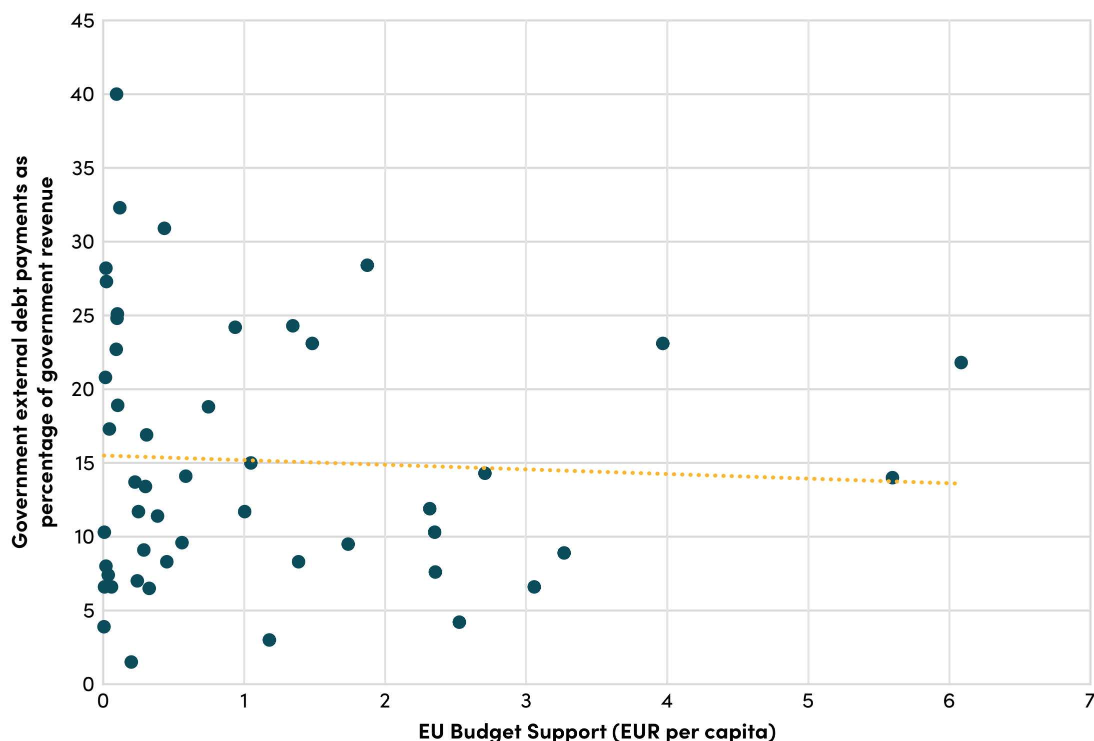
Budget support in the form of grants

At the EU level, the European Commission supports partner countries eligible for its external aid programmes under the Neighbourhood, Development and International Cooperation Instrument (NDICI)—Global Europe with almost EUR 2 billion annually in budget support in the form of grants only. These are provided independently of partner countries' creditworthiness, debt vulnerability or income category. As a result, amounts of EU budget support are uncorrelated, or even negatively

3 European Commission (2023), "*Budget Support: Trends and Results 2023*", retrieved from https://op.europa.eu/en/publication-detail/-/publication/627a8bb9-51db-11ee-9220-01aa75ed71a1/language-en/format-PDF/source-search

correlated, with some common indicators of debt distress, like a high share of government revenues absorbed by external debt service (see Figure 1). This is counterintuitive in a context where grants are of greater strategic and efficient use in countries with no fiscal space but less in countries that can access other financing modalities. The reason is that the EU does not consider its grant budget support for addressing macro- and balance-of-payment imbalances, but rather as sectoral budget support, with policy-based objectives, disconnected from debt-vulnerability considerations.

FIGURE 1. Government external debt payments as percentage of government revenue in 2022 and EU budget support per capita in 2021



Source: OECD CRS and Debt Justice.

Note: Countries represented in the figure are those benefiting from EU budget support in 2021. The selection excludes (i) EU candidates and potential candidate countries which receive significant amounts of budget support through the Instrument for Pre-Accession (IPA) and (ii) small islands developing states (SIDS).

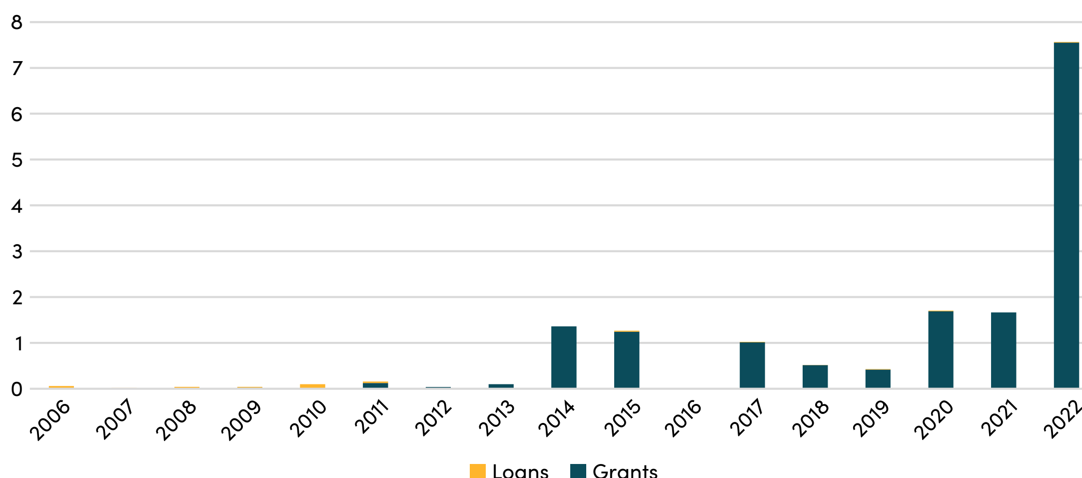
Macro-financial assistance

Beyond grants, the European Commission offers the Macro-Financial Assistance (MFA) programme, designed originally for Neighbourhood countries and conditional on International Monetary Fund (IMF) programmes and progress on democratic indicators. In short, it provides medium- and long-term support through concessional loans to help partner country governments work through balance-of-payments difficulties. Despite the recent rapid increases, MFA total annual loan disbursements were only close to EUR 8 billion in 2022 (see Figure 2).[4] This includes Ukraine,

4 For comparison, this was about a quarter of the disbursement level of the World Bank's IDA in the same year. Ukraine has also received a similar amount (USD 33 billion) for the two years since February 2022 via other facilities managed by the World Bank, mostly funded by grants from development partners, including EU members (https://reliefweb.int/report/ukraine/world-bank-group-financing-support-mobilization-ukraine-february-24-2022-enuk).

following Russia's war of aggression, which alone has received EUR 7.2 billion in the form of an exceptional MFA in 2022 and an additional EUR 18 billion by the end of 2023 as part of a special "MFA+" instrument. Two-thirds of the EUR 50 billion EU support provided under the new Ukraine Facility will consist of concessional finance,[5] including MFA. Up until now, most of the borrowers have been in the UMIC group.

FIGURE 2. MFA amounts disbursed by year, 2006–2022 (EUR billion)[6]



Source: European Commission, Report from the Commission to the European Parliament and the Council on the implementation of macro-financial assistance to third countries in 2022, COM (2023) 409 final.

The European fund for Sustainable Development Plus

The European Fund for Sustainable Development Plus (EFSD+) investment window implemented exclusively by the European Investment Bank (EIB) and targeting sovereign and non-commercial sub-sovereign operations is another example of the EU's instruments in the broad field of concessional finance.[7] As part of the EFSD+, the European Commission provides the EIB with grants for blending operations, and a EUR 26.7 billion guarantee,[8] de-risking the bank's investments in partner countries all over the world. In doing so, it boosts the EIB's capacities to provide more lending and/or more affordable lending (reaching, for example, more challenging geographical

5 Similarly, two-thirds of the EUR 6 billion under the Reform and Growth Facility for the Western Balkans will be in concessional loans.

6 Figure 2 includes disbursements until the end of 2022. In November 2022, the EU adopted the MFA + for Ukraine of a total of EUR 18 billion. Under this package, EUR 9 billion have already been disbursed. In 2023, the EU adopted an additional EUR 145 million MFA for Moldova, to be disbursed within this year.

7 According to the NDICI regulation, the EFSD+ should constitute "an integrated financial package supplying financing capacity in the form of grants, technical assistance, financial instruments, budgetary guarantees and blending operations worldwide."

8 Although the guarantee is managed by the EIB, given that the EIB does not invest more than 50 percent in any given operation, the EFSD+ investment window exclusive to the EIB always mobilises additional financing from other multilateral and bilateral public development banks (such as EBRD, AFD or KfW).

or sectoral contexts).[9] With its 2022 strategy towards fragile states and its ambitions laid out in its strategic roadmap, EIB Global is developing its approach to reach challenging contexts.[10]

The EFSD+ sovereign investment window is dedicated exclusively to the EIB. However, given that the EIB always needs to mobilise over 50 percent of the total amount of the investment from other multilateral and bilateral public development banks (PDBs), it can, to an extent, benefit from the substantial knowledge, experience and tools of European PDBs. However, more needs to be done to facilitate the collaboration between the EIB and PDBs to exploit their complementarities, respective resources, and expertise around policy-based lending. The EU should also consider options for how to use the EFSD+ to do more policy-based lending specifically.

Beyond its role in the EFSD+, the EIB also offers concessional loans, though with a significantly lower grant element compared to IDA and similar concessional finance windows (see Table 1).[11] Finally, even though EIB Global does not offer policy-based lending instruments, it is currently piloting results-based lending, which should enable the EIB to finance public sector expenditure programmes, with disbursements linked to the achievement of agreed sector results. This is an important addition to the sovereign lending toolbox, where the financing is explicitly linked to the achievement of sector policy objectives.

Overall, and despite notable progress, more needs to be done to promote concessional finance. In particular, policy-based lending under the EFSD+ and support for the EIB's ability and capacities to take more off- and on-balance sheet risks in LICs and fragile states, merit further consideration. Expanding these approaches would enable the EU to provide sovereign concessional finance to where it is most needed.

9 Limited information on EIB lending volumes in the context of the EFSD+ Window 1 is available to date.

10 EIB Strategic Approach to Fragility and Conflict (2022). https://www.eib.org/en/publications/eib-strategic-approach-to-fragility-and-conflict; EIB Global Strategic Roadmap (2023) https://www.eib.org/attachments/lucalli/20230336_eib_global_strategic_roadmap_en.pdf.

11 In 2022, ODA loans for LDCs provided by EU institutions including the EIB had an average grant element (GE) of 57%, with an interest rate of 1.2% and maturity of 22 years (DAC ODA loan monitoring report, 2023). Regular IDA terms for moderately-indebted low-income countries are now 50-year, zero-interest loans, with a GE of 73%, calculated using a much lower discount rate (thus understating its grant element advantage over EU terms). This replaces earlier packages consisting of equal proportions of (100%) grants and IDA 38-year loan terms (53% GE), so approximately 76% GE overall. (This is the kind of combination which the Commission should be able to reproduce, by adding a new instrument of long-term low-interest loans alongside reduced volumes of pure grants, within an overall country grant envelope, perhaps in different proportions according to country conditions).

TABLE 1. Overview of selected loan terms among multilateral development banks (concessional windows)[12]

Creditor	Loan Type	Grace Period (years)	Maturity (years)	Interest Rate	Service Charge	Commitment Fee	Amortisation
EIB	EIB Sovereign[13]	From 4 to 10 where justified	From 20 to 30 where justified	Base rate + [0.90–1.00%] or fixed rate equivalent	0%	0%	Flexible
IDA	Small Economy	10	40	0%	0.75%	0–0.50%	2% yr 11–20 4% yr 21–40
IDA	50-Year credit	10	50	0%	0%	0–0.50%	2.5% for yrs. 11–50
ADF	Regular	10	40	0%	0.75%	0.50%	2% yr 11–20 4% yr 21–40
ADF	Advance	5	40	0%	0.75%	0.50%	Annually
ADF	Blend	5	30	0%	1.75%	0.50%	
IFAD	Highly concessional loan terms	10	40	0%	0.75%	0%	Semi-annually equal
IFAD	Blend term loans	5	20	1.25%	0.75%	0%	
IFAD	Loans on ordinary terms	3	15–18	100% of variable reference rate	0%	0%	
AsDB	Group A (Concessional Assistance Only): Project Loans	8	32	1% during the grace period 1.5% during the amortisation period	0%	0%	Equal
AsDB	Group A (Concessional Assistance Only): Policy Loans	8	24	1% during the grace period 1.5% during the amortisation period	0%	0%	Equal
AsDB	Group B (OCR Blend)	5	25	2%/year	0%	0%	Equal
AsDB	Emergency Assistance Loans	10	40	1%/year	0%	0%	Principal repayment at 2% per year for first 10 years after the grace period and 4% per year thereafter

12 We were unable to verify the range of EIB interest rate subsidies in favour of developing countries, funded by the EU, for specific purposes or sectors. We understand the reduction to be up to 3% however. The EIB's standard rates shown in the table, with their mark-up on the EIB's market borrowing reference rates, are not concessional as defined in this paper. They are analogous to other market-based MDB windows such as IBRD.

13 Based on anecdotal evidence as lending terms not publicly available.

TABLE 1. (Continued)

Creditor	Loan Type	Grace Period (years)	Maturity (years)	Interest Rate	Service Charge	Commitment Fee	Amortisation
IsDB	Islamic Solidarity Fund for Development (ISFD) Loans	3–7	15–25	0%	0–1.5%	0%	Annually equal
IsDB	ISFD Loans (High Poverty Content)	10	30	0%	0.75%	0%	Annually equal
JICA	LICs/LDCs	10	50	0.01%	0%	0%	Dependent on the loan agreement
JICA	LDCS/LICs	5–10	10–30	[0.10%,1.20%] (fixed) TOR+ [0.15%,0.50%] (floating)	0%	0%	Dependent on the loan agreement
JICA	LMICs	5–10	10–30	[0.35%,1.70%] (fixed) TOR + [40%,1.10%] (floating)	0%	0%	Dependent on the loan agreement
KfW	Sovereign Loans	5–10	20–30	0.75%	0%	0%	Flexible
AFD	Loans to States	Avg 15	Avg 15	2.50%	0%	0%	Flexible
AFD	'Soft Loans'	Avg 10–30	Avg 10–30	0.25%–1%	0%	0%	Flexible

Source: Lions Head 2022, Unpublished. The table has been updated to reflect new IDA terms.

Policy-based lending

At the national level, several EU Member States have different means of providing concessional finance. The first is through their national public development banks (PDBs).[14] Not only do these institutions have a track record in financing public sector operations, but they also offer additional tools, including policy-based lending in the case of French AFD, German KfW (over EUR 1 billion annually) and the Italian CDP. In 2021, these three institutions, together with the Spanish development agency AECID and, most recently, the Polish development bank, BGK, signed an agreement to form the Joint European Financiers for International Cooperation (JEFIC). This new structure, which pulls together financial and technical expertise, represents an opportunity to increase co-financing operations, including sovereign policy-based lending for specific sectors. Policy-based lending is particularly relevant for MICs, which often have a greater capacity to implement reforms. It is worth stressing that policy-based lending can usefully be combined with non-repayable support, including in the form of technical assistance for reforms and capacity building. Thus, grants not only serve to increase the concessionality of policy-based and results-based lending, but to strengthen the capacity of LICs and fragile countries to effectively absorb and make better use of policy-based loans.

Lastly, beyond the EU landscape, EU Member States are also active in providing concessional finance in their capacity as members and shareholders of several multilateral development banks (MDBs), including the World Bank Group, through IDA.[15] These MDBs have solid experience and a track record of providing concessional finance under multiple forms, including policy-based lending. Note that proposals by the recent Eminent Persons Group to the G20 for global financial reform to enable a "Triple Agenda" of growth, poverty reduction and climate finance, included roughly *tripling* IDA annual disbursements from some USD 30 billion pre-Covid to around USD 90 billion by 2030.[16] Some of this additional volume can be funded through higher future loan repayments and some from additional market borrowing, but the largest single increase would have to come from additional grants from national IDA donors, including the EU Member States. Moreover, as MDBs start to look for innovative ways to increase available funding, they should also cooperate more efficiently by aligning their reporting framework and by working as a system together with partner countries.

14 In February 2024, members of the Joint European Financiers for International Cooperation included the Agence Française de Développement (AFD), the Spanish Agency (AECID), the Polish development bank (BGK), the Italian Financial Institution (CDP), and Germany's state-owned KfW.

15 EU MS contributing to IDA during the 2020 replenishment include: Austria, Belgium, Croatia, Cyprus, Estonia, Finland, France, Germany, Hungary, Italy, Latvia, Lithuania, Czechia, Denmark, Luxembourg, Netherlands, Poland, Portugal, Slovak Republic, Spain, Sweden.

16 G20 Independent Experts Group. (2023a, July 19). Strengthening Multilateral Development Banks: The Triple Agenda. https://www.cgdev.org/publication/strengthening-multilateral-development-banks-triple-agenda.

3. Six options to optimise the leverage and impact of EU concessional finance

A. Options implemented solely or largely by the European Commission, drawing on the EU budget and related borrowing facilities

1. Optimise the use of existing European Commission budget support by combining (new) loans with (existing) grants

Rationale: Systematically relying on grants to finance policy reforms in partner countries is neither efficient nor equitable, and it limits both the volume and the impact of investments. Concessional loans can also have important intrinsic advantages over grants, including helping countries improve investment appraisal and debt management as well as forging more equal partnerships. The European Commission could consider complementing the use of grants for budget support with new concessional loans, especially for partner countries whose macroeconomic context and debt-carrying capacity are sustainable. This does not mean that grants (and grant elements implicit in concessional loans) are not relevant, but rather that they should be used strategically, for countries with limited or no fiscal space to invest in sustainable development. Decisions on allocating budget support solely in the form of grants should also be based on debt sustainability assessment criteria in addition to the current set of criteria. There are, of course, budget implications for the cost of subsidising on-lending terms to more vulnerable countries, but these will be a fraction of the face value of the additional financing deployed. The combination of grants and loans could be earmarked for specific sectors with policy objectives agreed between the EU and the relevant partner countries, with grants also considered for technical assistance and capacity development to support sectoral reforms.

Considerations: While this option makes sense from a technical perspective, and is established practice outside of the EU institutions, it may be harder to sell from a political perspective—at least in the short term. Objections may arise especially among partner countries where we would expect to see a shift from grants to concessional loans, as well as their Member State supporters. Even if the *quid pro quo* involves much larger overall funding availability for them, this may still be the case. Such a shift could, however, be envisaged in the context of the upcoming negotiations of the 2028–2034 MFF, with the European Commission's Directorate General for International Partnerships (INTPA) engaging in dialogue with partner countries on the appropriate distribution between grants and loans.

From an internal European Commission institutional perspective, questions around responsibilities for the management of concessional loans will necessarily arise. As INTPA currently lacks the capacity to manage concessional lending, other directorates may be more involved. The EIB

know-how and lending capacity could be mobilised to provide loans in conjunction with national PDBs, under the Commission's overall policy guidance.

2. Extend the MFA well beyond the neighbourhood, while retaining its balance-of-payments support focus and democratic progress conditions

Rationale: The European Commission (via ECFIN) already provides some concessional loan finance through the MFA in a limited set of countries, and in doing so, provides a set of tools and instruments complementing IMF programmes. Expanding the MFA to sub-Saharan African countries could, in principle, be efficient (building on existing tools, instruments, capacities, and knowledge), effective (given that the MFA has worked well thus far, including in responding to crises such as in Ukraine), and coherent (having a homogenous approach between countries in the Neighbourhood and those in Africa—based on the same criteria for eligibility).[17] Also, its basic eligibility framework, linked to IMF supervision and to democratic progress indicators, is well established and understood. There are potentially 23 LICs and LMICs outside of the EU neighbourhood, including 14 in sub-Saharan Africa, that currently meet the eligibility criteria for MFA.[18]

Considerations: Expanding the scope of the MFA to additional countries could be challenging from a political perspective. While there has been some interest in exploring such an option, and some exploratory discussions, any substantial expansion of the geographic reach of the MFA has been so far opposed by EU Member States on the grounds that it was never intended to operate far beyond the EU Neighbourhood. Its expansion would, of course, also require additional funding from the EU budget, albeit leveraged through loans (see box 1). This is currently an unlikely prospect, given the immediate budget constraints that the EU and the Member States face, including from ever-expanding geopolitical commitments like Ukraine.

Of lesser importance is the issue of operational capacity in INTPA, which would need to be boosted to facilitate a smooth and effective implementation. Overall, this option could only be thoroughly developed in the longer term, within the upcoming MFF 2028–2034, provided that EU Member States are interested in pushing for such an approach.

17 It is worth noting that until the Lomé III Convention, the EU provided not only grants, but also concessional loans to the group of African, Caribbean and Pacific (ACP) countries, called "special loans," combined with interest rate subsidies (see Lomé III Convention Art. 194 & 196). It is only with the Lomé IV Convention, at the end of the 1980s, and with the debt trap many developing countries were experiencing, that the European Commission offered to provide ONLY grant budget support, so as to not further exacerbate the debt problem of many ACP countries.

18 Pleeck & Gavas (2023). A lifeline for Developing Countries: The Untapped Potential of EU Macro-Financial Assistance. Center for Global Development.

B. Options implemented mainly by the EIB, but with support from the European Commission, EU budget, and Member States' public development banks

3. Empower the EIB to engage in policy-based lending

Rationale: While the EIB already provides concessional loans with the backing of the EU, the EIB, as the "EU Bank," could do more by integrating policy-based lending into its financing toolbox. In doing so, the EIB would provide partner countries with flexible and liquid funding to support policy reforms in given sectors. The EIB could build on its recent experience of results-based lending, which links disbursements to the achievement of policy objectives in a specific sector. This approach could:

- Capitalise on the existing strong coordination with the European Commission, which is steering EIB investments towards achieving EU policy goals (including in the context of the EFSD+), with the guidance of the EU Member States as sole EIB shareholders, and with the EIB local offices in EU Delegations in partner countries, making the EIB well-placed to provide policy-based lending in a way that reflects EU policy objectives and builds on the EU grant sectoral support for reforms.
- Strengthen a European approach to policy-based lending, which has so far been led by bilateral PDBs at the European level. However, these institutions do not necessarily align with EU policy objectives.
- Add an additional tool at the disposal of the European Commission to steer concessional finance in a way that leverages limited public funds, including in the context of the EFSD+, where the EIB has exclusive access to guarantees targeting sovereign and non-commercial sub-sovereign operations. In doing so, the European Commission could further build synergies between the investments under the EFSD+ and policy reforms—an issue often raised in the past, including by the 2020 EFSD Implementation Report.

Another option related closely to policy-based lending would be to develop, based on existing instruments, an integrated concessional financing solution by pairing EU budget financing in the form of grants with EIB Global Results-Based Lending loans based on common agreed results indicators, with co-financing from European PDBs. This option relates closely to Option 1 above.

Considerations: The EIB considers itself a "policy-taker" of the EU policy agenda and thus does not engage in policy-based lending, though it is not prohibited from doing so. Changing the emphasis would require political backing from its shareholders, some of whom have so far been reluctant to see the EIB doing more on this issue, as it can be perceived as competing with existing, national policy-based lending providers.

This is where collaboration with other European PDBs could be helpful, with bilateral PDBs potentially sharing good practices and expertise. The EIB, meanwhile, could identify more systematic ways to engage with its peers on this type of approach, including through the EFSD+. Though this

option would not require additional resources (the EIB benefiting from the EFSD+ guarantee could use it to engage in policy-based lending), it would take time to get the green light from EU Member States and build capacities (even if this could be boosted through partnership with Member States' national development banks). So, it is more likely to be implemented in the medium term.

4. Comprehensively review the use of EU guarantee instruments, including unblocking EIB constraints on sovereign loans to low-income countries via targeted country-risk guarantees (could be a corollary, or variant, of Option 3, above)

Rationale: The use of EU development loan guarantees for a variety of different settings and aims has so far grown organically, for many years, with inevitable inefficiencies and gaps. It now badly needs an overhaul. The European Commission and EU Member States should engage in a strategic overview of the deployment and effectiveness of the guarantee instruments at project, sector, and country levels.

As part of this review, EU policymakers and EIB shareholders should address the problem of the EIB's country risk profile limiting access by developing countries with low credit ratings to its sovereign lending. Targeted guarantees under the EFSD+ could counteract such country-risk restrictions, as against project risks (see, for example, the Currency Exchange Fund's initiative on the protection of poor countries against foreign exchange risks, KfW's initiative on local currency risks, and the EIB's past local currency capacity under the Cotonou Agreement's ACP Investment Facility).[19] Targeted subsidies could also be used to lower the cost of borrowing. This could be particularly helpful for countries with IMF programmes which restrict sovereign borrowing to concessional loans.

Considerations: Such a change of approach runs against the grain of the EIB's practice of deploying EU-funded grants as interest subsidies and/or risk guarantees based on a (relatively non-transparent) mosaic of project-specific considerations (for example, to extend infrastructure to populations that cannot afford full cost tariffs, to pilot innovative technologies, to promote green infrastructure components, etc.). Instead, it would need to focus on mitigating country risk portfolio restrictions and meeting legitimate country macroeconomic needs for more concessional terms. This would cover policy-based lending, if introduced as in Option 3 above, but also sovereign lending for specific sectors of existing EIB expertise, like energy and transport. The purpose would be to extend the EIB's country coverage without adding more portfolio risk. It would not be to subsidise otherwise viable investments with ODA, nor to encourage funding of public-sector agencies where private alternatives exist. It could be started at a pilot scale.

19 See examples from the Currency Exchange Fund (https://www.afd.fr/en/actualites/communique-de-presse/usd-200-million-capital-increase-tcx-investors-support-tcx-protect-poorest-against-fx-risks-amidst-covid-19); KfW's African Local Currency Bond Fund (https://global-gateway-forum.ec.europa.eu/news/global-gateway-forum-commission-and-kfw-sign-guarantee-agreement-enhance-local-currency-financing-2023-10-26_en) and EIB's ACP investment (https://www.eca.europa.eu/Lists/ECADocuments/SR15_14/SR_INVESTMENTS_EN.pdf).

5. Within such an overall review of guarantee instruments, open up to national PDBs the EFSD+ Guarantee Window for sovereign and non-commercial sub-sovereign operations, currently under exclusive EIB access

Rationale: The European Commission provides exclusive guarantees to the EIB through the EFSD+, which are used to invest in sovereign and non-commercial sub-sovereign operations. EU policymakers and legislators could consider opening up the EIB-exclusive investment window of the EFSD+ to other bilateral PDBs, which already engage in sovereign lending (including AFD, CDP, and KfW). This could enable bilateral PDBs to combine national guarantees with European Commission guarantees in a fully “open architecture,” leveraging scale and experience. Indeed, within the EU, the InvestEU guarantee operates in an open architecture, with the EU guarantee open to national promotional banks and institutions as well as the EIB and other international financial institutions.

Considerations: Debates around the merits of continuing the current exclusivity of the EFSD+ Guarantee Window for the EIB are inherently sensitive and divisive. They would not likely lead to a solution in the short term but could instead be re-opened as part of the future MFF 2028–2034. This option, however, should not be considered as a zero-sum game. A larger investment window for sovereign operations could allow the EIB to maintain similar levels of financing and national PDBs to both compete and cooperate for guarantees dedicated to sovereign lending through a Team Europe approach. This approach would provide the EIB with the necessary guarantees from the EU budget, allowing it to operate outside of the EU, while bringing in European PDBs knowledge and expertise, which, if well-coordinated, could lead to more efficient and effective investments and a strengthened European Financial Architecture for Development (EFAD).

C. Options to be implemented mainly through other regional and global multilaterals

6. Increase the EU’s multilateral contributions to other MDBs, especially IDA, and the visibility and coordination of the EU presence within them

Rationale: Instead of, or in addition to, pursuing a solution at the European level to foster concessional finance, EU Member States could support other, global/regional multilateral bank options individually or, more efficiently, collectively. The World Bank and other major MDBs have solid experience and expertise in policy-based lending, which the EIB lacks. In the case of the World Bank, IDA is seen by many as the key institution in this field for LICs and LMICs especially—and is currently undergoing a new replenishment cycle. The EU Member States could increase their participation, relative to earlier replenishments, both via individual stakes, as before (France and Germany are in 4th and 5th rank behind the US, Japan, and the UK), and perhaps via a contribution funded at the EU level. Another possible EU support focus is the ADF concessional facility (part of the African Development Bank). This is now implementing a new approach of reduced loan principal reflows balanced by upfront charges on

grants, supported by targeted donor contributions. Besides capital injection, EU Member States could also consider collectively investing in separate trust funds dedicated to providing concessional finance for LICs and LMICs for specific sectors (e.g., health) or themes (e.g., fragility).

Alternatively, the same funds can be deployed for additional risk guarantees for specific new programmes or portfolios (like climate change or education), freeing up the equity capital of the banks that would otherwise have to underpin them.

Considerations: While this option appears efficient, and builds on well-tested concessional loan mechanisms already operating at higher volumes than EU ones, EU Member States may see at least three drawbacks:

- Concessional finance is not only a technical tool but is highly political, granting providers potential political gains and influence in partner countries. Given the current geopolitical fragmentation globally, EU Member States may prefer to opt for an avenue allowing them to remain more visible individually—whether at the bilateral or European level—to reap all political benefits arising from this type of finance.
- At the more operational level, EU Member states would arguably have less control over how their contributions are disbursed; they have arguably less control over IDA or the African Development Bank than over the European Commission or the EIB.
- The EU via the European Commission can, however, legally, and already does in practice, contribute to specific multilateral trust funds in its own right, and exert considerable oversight on how funds are spent via dedicated memoranda of understanding. However, it is not a voting shareholder/member of the governance structure of the relevant apex institutions, like IDA, with the notable exception of the European Bank for Reconstruction and Development (EBRD). Changing such formal structures to include a common EU voice would require an even wider consensus, probably involving some dilution of existing ownership positions.

Potential alternatives or variants could be explored, allowing EU Member States to have more influence on what and how such multilateral windows finance, including by earmarking some of their contributions, and/or progressively seeking some significant, initially non-voting, status for European institutions as such within their governance framework, as is already formally the case for EBRD. However, such flexibility can be explored only if the more influential EU Member States already active in windows like IDA agree it is desirable in principle, which is not given (even if EU collective contributions could partly relieve funding pressure on individual EU Member States).

Such a step would make better sense if it were embedded into a broader strategy aimed at enhancing the EU's coordination in the MDBs. There has been some progress related to EU coordination on that wider stage, but there is still a long way to go. A renewed effort could pay good economic and political dividends.

4. Preliminary cost-benefit snapshots of options

All six options come with various financial and political implications for the EU. Here, we attempt to provide a preliminary cost-benefit assessment of each option based on the financial and political costs and the impact of EU concessional finance flows, as well as a crude snapshot of the likely time dimension for implementation (not including that required to reach political consensus to proceed at all, captured in the Political Cost column). We assume the package of options selected should remain broadly budget-neutral (in real terms).

TABLE 2. Summary cost-benefit analysis of options for optimising EU concessional finance

Option	Financial Cost	Notes	Action Time Frame	Political Cost	Notes	Benefits	Notes
1. Add loans to European Commission budget support tool	Low	Uses leverage: the budget impact depends on weighted average grant element of new terms offered, and rate of expansion of new loans. Could be designed to be fiscally neutral.	Short-term	Medium	Might be divisive, via e.g. resistance to country grant reallocation; needs realignment of European Commission capacity, new financial regulations etc (= more implementation time).	Medium-high	More upfront support volume, better use of existing grant pool, middle-income grantees can be compensated for harder terms.
2. Extend MFA beyond Neighbourhood	High	Depends on coverage-need to retain strict eligibility rules; also grant elements to be determined.	Medium-term	Medium	Precedent of Neighbourhood support at stake; fears of higher risks; internal management concerns.	Medium	If restrictions on democratic progress and IMF programme supervision retained only some 20 countries eligible.
3. Empower EIB to engage in policy-based lending	Low	Policy-based lending is not inherently riskier than project loans (to same country credit groups), covered by existing EFSD+ guarantee.	Medium-term	Medium	Opposed by some Member States and their PDBs, questions the role of the European Commission in steering policy; EIB capacity takes time, could be built by collaboration with national DBs	Medium	Shift from project to programmatic approaches is inevitable for all MDBs, including the EIB: it could have a multiplier on country performance.
4. Unlock EIB sovereign loans via guarantees, concessional terms where necessary (under overall EU guarantee review)	Low-medium	Depends on the pipeline, the extent of guarantees required and grant element. The main objective is to unlock (some) lending to moderately debt distressed LICs.	Medium-term	Low-medium	Lower resistance likely within current (no policy-based) lending mandate, could be an add-on to option three with the same caveats.	Medium-high	Depends on range covered and demand factors, more likely to have a higher impact if combined with policy-based lending mandate expansion (see option three).

TABLE 2. (Continued)

Option	Financial Cost	Notes	Action Time Frame	Political Cost	Notes	Benefits	Notes
5. Open up EIB exclusive EFSD+ guarantee window to national PDBs (under overall EU guarantee review)	Low-medium	Not a zero-sum game with EIB, but unlikely to see a very rapid overall increase in calls on guarantees.	Long-term	Medium	Potentially divisive and politically sensitive regarding the role of the EIB as the EU's 'natural partner'; questions on European as against national policy steers and ability of the European Commission to influence.	Medium	Enables scale and an 'open architecture' encouraging greater competition.
6. EU to invest alongside Member States in non-EU MDBs	High	Entry stakes would have to be substantial to secure visibility and influence; highly leveraged stakes, however.	Medium-term	Medium-high	EU has given grants to other multilaterals (e.g. Global Fund, IBRD, EBRD), but Member States will want to protect their own visibility/sphere of control; there could be hybrid governance arrangements, within an initially smaller earmark, to allow significant EU influence.	Medium-high	Highly impactful players with established reach into important categories of countries not receiving EU concessional loans; builds on well-tested mechanisms. Raises EU combined policy profile on regional and global stages.

5. Conclusions

The EU already provides concessional finance, but it is not nearly enough to meet the growing needs of LICs and LMICs. To remain relevant and maintain relationships and influence with partner countries—especially in a world characterised by the polycrisis and geopolitical fragmentation—the EU will have to step up its game when it comes to providing more and more strategic concessional finance.

This paper highlights a set of non-mutually exclusive options that could lay the ground for discussions in 2024–2025 based on the results of the Mid-Term Review of the EU's financial instruments, and decisions ahead of the next MFF. Now is a good time to consider the intrinsic merits of such options, before those framework negotiations begin.

The EU and its Member States have the bandwidth to operationalise the different options. Before doing so, they may want to take a step back and engage in more strategic discussions on what they hope to achieve by boosting concessional finance. Is it solely about increasing the volume of concessional finance or are there specific priorities they want to pursue, and in doing so position the EU more strategically? For instance, do they want to target concessional resources towards fragile countries? Should concessional finance primarily serve social sectors, or be used to attract additional investments including from the private sector? How can concessional finance best respond/build on partner countries' priorities? To what extent should the EU concessional lending be aligned to the EU "policy-first" objectives, and what are the priorities for these? Does the EU want to boost its development and geostrategic clout through policy-based lending? This reflection will help the EU and its Member States use concessional finance in a more strategic way, which is important given their constrained fiscal budget.

In addition to thinking more strategically, the EU and its Member States should pay careful attention to the costs and timeframe for implementation of each of the options laid out in this paper. Given the current needs and urgency, they must put forward solutions that can be deployed fast, efficiently, effectively, and in an agile manner. The lessons from the Mid-Term Review and evaluation of EU financial instruments should be taken onboard—including the slow pace of implementation of the EFSD+ open architecture window—which can affect the relevance and effectiveness of the options to maximise concessional finance. Combining strategic and practical thinking should help the EU and its Member States to understand which of these options they should prioritise.

It is tempting, however, to focus initially on fiscally low-cost options. These include expanding an existing loan programme (the MFA) with a commensurate (modest, in the scale of the EU) increase in EU borrowing authority and/or guarantees; or switching some NDICI grant aid into concessional loans, in a fiscally neutral way, such that countries "losing" pure grants would "gain" overall up-front volume to compensate. The design of the scheme would, of course, also hinge crucially on the average grant element of the new loans, and the size of the gap between average borrowing and lending costs in any given interest rate context.

However, the European Commission and within it, INTPA, have had only limited direct exposure to the world of development banking and many might argue things should remain that way. The required changes in working methods and procedures may take considerable time to bed down, and there is no silver bullet. Of course, hypothetically the same programmes could be managed by the EIB and/or the national development banks under strategic criteria set by the Commission, which raises further complexities. Consultations suggest that, currently, there is limited appetite within the European Commission and among EU Member States to broaden the scope of MFA (Option 2) beyond specific circumstances, as in the case of Ukraine.

Complexities will also have to be addressed for expanding the EIB's mandate into policy-based lending (Option 3), but this could usefully complement and on some occasions, substitute for the current grant-based sectoral support provided by the European Commission. It could usefully build on and further develop the recent EIB Global results-based lending. In doing so, considerations should be given to the merits of simultaneously encouraging some form of efficient collaboration with national PDBs whose incentive for greenlighting such options rather than going solo may not be strong to begin with (Option 5). A narrower approach, keeping the EIB focussed on sovereign project and sector-investment lending without a major policy dimension, but removing major roadblocks to effective access by LICs (portfolio risk restrictions on the supply side, sufficiently concessional terms for moderately debt-distressed countries on the demand side) might be more easily palatable (Option 4). It would not be costless, of course.

Finally, bringing an EU dimension into other (global or regional) multilateral banks is not just a theoretical possibility (Option 6). The European Commission has supported a number of significant trust funds at the World Bank and some thematic funds like the Global Fund to Fight AIDS, Tuberculosis and Malaria, and has its own seat at the table at the EBRD. Whether the leading EU Member State shareholders of, say the World Bank's IDA, would want to contemplate a more visible common governance presence and influence in such windows, even assuming the management and other owners welcome it, remains to be seen. On the positive side, this could extend Member States' financial reach indirectly, but of course, it may also be perceived as restricting their visibility and freedom of action, if only at the margin.

If there were easy answers without such trade-offs, the European financial architecture for development would not be so complex. As it stands now, it is also far from fully coherent in terms of delivering the outcomes most needed by developing countries and tackling global challenges.

It is also tempting to repeat important, and costless, truisms about the overarching need for, and advantages of, better coordination and improved division of labour among the EU regional players, including the European Commission, the EIB, the EBRD, and the EU Member States and their banks, which have surfaced in many past assessments of this architecture. However, this is not likely to get much rapid traction, unless backed with sufficient incentives, meaning targeted resources and guarantees aimed at attracting better efficiency, coordination, and specialisation.

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