Evaluation Report

Operations Evaluation (EV)

Evaluation of SME Global Loans in the Enlarged Union

Synthesis Report

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NOTICE

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GLOSSARY

Allocation	A single loan provided by a FI to a FB and presented for approval to the Bank as part of the justification process for funds already disbursed, or to be disbursed, by the EIB.
Allocation Procedure	The control mechanism designed to ensure that disbursed funds have been used for the intended purpose.
Article 267	Article of the "Consolidated Version of the Treaty Establishing the European Community" which defines eligible areas of involvement for the EIB.
BPs/bps	Basis Points. 1 bp = 0.01% of interest.
COP	Corporate Operational Plan
Disbursement	Tranche of funding supplied to a Borrower
EIB	European Investment Bank
EV	Operations Evaluation of the EIB
FI	Financial Intermediary
FB	Final Beneficiaries of the GL
GL	Global Loan
MLT	Medium- and Long-Term (Funding)
NPL	Non Performing Loan
Objective 1 Area	Objective 1 and Objective 2 regions, often called “assisted areas” or “less developed regions” within the EIB, are defined by the EC on the basis of macro-economic criteria (per capita GDP, measured in purchasing power parities, of less than 75% of the Community average for Objective 1 regions; unemployment rate, loss of industrial employment, population, etc for Objective 2 regions) or on the basis of geographical or demographic characteristics (peripheral regions, regions with low population density).
Onlending	The lending by the FI to the FB, when the FI is in receipt of EIB funding
World Bank (IBRD)	International Bank for Reconstruction and Development

Evaluation

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EXECUTIVE SUMMARY AND RECOMMENDATIONS

INTRODUCTION

The European Investment Bank (EIB) was originally established to provide long term funding for projects which would further the interests and policies of the European Economic Community. These projects were expected to be large: too large to be funded from domestic sources. However, policy developments in the 1960s gave the Bank the additional mission of funding smaller investments. To meet this new challenge, the Bank chose to maintain its existing, lean structure and adopted the "Global Loan" mechanism developed by the World Bank. In a Global Loan, a loan is made to a Financial Intermediary, which in turn provides an equivalent amount of funding to their smaller clients: the Final Beneficiaries. The Financial Intermediary takes the credit risk on the operations with these Final Beneficiaries and is responsible for: identifying the clients, appraising and approving their credit requests, disbursing the funds, and monitoring remuneration and repayment.

Global Loans have become an important part of the Bank's activity, representing 27 % of the Bank's EU lending approvals in 2004. Of this, 50% is meant to go to Small and Medium-sized Enterprises (SMEs). The Bank's guarantee requirements are the same for both Direct Loans and Global Loans, but the relationship with Financial Intermediaries can be more complex than with other Borrowers. Financial Intermediaries may also be intermediating lending to individual projects, guaranteeing direct loans, co-financing large projects, and have an involvement in the Bank's bond issues. On Global Loans, Financial Intermediaries typically make large numbers of small operations every year and therefore require a continuous flow of funding. The Bank has carried out a large number of repeat operations with many of its Financial Intermediaries, creating a sense of partnership between the two parties.

There are two main criteria for funding an SME under a Global Loan: it must meet the Bank's normal eligibility criteria, and have a project cost of less than EUR 25 million. Investments by SMEs are eligible in its own right, except for investments in excluded or sensitive sectors, and it would be rare for an SME to be involved in project which did not meet the project cost limit. Global Loans dedicated to SMEs were introduced during the 1980s, with an increased focus from 2000 onwards.

EVALUATION FINDINGS

For this evaluation, EV carried out a desk review of twenty-five Global Loans which were either dedicated to SMEs or which had SME as a principal lending objective. These operations were spread across sixteen of the current twenty-five Member States. Fifteen of these loans, in fourteen countries, were then selected for individual evaluation. The operations were evaluated against internationally accepted evaluation criteria: Relevance, Efficacy, Efficiency and Sustainability (see Appendix II), modified and grouped to meet the particularities of the Global Loan mechanism. The findings and ratings are grouped under the headings of Relevance, Performance of the Financial Intermediaries, and Performance of the EIB Global Loan. In addition, the evaluation considered EIB Value Added and the EIB Project cycle.

Relevance

Since the 1980s, the principle policy objective for SMEs has been to improve their productivity and competitiveness, with a policy objective of increased access to suitable funding appearing in the 1990s. The importance of the question of access was underlined at the conference on SME funding organised by the Economic and Financial Studies Division of the EIB in 2003.

All of the operations evaluated were intended to fund investments by SMEs, and many of these investments also supported a range of other EU policies, e.g. regional development, rational use of energy, etc. The Bank's allocation mechanisms are well-developed, and there is a high degree of certainty that funding went to SMEs. Therefore, if it can be assumed that all

investments by SMEs are in pursuit of increasing competitiveness and efficiency, then all except one of the operations evaluated can be rated either Good or Satisfactory.

However, the data available makes it difficult to measure the policy impact of Global Loans at the level of either the Financial Intermediary or the Final Beneficiary. It is particularly difficult to demonstrate Relevance to the EU policy of increased access to funding. This should not be taken to mean that access was not improved. The evaluation identified many individual examples of improved access, particularly in the new member states and with new intermediaries. The issue is that there is currently no mechanism for assessing the overall policy impact of Global Loans, other than by measuring the volume of funding provided.

Performance of the financial intermediaries

Financial Intermediaries have an incentive to perform well. On the one hand they have to meet shareholders' expectations, which encourages Efficiency, while on the other they have to meet prudential regulations which encourages Sustainability. The Bank's Financial Intermediary selection process is prudent and the Financial Intermediary types range from the very large to some of the smaller EU financial institutions. Financial Intermediaries generally handled the EIB's funding efficiently and effectively and where there were difficulties, these were due to factors beyond the control of either the Financial Intermediary or the EIB.

Performance of the EIB Global Loan

The total amount of the Global Loans was committed, fully disbursed and fully allocated in all except one of the cases evaluated. There were two cases where there was a delay, but both of these were with new intermediaries and can be accepted as part of the learning process. In the majority of cases, the stated objective of lending to SMEs has been met, but there were a few operations where the funding was less well directed. Where this happened it was always due to exogenous market or timing problems, and not a lack of will on the part of the Financial Intermediary to meet the original objectives. When funding went to non-SME's, the lending would still have been eligible for EIB funding under a different eligibility criterion.

The onlending for investments in industrial plant and equipment was normally for a term of between five and seven years, including any grace period. Overall, the term of the onlending ranged from three years for leasing operations, up to twelve years for property investments. The term of the lending to the Financial Intermediary was usually longer than the average term of the onlending, although there were cases were the onlending was substantially longer. The availability of longer duration funding from the EIB should encourage Financial Intermediaries to provide the Final Beneficiaries with loans of longer duration, and there was evidence of this where alternative sources of term funding were particularly limited. The Bank’s policy is to allow market forces to determine the on-lending conditions and, except where there was government intervention, all onlending was on terms which were dictated by a competitive marketplace.

There was no evidence that the credit quality of the Final Beneficiary portfolios was different to the general portfolio of the banks financed. It might be argued that this was a failure, because it would indicate that weaker SMEs were not gaining access to term funding. However, this is not necessarily true, because different types of bank target clients with different risk profiles. The availability of EIB funding allowed the Financial Intermediary to do more lending to its clients at the level of risk it normally found acceptable. There was no evidence that the availability of funding made Financial Intermediaries willing to accept higher risk clients. However, by providing additional funding to a wider range of banks, in line with an EIB policy of 2000, and particularly those dealing with higher risk clients, a larger number of such clients will have received funding.

EIB value added

The evaluation considered both financial and non-financial value added. Non-financial value added could be identified, particularly in new member states where the Bank is managing an SME facility on behalf of the European Commission. Elsewhere it was less significant, although staff would work in close collaboration with new Financial Intermediaries to develop their ability to handle the funding and to comply with the EIB's loan conditions. Conversely, the Bank did offer clear financial value added, particularly for smaller Financial Intermediaries and Financial Intermediaries in less developed markets. This took three forms: "currency", "term" and "funding advantage". The value added from "currency" applied where Financial Intermediaries in new Member States were able to borrow in a non-domestic currency, e.g. EUR or USD, for onlending to appropriate clients.

The "term" value added was found in all of the operations evaluated. The long-term nature of EIB funding gives Financial Intermediaries a better match of assets and liabilities and, in some markets, was becoming as important as the "funding advantage" value added at the time of the evaluation. This was partly because the Bank's funding advantage had been falling. Three distinct conditions were found which were affecting the Bank's funding advantage :

- Increasing liquidity in some markets driving down the cost of alternative resources;
- Other funding bodies making resources available at lower rates than the Bank offers;
- The costs of complying with the Bank's loan conditions and credit risk guidelines.

This may reflect the timing of the evaluation within the economic cycle, but in the liquid markets mentioned above, the Bank's net funding advantage is very small and approaching zero. When this happens, there is no incentive for the Financial Intermediary to take EIB funding unless there are enough other forms of Value Added to make the loan attractive.

All of the Financial Intermediaries in the evaluation could show the Bank's funding advantage being passed to Final Beneficiaries. However, the evaluation also found that competition played a much more important role in reducing costs to SMEs than the funding advantage offered by the EIB.

EIB management of the project cycle

All of the Financial Intermediaries evaluated had access to an SME client base and all had suitable procedures in place to originate, approve and monitor loans to this type of client. Nevertheless, there were substantial differences in operational procedures in areas such as categorisation of clients, risk pricing, etc. Bank staff had a sound understanding of Financial Intermediaries' business models, and were willing to work to find a suitable balance between the Bank's guarantee requirements and the type of security the Financial Intermediary could make available. However, much of this knowledge and experience is personal, rather than institutional. Similarly, the relationship between the Bank and the Financial Intermediary seems to depend on personal, rather than corporate, relationships. The appraisals carried out by the Bank were satisfactory, but with an emphasis on the credit risk and financial health of the potential Financial Intermediary, rather than its ability to handle EIB funds, and there was very little on specific SME aspects. The need to establish suitable guarantees, or to justify an increased exposure, or to establish exposure-shifting mechanisms such securitisation, seemed to absorb a large part of the lending departments' time and resources.

Apart from the allocation processes, the follow up of operations was limited. While allocations were handled well, there may be scope for improving the quality and types of data held in the Bank's IT system. Although the margin of error is not large, and there was no evidence of inappropriate lending, it would be difficult for the Bank to say exactly what the level of funding to SMEs is.

CONCLUSIONS

Apart from the difficulty of measuring the policy impact of the Banks SME Global Loan operations, the evaluation found that the current processes and procedures provide an efficient and effective means of providing funding to SMEs. Long-standing Financial Intermediaries continue to channel funds to large numbers of SMEs, while the diversification of Financial Intermediaries since 2000 has introduced new SMEs to EIB funding. However, the Bank's operating environment is becoming more difficult, and this is compounded by the heterogeneity of the financial sectors throughout the enlarged union.

The following recommendations focus on : improving the measurement of the Bank's policy impact, developing non-financial Value Added by product dissemination, and increasing financial value added through product development on the one hand, and reducing the costs of doing business with the Bank on one other.

TABLE OF RECOMMENDATIONS

	EV Recommendation	Accepted	Ops A/ PJ Comments
1.	To more clearly demonstrate the Bank's support for EU policy objectives, the Bank should : • Clarify its own SME policy objectives, putting them into the EU policy context; • Present clear, deliverable objectives for each Global Loan (GL) operation and measure the performance of the Financial Intermediary (FI) against those objectives, for example through a rigorous analysis of the FI's SME and overall MLT portfolios, *ex-ante* and *ex-p*ost; • Present the performance against objectives at appraisal for repeat operations, and summarise the results in the annual report on Global Loans. (§3.2)	Yes	a) There is a general consensus in the EU on the fact that support to SMEs (and therefore endeavouring their access to finance) is one of the most efficient ways to favour investment, competitiveness and job creation. This has been confirmed internally by the recent Management Committee's decision to possibly reinforce strategic priority given to SMEs in the Bank's lending operations in the EU, which has to be viewed in the context of the EIB Group. b) & c) The implementation of the GLs' Value Added framework at the level of each operation provides an answer to the need for a better formalisation of objectives at appraisal and for an ex post performance assessment. Consideration will be given to the opportunity to summarise results in the annual report on Global Loans.
2.	Appraisals should be more evenly balanced between credit/financial analysis, and the FI's ability to work with the Bank to achieve its objectives. (§5.2)	Yes	In the context of the Value Added framework, the capability of FIs to comply with the EIB requirements is to be assessed, notably the resources assigned to the marketing, allocation and reporting of the GL as well as the FIs' experience in the specific sector or objective targeted.
3.	The *Centre d'expertise* should use the Bank's EU-wide experience to develop a toolbox of onlending products which would increase Value Added to the Final Beneficiary. (§4.1)	Yes	The Centre of Expertise will continue to share experiences and disseminate best practices, taking into account the various country situations.
4	The *Centre d'expertise* should also seek to develop Value Added to the Financial Intermediary, and by extension to the Final Beneficiary, by identifying and developing best practices to allow the maximum level of funding within any given security situation. (§6.)	Yes	In 2004, the Centre of Expertise contributed *inter alia* to the formalisation of the strategy towards the banking sector and refined the value added approach on GLs. Decisions taken will now be implemented and the dialogue will be continued with RM on the credit risk policy implications.

5	The evaluation found that competition was more effective in transferring benefits to SMEs than contractual conditions. Devoting EIB and FI resources to tracking a funding advantage from the FI to the SME would reduce the Bank's Value Added for no policy benefit. Tracking at this stage should therefore not be recommended, except where the FI is not exposed to normal market forces. (§4.3)	Yes	Ops is implementing what was decided in the context of the Value Added framework: a financial advantage should be identified at the level of the financial intermediary as well as a mechanism to transfer part of this advantage to eligible beneficiaries, in this case SMEs. Competition should then ensure that maximum benefits are transferred to SMEs.
6	The justification for the 50% funding limit is unclear. It should therefore be reviewed, with a view to requesting the Board to either raise it substantially, or delete it altogether. (§3.4.2)	Yes	Ops is in favour of reviewing the 50% funding limit for each allocation, especially in the context of the new definition of SME.

* Final Beneficiary

1 INTRODUCTION

1.1 Background to the Evaluation

This evaluation forms part of the EIB's rolling evaluation programme which aims to achieve evaluation coverage of 10 % of the Bank's financial intermediation operations. Global Loans (GLs) are the means by which the Bank is able to fund investments which are too small for it to deal with directly. GL issues are introduced in Section §2. and the concept is more fully described in Appendix I. The Final Beneficiaries (FBs) of the Bank's funding can be in either the public or private sector, but all onlending has to meet the same eligibility and quality criteria as a directly funded project. In 2004, the Bank approved Global Loans with some 80 Financial Intermediaries (FIs) within the European Union, offering the possibility to fund nearly EUR 11 billion of investment. Global Loans therefore represent more than one quarter of the EIB's lending by volume.

The evaluation itself was focused on GLs which were intended to support the investment needs of Small and Medium-Sized Enterprises (SMEs) within the enlarged European Union (EU-25). Some of these operations were dedicated SME operations, but most had SMEs as a primary objective, with the possibility of supporting other eligible investments in areas such as energy and the environment. There is a clear separation between the Bank's relationship with its FIs and the FIs' commercial relationship with their clients: the FBs. **This evaluation is primarily concerned with the GL mechanism, and does not set out to evaluate the impact of either the FIs internal operations, or the FBs investments.** A set of 25 individual GL operations were selected for a desk review, aimed at identifying the key issues to be examined in detail during the in-depth evaluation phase. These operations were chosen to be representative of the size, scope and geographical coverage of the Bank's portfolio. Fifteen individual GLs were then selected for individual evaluation. The chosen operations, from fourteen different countries, covered as wide a range as possible of different types of FI and size of loan. Typically, an individual evaluation included background research on the FI and its market environment, a site visit for discussions with the management of the FI, and field visits to one or more FBs.

> *FB Case Study: Packaging Company*
>
> *The FB is a family-managed enterprise producing corrugated board and packaging. It covers almost the complete value chain from production through to product completion. The EIB funded investment was crucial to preserve the company´s competitive position. The company has a strong sense of social responsibility, as demonstrated by two key decisions. Firstly, it has decided not to relocate to a lower wage economy. It will remain and try to develop within its current community. Secondly, it has introduced an active staff development programme which is intended to maximise the potential of all of its employees, while also improving their productivity.*
>
> *This particular FB has been growing over a number of years and no longer meets the Bank's SME criteria. It is now a potentially attractive "mid-cap" client, which could take advantage of the Bank's recent introduction of a funding mechanism for this client category.*

This synthesis report is made up of six sections, including this introduction, which also covers the question of why there should be a particular need to make funding available to SMEs. Section §2. has already been mentioned, while the performance of the operations as measured against the Bank's standard evaluation criteria[1] is presented in Section §3. This is followed by a discussion of the EIB's Value Added in Section §4. Section §5. considers the EIB's management of the project cycle, with Section §6. presenting a set of conclusions and "lessons learnt".

[1] Relevance/Efficacy, Efficiency and Sustainability. See Appendix II for definitions.

1.2 The Financial needs of SMEs

Support for SMEs has been an EU priority since the 1980s, when all SME lending across the member states became eligible for EIB funding. This preferential treatment of SMEs is based on two characteristics: that they can exhibit high rates of growth and employment, and that they can have difficulty in finding sources of suitable funding. This evaluation is specifically concerned with the supply of Medium and Long-Term (MLT) funding to private companies which meet the EU definition of an SME[2]. However, while the EIB has adopted this definition as from 01 January 2005, the operations evaluated were based on the previous EIB definition which had higher limits. In practice, neither definition is particularly helpful in dealing with the financial sector. Most banks classify their clients by turnover, and very few can readily filter their clients using all of the EU criteria. FIs therefore err on the side of caution and submit allocations from FBs which are well below the limits. The result is that a substantial, but unquantifiable, number of eligible SME FBs miss out on EIB funding. The Bank has recently introduced a parallel funding mechanism, again working through FIs, aimed at larger "Mid-Cap" companies which will help to address this particular problem.

The question of whether or not SMEs need or deserve special treatment was discussed at a conference in late 2003, hosted by the Economic and Financial Studies Division (EFS) of the EIB. The conference Proceedings may be found at www.eib.org/efs under "EIB papers", Volume 8, No. 2, "Europe's changing financial landscape: The financing of small and medium-sized enterprises". The situation may be summarised by presenting the conclusions of the first two papers :

"SME finance in Europe: introduction and overview" – Rien Wagenvoort, EIB – EFS

"Bank consolidation and Basel II have widely raised the fear that banks may reduce their participation in the SME loan market segment. So far, these expectations cannot be borne by empirical findings. On the contrary, there are indications that recent and future developments in the European banking industry will actually foster SME lending.

That said, especially for firms with less (sic) *than 50 employees (or annual turnover with less than EUR 2 million) finance constraints still seem to hamper their development. It is worthwhile noting that a lack of financing does not necessarily imply a lack of debt. Indeed, credit rationing in the strict sense is rarely observed in France, Italy and Germany. However, this does not rule out that banks overcharge SME loans and, as a consequence, that financial market imperfections have a negative impact on the growth of SMEs and thus the economy at large.*

Public policy support of SMEs needs to be designed in such a way that relief is offered where financial constraints are most binding. In this respect, equity financing deserves more attention. According to a recent OECD report (OECD 2002), small businesses experience considerable difficulty in obtaining risk capital. In Europe, small firms are relatively unimportant on the equity market in comparison to the United States. Therefore, the promotion of secondary capital markets and venture capital funds need to rank high on the political agenda."

"Are finance constraints hindering the growth of SMEs in Europe?" - Rien Wagenvoort, EIB – EFS and Andre Meier, Ph.D. student at the European University Institute (Florence).

"Finding empirical evidence of finance constraints is inherently difficult, and very little is factually known about their relevance and consequences. Certainly, in a number of EU countries, small and medium-sized firms complain about limited access to credit markets and/or excessive financing costs. These complaints, however, do not tell us whether lenders have turned down firms for the wrong reasons. This paper substantiates the perception expressed by potential borrowers: our analysis shows that the sensitivity of company growth to cash flow rises as company size falls, which suggests that SMEs indeed encounter finance constraints that prevent them from fully exploiting their growth potential. The smaller the firm is, the stronger the binding nature of finance is.

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[2] Fewer than 250 employees, an annual turnover not greater than EUR 50 million, and an annual balance sheet not exceeding EUR 43 million. Please refer to Commission Recommendation of 6 May 2003, Ref : 2003/361/EC, for the full definition.

Second, in deriving the results we found that there is no such thing as a typical SME. The variation in balance sheet structure with each size class is much more important than the variation across the average firm of each size class. Some small businesses are therefore more likely to be finance constrained. Young and information-opaque borrowers with little credit history are more vulnerable to imperfections in financial markets than more mature firms. We find that quoted firms, even when small, suffer less from finance constraints than unquoted firms. Geographical differences are also an important determinant of the liability structure of the balance sheet, suggesting that national factors need to be taken into account when addressing the problem of finance constraints.

These findings substantially validate the current policy support given to SMEs, although there could be greater focus and an increased emphasis on support for equity funding mechanisms. They also suggest that EIB operations will be of greatest value for smaller, newer, more "difficult" SMEs, rather than well established, mature businesses.

2 THE EIB GL MECHANISM

A more detailed description of the GL process may be found in Appendix I.

2.1 Background

The basic principle of the Global Loan is quite simple: a loan agreement is signed between the EIB and the FI, in which EIB agrees to lend to the FI and the FI agrees to repay the money, having made loans to the same value to suitable FBs, e.g. SMEs. Within that framework, the FI accepts:

- operational responsibility for the identification, appraisal, approval, and monitoring of FBs and the use of the funds, although the Bank will test the eligibility of "allocations".
- the full credit risk under its normal security requirements for the lending to the FB.
- that it will meet the specific terms and conditions.
- to provide evidence that the funds were used for suitable purposes via the allocation mechanism.
- to provide a suitable guarantee to the EIB.

EIB Guarantee Requirements

By its statute, all EIB lending must be backed by an acceptable guarantee which meets the requirements of the Bank's Credit Risk Guidelines. However, there is also an over-riding exposure limit. For an FI which is a prime bank, the EIB's total exposure should not normally exceed 20-25% of its own funds, but the reference limit might also be 10% of the counterpart's total funding.

FB Case Study: Combined Heat & Power Plant

The investment was the creation of a small CHP facility, based on the site of a former aluminium processing plant, producing 3 MW electrical and 3 MW thermal energy. Historically, this plant had provided hot water for district heating but when the factory closed down it was not economic to continue producing either power or just hot water from the existing facilities. At present, the new plant meets all existing thermal demand except during exceptionally cold periods and, for most of the year, would be able to provide thermal energy for a planned industrial estate to be developed on the site. Electrical power is supplied to the National Grid under a preferential pricing scheme for generating facilities which are more than 75% efficient and which meet current emission regulations. The existing facility is probably too small to be cost effective without the preferential pricing and it may need to consider additional units if thermal demand increases. At that point, the plant might become sustainable in its own right. The plant was well managed and the sole manager had a sound grasp of business as well as technical issues. The availability of the term loan allowed a capital-intensive business to be set up without a track record, although there was secure demand from the municipality, which is a minority shareholder, and a ready offtaker for the electrical energy.

In return for the guarantee, the Bank offers :

- funding resources which might otherwise not be available to the FI.
- maturities which are comparable to the FI's onlending.
- a loan without risk pricing, resulting in a small funding advantage, i.e. a slightly lower interest rate than the FI's marginal cost of funds. This is not considered to be a subsidy.

2.2 Objectives of EIB Global Loans

The specific objective of Global Loans is to channel EIB funding to investments which are too small for EIB direct lending. Global Loans are therefore not policy objectives in their own right; they are a mechanism by which policy objectives can be achieved. In this particular case, the policy objective is the provision of funding to SMEs, in line with EU policy.

Below the overall EU Policy lies the Bank's own GL policy, most recently updated in 2000 when three specific policy objectives were introduced:

- Diversification of FIs in order to promote competition and the passing-on of the EIB's attractive financing terms to final beneficiaries;
- Transparency - i) ensuring that FIs inform FBs that part of the funding came from the EIB, ii) seeking to ensure that the EIB funding advantage is appropriately passed on to the final beneficiaries and iii) that GLs should have specific objectives in line with the Bank's COP, including SMEs;
- Reporting - the presentation to the Board of Directors of an annual report on the contribution made by GLs to the Bank's operational priorities.

The combination of EU and EIB policy objectives form the basis of the evaluation of the operations against the evaluation criterion "Relevance".

2.3 The Global Loan Process

Identifying Potential FIs

GLs usually follow on from an existing business relationship and, for many FIs, the GL is just one part of the relationship it has with the EIB. This may include co-financing on large projects, guaranteeing direct lending, intermediating lending for direct projects, and collaborating with the Bank on bond issues. In the 1990s, the average number of FIs increased at 6 per cent per annum. This figure increased by up to 50% after the change in policy in 2000, but even allowing for some dropping out of established FIs, there is a pattern of loyalty to existing business relationships. At the time of the evaluation, the number of FIs stood at some 200, with active operations in 21 of the 25 Member States.

Appraisal (ex-ante evaluation), Approval, Contract Negotiations and Signature

All EIB GLs are the object of an appraisal (ex-ante evaluation) to judge the FI's suitability as an EIB partner. These appraisals are standardised, but there are significant differences between the first operation with a new FI and repeat operations. Since 2000, the appraisal has also considered the willingness to ensure transparency (see paragraph §2.1 above) and to pass on the EIB funding advantage to the final beneficiaries.

Disbursement is usually dependent on a number of conditions being satisfied, particularly the question of the Bank's guarantee. The actual disbursement and allocation mechanism may vary, depending on the allocation procedure used and the depth of previous experience with the FI. However, for a FI with a long established GL relationship, a typical procedure would involve a request by the FI for a disbursement of a tranche of funding, at a time it chooses. It then has a period of twelve to twenty-four months to provide allocation data that can satisfy the Bank that the funds have been used appropriately.

2.4 Specific conditions of SME GLs

The Bank's eligibility criteria and allocation procedures limit the use the funds, and the FI has to be able to demonstrate that the funds have been used for a suitable purpose, regardless of the allocation procedure used. Since 2000, the FI has also had to be able to demonstrate that a proportion of the EIB's funding advantage is being passed on the FBs. Both of these requirements imply additional work, and hence cost, for the FI.

There are four more contract conditions which have to be observed, two of which are based on the need to operate in line with EU legislation:

- All investments should comply with EU environmental legislation.
- All FBs have to comply with EU procurement rules.
- The EIB has the right of entry to any FB it has funded.
- The FB should be aware that the funding has come from the EIB.

2.5 Constraints on EIB GL Operations

There are at least three constraints on the Bank's lending operations:

1. The willingness of FIs to take funds from the EIB as opposed to other sources, see §2.6;
2. The absorptive capacity of the market;
3. The ability of the FI to provide an acceptable guarantee.

2.6 Market Forces and the SME GL mechanism

The Bank does not have a privileged position in the marketplace and relies on its financial Value Added to persuade FIs to take its funding. Alternative sources of funding for FIs include own deposits, bond issues, the Inter-bank market, "Intrabank", e.g. from a parent company treasury, and other funding agencies.

The strengths of EIB's product are :

- Fine rates based on the Bank's AAA rating without additional risk pricing;
- Long term funding;
- Flexible disbursements: timing and currency.

Conversely, the Bank's weaknesses include:

- The FI has to comply with the Bank's loan conditionalities, particularly the allocation procedures and the need to control the flow of funds between the Bank and the FB;
- The additional costs to the FI of being appraised, monitored and evaluated;
- The cost of meeting the Bank's guarantee requirements.

3 PERFORMANCE OF THE GLS EVALUATED

3.1 Evaluation approach

It is important to repeat that this evaluation is of the Global Loan mechanism as applied to the funding of SMEs. It does not include the wider performance of the FIs, nor of the individual FBs. The EIB has no involvement in the FIs client selection and financing

processes, does not take FB credit risk[3] and does not interfere in the normal client relationship between the FI and the FB.

The performance of the Global Loans mechanism has been evaluated using the Bank's three principal evaluation criteria: Relevance/Efficacy, Efficiency and Sustainability, as defined in Appendix II. However, while considering each of these in turn is appropriate for the evaluation of directly funded projects, such an approach would not reflect the intermediated financing arrangements associated with GL operations. This section has therefore been structured as:

- Relevance : consistency with relevant EU and EIB policies (*relevance*).
- Evaluation of the FI: organisation, financial situation (mainly portfolio quality) and sustainability as it applies to the FIs SME operations (*efficacy, efficiency and sustainability*).
- Evaluation of the EIB GL: Amounts disbursed versus initial expectations, proportion of Loans going to target FBs; on-lending conditions and sustainability of the investments financed (*efficacy, efficiency and sustainability*).

A common template, shown in Appendix III, has already been used in the evaluation of GL operations, and allows comparability between different types of operation, with different types of FI, in different countries. The comparison of the ex-post results with the expectations and objectives at appraisal is used as the basis to evaluate the operation. An operation that has achieved more than its original objectives will be rated "Good", while a "Satisfactory" rating means that the performance has been wholly acceptable. Ratings of "Unsatisfactory" or "Poor" are applied if some or all the key objectives have not been achieved. It is difficult to separate Efficacy and Efficiency on GLs, so these have been evaluated together. The evaluation of a FI compares the current situation of the FI with the situation at appraisal. It assesses the improvements in its organisation and in its financial situation. Specific benchmarks, e.g. return on capital employed, capital adequacy ratio were not used to rate FI financial performance. The Bank does not take this approach *ex-ante*, and the evaluation therefore should not take it *ex-post*.

The GL operations selected for individual analysis were chosen to provide typical examples of different types of intermediaries in different markets across the EU. All of the operations were primarily intended for onlending to SMEs and four also included the option of financing small and medium sized investment by the public sector. The loans ranged from EUR 40 million to EUR 400 million, with an average EUR 115 million. Of the group selected, one was the object of an evaluation based on the information available within the Bank and on the comprehensive information already made available for an evaluation by the European Commission. Two others were the object of an extended desk-review, based on publicly available material and on the Bank's internal files.

The evaluation started in November 2004 and was carried out in three overlapping phases:

- A general overview of EIB financing using the GL mechanism and a desk review of 25 potential FIs for individual evaluation. This phase was used to identify both the most appropriate candidates and the key issues to be addressed during the individual evaluation phase.
- Individual evaluation of the fifteen GL operations selected.
- The preparation of this synthesis report, presenting the main findings of the previous phases , drawing conclusions and making recommendations.

[3] Except where additional security is provided based on either an assignment of rights relating to the Final Beneficiaries or a securitisation package based on a portfolio of SME loans.

The first phase of the evaluation was carried out by the EV team, which was augmented by two specialist consultants for the individual evaluation phase. The reports prepared by the EV team and the individual consultants formed the basis of this report which was drafted by EV.

3.2 Relevance

> *FB Case Study: City Centre Restaurant*
>
> *An up-market lifestyle restaurant offering first quality food and a show-case wine cellar. The restaurant is a conversion of a number of old, run-down buildings in the centre of a capital city, which is a major tourist destination. The conversion also created a small number of short-term letting apartments on the upper floors; directed towards tourists rather than business-people. Both the interior and exterior exhibit an eclectic design philosophy. The investment will have been substantially higher than for a more conventional restaurant, and the style may have a limited life. The investment therefore carries a higher than average risk. However, the Promoter has developed the facility incrementally, and the restaurant has a good reputation. The fundamentals of the business are probably sound, even if the appearance is somewhat* farfelu.

If the EU policy objective is interpreted as the provision of funding to SMEs, then all of the GLs evaluated are clearly consistent with EU objectives.

While there is an annual report on the performance of the Bank's GL operations, there is no completion or allocation report on individual FBs; and the failure to meet a priority objective may not be disseminated beyond the relevant Ops division. This approach follows a Board decision in 2000 to (i) discontinue the provision of individual allocation reports to the CA, (ii) replace it by an annual report providing an overview of EIB GL activity, and (iii) include in Board reports a review of the results of the previous operation for repeat operation. The evaluation confirmed that a paragraph on the performance of previous operations with the FI is included when a GL is renewed, but this usually limited to a breakdown of the allocations.

If the policy objective is expressed as being to improve productivity, competitiveness, job creation and access of SMEs to MLT funding, then the position is less clear. Specific objectives were not defined *ex-ante,* and therefore performance against those objectives could not be measured *ex-post*. Only two of the GLs evaluated, both in the same country, included these at approval and no loan proposals identified a performance benchmark. In fact, only one of the GLs evaluated contained any analysis of the FIs existing SME portfolio or of its SME operations which could have been the basis of a benchmark. See also Section §5.2. It might be reasonable to accept that a SME would only invest to improve productivity or competitiveness, in which case the volume of lending would be a direct measure of the policy impact. However, it would remain an unquantified assumption, and would not address the issue of increasing SME access to funding.

The obvious alternative would be to consider each FB individually, but this would be unrealistic; the EIB supports tens of thousands of SMEs every year.

This would suggest that any analysis needs to be at the level of the SME portfolio. An *ex-ante* analysis of an FIs MLT portfolio, including specifically the MLT lending to SMEs, would establish a performance datum. Repeating the analysis on a regular basis, either for each operation, or, say, every three years, would provide evidence of changes in lending patterns involving SMEs. Even allowing for macro-economic effects, this approach, already recommended in the "Review of the Portfolio Approach for SME Global Loans", would provide a measure of the policy impact of the Bank's GL operations.

3.3 Evaluation of the financial intermediaries

The fifteen FIs examined in-depth included :

- A parastatal institution with explicit state support, but without a state guarantee being available to the Bank;
- Two banks offering funding on commercial terms, but part of a mutual ownership or not-for-profit structure;
- Two FIs which were wholly owned subsidiaries of two other FIs included in the sample, but operating in a different country;
- Three FIs which were either wholly owned subsidiaries of, or effectively controlled by, larger banking groups banks operating in a different country from the FIs main business operations;
- Two were the specialist leasing companies of larger parent banks.

The remainder were conventional, independent commercial banks, with their main sphere of interest in a single member state or region.

The financial situation of the FIs evaluated varied from Satisfactory to Good. All were in good standing with the Bank, the various rating agencies, and their national regulator. All complied with normal prudential ratios, and all except one had wholly satisfactory levels of credit losses. The exception was the parastatal institution[4]. This accepts higher risk operations in line with government policy and, in return, receives coverage of some 50% of its credit losses. These are not exceeded and the institution is perfectly stable, although this stability depends on the continuing support of the government.

All the FIs evaluated were considered Sustainable. Only one FI was in imminent danger of a ratings downgrade at the time of the evaluation, and that was due to problems with the parent, rather than the FI itself.

3.4 The EIB GL

3.4.1 Commitments and disbursements

There were two cases where the allocation period had to be extended to allow the funds to be disbursed. In the first case this was mainly due to difficulties in setting up the required guarantee which were largely beyond the control of either the Bank or of the FI. In the second case there were short delays which can be attributed to the learning process and were not repeated in later operations. All other operations were disbursed and allocated within the normal time limits. The disbursement and allocation procedures appear to be well managed and the Bank Assistants in charge of controlling the allocation process handle their work effectively, including the day-to-day relationship with the FI.

The FI normally had the choice of either an amortising or a bullet loan, with the bullet averaging just over 50% of the length of an amortising loan. There did not appear to be any coherent rationale for the terms; reflecting the absence of portfolio analysis. However, if the GL would be used to fund real estate, e.g. for tourism SMEs, then the period was significantly longer. FIs fell into two clear groups: those which chose an amortising loan of 12 years or more, and those which chose a bullet of 6 to 8 years. After the choice between amortising and bullet, most FIs opted for the longest term available. FIs had the possibility of having different repayment conditions on different disbursements, but this option was rarely taken up. Two operations had significantly longer repayment periods than the average of each type; a 12-year bullet and 15 years amortising.

[4] Because of its particular status, this FI is neither a regulated nor rated institution.

3.4.2 On-lending conditions

Loan duration The term of the sub-loans was normally significantly shorter than the duration of the EIB loan. For the 15-year amortising loan referred to above, the onlending term was expected to be 7 – 8 years at appraisal. Full data was not always available, but onlending in amortising terms appeared to be a closer match with the terms of bullet loans. A degree of mismatch between the lending and onlending is inevitable and may even be desirable, to provide a smoothing effect between the stop-go nature of the Bank's funding. The number of individual allocations makes it impractical for the Bank to operate on a "back-to-back" basis and the system has to have sufficient flexibility to allow the FI to meet its funding needs. However, the mismatch in terms should be limited. It represents an additional benefit to the FI, although this benefit is likely to be small. Comparing the cost of EIB funds against an FI's average cost of funds makes an EIB loan look quite expensive, particularly if they usually rely on their own deposits.

Onlending rate and Funding Advantage The onlending of EIB funds should be at the finest rates, but this does not include a subsidy element and, as will be seen in Section §4.2, the net funding advantage is small. However, since 2000 there has been a requirement for a proportion of the funding advantage to be passed on to the FB. The evaluation found clear evidence of the funding advantage being passed to the FBs in all cases except two, and in those cases the competitive pressure almost certainly ensured that the FB received funding at the lowest possible cost. The actual mechanism varied, but there was only real transparency on the process with two intermediaries. The relative importance of the funding advantage may be seen from one particular FI, where introducing the lower liquidity risk of EIB funds had an impact on the cost to the SME which was several times larger than funding advantage itself. However, very few FIs had credit risk procedures which took account of that particular risk when setting the rate to the client. Again repeating a finding of the "Review of the Current portfolio Approach for SME Global Loans", the degree to which the Relationship Manager could vary the rate to the client was up to ten times greater than the funding advantage available from the EIB.

FB Case Study: Bio-Pharmaceuticals and Fine Chemicals

The Managing Director initially established a company providing medical analytical services in the first Science Park in the region in 1987, with some initial help from the FI. There are three main business areas :

- *Subcontract manufacture of liquid reagents and solutions. This provides a base-load activity and cash flow which supports the more advanced areas of the company*
- *Own well-established products, e.g. solutions for biological staining in laboratory medicine.*
- *New test-kit products to detect the presence of specific viruses, etc. These test-kits are the leading edge of the companies operations and are also developing spin-off products to be licensed to others, e.g. electronic dispenser and delivery mechanisms.*

The company employs 14 full-time and 7 part-time staff. Seven of these are graduates, including two PhDs, and all the rest are qualified technicians. The intention is to increase full-time employees to 20 this year. By 2004, the turnover had grown to EUR 700 000 and the company is aiming for EUR 1 million in 2005. The company is also now receiving some external funding support for its R&D and has now reached the stage where it will start capitalising its R&D expenditure.

The company's business prospects look reasonably secure, but the operation was a very significant risk for the FI. The Promoter was able to use EIB funds to convert an untidy structure operating in unsuitable premises into an R&D led organisation operating out of best-in class facilities.

EIB limit on "Project Cost" The Bank imposes a limit of 50% of project cost, as defined by the Bank, for each individual allocation. All FIs complied with this, and with the upper limit on allocations, although some allocations dipped below the lower limit. However, it is questionable whether the rationale for the 50% limit applies when dealing with SMEs through FIs. It was clear from the evaluation that applying the limit creates a mismatch between the lending to the FI and the on-lending to the FB. It is common for FIs to meet 100% of the debt funding need of their clients, and it is rare for it to fall below 70% for an SME. With the need to be able to show that the EIB funding advantage is being passed to the FB, it is necessary either to have multiple terms and conditions for the different amounts in a single contract, or to have two separate contracts for the same investment. Using a blended rate does not produce a transparent result.

In all cases, a stronger focus on the FB and its investment plan, rather than "projects" to be financed, seems reasonable.

3.4.3 Quality of the onlending

The Bank has no direct information on the quality of the onlending, regardless of the allocation procedure used. The Bank does not require FIs to report on the *ex-post* performance of its clients. Ten FBs were visited during the evaluation, in different countries, sectors and size category. All except one were performing well, but the sample was not wholly representative and in the case of one FI, it was very difficult to find an EIB funded FB which had not reimbursed its loan early. All except one of the FBs visited were operating in competitive markets, and the credit quality of the investments financed should be an acceptable proxy for the onlending quality. The level of non-performing loans of the FIs suggest that the investments have been well implemented, are achieving their operational objectives, and that the FBs are servicing their the loans.

FB Case Study: Hotel in Tourist Centre

Family owned hotel based on a grand, historic building in the centre of the city. The layout of the public rooms of the hotel is rather eccentric, but this has followed from a clear desire to retain as much of the fabric of the original building as possible. The ceilings in particular are fine examples and have been sympathetically restored, except in the loggia where the original has been retained. The investment was for the conversion of an adjoining, historic building to provide : 12 double bedrooms, 2 double bedrooms with disabled/wheelchair access, 1 single bedroom, 2 small conference rooms, additional toilet facilities, and sports and social facilities. The conversion was carried out sympathetically, making extensive use of recycled materials, e.g. terracotta roof and floor tiles.

Overall it is an architecturally and environmentally creditable project, bringing an old building back into economically productive use, which appears to be operating successfully.

All FBs were happy with the service they had received, but they tended to fall into two distinct categories: those which had problems getting access to funding, and those which had banks queuing up to lend them money. Predictably, the latter category were mainstream investments with established Promoters. Those with more difficulties were usually new or developing companies, or had slightly unusual business proposals. Given a choice of a longer-term loan at a slightly higher price, most of the FIs visited would go for a longer term, but the cost difference would need to be small. In one case, one or two bps made the difference between taking the FIs financing and financing from another bank. The EIB funding enabled the FI to win a specific contract, according to the FB, but this may have been hyperbole. There were also two further distinct categories of FB: those which were prepared to pay a loyalty premium to continue the financial relationship, and those which were only interested in the lowest price.

3.5 Aggregate GL performance

The results of the evaluation can be summarised as :

	G*	S*	U*	P*	
Relevance:					
Provision of funding to SMEs	7	7	1	-	
EU Policy Objectives **	Not adequately documented				
FI Performance:	1	14	0		
GL Performance:					
Commitment and disbursement	3	10	2		
Information to client		15			
Onlending conditions	Satisfactory				
Quality of investments financed	Implicit: satisfactory (through the quality of the FIs relevant portfolio) *- The Bank should focus more on the performance of the final beneficiaries (including fixed assets creation) and less on sub-projects financed*				
Overall:	4	10	1	-	

* G=Good, S=Satisfactory, U=Unsatisfactory, P=Poor

** Increased competitiveness and productivity of SMEs, Improved access to funding, etc.

Four operations were given an overall rating of "Good", and ten of "Satisfactory". One was rated "Unsatisfactory" overall and none were rated "Poor".

All the FIs were soundly based, well managed and financially stable. The actual process of lending, allocating, and recovering the funds has gone well. There are issues relating to the handling of the funding advantage and the traceability of EIB funds, but these are addressed in Sections §5.2 and §5.3. Similarly, all of the FIs evaluated individually were rated "Satisfactory" or "Good" in relation to their Sustainability. For the FBs, the information available suggests that they should be at least as sustainable as similar operations without access to EIB funds. Only one FI could show that its clients had a substantially higher survival rate than those of other FIs. This is probably attributable to its development role, with the FI offering substantial advice and business support services.

However, the question remains as to the Relevance of the lending. Setting aside the issue of whether all or most of the funds went to SMEs or some other eligible purpose, the issue of the exact nature of the EU and EIB policy remains. Is the policy to provide a pool of funding which is available to SMEs or is it, for example, to facilitate the access of SMEs to suitable sources of finance? If it is the former, then the operations score highly on Relevance. If it is the latter, then a clear rating cannot be given because there is very limited data available either *ex-ante* or *ex-post*, either direct or indirect.

FB Case Study: Wood Finishing Company

The company has been a client of the FI since 1963 and manufactures a wide range of wood-based profiles and mouldings for picture frames and cornices. The plant is located in a semi-rural area, but in a region with a tradition of family-owned SME operations. This is clear from the number of small industrial operations nearby. The company is obviously trying to balance production costs with product quality. Most of the recent investments have been to deskill and automate production and packaging processes to increase per capita productivity. Current employment is down to 76, in two shifts, from a high of over 90 - but with much higher levels of production. The "project" could not be clearly defined by the Production Manager, probably because it was only one of a series of loans made over the years.

The company is stable and remains competitive, despite challengers from lower-cost economies. The company receives many offers of funding, but has remained loyal to the FI. It may be paying a fraction more on the interest rate, but it is prepared to carry that to maintain the wider set of business relationships.

As a first attempt at establishing whether or not EIB lending does improve SME access to MLT lending, a comparative analysis was made of the lending patterns of EIB FIs and comparable institutions which do not have access to EIB funding. It is very difficult to find closely matched pairs within any given country, so as well as comparing institutions within countries, a comparison was also made across countries. For fourteen of the FIs evaluated individually, one in each country, a matching Financial Institution was identified and analysed. Comparisons were then made of the proportion of MLT operations as a proportion of total lending. This did not show that EIB FIs make more MLT operations as a proportion of their business activity. Similarly, other comparisons could not show that EIB FIs have lower non-performing loans than other banks or that they were more or less profitable than other banks. The sample used was not statistically significant, and there were serious problems in identifying suitable Banks with which to make the comparisons. However, regardless of these findings, it is clear that the Bank does not have the data available to say whether or not specific policy objectives are being achieved. It must be a Recommendation that the Bank's policy impact should be measured in greater detail.

4 EIB CONTRIBUTION

EIB additionality	High	Significant	Medium	Low	
Non-financial value-added		3	5	7	See (1)
Financial value-added to FI*	1	6	3	3	See (2)
Financial value-added to FB*		8	2	3	Mainly implicit - see (2)
Recommendations	*1) Develop a toolbox of on-lending products to be made available to FIs*				
	2) Increase value-added to FBs through new financing products for FIs				

* Two projects could not be rated for financial value added.

4.1 Non-financial Contribution

To the FB

Section §2.1. presented how the Bank delegates the appraisal and approval of sub-loans to the FI. With the exception of checks on sub-project eligibility, the Bank does not actively involve itself in the FI's operational activities. There is therefore very limited scope for Value Added at the level of the FB, and what purely EIB Value Added there is relates to Relevance issues rather than project quality *per se*. There is some passive involvement through contract conditions on Procurement and the Environment. However, while these remind the FI that its clients have to meet EU Directives, this does not add anything to the process. The clients should be complying with the relevant legislation anyway. As will be seen below (*cf.* §5.2) there was very limited evidence of the Bank actively reviewing the appraisal and approval procedures of the FIs, either *ex-ante* or *ex-post*. The Bank's Value Added in the area of sub-project quality is therefore very limited. However, bearing in mind the quality of the Bank's FIs, this position should be expected and accepted. Where the Bank was able to demonstrate significant non-financial value added, was in its management of the European Commission's SME facility in the new Member States. Similarly, the evaluation found examples of the FI using the Bank's name to promote its SME products.

The Bank could, however, offer greater Non-Financial Value Added to the FB by working with FIs in areas such as product development. As an example, one of the FIs evaluated had

developed a specific product based on EIB funding. This product was very simple to manage within a branch network, and offered SMEs a fixed rate loan for five years, but with the option of a swap to a variable rate after two years. The product increased the EIB's Financial Value Added by providing additional fee-paying transactions for the FI, and Non-financial Value Added to SMEs by providing additional flexibility in their asset financing strategy. If that model, or a model following similar principles, had been developed by the Bank, it could have been applied within other FIs. Reflecting the opportunities of such an approach, another FI evaluated in-depth reported that it had been approached by a client looking the same type of EIB-backed SME product that another FI had developed.

It might be appropriate for the Bank to consider the form in which the FBs receive their funding and not just how much and at what cost. The Bank could develop a toolbox of products to be offered to new and existing FIs. This would allow the Bank to optimise its Value Added, and the distribution of that Value Added between the FI and the FB. It would be desirable to involve the FIs in this activity, developing best practice across FIs, although the Bank would then have to manage issues of confidentiality and inter-client competition.

To the FI

Also following from the quality of the FIs, is the limited scope for the Bank to provide other forms of non-financial value under its current operating philosophy. Intermediaries are selected for their competence, their understanding of their role in the provision of funding to SMEs, and their compliance with prudential regulations. The Bank then focuses its resources on maximising the Financial Value Added.

FB Case Study: Shipping/Freight Handling

The company handles roll-on-roll-off (RoRo) ferry business and container traffic, based on a long lease from the Port Authority. The investment part-funded by the EIB was for a quayside container crane. Future investment will be needed to meet shipping lines' ever more demanding requirements for container handling (e.g. container weight and logistics). The company employs 137 staff and envisages 5-6% employment growth by 2007. The main staffing issue is the need for training to use and maintain specialist container handling equipment, of which they are the only operator in the country. Since making the investment, trade has continued to grow and the business has continued to invest (approximately EUR 4.4 million 2002-2003 alone). The company has a long-standing relationship with the FI, since 1994, and has completed approximately 10 financings with them. In the past, the FI was the only financing option available, but the market has changed dramatically in the last three years and they are now able to obtain competing and better offers. In fact, the FI has now reduced its margin on the EIB funded operation.

4.2 Financial Value Added to the Financial Intermediary

The funding the Bank provides offers three types of Financial Value Added :

Pricing

This is the most obvious form of Financial Value Added and is critical in persuading FIs to borrow. The evaluation found that the EIB funding advantage was in the lower to middle range. This repeats the findings of "Review of the Current Portfolio Approach for SME Global Loans". However, while the historical range was unchanged, all of the FIs visited felt that the figure was unsustainable. The typical current and future funding advantage was estimated to be even lower.

For most of the FI's evaluated, their marginal cost of funding is set by the interbank market. One FI was regularly issuing bonds, two had access to parent company "Intrabank" funding, but the rest were dependent on either term deposits or interbank funding, based on Euribor pricing. When reaching the net funding advantage, however, the additional cost of working with the EIB has to be considered. Compared with Interbank funding, the FI may face additional costs in meeting the Bank's guarantee requirements, and it always has to:

- Develop procedures for identifying suitable clients;
- Prepare new contracts for FBs, in line with the EIB's contract conditions;

- Manage the relationship with the EIB, including Evaluation;
- Develop procedures for the operational units to comply with the Bank's allocation requirements;
- etc.

FB Case Study: Subcontract Print shop

The company was set up to print magazines, brochures, etc. and operates from leased premises of approximately 1500 sq m. These were refurbished to its specification, and are equipped with a Heidelberg printing machine and other finishing equipment. The plant has been operational since March 2003 and now employs approximately 30 people, of whom 10 are highly skilled. The 50% owner has had a relationship with the FI since 1992: the remaining 50% of the equity is held by financial investors.

The company has faced a number of challenges, including staffing and training problems which led to very low productivity. It has also found market penetration difficult. Most domestic magazine titles are owned by publishing houses with their own printing capacity.

There have been some financial difficulties resulting in late lease payments, possibly because the business case for the investment seems poorly conceived (inadequate market research or sales planning). It was, none the less, a highly appropriate SME operation, looking at ways to address new markets in higher value segments than the traditional business.

The "Review of the Current Portfolio Approach for SME Global Loans" gave these costs in bps range, based on responses from the FIs. For this evaluation, the direct staff-related costs were estimated by EV to be in a given bps range, based on the amount of FI staff time devoted to EIB GL operations. However, none of the FIs had ever actually tried to quantify the costs. When this cost is considered, the Bank's funding advantage is approaching zero. Ops is acutely aware of this problem, which is greater for larger banks, and particularly those in countries with well developed financial sectors. It might be argued that the Bank should therefore focus on smaller FIs in less developed markets. However, this would deny access to EIB funding for large numbers of SMEs. Large Banks have large branch networks which act as an important EIB funding delivery mechanism.

Term — EIB funds provided on a long-term basis, from 5 to 15 years depending on the type of FB investment that the FI wishes to finance. The matching between liability and assets is important to the FI's Risk Management, but appears to have very little impact at the FI's operational level. The term provided to the FI is usually substantially longer than the FI provides to the FB, although two of the FIs had lent for longer to a limited number of FBs. This suggests that the FIs have EIB funding within their treasuries which may not be getting applied to SMEs. In practice, the FI is paying interest on this amount at a level which is above its average cost of capital, and long term funds being used for shorter term lending carries a financial penalty. A reasonable level of "float" is helpful for FIs. It allows them to continue operations with target FBs between successive GLs. The Ops Procedures manual gives guidelines on the appropriate terms for different types of GL. The evaluation only found one GL where there was a significant mismatch, and that can be attributed to the fact that single disbursements were being used to fund a mix of medium- and long-term leases.

Treasury — The EIB can provide different currencies for different terms on different bases, e.g. fixed or variable interest rates. This can allow an FI to use the EIB to match its broader treasury needs or to take advantage of market disparities. However, while there was significant evidence of this in the "Review of the Current Portfolio Approach for SME Global Loans", there was very little on this evaluation. FIs were almost always borrowing at the lowest rate, for the longest term, in the currency of onlending.

4.3 Financial Value Added to the Final Beneficiary

Pricing Since the 2000 policy paper, there has been a requirement for the EIB's funding advantage to be clearly passed on to the FB. To a greater or lesser extent, all except two FIs could show that the funding advantage was being passed. However, the mechanism by which this was achieved varied substantially between FIs. The approach taken by most FIs was to reduce their internal base rate for SME lending when EIB funds were available. However, this is not an entirely transparent process and the small funding advantage available gets washed away in the degree of flexibility which FIs give their lending staff to meet competitive pressures. The evaluation found one case where the EIB name, combined with the Bank's funding advantage, was being used to win business from desirable clients. In another case, the selection of the FBs to receive EIB funding, and the level of funding advantage to be passed on, was at the discretion of the Relationship Manager. This might be seen negatively: applying the funding advantage in this way is to create a competitive advantage for the FI rather than to provide lower cost funds to a disadvantaged SME. However, it must be remembered that this approach clearly resulted in the lowest possible costs for the SME.

Term The access to MLT funding was more important to the FB than the price, and most FBs would have been willing to pay slightly more for an even longer term than they had already received. The loan term is also of prime importance when dealing with property-based SME businesses, e.g. in tourism. The term of the onlending to the FBs visited ranged from three to twelve years, depending on the asset to be acquired. The terms offered to FBs were always shorter than the economic life of the asset, but long enough to make the asset affordable.

While the evaluation found plenty of evidence that the funding advantage was being passed on to the FB, it found no evidence that it was critical to the SME investment decision. The EIB's funding advantage is small compared to the latitude that FBs have internally to vary their lending rate in the light of competition. Only one FI said that the EIB funding advantage was critical, but it was critical to their ability to win business in a highly competitive environment, not as to whether or not the SME made the investment. All FIs visited claimed they were operating in a highly competitive environment. That may have been an exaggeration, but the evidence suggests that SME clients are not sensitive to the EIB funding advantage, and that onlending rates to clients are primarily driven by market conditions.

A way forward would be to seek ways of increasing the transfer of value added by optimising the value added that can be achieved through security structures, and maximising the value added by the development and dissemination of new on-lending products.

5 EIB MANAGEMENT OF THE PROJECT CYCLE

	G	S	U	P	
Identification & selection	4	11	-	-	
Appraisal		13	2	-	
Financial Portfolio management Transparency	X	 X	 X		EIB's priority *To be developed* Well rated
Follow-up and monitoring	4	11	-		
Allocations Measured against objectives		X	 X		For the quality of the allocation *Insufficient measurement of EIB's performance against EU's objectives*

5.1 Identification and selection

In all of the GLs evaluated, the management of this part of the project cycle was rated Good or Satisfactory. The Bank has identified suitable FIs in terms of their financial stability (Sustainability) and their ability to deliver funding to SMEs (Relevance). The number of FIs was already increasing in the 1990s, but the 2000 policy requiring increased levels still further. The actual rate of increase was not substantial, but took account of the need to maintain existing relationships while developing new ones.

There is still scope to develop new intermediaries: competing facilities for SMEs are not present in six of the EU 25 countries (Luxembourg, Sweden, Denmark, Malta, Cyprus and Finland) and not all competing banks have access to EIB funding at the same time. Three of the FIs evaluated were leasing companies. Leasing is particularly attractive to SMEs due to its low up-front costs and absence of additional guarantees.

Only one of the FIs evaluated specialises in SME lending and development. One other had a *de facto* specialism, by virtue of its client base, and all of the smaller FIs had SMEs as a key part of their client base. Larger banks were less focused on SMEs, but offered a degree of SME coverage that smaller FIs could not manage. Many of the FIs visited in countries with less developed financial sectors saw SMEs as being a target for growth. Previously these banks had focused on larger companies and short-term operations, but were now more actively pursuing SME business. The evaluation found that smaller banks, or larger banks which had maintained their local identity, tended to attract a loyal clientele, even if this loyalty carried a cost to the client.

FB Case Study: Building Materials Recycling

The company was set up in the 1960's as a building materials recovery and recycling operation; mainly handling slate roofing tiles and traditional bricks. The company is controlled by a single entrepreneur, although the company is a family business in the sense that a number of the Promoter's family members are employed. The operation is run from two sites close to a city centre and appears to have been trading profitably.

The main activity is clearing sites and transporting the spoil to one of the company's depots. At the depots the material is screened and separated into re-usable materials such as topsoil, hardcore, etc., before being transported to clients for re-use. Only a very small proportion of the input material has to go to landfill. The investment took the form of three-year leases on six new tipper trucks, and allowed the FB to bid successfully for new contracts. Overall this is a commercially successful and environmentally creditable SME business.

The Bank's mix of FIs strikes an appropriate balance between large banks which offer greater coverage and increased competition, and smaller, often regional banks which offer a more local service. Ideally, the Bank would fund more FIs like the parastatal noted in §3.3, which complements the local commercial banks but provides a different type of service to SMEs. However, that type of organisation is rare. Increasing competition is still the goal, and the Ops approach of introducing new, usually smaller FIs has been successful.

5.2 Appraisal

In all the cases examined, the appraisal and approval process was simple, straightforward and rapid. The responsibility for appraising the FIs activities and identifying a suitable security structure lies with Ops, and the Ops Procedure manual identifies three areas to be analysed : financial situation and management ability, ability to channel EIB funds, and willingness to ensure transparency. However, the evaluation found limited evidence of analysis of anything except the financial strength and creditworthiness, although it should be recognised that Ops has been developing its procedures since the time the evaluated operations were appraised.

With the exception of the parastatal organisation, the FIs in question were all well-established commercial banks with sound financial structures and acceptable ratings from the three main rating agencies. It is not clear to what extent the current credit/financial analysis complements or duplicates the work of the ratings agencies, but the Bank's current policy is to maintain an

independent capacity to analyse FIs. In specific cases, a tailored analysis can lead to increased financial value added. Nevertheless, the fact that the FIs have already been rated might justify a different balance of resource allocation between credit/financial analysis and analyses directly related to the operation. In particular, time might be found to develop the objectives of the operation. There seemed to be some confusion between the objectives of the operation and eligibility. It was common for the sections on objectives and rationale for the operation to refer to the eligibility criteria rather than policy objectives *per se*.

None of the appraisals reviewed contained an analysis of the management ability of the potential FI and, apart from an occasional reference to portfolio quality, there was no portfolio analysis. In particular there was no analysis of the potential FI's SME portfolio. For the loans in one Department, there were Notes to File on the activities and performance of various Intermediaries. These contained a rigorous analysis, but similar Notes were not found elsewhere.

There was no problem with contract terms relating the source of funding and access to FBs for EIB staff, nor with complying with the allocation procedures. However, as shown in 3.4.2, only two FIs could clearly demonstrate *ex-post* how the benefit was being passed on, and none of the Board Reports presented how the funding advantage would be passed on. They all stated that it **would** be passed on, but not **how** it would be passed on. This subject is an example of a process of continuous development. Reporting has already been reviewed by Ops and, as from January 2005, appraisals should include a commentary on the passing-on mechanism.

The appraisals carried out by the Bank were generally rated as Satisfactory, but this was based on the Loan Officers' understanding of the FIs business, and the background work which had been carried out, rather than what was presented in the approval documents.

5.3 Follow up and monitoring

On repeat operations, which is the norm for the Bank, the Board Report for the subsequent operation almost always contained a short paragraph about the previous operation. The focus of these paragraphs was on the allocation process, highlighting the number of allocations and the proportion of funding which had gone to SMEs as opposed to other eligible investments. The Board Report also considered the financial situation of the FI and any changes in both this and its operational strategies since the last appraisal. Otherwise, the Bank's reporting of its GL operations in member States is confined to an annual summary of activities. This provides a comprehensive analysis of the Banks GL portfolio and lists the global loans approved, with their main characteristics, including the FIs, but does not give a breakdown of activities by individual FI.

In all cases the quality of the follow up and monitoring was rated as satisfactory – but that reflects the quality of the allocation process and the continuing relationship between the Bank and the FI, rather than monitoring and reporting.

6 LESSONS LEARNED AND RECOMMENDATIONS

When considering the EIB's performance, it is often forgotten that the EIB is both an instrument of EU policy and a financial institution. The evaluation concentrated on the Bank's policy role, but it should also report that it found no evidence of inappropriate lending, and none of its EU SME GL operations pose a threat to the Bank's own sustainability. At the operational level, the Bank clearly knows and understands its FI counterparts, but that knowledge and understanding is not being presented to either the Management Committee or the Board. Similarly, although it has lending to SMEs as an operational priority, and the Loan Officers work hard to provide funding to SMEs through competent FIs, there is a lack of clarity about what the Bank is trying to achieve. Finally, there is the ability of the Bank to continue supporting SMEs in a number of Member States.

The evaluation found that there was a lack of clarity over the Bank's objectives, although this may reflect a certain vagueness on the part of the EU policies themselves. The stated objectives were often a repetition of the eligibility criteria, and where objectives were stated they were incomplete. It is therefore recommended that the Bank should clarify its SME policy objectives to align them more closely with stated EU objectives, and to present them systematically at the approval stage. Without knowing what an operation is meant to achieve, it is not possible to say whether or not the Bank is achieving its objectives or not. It is also unclear whether the Bank is achieving the EU SME policy objectives of increased productivity, competitiveness, employment creation and access to suitable funding. There are no measures in place to measure the impact of the Bank's GL operations. There is a clear annual report presented to the Board on the Bank's GL operations, but this was at the request of the Board for the Bank to provide reporting on lending against the Bank's operational priorities, rather than the impact of operations against policy objectives.

The Bank only delegates its operating responsibilities to FIs which meet its standards of technical capability and financial stability. It carries out its own, independent credit and financial analyses but, effectively, potential FIs already have to be either rated or public institutions. There is therefore no obvious need to carry out an in-depth analysis, except where the ratings are inappropriate for the specific operation being considered. Conversely, the areas in which the Bank is delegating responsibility to its FIs: selection, appraisal, approval, disbursement, monitoring are rarely appraised in depth. Related to this is the opportunity the Bank has to use its substantial experience of GL operations in different countries and with different types of FIs to develop new and existing FIs through cross fertilisation. The evaluation found a number of examples of innovative products and processes which would be appropriate to a number of existing FIs, and particularly to new FIs. The Bank could increase its Value Added by developing a toolbox of products which it could tailor to meet the needs of individual FIs.

Normally, an evaluation deals purely with *ex-post* issues. However, it became clear during the discussions with Ops, and confirmed during the site visits, that the Bank may find it difficult to maintain its current level of SME GL activity, at least in the short term. There are three distinct dimensions to the problem :

- Competition The development funding organisation of an EU Member State is providing funding for SMEs domestically and internationally which some FIs are taking in preference to EIB funds. It is also taking strategic shareholdings in FIs and potential FIs in a number of Member States. The impact was being felt in three of the FIs visited. In another EU Member State, an investment facility funded by the government was available on highly advantageous terms: borrowing in local currency, but with a Euribor based interest rate, at a time when inflation was standing at circa 5%. It is impossible for the EIB to match that type of funding.
- Macro-economic conditions It would appear that the Bank's funding advantage is being squeezed between relatively higher prices to FIs for EUR funding and the falling cost of alternative funding. The cost of EIB funding is set in-house using agreed procedures and a review of that process is beyond the scope of the evaluation, as is an adequate analysis of the macro-economic conditions and market forces which drive the cost of alternative sources of funding. However, the ability of the Bank to continue offering support in some important EU markets is likely to be limited, particularly for funding via FIs with a large deposit bases.
- Credit Risk Policy The Bank established a sound Credit Risk Policy for good reasons; relating to its sustainability and the appropriate use of shareholders funds. This limits the Bank's exposure to individual institutions. The Bank is making increasing use of more complex security structures : securitisation, assignment of rights over portfolios of loans to public sector borrowers, etc.. Although some can be very cost effective in terms of the improvement of rating achieved, they all imply an additional cost and this activity could be seen a distraction from the Bank's principal activities.

Finally, there is the question of lending conditions and conditionalities. As noted in §3.4.2, the 50% limit on on-lending may be an unnecessary intrusion into the FI's relationship with its client. The limit is not statutory and could be varied by CA decision. It is therefore proposed that the 50% limit should be the subject of a review. An alternative approach would be to consider the EIB's objective as being to finance SMEs with a clear investment plan, working with the FIs analysis of the Balance Sheet and past performance, rather than trying to artificially define a sub-project to be promoted by the SME.

The passing on of the funding advantage remains an issue. The evaluation found that all FIs were operating in competitive markets. The degree of competition varied but the fact that the markets were competitive provides a sufficient incentive to the FI to pass the funding advantage on to the FB. If there are market forces ensuring that the funding advantage is passed on, then it is difficult to see why additional costs and procedural complications should be imposed on the Bank's clients. The impact can only be to reduce the level of funding advantage available to the FB. The question of transparency is more difficult. The question is how the Bank can be sure that the EIB funding advantage went to SMEs, rather than any other client segments. With no subsidy element included in the rate to either the FI or the FB, there is no clear argument that individual FBs have to be identified. However, there is an argument that that it should be possible to demonstrate that the EIB's funding did go to the intended category of client. This implies working with the FI to ensure that the funding advantage is passed to the units which are responsible for making loans to the SME, but not necessarily tracking the funding to the individual FB. As suggested in the "Review of the Current Portfolio Approach for Global Loans", transparency can be achieved through a sound analysis of the FIs relevant portfolio *ex-ante* and *ex-pos*t, and how this compares with the FIs MLT operations overall. It would offer two other advantages: it would give a clear indication as to whether the FI was using the funds as intended and, as it would be same type of analysis already recommended for assessing the impact of the operations, it would provide a measure of the operations Relevance.

THE EIB GL MECHANISM

The "Global Loan" concept was developed by the World Bank (WB) in the 1960s and adopted shortly afterwards by the EIB as a means of financing investments which were too small to finance directly. The basic principle of the Global Loan is quite simple: a loan agreement is signed between the EIB and the FI, in which EIB agrees to lend to the FI and the FI agrees to repay the money, having made loans to the same value to suitable FBs, e.g. SMEs. Within that framework, the FI accepts:

- operational responsibility for the identification, appraisal, approval, and monitoring of FBs and the use of the funds, although the Bank will test the eligibility of "allocations";
- the full credit risk under its normal security requirements for the lending to the FB;
- that it will meet the specific terms and conditions;
- to provide proof that the funds were used for suitable purposes via the allocation mechanism, and that these proofs will be provided within a set time-period;
- to provide a suitable guarantee to the EIB.

Considering each of these in greater depth:

Operational responsibility

All onlending must meet EIB eligibility rules. A side-letter to the loan contract normally defines what may be financed using EIB funding and under what conditions, e.g. minimum loan term, etc. It may also state what flexibility is available to the FI to finance lending which does not meet the primary objective of the loan. In the case of loans where SMEs are the primary objective, it is not unusual to include operations in support of environmental or energy investments.

The EIB, as a policy driven bank, would normally carry out a techno-economic analysis on the projects it finances. However, this does not form part of the normal operational activity of commercial banks which form the vast majority of the Bank's FIs and which are the only means of supplying competitive funding to the maximum number of SMEs. For private sector SME operations within the EU, it can reasonably be assumed that the financial analysis carried out by an FI will be an acceptable proxy for an economic analysis, and that FIs would not normally finance operations which were not "bankable", i.e. viable in both financial and credit-risk terms.

The onlending by the FI may have been partly funded by the FI or it may have been wholly funded by the EIB, but it is the FI alone which takes the credit risk and the full onlending appears on the FIs balance sheet. FIs are expected to apply their normal procedures in appraising, approving, disbursement, monitoring and recovery procedures.

Credit Risk and Security

As all risks lie with the FI, the Bank expects FIs to apply good banking practice and to take the same level and type of security as they would normally. The Bank does not intervene in the commercial relationship that exists between the FI and the FB. However the security structure for an individual GL may include an assignment of rights relating to the onlending, or a securitisation package involving an SME portfolio.

Specific terms and Conditions

These include the need for all FBs to comply with EU law in respect of the environmental and procurement issues, the right of entry of the EIB to any FB which it has funded, and the requirement for FIs to inform their clients that part of the funding for their investment has come from the EIB.

Allocation Procedures

The FI must be able to demonstrate that EIB funds have been used correctly. The mechanism for achieving this is the allocation procedure which relates disbursements to the FI with the use of the funding. This activity was the subject of a Review published in March 2002. The findings of that study remain valid and the report may be found at www.eib.org/publications - Ex-post evaluations - "Review of the Current Portfolio Approach for SME Global Loans". In brief, the main allocation reporting mechanisms used within the EU are:

List Procedure Information on FBs is supplied in the form of a list of allocations, containing basic details of each allocation: name of FB, location, sector, loan amount, investment cost, etc. The list has to be supplied within a certain time of the disbursement. If the Bank identifies an ineligible allocation it tells the FI that it is being rejected but FI staff frequently contact the Bank during the selection process to discuss eligibility and avoid rejections.

Fiche Typically one page, with summary details of the proposed client and investment, with more details than the List Approach. This was originally supplied before the loan was disbursed to the FI (ex-ante) but, more recently, fiches have been supplied ex-post.

Portfolio Approach This approach is based on the idea that the Bank is financing a portfolio of SMEs, not a list of individual SMEs. At appraisal, for each new GL, FIs provide an analysis of their SME term lending portfolio broken down by sector, size and location of operation. They then have to confirm, ex-post, that EIB funds have been used for eligible purposes. There is a general requirement for the portfolio to be a multiple of the disbursed amount e.g. the volume of new SME loans should be twice the value of the GL.

Loan and Security Structure

By its statute, all EIB lending must be backed by an acceptable guarantee which meets the requirements of the Bank's Credit Risk Guidelines. However, there is also an over-riding exposure limit. For a prime bank the EIB's total exposure to the FIs should not normally exceed 20-25% of its own funds, but the reference limit might also be 10% of the counterpart's total funding.

In return for the above, the Bank offers:

- funding resources which might otherwise not be available to the FI;
- funding maturities which address the needs of the FI's onlending;
- a small funding advantage i.e. a slightly lower interest rate than the FI's marginal cost of funds. This is not considered to be a subsidy.

Objectives of EIB GLs

The specific objective of Global Loans is to channel EIB funding to investments which are too small for EIB direct lending. Global Loans are therefore not policy objectives in their own right, they are a mechanism by which policy objectives can be achieved. In this particular case, the policy objective is the provision of funding to SMEs, in line with EU policy. EU policy has been largely unchanged since the 1980s. Documentary evidence of early EU and EIB SME policies can now be difficult to locate, but although PJ[5] is no longer active in GL operations, it does retain elements of the Bank's institutional memory. From this, it is clear the original, and persisting, policy objective is to improve the productivity and competitiveness of SMEs,

[5] PJ retains responsibility for questions relating to eligibility and for the sensitive sector list.

particularly in the context of job creation. To this has been added a policy of facilitating access to suitable forms of funding, although this primarily concerned with equity funding.

Below the overall EU Policy lies the Bank's own GL policy. The Bank's Corporate Operational Plan (COP) sets objectives for the volume of lending via GLs and the proportion that should be directed towards SMEs. In addition to this quantitative dimension, the Bank introduced three specific policy objectives in the year 2000:

- Diversification of FIs in order to promote competition and the passing-on of the EIB's attractive financing terms to final beneficiaries;
- Transparency - i) ensuring that FIs inform FBs that part of the funding came from the EIB, ii) seeking to ensure that the EIB funding advantage is appropriately passed on to the final beneficiaries and iii) that GLs should have specific objectives in line with the Bank's COP, including SMEs;
- Reporting - the presentation to the Board of Directors of an annual report on the contribution made by GLs to the Bank's operational priorities.

The combination of EU and EIB policy objectives form the basis of the evaluation of the operations against the evaluation criterion "Relevance".

The Global Loan Process

Identifying Potential FIs

All except one of the GLs evaluated individually were repeat operations with the FI, and the GL which is the exception has already been followed by a repeat operation. GLs usually follow on from an existing business relationship and, for many FIs, the GL is just one part of the relationship it has with the EIB. This may include co-financing on large projects, guaranteeing direct lending, intermediating lending for direct projects, collaborating with the Bank on bond issues. In the 1990s, the average number of FIs increased at 6 per cent per annum. This figure increased by up to 50% after the change in policy in 2000, but even allowing for some dropping out of established FIs, there is a pattern of loyalty to existing business relationships. At the time of the evaluation, the number of FIs stood at some 200, with active operations in 21 of the 25 Member States.

FI identification and selection is facilitated by the fact that loan officers are already dealing with local financial institutions on a regular basis. When identifying potential new FIs, the Loan Officer will often already be aware of the potential FIs client profile, creditworthiness, and its appetite for external funding. There are few restrictions on the type of financial institution which can be considered as an FI. The main reason for excluding a potential FI – assuming it was a competent financial institution - is a lack of independence. Organisations which are tied in any way to specific asset manufacturers or service providers are not eligible for funding.

Appraisal (ex-ante evaluation), Approval, Contract Negotiations and Signature

All EIB GLs are the object of an appraisal (ex-ante evaluation) to judge the FI's suitability as an EIB partner. These appraisals are standardised, but there are significant differences between the first operation with a new FI and repeat operations. New operations should be appraised in detail to establish a benchmark for the FI. Repeat operations can focus on changes and developments since the previous operation. Since 2000, the appraisal has also considered the willingness to ensure transparency and to pass on the EIB funding advantage to the final beneficiaries.

The Bank's Statutes state that credit responsibility lies with the Board of Directors. Once the appraisal process is completed, and the Management Committee is satisfied, the proposal is formally presented to the Board of Directors for approval. Assuming the CA does approve, the lending department will proceed to finalise the deal and sign the contract. Disbursement is

usually dependent on a number of conditions being satisfied, particularly the question of the Bank's guarantee. The actual disbursement and allocation mechanism may vary, depending on the allocation procedure used and the depth of previous experience with the FI. However, for a long-established FI, a typical procedure would involve a request by the FI for a disbursement of a tranche of funding, at a time it chooses, after which it has a period of twelve to twenty-four months to provide the allocation data to justify the level of funding provided.

Specific conditions of SME GLs

The Bank's contracts include a number of conditions which separate its operations from normal inter-bank operations. Firstly, the Bank's eligibility criteria and allocation procedures limit the use the funds. The FI has to be able to demonstrate that the funds have been used for an appropriate purpose, regardless of the allocation procedure used. Since 2000, the FI has also had to be able to demonstrate that a proportion of the EIB's funding advantage is being passed on the FBs. Both of these requirements imply additional work, and hence cost, for the FI.

There are four more contract conditions which have to be observed, two of which are based on the need to operate in line with EU legislation:

- The FI undertakes to ensure that all investments funded by the onlending comply with EU environmental legislation. In practice, most FIs within the EU can rely on their national regulatory framework and enforcement mechanisms. The FI is taking the credit risk on the FBs, and the FI therefore has an incentive to avoid environmentally sensitive investments where problems would affect the FB's ability to service the debt.
- The FI also undertakes to ensure that all FBs comply with EU procurement rules. In practice, it would be rare for an SME to have lead responsibility in activities which fall under the relevant Directive.

The other two conditions are that:

- The EIB should have the right of entry to any FB it has funded, and that this requirement should be included in the contract between the FI and the FB.
- The FI should inform the FB that the funding has come from the EIB. FIs meet this requirement in a number of ways: in the onlending contract, in publicity material, etc. Or the FI may set up a separate product, which makes the situation clear to the FB.

Constraints on EIB GL Operations

There are at least three constraints on the Bank's lending operations:

- The willingness of FIs to take funds from the EIB as opposed to other sources;
- The absorptive capacity of the market. This can occur if the local demand for funding for SME operations is limited, either by the level of demand from the SMEs themselves, or the willingness of potential FIs to get involved in term lending to SMEs.
- The requirements of the EIB's Credit Risk Guidelines. The exposure limits outlined above should not be a general problem, even allowing for the multi-faceted relationship between the EIB and the FI. However, the question of the guarantee may be more difficult. The arrangements needed to meet the Bank's security requirements can imply an additional cost for the FI, which in turn affects the willingness of the FIs to take EIB funds.

Market Forces and the SME GL mechanism

The Bank does not have a privileged position in the marketplace and relies on its financial Value Added to persuade FIs to take its funding. Alternative sources of funding for FIs include:

Own deposits. Potential FIs often have substantial unremunerated deposits, although these are usually sight deposits. The longer the term of the deposit, the higher the price the FI has to pay for the resources. Mismatches between the terms of the deposit and the lending is normally limited by internal or regulatory policy, and has to be priced. EIB funding should be compared with long-term deposits, which are relatively rare, but would be priced substantially lower than EIB term lending.

Bond issues by the FI. A AAA-rated FI which issues its own bonds will receive it's funding at a lower cost than it could borrow from the EIB. However, the lower the rating the higher the price it would have to pay.

Inter-bank market. EIB funding has traditionally been available at a discount to the inter-bank market, but in some cases this advantage has been reducing: see also §4.

"Intra-bank". It is common for subsidiaries to rely on the treasury function of the controlling shareholder. This treasury function may or may not be a profit centre: a factor which can make a significant difference to how EIB funds are managed and priced internally.

Other funding agencies. The EIB is not the only institution which makes funding available to EU banks. The cost of these funds can be lower than is available from the EIB.

The strengths of EIB's product are:

- Fine rates based on the Bank's AAA rating, non-profit taking status and unremunerated capital. The problem for the Bank is that many of the banks which have the largest branch networks, and hence a ready delivery mechanism to SMEs, are also highly rated, reducing the Bank's funding advantage. The Bank is non-profit taking and benefits from unremunerated capital, but it also has to fund a range of activities which commercial banks do not. These additional costs significantly reduce the EIB's theoretical funding advantage. In addition, the Bank does not employ risk pricing on its GL operations.
- Long term funding. This is one of the Bank's key advantages, but it does not have a monopoly.
- Flexible disbursements: timing and currency. The Bank can offer the availability of a range of different currencies at different terms, and all at relatively short notice. This allows some FIs the possibility of fine-tuning their treasury needs, provided that they can demonstrate that an equivalent level of funding has been used for eligible purposes.

Conversely, the Bank's weaknesses include:

- The FI has to comply with the Bank's loan conditionalities, particularly the allocation procedures and the need to control the flow of funds between the Bank and the FB;
- The additional costs to the FI of being appraised, monitored and evaluated.
- The cost of supplying a suitable guarantee.

EVALUATION CRITERIA

Project performance is assessed using the core evaluation criteria as defined by the Evaluation Cooperation Group (ECG), which brings together the operations evaluation units of the multilateral development banks (World Bank group, regional development banks, and EIB), in line with the work of the OECD- DAC Working Party on Aid Evaluation, and adapted to meet the particular operating needs of the EIB. Evaluations take due account of the analytical criteria used in the ex-ante project appraisal and the strategy, policies and procedures that relate to the operations evaluated. Changes in EIB policies or procedures following project appraisal, which are relevant to the assessment of the project, will also be taken into account.

- Relevance is the extent to which the objectives of a project are consistent with the relevant EU policies (the Treaty, Directives, Council Decisions, Mandates, etc.) and the decisions of the EIB Governors, as well as the beneficiaries' requirements, country needs, global priorities and partners' policies. In the EU, reference is made to the relevant EU policies in the context of the Article 267 of the Treaty that defines the mission of the Bank and the EIB related policies. Outside the Union, the main reference are the Community's relevant external policy objectives considered in the specific mandates given to the EIB by the Council of the European Union and the EIB interpretation of them.

- Efficacy (or effectiveness) relates to the extent to which the objectives of the project have been achieved, or are expected to be achieved, taking into account their relative importance, while recognizing any change introduced in the project since loan approval.

- Efficiency is the measure to which project benefits/outputs are commensurate with resources/inputs. For the ex-ante appraisal, a project's efficiency is normally measured through the economic and financial rate of returns. In public sector projects the economic and financial rate of returns often are not calculated ex-ante. In those cases the efficiency of the project is estimated by a cost effectiveness analysis.

- Sustainability relates to the likelihood of continued long-term benefits and the resilience to risk over the intended useful project life. The assessment of the project's sustainability varies substantially from one case to another depending on circumstances and takes into account the issues identified in the ex-ante due-diligence carried out by the Bank. Among the issues reviewed in the assessment are:
    - Technical and management issues, mainly willingness, capacity and funding to carry out the necessary maintenance of the project in order that it can reach its useful life;
    - Government commitment, regulatory environment and socio-political support (this is particularly important in weak institutional context such as in some developing countries);
    - Financial sustainability for revenue generating projects, whether there is a significant risk that those revenues become unacceptably low, e.g. that they cannot cover at least the operating and maintenance costs;
    - Environmental sustainability, whether there are environmental risks that might be a significant threat to the future operation of the project.
    - Others issues that might affect the continued long-term benefits during the useful project life.

EVALUATION SUMMARY

EVALUATION CRITERIA		
1. RELEVANCE	Comments	Rating
Policy and other economic objectives		
2. FINANCIAL INTERMEDIARY		
Organisation and management, including: Delivery to target SMEs Credit assessment Risk management Approval mechanisms)		
Financial situation Overall profitability Condition of relevant portfolio Market position		
Sustainability Financial health and trends Bad debts & provisions		
3. EIB GLOBAL LOAN		
Amounts disbursed versus initial expectations		
Quality of the projects financed (Case studies only) Specific data, if available Portfolio data		
On-lending conditions Margins applied by the intermediary Passing through of EIB Financial advantage		
Sustainability of the projects financed		
4. QUALITY OF THE OPERATION (2+3)		
5. TOTAL GLOBAL LOAN PERFORMANCE (1+4)		
6. EIB PERFORMANCE		
A. EIB value-added (high, significant, medium, low)		
Financial: Financial intermediary Final beneficiary		
B. Management of the project cycle		
Identification and selection		
Quality of appraisal		
Quality of follow up and monitoring		

Ratings are based on a 4-level scale: poor, unsatisfactory, satisfactory and good.

EUROPEAN INVESTMENT BANK

OPERATIONS EVALUATION (EV)

In 1995, Operations Evaluation (EV) was established with the aim of undertaking ex-post evaluations both inside and outside the Union.

Within EV, evaluation is carried out according to established international practice, and takes account of the generally accepted criteria of relevance, efficacy, efficiency and sustainability. EV makes recommendations based on its findings from ex-post evaluation. The lessons learned should improve operational performance, accountability and transparency.

Self-evaluation, based on a project scorecard system, is carried out by the operational directorates. EV coordinates this process and prepares an independent annual self-evaluation report.

Each ex-post evaluation involves an in-depth evaluation of selected investments, following which a synthesis report is produced and sent to the Management Committee. The Management Committee then decides if the report is to go to the Board and to be published on the EIB Website, in keeping with the importance the Bank attaches to transparency.

The following thematic ex-post evaluations are published on the EIB Website:

1. Performance of a Sample of Nine Sewage Treatment Plants in European Union Member Countries (1996 - available in English, French and German)
2. Evaluation of 10 Operations in the Telecommunications Sector in EU Member States (1998 - available in English, French and German)
3. Contribution of Large Rail and Road Infrastructure to Regional Development (1998 - available in English, French and German)
4. Evaluation of Industrial Projects Financed by the European Investment Bank under the Objective of Regional Development (1998 - available in English, French and German)
5. An Evaluation Study of 17 Water Projects located around the Mediterranean (1999 - available in English, French, German, Italian and Spanish).
6. The impact of EIB Borrowing Operations on the Integration of New Capital Markets. (1999 – available in English, French and German).
7. EIB Contribution to Regional Development A synthesis report on the regional development impact of EIB funding on 17 projects in Portugal and Italy (2001 – available in English (original version), French, German, Italian and Portuguese (translations from the original version)).
8. Evaluation of the risk capital operations carried out by the EIB in four ACP countries 1989-1999 (2001 - available in English (original version), French and German (translations from the original version)).
9. EIB financing of energy projects in the European Union and Central and Eastern Europe (2001- available in English (original version), French and German (translations from the original version))
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