

EUROPEAN COURT
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BANKING MEASURES IN THE
MEDITERRANEAN AREA IN THE CONTEXT
OF **THE MEDA PROGRAMME**
AND THE PREVIOUS PROTOCOLS



EN



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BANKING MEASURES IN THE MEDITERRANEAN AREA IN THE CONTEXT OF THE MEDA PROGRAMME AND THE PREVIOUS PROTOCOLS

(pursuant to Article 248(4), second subparagraph, EC)

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REPLY OF THE COMMISSION

GLOSSARY

Beneficiary: Middle-sized companies, investment funds, microfinance institutions.

EIB: European Investment Bank, Luxembourg.

Environmental impact: (and social when relevant) of the projects evaluated, specifically considers two categories:

- (a) compliance with guidelines, including EU and or national as well as the EIB guidelines, and
- (b) environmental performance, including the relationship between *ex-ante* expectations and *ex-post* findings, and the extent to which residual impacts are broadly similar, worse or even better than anticipated.

FEMIP: Facility for Euro-Mediterranean investment and partnership. Since October 2002, all EIB's operations in the Mediterranean region have been brought together under FEMIP, which was set up following a decision of the European Council taken in Barcelona.

FEMIP operations: Primarily involve three types of products: loans (possibly associated with interest subsidies in the case of environmental projects), risk capital (equity and quasi-equity) and technical assistance.

Financial intermediary: When the EIB does not directly finance FEMIP projects, it may do so indirectly via credit lines in favour of commercial banks or other financial intermediaries.

Interest rate subsidies (interest rebates): Interest rate subsidies are grants provided from the EU budget for loans issued by the EIB under a lending mandate to diminish financial costs of projects. From 1992 (in practice 1996) interest rebates are provided only for loans concerning environmental projects.

MEDA: This acronym stands for: "*MEsures D'Accompagnement*" — accompanying measures. The principal financial instrument of the European Union Euro-Mediterranean partnership. The programme offers technical support and guarantee finance through the EIB.

RCO: Risk capital operations. They started in the 90s and may be divided into two categories: long-term loans with a duration of 10 to 20 years and equity financing loans, the latter being performance-dependent. Some 70 % of the loans for risk capital in the Mediterranean region go to Morocco, Tunisia, and Egypt.

SME: Small and medium-sized enterprises.

Sustainability: private equity operations are designed to support profitable ventures creating value added and jobs. The achievement of an expected return commensurate with the risk taken is a *sine qua non* for each investment decision by the EIB. The assessment of project sustainability varies substantially from case to case, depending on circumstances, and takes into account the issues identified in the *ex ante* due-diligence carried out by the Bank.

Technical assistance: Technical assistance (TA) activities in the Mediterranean countries are financed from the FEMIP technical assistance support fund, set up in 2003. TA is entirely financed from the EU budget to improve the quality and development impact of FEMIP operations by:

- strengthening the capacity of Mediterranean partner countries and promoters; and
- financing upstream studies and activities focusing directly or indirectly on strengthening private sector growth.

SUMMARY

SUMMARY

I.

Cooperation between the EU and non-member Mediterranean countries started some 30 years ago and has gradually developed over the years. The framework for financial and technical measures (MEDA) aiming to accompany the reform of economic and social structures in the partner countries in the context of the Euro-Mediterranean partnership covered the period 1996–2006.

II.

Three types of banking measures are financed under the MEDA regulations or the previous protocols from the EU budget and implemented by the European Investment Bank (EIB): technical assistance through the FEMIP Support Fund, interest rate subsidies for certain EIB loans and risk capital operations.

III.

The Court audited the banking measures under the MEDA programme and the previous protocols to determine whether the ongoing projects were being adequately monitored by the Commission and the EIB and whether the projects had achieved their objectives.

IV.

Regarding the monitoring by the Commission and the EIB, the Court found that:

- the Commission relied entirely on the work performed by the EIB and did not carry out any monitoring of its own;
- until 2005, the level of monitoring by the EIB was not adequate;
- there was a lack of coordination between the EIB's activities and the Commission's, especially at the local level;
- not enough emphasis was put on environmental monitoring.

V.

Regarding the achievement of project objectives, the Court found that technical assistance projects had broadly achieved their objectives. For interest rate subsidies and risk capital operations projects, the situation was more diverse as they only partially achieved their objectives.

VI.

With the end of the MEDA programme and the start of the new European neighbourhood and partnership instrument (ENPI) that was launched in 2007, the Commission should:

- set up a tailor-made evaluation and monitoring programme for banking measures;
- ensure the effective coordination of the assistance work undertaken by the Community, the EIB and other international/local partners in order to increase the consistency and complementarity of their actions;
- negotiate adequate management conventions that ensure appropriate monitoring, cover the environmental aspects and safeguard the Community's financial interests;
- ensure that monitoring by the EIB provides that all projects are adequately executed and that the financial and reporting obligations of the intermediaries/promoters are met;
- for risk capital operations, define an overall strategy at the Commission level and choose the best implementation process, involving either direct management or management by international/local partners.

INTRODUCTION

BACKGROUND

- 1.** After several years of cooperation between the Community and its Mediterranean partners¹ by means of bilateral protocols on financial and technical cooperation, Council Regulation (EC) 1488/96² provided a new framework for financial and technical measures (MEDA). Its aim was to accompany the reform of economic and social structures in the partner countries in the context of the Euro-Mediterranean partnership covering the 1996–99 period (MEDA I). It was amended by Council Regulation (EC) 2698/2000³ covering the 2000–06 period (MEDA II).
- 2.** The purpose of the MEDA regulations was to contribute to initiatives of joint interest in the three sectors of the Euro-Mediterranean partnership:
 - the reinforcement of political stability and democracy;
 - the creation of a Euro-Mediterranean free-trade area; and
 - the development of economic and social cooperation, taking due account of the human and cultural dimensions.
- 3.** The measures directly managed by the Commission took the form of grants to finance or co-finance activities, projects or programmes which contribute to the realisation of the objectives defined in the MEDA regulations. These measures were examined in the Court's Special Report No 5/2006⁴.
- 4.** Besides the EU financial support for Mediterranean partner countries directly managed by the Commission, the MEDA regulations also envisaged three types of banking measures which are managed by the European Investment Bank (EIB) under a mandate from the Commission:
 - technical assistance.
 - interest rate subsidies for environmental loans granted by the EIB from its own resources.
 - risk capital operations.

¹ The partner countries in 1995 were: Morocco, Algeria, Tunisia, Egypt, Israel, Jordan, the Palestinian Authority, Lebanon, Syria, Turkey, Cyprus, and Malta. Cyprus and Malta have become EU Member States and Turkey is receiving special pre-accession assistance.

² OJ L 189, 30.7.1996, p. 1.

³ OJ L 311, 12.12.2000, p. 1.

⁴ OJ C 200, 24.8.2006, p. 1.

5. For technical assistance, two framework agreements⁵ were signed in 2003 and complemented by annual implementation agreements⁶. The management of interest rate subsidies and risk capital operations is regulated by a convention signed in 1992 between the Commission and the EIB⁷.
6. Major findings concerning the legality, regularity and reliability of the accounts of the above-mentioned banking measures were included in Chapter 11, "Financial instruments and banking activities", of the Court's Annual Report concerning the financial year 2006⁸.
7. The financial reference amounts for the implementation of the MEDA programme were 3 424,5 million euro for the 1996–99 period and 5 350 million euro for the period 2000–06. The total amounts financed from the EU budget concerning banking measures were as follows:

⁵ One framework agreement provided financial support for the 2003–06 period for MED countries. The second agreement covered the 2003–04 period for Turkey.

⁶ Article 8 establishes the modalities of information and control.

⁷ Audit and control modalities are established by Article 6.

⁸ Paragraphs 11.7 to 11.18 (OJ C 273, 15.11.2007).

TABLE 1

**FINANCIAL IMPORTANCE OF BANKING MEASURES
MANAGED BY THE EIB ON BEHALF OF THE COMMISSION
UNDER THE MEDA PROGRAMME AND THE COOPERATION
AGREEMENTS FOR MEDITERRANEAN PARTNERS**

		<i>(million euro)</i>	
		31.12.2006	31.12.2007
Risk capital operations	Total amount committed for all ongoing-operations (MEDA only)	380,1 (289,4)	388,4 (309,1)
	Net value at end 2007 of all ongoing-operations (MEDA only)	213,5 (144,9)	218,0 (159,0)
Interest rate subsidies	Total loan amounts	2 867,77	2 867,77
	Total amount of interest rebates	479,5	487,67
Technical assistance	Budgetary appropriations	105,0	105,0
	Total amount paid by the budget	50,0	50,0

Source: Commission and European Investment Bank.

8. Since October 2002, all EIB operations in the Mediterranean region have been brought together under the facility for Euro-Mediterranean investment and partnership (FEMIP), which was set up following a decision of the European Council in Barcelona. The objective was to provide a new impetus to the economic development of the Mediterranean region by improving financial and economic cooperation.

AUDIT SCOPE AND APPROACH

9. In the period from September 2006 to November 2007 the Court carried out a performance audit of the banking measures financed under the MEDA programme and the previous protocols, on the basis of the following two questions.
 - (a) Are the projects adequately monitored by the Commission and the EIB by means of proper control procedures, ensuring that there is feed-back in the event of obstacles affecting the execution of the projects?
 - (b) Are the projects achieving their objectives?
10. The audit was based on a review of the approval, implementation, monitoring and reporting systems in place at the Commission and the EIB. The audit also included a review of relevant reports issued by the Commission, the EIB or external consultants.
11. At the project level, a detailed desk review was conducted on:
 - 30 technical assistance projects, selected from the 2003–06 period and representing a coverage of 32 % in terms of the number of projects;
 - 30 loans with interest rate subsidies, selected from the 1988–2006 period and representing a coverage of 25 % in terms of the number of projects; and
 - 30 ongoing risk capital operations, including one operation directly managed by the Commission, selected from the 1989–2006 period and representing a coverage of 82 % in terms of net value as defined in the 2006 Communities' balance sheet.
12. This audit was completed by on-the-spot visits to Egypt, Tunisia and Morocco. During these visits, meetings were held with representatives of local EC delegations, EIB offices, local authorities, project promoters, financial intermediaries and final beneficiaries.

OBSERVATIONS

MONITORING AND COORDINATION OF THE PROJECTS

MONITORING BY THE COMMISSION

- 13.** For delegated management, the Commission is supposed to implement a form of monitoring that is complementary to the monitoring performed by the EIB. The Commission should notably ensure:
- that the banking measures financed under the MEDA programme are adequately managed by the EIB; and
 - that information is received by the Commission from the EIB, both at the central and local level, so that it can fulfil its duties.
- 14.** The Court noted that the Commission did not define its own monitoring and evaluation strategy for banking measures managed by the EIB. It relied entirely on the EIB for the financial and operational management of these measures. The management convention for risk capital operations and interest rate subsidies signed in 1992 is vague and does not set out clear management rules and procedures.

TEXTBOX 1

EXAMPLE OF SUCCESSFUL DIRECT MANAGEMENT BY THE COMMISSION THROUGH THE LOCAL EC DELEGATION WITH THE SUPPORT OF EXPERTS

Support programme for the Moroccan guarantee institutions — Morocco

This programme is administered locally by the EC Delegation, with the support of an external expert.

The objectives of the programme are:

- to develop the financial and technical capacities of the guarantee institutions and the banks requesting the guarantees;
- to increase the financing of enterprises by providing counter-guarantees.

After some delay at the outset linked to the establishment of the technical assistance team, this project was closely monitored by the local EC Delegation, making it possible for appropriate action to be taken wherever necessary.

As the result of the good Commission direct management, the financial environments for local SMEs improved and the capacity building powers of the local guarantee institutions and banks were enhanced.

15. For the directly managed operations, the Commission should implement a form of monitoring designed to ensure:
 - that weaknesses in the management of the operations are quickly identified; and
 - that corrective action is taken.
16. For individual support projects/programmes which the Commission administered directly, the Commission undertook systematic and effective monitoring and evaluation through its local EC delegations.

MONITORING BY THE EIB

17. In general, an effective monitoring has to cover all stages of a project to ensure the quality of the project design, its relevance, the efficiency and timeliness of its implementation and the achievement of the foreseen objectives. It should be performed on a regular basis to ensure that the required information is provided and that the legal and contractual obligations are met.

TEXTBOX 2

EXAMPLE OF IMPACT ON THE COMMUNITY'S FINANCIAL INTERESTS

Global risk capital operations — Morocco

These global risk capital operations were characterised by the channelling of funds to SMEs through local financial intermediaries via a centralised intermediary.

For several years the EIB did not ensure sufficient follow-up of these operations and did not ensure that the various actors fulfilled their contractual obligations. For example some final beneficiaries did not pay the interest on their loans for more than 10 years.

The EIB had no complete financial overview of the amounts due but unpaid from the centralised intermediary, financial intermediaries and final beneficiaries. In addition the valuation of the participations is uncertain and has not been subject to any write-down. Out of an original value of 31,6 million euro, the value remaining was assessed to be only 10,5 million euro as per EIB valuation.

18. Due to their specific nature, banking measures represented an area of high risk, especially as they were based on assumptions as to the capacity of the intermediary/promoter to meet predefined objectives. Furthermore these activities were highly dependent on external factors. Against this background, monitoring, controls and reporting were key success factors.
19. During the early years of the programme, and until 2005, the EIB did not implement adequate monitoring and controls. In addition the reporting flow from the intermediaries/promoters was insufficient. This mainly affected the monitoring of projects and the implementation of corrective action for projects that were not meeting their objectives or intermediaries/promoters who were not meeting their contractual obligations. This lack of adequate monitoring affected the Community's financial interests, notably due to late recovery or non-recovery of funds and the waiving of some contract clauses, for example regarding penalties for late payment.

TEXTBOX 3

EXAMPLE OF WEAK EIB MONITORING COMBINED WITH A LACK OF REPORTING FROM THE INTERMEDIARY

Risk capital investment company — Tunisia

This financial intermediary was a risk capital partner under the “Development of the private sector II” and “Support private sector” projects and financed 29 projects in various sectors for a total amount of over 7,5 million euro. It also participated in two Tunisian privatisations for a total amount of 6,7 million euro.

The intermediary did not systematically forward information allowing the EIB to follow the evolution of its participations within the contractual deadlines. It did not always inform the EIB of events that substantially affected the investments, although it was contractually obliged to do so.

Reimbursements and remunerations for an amount of 2,2 million euro dating back to the 1999–2004 period were not paid by the intermediary. When this was discovered by the EIB in 2004, an amount of 743 544 euro was paid and a specific protocol was established in 2005 to regularise the situation before the end of 2006 at the latest. After the signature of the protocol, payment defaults were still noted during the audit of subsequent amounts due. This situation was only settled at the end of 2007.

- 20.** Since 2005, when the department responsible was reorganised, the EIB has implemented a more structured monitoring approach, including enhanced controls and reporting, notably with the establishment of individual follow-up sheets. However, shortcomings resulting from the past are being addressed but still need to be resolved. This was notably the case for the global risk capital operations granted to financial intermediaries in Egypt, Morocco and Tunisia, for which an information gap still existed.

COORDINATION BETWEEN THE EIB AND THE COMMISSION

- 21.** According to Article 4(1) of the MEDA regulation, the Commission is required to ensure the effective coordination of the assistance efforts undertaken by the Community, including the European Investment Bank, and individual Member States, in order to increase the coherence and complementarity of their cooperation programme.
- 22.** The Commission, and especially two of the EC delegations in the partner countries visited by the Court, were not sufficiently informed of EIB projects and was therefore not able to monitor or follow them. Furthermore, even when information had been transmitted by the EIB to the Commission's central offices in Brussels, it had not always been shared with the delegations visited by the Court. The audits on the spot did, however, show that the establishment of EIB representative offices had facilitated communication between the Commission and the EIB at the local level. This was especially noted in Morocco, with the organisation of regular meetings.

ENVIRONMENTAL MONITORING

- 23.** When delegated management is applied and especially in the case of projects with potential environmental impact, environmental compliance has to be monitored to ensure that environmental rules and requirements are being respected. Environmental assessments should identify possible environmental effects and propose measures to mitigate them. Regular environmental monitoring should be conducted to ensure that mitigating measures are taken and that significant adverse environmental effects are avoided.

- 24.** The working procedures between the Commission and the EIB⁹ specify that “the EIB shall satisfy itself that projects to be financed comply with environmental rules and requirements”.

⁹ Memorandum of understanding between the EIB and the Commission services on environmental aspects of 2002.

- 25.** The EIB did not always receive sufficient evidence from financial intermediaries/promoters regarding environmental compliance. This was the case for two projects (nitrogen fertilizers and pharmaceuticals) included in the list of sectors requiring detailed description and an analysis of the environmental measures.

- 26.** The environmental monitoring performed by the EIB was limited to documentary checks, which did not constitute a comprehensive environmental monitoring exercise. For intermediated operations, the financing contracts and the practical provisions did not require environmental monitoring by the financial intermediaries after the investment screening and approval phases.

ACHIEVEMENT OF THE PROJECTS’ OBJECTIVES

FEMIP TECHNICAL ASSISTANCE

- 27.** Since 2003 the EU budget has financed technical assistance projects in the context of the “FEMIP support fund”, managed by the EIB.
- 28.** The objectives of technical assistance were to improve the quality and development impact of FEMIP operations by:
- strengthening the capacity of Mediterranean partner countries and promoters;
 - financing upstream studies and activities focusing on directly or indirectly strengthening private sector growth.

- 29.** The criteria used by the Court to assess the technical assistance were the appropriate planning and timeliness of the execution of the projects, as well as their effectiveness, efficiency and relevance.

¹⁰The findings resulting from the work conducted by the consultants charged by the EIB for technical assistance studies.

- 30.** The objectives of technical assistance were largely achieved and the technical assistance projects allowed the partner countries, promoters or private partners to upgrade their capacity building.

- 31.** Six technical assistance projects out of the 30 reviewed did not achieve all their objectives due to promoters who either did not accept the findings¹⁰ of the related study, did not take a position on the issues raised, accepted the findings but did not take the necessary follow-up action or did not address the internal weaknesses in the promoters' organisation or the needs for further training.

TEXTBOX 4

EXAMPLE OF A SUCCESSFUL COMBINATION OF TECHNICAL ASSISTANCE AND RISK CAPITAL OPERATION

Specialised bank in Egypt

This financial intermediary was a risk capital partner under the “Competitive upgrading of Egyptian enterprises” and “Upgrading Egyptian enterprises II” projects and financed six projects in various sectors for a total amount of over 7 million euro. It also benefited from technical assistance.

This combination of a risk capital operation with technical assistance was successful as it helped the Egyptian financial intermediary develop organisational adjustment, enhance its procedures and policies, develop a risk management function, upgrade its treasury and asset liability management. Furthermore, it helped the intermediary to develop its information system and adopt a more structured approach regarding risk capital operations, notably at the investment screening and monitoring levels.

INTEREST RATE SUBSIDIES

32. The objective of interest rate subsidies was to support loans granted by the EIB from its own resources for environmental projects. The projects financed should be sustainable in the long run, delivered within a defined timeframe and provide the expected environmental benefits.
33. The criterion of sustainability was not satisfied in all projects. For eight out of 30 projects, mainly in the water sector, there was no evidence that they would be sustainable with the set tariffs. Although the EIB identified these situations at the appraisal stage and the borrowers agreed in their loan contracts to remedy the situation, the obligation was not fully enforced or only led to a tariff study (instead of raising tariffs to the appropriate level to ensure sustainability). An external evaluation commissioned by the EIB also concluded that project sustainability was a significant issue.
34. Projects benefiting from loans with interest rate subsidies were often subject to delays. Significant delays, up to seven years, were found in 11 out of 30 projects analysed. A significant delay in the execution of a project either calls into question the project's relevance for the EIB, the Commission and the partner country or has negative consequences for the environment (as illustrated in Textbox 5).

TEXTBOX 5

EXAMPLE OF A LOAN WITH INTEREST RATE SUBSIDIES NOT ACHIEVING THE REQUIRED OBJECTIVES WITHIN THE DEFINED TIMEFRAME

Preventing further pollution of the Gulf of Gabès — Tunisia

The initial project approved in 1999 aimed at creating a storage place together with a pumping station and pipelines to transfer phosphogypsum, instead of pouring it into the sea. The total estimated cost was 107 million euro. After several amendments, the new project structure presented in 2007 involved transferring the plant to a new site and setting up a pipeline network. The updated estimated cost of the project was 235 million euro for the storage and the pipeline network, plus 165 million for the transfer of the plant.

The project was subject to numerous delays. Consequently, dates for the start of operations and the end of work were put back several times. While both were initially set for October 2002, they are currently set for end 2009 and mid-2010 respectively. The environmental impact of these delays is very significant. The current plant is generating between 5 and 8 million tons of phosphogypsum per year. If the project meets its current target, the delays will then have generated an additional quantity of pollution in the Gulf of Gabès of between 35 and 64 million tons of phosphogypsum.

RISK CAPITAL OPERATIONS

35. The risk capital operations provided and managed by the EIB took, in particular, the form of:

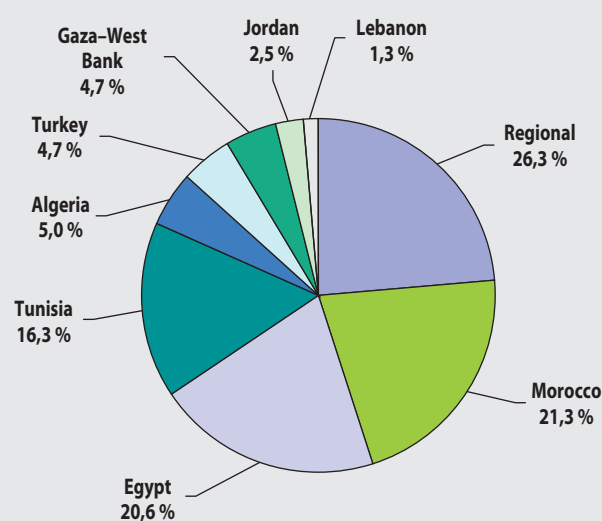
- direct investments: acquisition of equity or quasi-equity instruments (subordinated loans) in private companies;
- private equity funds: participation in investment funds taking participations in private companies or other investment funds;
- co-investments with pre-selected local intermediaries;
- loans on special conditions, notably to micro-finance institutions; and
- support to guarantee schemes.

¹¹ The difference between committed amount and net value is mainly due to amounts yet to be disbursed, as per contractual provisions.

36. The MEDA portfolio of risk capital operations represented a total committed amount of 309,1 million euro and a net value of 159 million euro at the end of 2007¹¹. The geographical spread of the portfolio is presented in the **graph**.

GRAPH

GEOGRAPHICAL SPREAD OF MEDA RISK CAPITAL OPERATIONS



Source: European Investment Bank.

- 37.** The Court first assessed the global planning of the Risk Capital facility based on the objectives set by Article 6(4) of the MEDA regulation: “Risk capital shall be used, first and foremost, to make available own funds to undertakings in the production sector, in particular those that can bring together natural or legal persons who are nationals of a Community Member State and of Mediterranean non-member countries or territories. Risk capital shall be used primarily to strengthen the private sector, and in particular to reinforce the financial sector in MEDA countries. It shall add value clearly, by offering financial products and terms that are not available locally”. At the project level, the following additional criteria were used to measure the achievement of the project objectives: reaching the target group, relevance, timeliness, sustainability, as well as financial and non-financial performance.
- 38.** There was no defined strategy as to the type of projects and sectors to be supported, at either the level of the Commission or the EIB or at the level of the financial intermediaries. For several projects, there was no evidence that EU participation was playing a significant role and that they would not have been realised without it (see Textbox 6).

TEXTBOX 6**EXAMPLE OF EU PARTICIPATION NOT ADDING VALUE AND NOT ACHIEVING ITS OBJECTIVES****Technology investment fund — Regional**

The fund was established in 2000 in order to invest in information technology, software, media, telecommunications and related industries established, or having significant operations, in the Middle East.

The EU participation in the fund took place in 2001 when almost all the fund’s investments were committed. Furthermore, the fund deviated both from its investment target and from its investments restrictions. There was also insufficient monitoring and controls by the fund over its investments.

As at mid-2007, out of a total of 25,6 million USD invested in the fund, 7,2 million USD were repaid to the investors in the context of its liquidation, whereas the residual value is only 3,1 million USD. Out of the EU participation of 5,4 million USD, 1,52 million USD were repaid and the residual value was 0,66 million USD.

- 39.** The Commission did not set up controls in order to detect whether the same beneficiary was benefiting from different risk capital operations, either managed directly or through financial intermediaries. This was due to the absence of a central database at Commission level of all beneficiaries benefiting from risk capital operations.
- 40.** At the start of the risk capital operations, the EIB focused its activities on providing global risk capital operations contracted with multiple financial intermediaries, sometimes with an additional intermediate level, either public or private. While global risk capital operations often reach a large number of beneficiaries, they are difficult to administer and require intensive monitoring. In the past, the EIB did not ensure efficient use of global risk capital operations (see also Textbox 2). Several financial intermediaries and agents did not meet their monitoring, reporting and financial requirements or were acting as promoters instead of as independent intermediaries (see Textbox 7).

TEXTBOX 7**EXAMPLE OF RISK CAPITAL OPERATION NOT ACHIEVING THE REQUIRED OBJECTIVES IN TIME****Investment company based in Egypt**

This financial intermediary was a risk capital partner under the “Competitive upgrading of Egyptian enterprises” project and financed three projects, all in the tourism sector, for a total amount of over 6,8 million euro.

This risk capital partner was the direct promoter of the three projects and not an independent financial intermediary. The aims of the projects were to establish a new superior tourism destination in Egypt and build five-star hotels.

The investment evaluation conducted by the intermediary was based on ambitious targets that were not achieved. The projects also suffered from under-capitalisation and delays of four to five years in the construction of the hotels that were not reported in due time to the EIB.

41. As indicated in paragraph 37, while initial risk capital operations focused on the aim of bringing together EU and Mediterranean beneficiaries, more recent projects mainly involved Mediterranean partners only.
42. The financial performance of the risk capital operations showed mixed results and often depended on the quality of the financial partners selected by the EIB. The risk capital operations are shown in the accounts at historic cost less any provisions for impairments¹². Furthermore, it was difficult for the Court to assess, whether the risk capital operations had achieved their objectives as, most of the time, no indicators other than financial ones, were available.
43. Even if the achievement of the objectives set for risk capital operations was difficult to assess, the Court recognises the positive effect of EIB actions on regional integration and on the enhancement of corporate governance and business conducts in the partner countries.

¹² Impairments should be based on definitive and provisional write-offs. However, only definitive write-offs are currently communicated by the EIB to the Commission.

TEXTBOX 8

EXAMPLE OF A SUCCESSFUL TRANS-REGIONAL FUND MANAGEMENT

Specialised fund managers with operations in Algeria, Morocco and Tunisia

This fund management company, which manages several investment funds across the Maghreb region, has developed a successful business model based on clear investment rules and procedures. These rules and procedures not only covered investment screening, monitoring and valuation, taking into consideration European and international standards, but also led to coherent exit strategies and detailed reporting to shareholders. All this resulted in a positive financial performance.

This successful business model, combined with the dynamism of the local fund managers has further allowed an extension from Tunisia to Morocco and Algeria.

CONCLUSIONS AND RECOMMENDATIONS

MONITORING OF THE PROJECTS

- 44. There was no monitoring of the projects under delegated management at Commission level. Monitoring by the EIB had been inadequate in the past and had been recently upgraded in order to reach a satisfactory level.**
- 45.** Regarding the Commission's management of the banking measures financed under the MEDA programme, the absence of a monitoring and evaluation strategy was noted. The Commission effectively monitored the programmes that it administered directly. However, it did not sufficiently ensure the effective coordination of Community assistance with the EIB's supporting measures. Furthermore, the transfer of the responsibility for environmental compliance did not lead to adequate environmental monitoring (see paragraphs 13 to 16 and 21 to 26).

RECOMMENDATIONS ON THE MONITORING BY THE COMMISSION

With the end of the MEDA programme and the start of the new European neighbourhood and partnership instrument that was launched in 2007, the Commission should:

- (a) set up a tailor-made evaluation and monitoring programme for banking measures, taking into consideration the input received from the partners responsible for the implementation of the banking measures in the Mediterranean partner countries;
- (b) ensure the effective coordination of assistance by the Community, the EIB and other international/local partners on the basis of a reciprocal and regular exchange of information (including at the local level), in order to increase the consistency and complementarity of their activities;
- (c) negotiate adequate management conventions ensuring appropriate monitoring, covering the environmental aspects and safeguarding the financial interests of the Community.

- 46.** The EIB's management of banking measures suffered from insufficient monitoring during the first years of the programme. This not only affected the achievements of the projects but also the Community's financial interests, notably due to the late recovery or non-recovery of funds and the waiving or absence of some contract clauses. The EIB gradually improved its monitoring from 2005 onwards in order to reach a satisfactory level (see paragraphs 17 to 20).

RECOMMENDATION ON THE MONITORING BY THE EIB

Regarding banking measures mandated to the EIB on behalf of the Commission, the Commission should ensure that monitoring by the EIB provides that all projects are adequately executed and that the financial and reporting obligations of the intermediaries/promoters are met.

ACHIEVEMENT OF OBJECTIVES

- 47.** **The technical assistance projects achieved their targets while loans with interest rate subsidies and risk capital operations partially achieved their objectives.**
- 48.** While the objectives set for technical assistance were fulfilled, the situation regarding interest rate subsidies and risk capital operations was more diverse. Several loans with interest rate subsidies failed to meet at least one of the three achievement criteria (sustainability, timeframe and expected environmental benefits) (see paragraphs 27 to 34).

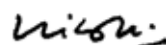
- 49.** The overall achievements of the risk capital operations were difficult to assess. Regarding financial performance, the fair valuation of the risk capital portfolio available was not reflected in the Communities accounts. Regarding non-financial performance, specific indicators were rarely available. In recent years the projects deviated from the target of bringing together Mediterranean and EU partners. However, the overall action by the EIB, in coordination with one of the other international and local players, made it possible to raise the level of corporate governance and promote developments in the field of private equity (see paragraphs 35 to 43).

RECOMMENDATION ON THE ACHIEVEMENT OF THE OBJECTIVES

For risk capital operations, the Commission should define an overall strategy and choose the best implementation process, either through direct management or through management by international/local partners.

This report was adopted by the Court of Auditors in Luxembourg at its meeting of 21 and 22 January 2009.

For the Court of Auditors



Vítor Manuel da Silva Caldeira
President

REPLY OF THE COMMISSION

SUMMARY

I.

The EU's Mediterranean partner countries witnessed a major evolution in the nineties. The private sector gained in importance, under the influence of large privatisation programmes. In some countries, the financial sector converged rapidly with European models. Environmental standards also changed drastically. This development has been reflected in MEDA operations, which followed the standards of their time.

Political interests and legislation have also evolved during the last 15 years. As a consequence, programmes initiated in the early or mid-1990s cannot be assessed in the light of present criteria.

II.

The sample selected by the Court stretches over a long period of time (1989–2006). For risk capital operations (RCOs) in particular, the sample contained many early projects.

IV.

First indent — Beforehand, it was the EIB's responsibility under the management agreement signed between the Commission and the EIB to monitor and follow-up the projects funded under budgetary resources. As from 2007, under the European neighbourhood policy (ENPI) budgetary resources, projects managed by the EIB are included in the Commission's results-oriented monitoring system.

Second indent — In agreement with the Commission, the EIB currently applies the most appropriate standards in terms of monitoring, as evidenced by the detailed, multiple and regular reports produced on RCOs, which contain detailed information on each project financed under MEDA. Based on information received from the EIB, the Commission recognises some past shortcomings with respect to the provision of adequate information contractually foreseen by some of the financial intermediaries. However, several of these shortcomings had already been identified by the EIB and are currently being remedied.

Third indent — Frequent exchanges take place between the Commission and the EIB. During the period of the MEDA programme as well as in the current period, the EIB contributed to the national indicative programme documents and discussed individual operations with the Commission at conception stage. Each RCO under ENPI needs individual approval from the Commission. Moreover, since 2005 the Commission, including the delegations, received regular and comprehensive RCO reports issued by the EIB.

Fourth indent — The Commission acknowledges that in the past, more emphasis could have been put on environmental monitoring. However, standards have evolved rapidly in recent years.

Depending on the nature of the project, the environmental monitoring is performed through documentary checks — often sufficient to ensure conformity with the EIB's environmental policy objectives — but also, where necessary, on-site visits by EIB representatives.

For intermediated operations, although environmental monitoring was not foreseen in the financing contracts, it is part of an overall obligation of the financial intermediary, which is required to verify the beneficiary's compliance with applicable laws and regulations (being noted that standards applicable at the time of signature of the operations audited by Court are different from today's) and, if requested to do so by the EIB, implementation of appropriate mitigation measures.

V.

Regarding interest rate subsidies and RCO, the situation was indeed more diverse, but overall positive, as the objectives set forth in the MEDA regulation (i.e., “to strengthen the private sector and to reinforce the financial sector of MEDA countries”) have been achieved. These operations have had a positive impact in terms of jobs created and have contributed to the economic development of the Mediterranean partner countries.

VI.

First indent — The tailor-made evaluation and monitoring programme requested are already in place in the context of ENPI. It complements the extensive monitoring programme already put in place by the EIB.

Second indent — The coordination is already in place, with the EIB contributing to the national indicative programmes and frequent contacts with the Commission. Moreover, the EIB has signed various memoranda of understanding with bilateral and multilateral institutions in order to ensure closer coordination and better consistency and complementarity of their actions with the ones implemented by other actors in the field.

Third indent — A new management agreement is currently being negotiated between the Commission and the EIB. The points highlighted by the Court will be taken into account.

Fourth indent — The current monitoring performed by EIB is adequate and ensures that financial and reporting obligations of the intermediaries/promoters are met.

Fifth indent — A strategy for risk capital operations has been defined within the ENPI.

INTRODUCTION**5.**

A new management agreement is being finalised and will be signed in the first half of 2009. It will cover all the types of cooperation between the EC and the EIB in the field of external aid.

OBSERVATIONS**13.**

Delegated cooperation is used when it is considered that certain tasks can better be managed by another institution/entity than the Commission, which is the case for risk capital operations and interest rate subsidies. This is the core business for the EIB as a banking institution.

14. and 15.

In 1992 the risk capital operation and interest rate subsidies approach was new and there were no clear guidelines and applicable rules about delegated cooperation and/or this type of activities. In this framework the management agreement established by the Commission provided for a “global” delegation of tasks in which the Commission had to be kept informed and was to be consulted in case of major changes. Recently with the entry into force of the new financial regulation in 2003 and its modification in 2007, rules, guidelines and templates have been elaborated on delegated cooperation. A new management agreement is being finalised by the services of the Commission and will be signed at the beginning of 2009. It will include detailed requirements in terms of reporting, monitoring, accounting, etc.

17.

In general, EIB practices aim to ensure effective monitoring covering all stages of a project. Its design, its relevance to EU objectives, its economic and financial return, as well as its environmental impact are issues that are assessed during a complete appraisal carried out by EIB's services. The contractual documentation negotiated with the promoter reflects EIB's recommendations resulting from its due diligence. After the signing of the contract, the EIB ensures the compliance of the borrower's obligation and applies the most appropriate standards in terms of monitoring.

19.

Currently, up-to-date monitoring information from intermediaries is available for almost the totality of the portfolio, leaving aside 3 old Moroccan global loans signed before the MEDA programme between 1989 and 1994 and for which some information gaps still exist.

Based on the information received from the EIB, the Commission considers that no negative financial consequences have been incurred. With the exception of minor amounts waived in order to facilitate a swift settlement, all amounts due have always been claimed and recovered (in the case of old Moroccan global loans, are still being recovered), with late payment penalties added on to the regular amounts owed, when applicable.

Textbox 2 — Example of impact on the Community's financial interests

First paragraph — This centralised intermediary is a ministry of the Kingdom of Morocco.

Second paragraph — The Court refers to the old Moroccan global loans, signed between 1989 and 1994, before the MEDA programme was in place. Such operations were the only practicable solution at the time, when there was no private equity firms present in MEDA countries, but they are no longer used. Past shortcomings with respect to the provision of adequate information contractually foreseen by some of the financial intermediaries in Morocco and by the ministry have indeed occurred in the case of these old operations. However, several of the shortcomings had been identified by the EIB prior to the start of the audit by the Court and are all currently being remedied. All amounts owed under the old risk capital global loans in Morocco have already been claimed from the intermediaries and final beneficiaries and have been or are being collected.

Third paragraph — These old Moroccan operations, pre-dating the MEDA mandates, account for 7,5 % of total currently committed RCO amounts and are not representative of the more recent RCOs signed since the start of the FEMIP, in 2002.

Data have now been provided for in most cases by the ministry regarding the funds disbursed by the ministry to the local financial intermediaries and the reimbursements made by these intermediaries to the ministry. Some information gaps still exist, despite EIB's continued efforts to fill them in. However, the situation keeps on improving. Write-offs have been made, where appropriate, on a number of operations.

20.

Since 2005, the corrective actions relating to shortcomings identified by the EIB have been implemented. Some of them take time to result in a concrete effect.

The EIB makes sure that the reporting obligation imposed upon borrowers and financial intermediaries are complied with. Today, old Moroccan global loans set aside, satisfactory information is received for the large majority of the RCOs in the portfolio.

The shortcomings resulting from the past have been addressed, although some intermediaries still need to improve their reporting in order to reach current standards.

Textbox 3 — Example of weak EIB monitoring combined with a lack of reporting from the intermediary

Second paragraph — The Commission stresses that, in the banking business, especially in emerging markets, breaches of contractual obligations (including payment default) from some counterparts may not be excluded.

Third paragraph — The intermediary's lack of timely reporting and payment delays had been identified by the EIB in 2004. The EIB had sent reminders to the intermediary on several occasions, had convened meetings in Tunis and Luxembourg and, finally, had drafted a settlement agreement (*protocole d'accord*) which was signed by the intermediary in late 2005. Eventually, as a result of this active monitoring, all payments due by the intermediary have been paid back at the end of 2007.

22.

The Commission offices in Brussels have since reinforced the team working with EIB-managed projects. This has already led to better communication with delegations.

25.

As a rule, when a project falls within the list of environmentally sensitive sectors, the EIB requests and gets a copy of all authorisations and permits that need to be obtained by the promoter under the relevant legislation. In addition, investments made by financial intermediaries in sensitive sectors are screened by the EIB. Other sectors are *per se* excluded from the EIB financing.

26.

Depending on the nature of the project, the environmental monitoring is performed through documentary checks — often sufficient to ensure compliance with the EIB's environmental policy objectives — but also, where necessary, on-site visits by EIB representatives.

For intermediated operations, environmental monitoring was not foreseen in the financing contracts, nevertheless it is part of an overall obligation of the financial intermediary, which is required to verify the beneficiary's compliance with applicable laws and regulations (being noted that standards applicable at the time of signature of the operations audited by Court are different from today's) and, if requested to do so by the EIB, implementation of appropriate mitigation measures.

31.

The ownership of the promoters is clearly crucial for the success of lending and related technical assistance (TA) operations. This was also reconfirmed by the external mid-term evaluation of the FEMIP support fund in 2006 concluding that the fund has been successfully implemented. 24 out of 30 projects have attained all their objectives and the other six have reached their objectives at least partially. In the meantime, the EIB has taken additional measures to further improve the performance of TA activity, such as the strengthening of the TA unit, increased on-site presence of Bank staff at an early stage of the project cycle and internal training measures.

33.

All projects selected within the sample are up and running and the tariff level is not the only condition to the sustainability of the project. Tariffs are fixed by governments and the EIB's counterparty has no control over tariffs levels. The EIB tries to influence the mechanism of tariff increase through conditionality in the finance contracts and discussions at the political level. However, in countries such as the Mediterranean partner countries, the level of acceptance of increases in tariffs is much lower than in other sectors. The water sector, more than any other, therefore needs some flexibility to ensure that projects are implemented in accordance with the EIBs requirements despite some high external constraints.

34.

The execution of a project benefiting from an interest rate subsidy mainly depends on the partner country's utilisation of the loan. Given that the projects imply a long-term indebtedness for the countries, delays may occur because of changing political/budgetary priorities, notwithstanding the project's relevance. In none of these cases, the relevance of the projects themselves has to be questioned. A delay in a project implementation postpones its environmental benefits but does not entail by itself negative consequences for the environment. In fact, a postponement can be preferable in case of projects to be implemented in a non-sustainable manner.

Textbox 5 — Example of a loan with interest rate subsidies not achieving the required objectives within the defined timeframe

Second paragraph — The phosphatic industry holds a key position within the Tunisian economy and nowadays represents around 17 % of GDP. The promoter of the project has been rejecting phosphogypsum since 1952. The driver for this project has always been to mitigate this significant source of pollution. The delays have been caused by exceptionally rare geophysical problems discovered on the proposed landfill site. The problems experienced have forced the promoter to re-design the whole project. Without the intervention by the EIB there would not have been such a project at all. Due to EIB persistence, the promoter has now been shifting from a polluting company to a responsible chemical producer who is now seeking to systematically monitor and minimise polluting effects according to best practice in the industry.

38.

The objective of MEDA risk capital operations, which was clearly stated as from the beginning, was to favour private sector development through a form of financial intervention that was not readily available at the time. Such was done by the EIB.

During the nine on-site visits of RCO financial intermediaries, most of them explicitly and repeatedly mentioned that the financing of their project would not have been possible without the European Community's intervention. Moreover, some beneficiaries emphasised that participation in the European funds gave them visibility and notoriety, which attracted other investors.

Textbox 6 — Example of EU participation not adding value and not achieving its objectives

Second paragraph — EU participation in the technology investment fund is an exception in the RCO portfolio. Amongst the 32 investments into funds under RCO, this fund is the only case of such a late entry of EIB in the course of the fundraising process. Besides, at the time of EIB's investment, the fund had plans to make many more investments but such plans were abandoned, following the bursting of the Internet bubble.

Third paragraph — The poor performance of this fund — one of the worst financial performances of the whole RCO portfolio — is mainly explained by the bursting of the Internet bubble and by the sharp devaluation of the Egyptian pound in 2002. This case is isolated in the portfolio. By way of comparison, MEDA II operations under RCO globally yielded a positive return of 12 % (multiple on investment). This return outpaces the one of RCOs made under the previous mandate (MEDA I), at the moment still slightly negative with a multiple on investment of 0,9 times, but steadily increasing and likely to exceed the break-even mark before the liquidation of these RCOs.

39. Setting up costly control mechanisms to monitor cases of cross beneficiaries between Commission programmes and RCO operations has been considered uneconomical and unnecessary, considering the very few cases of separate financing granted to a same beneficiary.

40. For many years now, the operational set-up of so-called global loans, which during the 1980s and early 1990s represented a pioneering way of providing equity financing in the region, has been replaced by more current forms of intervention. Today, problems have been resolved and apart from the old (1989–94) Moroccan global loans, satisfactory information has been received for almost of the RCOs in the portfolio.

Textbox 7 — Example of risk capital operation not achieving the required objectives

Second paragraph — The objective of the RCO operation involving an investment company based in Egypt was to build hotels to create thousands of jobs in a key sector for the Egyptian economy. These objectives have been achieved, albeit with delay.

Third paragraph — Delays often occurred in the tourism sector in Egypt in the period considered, due to the particularly unstable global and local geopolitical situation (years 2000–01).

41. The key objective of the RCO is to support the development of the private sector in the partner countries. However, neither the MEDA regulation nor the preceding protocols provide for an obligation to support only joint-ventures between European and local partners.

42. The EIB, in line with its current policies, monitors the financial and non-financial performance of its investments. In the case of intermediated investments, the monitoring is realised through reports provided by the intermediaries. For some of the intermediaries, a pragmatic and therefore simplified reporting framework has to be adopted for each report.

Since 2006, the EIB has imposed a comprehensive set of non-financial indicators to its new fund operations, which it developed together with other international financing institutions; in addition, the EIB has also increased the use of non-financial indicators to be used by other intermediaries under global authorisations. The review of FEMIP portfolio of investment funds made by the EIB in 2006 explains and quantifies the developmental impact of its fund activity, and proves the EIB's attention for and ability to deliver on non-financial performance indicators.

Textbox 8 — Example of trans-regional fund management

Second paragraph — The EIB's support through RCO has been a key element in the development of this successful fund management company.

CONCLUSIONS AND RECOMMENDATIONS

44.

The management delegated to the EIB includes a delegation of all monitoring and follow-up activities. The Commission has been kept informed and consulted with respect to major changes made to a project financed by the EIB.

45.

In addition to monitoring carried out by the EIB, under the new ENPI legal base, the Commission's external results-oriented monitoring (headquarters and delegations) carry out a monitoring of projects not administered directly by the EC (but by the EIB). The Commission's monitoring is complementary to the EIB's. Environmental standards and legislation have evolved tremendously over time. Standards applicable at the time of signature of the operations audited by the Court are different from today's and have been respected although the EIB's file did not contain the relevant documentation in the two cases mentioned by the Court.

RECOMMENDATIONS ON THE MONITORING BY THE COMMISSION

(a)

Under a delegation scheme as the one foreseen by the ENPI regulation, evaluation and monitoring responsibility should rest primarily with the EIB. The EIB currently has a complete and efficient monitoring routine. Banking measures managed by the EIB are part of the evaluation and monitoring plans of the Commission under the ENPI. As an example, an evaluation of the Commission's aid delivery through development banks and the EIB has been commissioned.

(b)

Such is currently done, especially with the EIB through its contribution to the national indicative plans and through regular exchanges both at headquarter and local levels.

(c)

A new management agreement between the EIB and the Commission is currently being finalised (expected for the first quarter of 2009).

46.

Based on the information received from the EIB, the Commission considers that no negative financial consequences have been incurred. With the exception of minor amounts waived in order to facilitate a swift settlement, all amounts due have always been claimed and recovered (in the case of old Moroccan Global Loans, are still being recovered), with late payment penalties added on to the regular amounts owed, when applicable.

RECOMMENDATION ON THE MONITORING BY THE EIB

The EIB currently has a complete and efficient monitoring routine. The new management agreement shall formalise the measures taken concerning financial and reporting obligations of intermediaries and/or promoters.

48.

The Commission finds that most TA projects are successful in terms of traditional performance evaluation criteria (effectiveness, efficiency, economy, sustainability). The Commission underlines that there was multiple evidence provided by the intermediaries and the final beneficiaries during on-site visits of the positive effects of past RCO operations on private sector development.

49.

The financial performance of the RCO can only be assessed once the related investment has been exited and not in interim valuation reports. Regarding the available fair valuation of the risk capital portfolio, the Commission is in discussion with the EIB so as to investigate how to align the current valuation reports with the new reporting requirements based on the EC accounting rules, considering also the best cost-benefit solution. Regarding non-financial performance, the EIB already produced a special report on the developmental impact of a majority of RCO operations. The EIB has developed non-financial performance indicators with other IFIs. During the past three years, the EIB has been incorporating such indicators as an additional reporting obligation in all of its new contracts.

**RECOMMENDATION
ON THE ACHIEVEMENT
OF THE OBJECTIVES**

ENPI strategy for risk capital operations does indeed foresee flexibility so as to choose the best implementation process: this allows for direct management or management by international/local partners, as recommended by the Court.

European Court of Auditors

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IN THIS SPECIAL REPORT THE COURT AUDITED THE BANKING MEASURES UNDER THE MEDA PROGRAMME AND THE PREVIOUS PROTOCOLS TO DETERMINE WHETHER THE ONGOING PROJECTS WERE BEING ADEQUATELY MONITORED BY THE COMMISSION AND THE EIB AND WHETHER PROJECTS HAD ACHIEVED THEIR OBJECTIVES. THE COURT'S REPORT MAKES A SERIES OF RECOMMENDATIONS AIMED TO SET UP A TAILOR-MADE EVALUATION AND MONITORING PROGRAMME FOR BANKING MEASURES. THE COURT EMPHASISES THE NEED FOR A BETTER COORDINATION OF THE ASSISTANCE WORK UNDERTAKEN BY THE EIB, THE COMMISSION AND THE OTHER INTERNATIONAL/LOCAL PARTNERS. THIS COORDINATION SHOULD BE BASED ON APPROPRIATE NEGOTIATED MANAGEMENT CONVENTIONS WHICH WILL COVER THE ENVIRONMENTAL ASPECTS AND THE SAFEGUARD OF THE COMMUNITY'S FINANCIAL INTERESTS.



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