Probing the role of domestic development finance institutions in implementing and evaluating financial instruments

Nils OELLERICH
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About the author

Nils Oellerich is a PhD researcher at the Department of Political and Social Sciences at the European University Institute (EUI) in Florence, Italy. In his research, he focusses on the interactions between states and financial markets in East-Central Europe with a specific focus on development banking, as well as the allocation of the EU funds in the region. His recent research has been published in the Journal of European Public Policy and East European Politics.

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Abstract

The need to administer, mobilise, and allocate resources to finance the green transition translates into an increasing role for development finance institutions, multilateral and domestic alike, to deliver increasingly complex policy objectives in the context of the EU budget. This paper lays out the multiple ways in which domestic development finance institutions are relevant in the delivery of the EU budget in ways that facilitate the green transition. Given the varying capacities of member states across the EU, these institutions' ability to cope with the additional responsibilities can be expected to differ considerably. In light of this expectation in particular, the current involvement of domestic development finance institutions in the implementation of the EU budget appears to confirm frequently-voiced doubts regarding the appropriateness of financial institutions as enablers of the green transition. This is reinforced by the absence of generalised evaluation standards across different programmes, countries, and institutions which would codify their need to deliver substantive policy objectives.

Introduction

The aim of this working paper is to (a) illustrate the importance of domestic development finance institutions in implementing and evaluating the impact of financial instruments, (b) argue that the increasing importance of financial instruments results in significant administrative challenges especially in the countries in the EU's (semi-)periphery, and (c) discuss the potential for these challenges to inhibit the effectiveness of both policy-steer and evaluation practices in accordance with the EU's green objectives.

In the context of both centrally-managed funds and funds under shared management, national development banks and other domestic development finance institutions take on increasingly prominent roles and thereby become crucial actors in overseeing and evaluating the environmental impact of EU-funded financial instruments. One can expect varying capabilities of member states to take on these tasks and successfully absorb financial instruments in this way as administrative capacities and development finance infrastructures differ significantly in their stage of development. Central and Eastern Europe (CEE) in particular may stand out as a potential loser of the increasing importance of financial instruments due to partly underdeveloped public infrastructures capable of administering these instruments. Moreover, the shift towards financial instrument may lead to a dilution of environmental (and other developmental) objectives given the increasing relative importance of financial objectives related to bankability at the possible expense of other substantive criteria.

EU-funded financial instruments and domestic development banks

The increasing prominence of financial instruments in public investment by the EU both concerns centrally managed funds – notably InvestEU and its predecessor the European Fund for Strategic Investments (ESFI) – and funds under shared management – the European Structural and Investment Funds (ESIF). Both forms of budgetary resources by the EU are increasingly (or, in the case of InvestEU, exclusively) administered as financial instruments rather than grants and both grant extensive opportunities for domestic institutions to take-on various responsibilities in the design and implementations of these instruments. InvestEU comprises an EU budget guarantee of EUR 26.2 billion that supports dedicated programmes set-up by selected implementing partners aimed at infrastructure, R&D, social investment, and SMEs (European Union n.d.). While the European Investment Bank (EIB) and the European Investment Fund (EIF) are the chief implementing partners, implementing 75 per cent of the guarantee, a total of five national institutions administer the remaining share next to other multilateral institutions such as the European Bank for Reconstruction and Development (EBRD) or the Council of Europe Development Bank (CEB). ESIF resources are also increasingly allocated as financial instruments with total volumes increasing from EUR 11.3 billion in the 2007-2013 programming period to EUR 23 billion in the 2014-2022 programming period (European Commission 2018; 2022). Under the ESIF framework, member states can assign the task of managing financial instruments to various eligible institutions with most countries selecting their national development banks and only a minority opting for the EIB or the EIF.

The relevance of green objectives for domestically managed financial instruments

Thus far, the importance and usage of these domestically co-managed financial instruments in the context of the European Green Deal (EGD) appears mixed. This is particularly true for the Just Transition Mechanism (JTM) – the EGD's primary source of funding (European Commission, n.d.a). Pillar I of the JTM – the Just Transition Fund (JTF) – constitutes a part of the ESIF and is, thus, managed by national managing authorities but relies predominantly on the allocation of grants. Pillar II, on the other hand, is funded from InvestEU sources and national development banks are of relevance if they are recognised as implementing partners that can allocate InvestEU instruments without further financial intermediaries. This is currently true for Cassa Depositi e Prestiti (CDP) of Italy, Caisse des Dépôts (CDP) and Bpifrance of France, Instituto de Crédito Oficial (ICO) of Spain, and Bank Gospodarstwa Krajowego (BGK) of Poland.

More generally, national development banks (and comparable institutions) are of note in the allocation of EU-funded financial instruments that should adhere to the objectives set out in the EGD because they manage instruments that are not funded from the JTF and, thus, fall outside the formal arrangements of the EGD but nevertheless should adhere to green objectives by way of the components (of ESIF and InvestEU) they are funded from. This holds true for, for example, the stricter implementation of climate targets in the 2021-2027 programming of the ESIF (European Commision n.d.b) or the Sustainable Infrastructure Window as one of four main policy areas of the InvestEU fund, which requires 60 per cent of investments to contribute to climate and environmental targets (European Union 2021). The latter thereby appears to be a more developed arrangement, with the European Commission publishing explicit guidelines on the monitoring of investments to be provided by the implementing partners (European Commission 2021).

Moreover, policy proposals yet to be ratified or implemented – such as the proposed Net-Zero Industry Act (NZIA) – are likely aimed at mobilising existing EU budgetary resources – including the ESIF and InvestEU – for the pursuit of its policy objectives. A recent analysis by the European Commission of the funding needs of the NZIA, for example, estimates needed investments of EUR 92 billion until 2030 (in addition to EUR 477 billion per year in relation to the green transition more generally) and specifically includes the financial instruments funded by ESIF and InvestEU in its projection of existing funding opportunities for net-zero industries (European Commission 2023). Given the subsidiarity of ESIF funding in particular, greater needs for national and regional managing authorities and its implementing partners to evaluate the environmental impact and/or contribution to green policy objectives is to be expected.

Financial instruments as an administrative challenge for Central and Eastern Europe

The additional (expected) policy objectives related to the green transition notwithstanding, the greater prominence of financial instruments in the ESIF and other EU budgetary instruments alone presents an administrative challenge that especially some states in the EU's semi-periphery, due to less experienced and equipped central administrations and a smaller pool of technical expertise, may have difficulties to overcome. For the effective domestic management of financial instruments, member states need to mobilise the political will to create or strengthen national development finance institutions, create and/or acquire financial expertise within the managing authorities, equip development finance institutions with the capacity to manage EU-resources (and the corresponding regulation), and create (or activate) the demand for financial instruments as opposed to simple grants among final beneficiaries.

Semi-peripheral countries, CEE in particular, are, in part, less likely to successfully weather these challenges because of (a) administrative capacity is shown to be underdeveloped in a number of

countries in the region especially in the context of EU funds absorption and usage (Karo & Kattel 2015; Medve-Bálint & Šćepanović 2020), and (b) development finance infrastructures are, similarly, underdeveloped and, thus far, appear partly inadequate to effectively make use of existing EU-provided resources (Piroska & Mérő 2021; Mikheeva & Juuse 2021). More concretely, while CEE states have allocated average shares of their ESIF funding to financial instruments in the 2014-2020 financial perspective, their payment and disbursement rates fall behind the EU average as of 2021 (European Commission 2022). Moreover, and as illustrated by Figure 1, CEE states are considerably slower than the EU average in disbursing its financial instruments. While the slow pace of disbursement does not constitute a problem in on its own as long as eventual disbursement is adequate, it points to structural problems in the design and allocation of financial instruments as it indicates programmatic overlap between these instruments and grants, which are taken up quicker.

While the difference in the average performance between CEE countries in the commitment to and disbursement of financial instruments and the EU average is not especially striking (but nevertheless present), variation within the region is considerable. For example, while Hungary, Slovenia and Lithuania commit between 12 and 14 per cent of all ESIF funds to financial instruments, numbers for Romania, Estonia, and the Czech Republic lie between 2 and 4 per cent. Similarly, disbursement rates (of Cohesion Policy funds) differ significantly with Hungary, the Czech Republic and Croatia disbursing

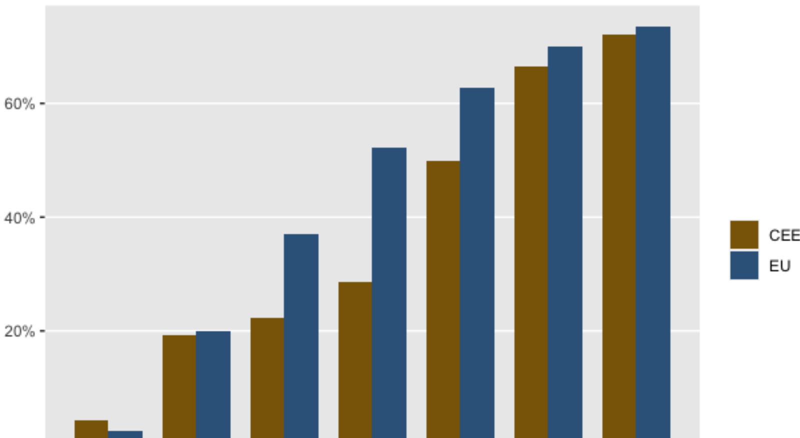

Figure 1: Disbursement rate of Cohesion Policy financial instruments (ERDF & CF) in the 2014-2020 programming period; Source: European Commission (2016; 2017; 2018; 2019; 2020; 2021; 2022)

more than 80 per cent of resources paid to financial instruments, Bulgaria, Latvia and Slovenia disbursed less than 65 per cent (European Commission 2022).

What are the implications of these evident administrative challenges for the implementation and evaluation of green objectives via domestically managed financial instruments? First, the lower capacity to absorb financial instruments alone constitutes a likely challenge as the introduction of additional substantive criteria for the disbursement of a given instrument is inhibited by an environment characterised by potential final beneficiaries hesitant to taken on debt or even cede partial ownership control. This constellation might contribute to domestic institutions' reluctance to effectively evaluate the environmental impact of the instruments they manage absent coherent and obligatory guidelines that explicate the details of this evaluation as well as the funds they shall be applied to. Second, the tendency of a number of CEE states not strengthening their development finance institutions in a way that enables them to actively engage with or even shape the framework of EU funding they operate with (cf. Mertens et al. 2021, 310-312) points to their lack of technical capacity to conduct the type of evaluation required from them.

The financialisation of Cohesion Policy and its consequences

The usage of financial instruments, the design of 'blended' instruments that mix public and private resources, and the resulting reliance on financial markets in the allocation of public investments has been likened to a form of (state) financialisation. State financialisation can, broadly, be defined as "the process in which states increasingly act as financial market participants themselves" (Schwan et al. 2021, 823). This pertains to the usage of financial instruments per se as their usage implies active state

intervention into the system of credit allocation as well as the reliance on private actors (such as commercial banks) in the disbursement of resources. Indeed, financial instruments have been listed as dimensions of state financialisation in pertinent research (Mertens et al. 2021; Wu et al. 2022)

Accounts of the pitfalls and risks related to state financialisation, too, are relatively widespread and emphasise the fact that the introduction and growing importance of financial rationalities may dilute their societal objectives and their pursuit in favour of financial ones (Pacewicz 2013; Løding 2020). A similar dynamic has been highlighted by a growing literature on the 'de-risking' state which focusses on the mobilisation of private capital by public and multilateral actors to finance the green transition (e.g. Gabor & Sylla 2023). This perspective holds that mobilising private capital for the green transition typically involves the alteration of risk/return ratios in favour of private capital by way of public subsidisation. Similar to perspectives on state financialisation, the criticism of this dynamic holds that states lack the 'compulsive institutions' to "to discipline private capital into pursuing green industrialization goals" (Gabor & Sylla 2023, 4). Such compulsive institutions, in turn, include "financial institutions, to design and enforce (a) stringent performance criteria; (b) monitoring and enforcement mechanisms; (c) curbs on market power" (Gabor & Sylla 2023, 10). The existence of such institutions has implications for the state's ability to effectively enforce conditionality, which differentiates industrial policy with a clear developmental mandate from mere 'corporate welfare' (Bulfone et al. 2023).

Again, these criticisms are relevant for the usage of financial instruments and domestic development banks' practice to allocate them because they (a) introduce precisely the financial rationalities highlighted by the state financialisation literature, and (b) increasingly involve private co-financing that needs to be 'disciplined' in the way described by accounts of the de-risking state. Indeed, the justification for the increasing share of financial instruments in total Cohesion Policy funds routinely involves a focus on the efficiency of investments that final beneficiaries need to repay (see fi-compass 2019). In this way, managing authorities and implementing partners are incentivised to monitor the bankability of their investments next to the substantive criteria attached to specific funds. Moreover,

while the de-risking initiative focusses particularly on initiatives by International Financial Institutions (IFIs) in the Global South, the EU's drive to multiply public funding by drawing on private providers of capital – a drive that involves national development banks as discussed above – is beginning to attract similar scepticism (Anguelov et al. 2018; Cooiman 2021).

A particularly striking example of the latter dynamic can be found in the field of Venture Capital (VC). VC is a form of early-stage equity investment that carries especially high risk and potentially high reward. Congruent to the increasing share of financial instruments in Cohesion Policy more generally, VC instruments are growing in relevance as both the EIF and domestic institutions allocate financial instruments as VC investments (Mocanu & Thiemann 2023). With the ultimate aim of creating and supporting innovative star-ups, this kind of intervention is promoted, in part, to ensure European technological sovereignty and, thereby, advance the green and digital transitions (Mocanu & Thiemann 2023). However, emerging critical perspectives on this development – focussing on the EIF – demur that business models aimed at profitability may inhibit the realisation of truly green and digital agendas as risky and progressive investments are balanced with less risky and less progressive ones (e.g. Cooiman 2021). While the EIF is at the forefront of this type of investment and, thus, on the receiving end of most criticism, the business model and resulting cautionary tales apply to national initiatives in a similar way.

The upshot of the general view on state financialisation and de-risking and the transposal of these perspectives to the usage of EU-funded financial instruments is that both multilateral and domestic development finance institutions require additional capacities – or 'compulsive institutions' – to enforce developmental criteria and 'discipline' private capital to further sustainable investments. The monitoring and evaluation of the environmental impact of financial instruments and the economic activities they fund are a crucial dimension of such capacities and institutions. Creating practices and criteria for environmental evaluation should be a unified and truly public undertaking so as to avoid the greenwashing of investments by simply importing evaluation practices developed by multinational corporations (see Kedward et al. 2022).

With reasonable doubt emerging regarding such capacities of the EIF (see Cooiman 2021), more research is needed to assess the activities of national institutions. Their capacity and developmental impact will depend on various factors specific to the national context, the particular set-up of fund-of-funds structures, their integration into wider development finance infrastructures, and the policy-steer of managing authorities. As discussed above, semi-peripheral member states, CEE in particular, tend to display lower capacities to *absorb* financial instruments which can be expected to extend to the capacity to direct these instruments to projects deemed desirable from an environmental point of view. This is particularly true in cases where a lack of capacity within national bureaucracies – e.g. inadequate hiring structures, the inability to pay competitive wages, and the overall lack of technical expertise – is compensated by strengthening the autonomy of development finance institutions. Granting such autonomy – in combination with market-based modes of operating – may further reduce the policy-steer of managing authorities vis-à-vis financial instruments.

Conclusion

In sum, the challenges of evaluating the environmental impact of investments in the context of the various EU-funded financial instruments managed by domestic institutions stem from a multitude of factors. First, the general fragmentation in programmes funded by both centrally managed funds and funds under shared management with differing objectives as regards their environmental contribution will likely result in a corresponding lack of coherence in the implementation and evaluation of these programmes, exacerbated by the variety of (types of) institutions tasked to do so. Indeed, of the discussed programmes, only InvestEU's Sustainable Infrastructure Window and the JTF provide explicit monitoring guidelines for implementing institutions, with all other components not (yet) formalising their environmental component and its evaluation. Second, domestic capacities to create, maintain, and utilise domestic development finance infrastructure differ significantly across the EU with observable

effects on their ability to absorb financial instruments and likely consequences for their ability to both implement and monitor the additional environmental objectives. Third, the increasing use of financial instruments amounts to a form of state financialisation whereby financial objectives are increasing in importance at the possible expanse of other, developmental objectives. Creating unified, transparent and purpose-driven evaluation practices is a central task to, nevertheless, ensure the sustainability of thus-created investments.

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