

# **Transparency Issues in European Investment Bank's External Action in the Eastern Partnership Countries**

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## **Introduction**

The funds provided to the Eastern Partnership countries are used to accomplish the goals of the European Neighborhood Policy and their improper use can lead to failure to achieve the strategic objectives of the EU. Financing of these countries by EIB has increased over the last years due to deeper cooperation with the EU, therefore the process of granting loans should be reviewed and improved to mitigate the risk of corruption, which is higher in the Eastern Partnership countries than in member-states of the EU. This policy paper includes analysis of EIB operations in three Eastern Partnership countries such as Georgia, Ukraine, and Moldova to identify the particular transparency issues common for this area.

## **Georgian cooperation with the EIB and the need of more stakeholders' involvement**

The agreement between Georgia and the EIB is in line with the European Neighborhood Policy, and aims to strengthen the links between the enlarged EU and its neighbouring countries. Furthermore, Georgia was the first Caucasian country to sign a framework agreement with the EIB in 2007. Currently, the EIB has a mandate of EUR 4.8bn for the period 2014 to 2020 from which projects in the country could be financed. It is important to note that the bank set up in 2014 a Neighbourhood Finance Facility (NFF), a EUR 3bn facility, with the goal to extend financing at bank's own risk. The main areas for which the EIB provides financial support are alike with the others for the EU Eastern neighbours, namely: local private sector development, in particular support to SMEs, development of social and economic infrastructure, and climate change mitigation and adaptation.

Since 2014, Georgia has been financed for projects amounting to EUR 777mln by the EIB<sup>1</sup>. Several sectors were covered like: transport (almost EUR 300mln), urban development and agriculture, fisheries and forestry (EUR 100mln each), credit lines, including loans for SMEs (EUR 77mln). Furthermore, the EIB Group (the EIB together with the European Investment Fund) started the implementation of two programmes which were designed "in the context of the Association Agreement of Georgia with the EU: the DCFTA Initiative East as well as the EU Research and Innovation Programme Horizon 2020: InnovFin – EU Finance for Innovators"<sup>2</sup>. The former focuses on providing financial and technical support targeted at SMEs, whereas the latter is a joint initiative with the European Commission under the EU Research and Innovation Programme Horizon 2020.

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<sup>1</sup> Data retrieved from EIB website, '[Projects financed](#)'.

<sup>2</sup> EIB, [The EU bank introduces a broad range of financial instruments to support small and medium-sized businesses in Georgia](#).

In general, lending to Georgia is governed by the External Lending Mandate<sup>3</sup> (ELM) of the EIB. Certain loopholes of the ELM in terms of transparency have already been put forward and are also valid for the case of Georgia. In fact, the ELM poses certain obligations to the bank in terms of transparency. One of them is to “make publicly available on its website information related to all of its financing operations carried out under the guarantee, in particular indicating whether an investment project is covered by the EU guarantee and how it contributes to the goals of the EU’s external action, in particular in relation to its economic, social and environmental impacts”<sup>4</sup>. Nevertheless, the EIB scores ‘fair’ on the 2016 Aid Transparency Index<sup>5</sup> which marks an improvement since the 2014 result ‘poor’, but still indicates a lot of room for improvement. One remark made is that evaluations and impact appraisals are not consistently published. In order to fulfil the highest transparency standards which the EU as a whole strives for, the EIB should act proactively in disclosing many documents in its public register and especially related to the project appraisal phase, such as: Result Measurement Sheets, Environmental and Social Appraisal Forms, Project monitoring reports, Project evaluations.

In fact, there is one recent project in Georgia (currently under appraisal) that highlights the need of more transparency in EIB’s external action. In June 2016, the EIB announced its intentions to lend a Georgian state-owned Partnership Fund and the South Korean public enterprise K-Water a loan for the construction and operation of a 280MW hydro-power scheme on the Nakra and Nenskra rivers in the Upper Svaneti region of north-western Georgia (NENSKRA HPP). The EIB did not communicate “whether and how it has acted on the project controversies that have emerged since the developer released the project’s environmental and social impact assessment (ESIA) in June 2015”<sup>6</sup>. Local population was concerned that the construction of the dam would trigger further natural catastrophes due to the geological instability of the area. The released ESIA and overall impact assessment in 2017 try to compensate the failure to engage stakeholders and local communities: “the Project has engaged with local communities and revised the design of certain facilities in order to avoid the need for physical displacement and minimise economical displacement. The Nenskra project is now seen in a more favourable light, and some members of the community express that they see the employment opportunities brought by the Project as positive”<sup>7</sup>. In any case, the project could serve as an example underscoring the need of more transparency in EIB’s external action.

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<sup>3</sup> Decision No 466/2014/EU of The European Parliament and of the Council of 16 April 2014

<sup>4</sup> CEE Bankwatch Network, *Going Abroad: A critique of the European Investment Bank’s External Lending Mandate*, p. 8

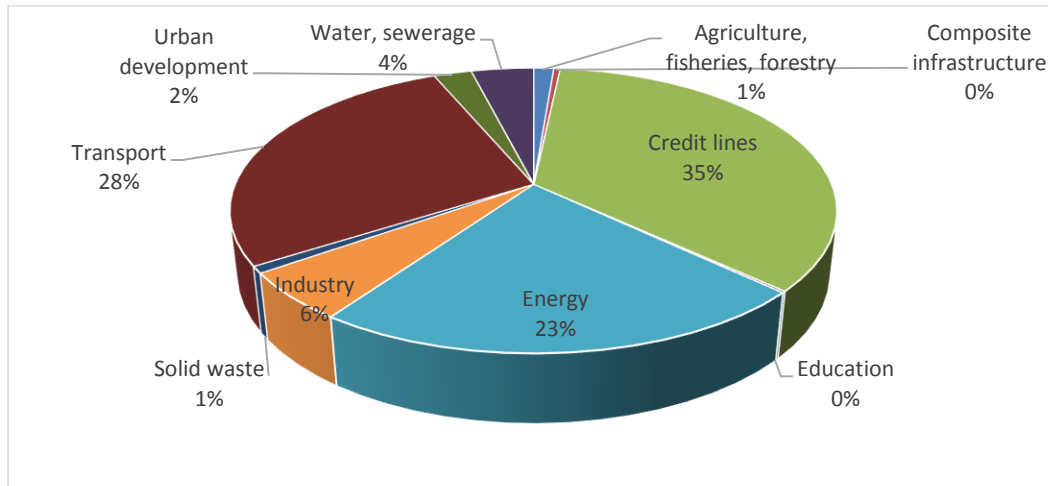
<sup>5</sup> [2016 Aid Transparency Index](#)

<sup>6</sup> CEE Bankwatch Network, *Going Abroad: A critique of the European Investment Bank’s External Lending Mandate*, p. 27

<sup>7</sup> NENSKRA HPP - Cumulative Impact Assessment, p. iii

## Financial Intermediaries for EIB Credit Lines in Ukraine

Lending to the third countries is more complex than lending to the EU member-states, as EIB has to interact with foreign governments and foreign financial intermediaries. According to the information disclosed by the EIB at its website, the bank has signed financing contracts with Ukraine in the amount of EUR 5 169 mln during the period from 2007 to 2017.<sup>8</sup> The largest shares of money were streamed to private sector through credit lines, transport infrastructure, and energy.



**Figure. EIB financing by sectors in Ukraine 2007 – 2017**

Having studied the process of projects approval, the focus fell on Credit lines as their approval seems to be the least transparent. The government of Ukraine usually agrees with the EIB on a certain amount of credit line to be further distributed to private sector as loans, but it is not disclosed how the demand for credit is calculated and how the particular amount is defined. Therefore, it is recommended that the EIB discloses a formula or the research results according to which it defines an amount of credit line.

Furthermore, the financial intermediaries, through which credit lines are distributed to the agents of real sector, do not disclose information regarding the use of funds received from the EIB.<sup>9</sup> These financial intermediaries have a lot of power and room for maneuver, because the lending decisions remain within the intermediary, the EIB does not take part in the decision-making process.<sup>10</sup> From one point of view it is rational to give the rights to approve loans to financial intermediaries, because it is cost-inefficient for EIB to analyze each client who needs a loan of less than EUR 25 thousand. It works in the same way for all the countries, but what attracts

<sup>8</sup> Data retrieved from EIB website, '[Projects financed](#)'.

<sup>9</sup> The EIB and financial intermediaries, Challenging Public Investment Banks, Counter-Balance website, August 31, 2012, [www.counter-balance.org/the-eib-and-financial-intermediaries/](http://www.counter-balance.org/the-eib-and-financial-intermediaries/)

<sup>10</sup> European Investment Bank: Intermediated loans. <http://www.eib.org/products/lending/intermediated/index.htm>, 28 June 2017

attention to the Ukrainian credit lines is the list of financial intermediaries. There are only two banks in this list, and both of them are state-owned. In Georgia, for example, there are 4 banks. The situation with the number of banks in such a list is even worse in Russia and Azerbaijan, where there is only one bank in the list.<sup>11</sup> There appears to be a relationship between corruption level in a particular country and a number of financial intermediaries for EIB credit lines. The more corruption is in the country, the less is the number of intermediaries. For example, Georgia, which rank is 44 in the corruption index chart, has 4 financial intermediaries, while Ukraine and Russia which have occupied rank 131 have 2 and 1 financial intermediaries correspondingly. In 2016 the average score of corruption perceptions index of the EU countries is 64 and average number of financial intermediaries per country is about 8. In the Eastern Partnership countries the average corruption perception index in 2016 is 35 and the number of financial intermediaries is about 3 (excluding Armenia, which is an outlier in this case with 17 intermediaries).<sup>12</sup>

There is a big risk of concentrating all the credit lines in the hands of one or two banks, if the management of the bank is corrupted, it can grant loans to the related parties implementing projects that are not related to the goals of the EIB. Moreover, approval of financial intermediaries by the government and the fact that these intermediaries are state-owned creates a risk of corruption as well, as actors from the both parties can be related and very well known to each other.

Ukreximbank is one of the Ukrainian financial intermediaries<sup>13</sup> for EIB credit lines and is known to be involved in financing related parties. In mass media there are many articles stating that Ukreximbank provides loans to the businesses of political figures, overestimates the value of collateral on purpose, and provides soft treatment to failed businesses of related parties that are unable to repay the loans<sup>14</sup> Moreover, the number of bank's branches is very limited compared to other Ukrainian banks that decrease accessibility of services for the average entrepreneur.

The other bank in the list of EIB financial intermediaries in Ukraine is Oshchadbank.<sup>15</sup> At the website of the bank on the page related to loans, there are offers only to retail customers. How the entrepreneurs can receive the information about loans remains unclear. The current CEO of the bank used to be the member of the parliament before his appointment, therefore the decisions taken by the management of the bank can be influenced by the political parties.

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<sup>11</sup> Lists of financial intermediaries are published at the EIB website

<sup>12</sup> Corruption Perceptions Index 2016, Transparency International  
[https://www.transparency.org/news/feature/corruption\\_perceptions\\_index\\_2016](https://www.transparency.org/news/feature/corruption_perceptions_index_2016)

<sup>13</sup> Ukreximbank website, <http://www.eximb.com/eng/profile/>

<sup>14</sup> Ivan Verstiuk (2016) : While police is looking for Andrei and Sergei Kliuiev, state-owned Ukreximbank saves their money (Пока правоохранители ищут Андрея и Сергея Клюевых, государственный Укрэксимбанк спасает их деньги), March 4<sup>th</sup>, 2016, *Novoie Vremia*.

<sup>15</sup> Oshchadbank website, <http://www.oschadbank.ua/en/>

Both banks are less client oriented compared to other banks and the logics of choosing these two particular financial intermediaries is not clear. Moreover, it is not disclosed what was the procedure for banks selection, what were the criteria, and how many banks were considered.

The EIB has to make a thorough audit of banks, which are approved by the government in order to ensure that funds provided by the EIB serve their purpose crediting SME's that don't have enough of access to financing rather than providing loans to related parties.

To mitigate the risks of corruption the following actions from the EIB are required:

- definition of the precise criteria for financial intermediaries selection, so that all the banks in a particular country meeting eligibility criteria could participate in a competition
- impose stricter rules on the quality of service and accessibility of information regarding loans
- set a minimum limit on number of financial intermediaries per country, for example, 5 banks to diversify the risks of improper use of funds
- create credit guidelines for financial intermediaries
- oblige financial intermediaries to create online database with companies that have received loans from the EIB credit lines

The high standards of eligibility criteria will assure better services and lower credit interest rates for SMEs, and, as a consequence, easier access to finance that will result in achievement of EIB financing goals, which are economic growth and jobs creation.

### **The EIB facing the domestic environment for investments in Moldova**

Trust of foreign partners for Moldova had seriously shrunk in the context of the bank fraud scandal - \$1 billion "disappeared" from three Moldovan banks in 2014. For good reason, conditions of maximum transparency in the external funded projects were expected to be endorsed by Moldovan counterparts. The EIB provides Moldova with financial support for projects targeting, inter alia, energy efficiency, agricultural and food processing sectors, small and medium-sized enterprises, the construction of a gas pipeline or the development of environmental infrastructure in the sector of solid waste management.

The EIB is present in Moldova since 2007 and signed 15 projects for a total loan of EUR 586 million, with the mention that this also includes EU grants from the Neighbourhood Investment Facility. The necessity to enforce its presence, multiply local contacts as well as to ensure visibility of its activity was translated into the opening of the EIB representation office in Chisinau in October 2014, being the second in the Eastern Partnership countries after the one in Kiev. However, for more than one year the representation office didn't work being partly

explained by the fact that investments and financing were frozen and the country did not sign an agreement with International Monetary Fund by that time.

Therefore, one of the greatest challenge for EIB in Moldova is to find stable and trustful partners for the implementation of the projects and the extension of its activities. For instance, instruments of programmes such as InnovFin (EU Finance for Innovators) are mainly available through financial intermediaries. The domestic context created relative tensed relations between foreign investors with Moldova's local banks and restricted their investments due to lack of transparency in shareholding structures or deficient regulation. The EIB strongly supported in 2014 the legislative project with new rules to ensure more banking transparency and security.

The most recent projects covered by EIB loans since 2015 are “Moldova solid waste framework loan” (EUR 100 million from EIB finance) to supporting the Waste Management Strategy of the Republic of Moldova 2013-2027, “Chisinau energy efficiency” (EUR 10 million) to reduce energy consumption in public and residential buildings, and “Ungheni-Chisinau gas pipeline” (EUR 41 million) to enable Moldova to diversify its sources of supply through connecting the existing Iasi (RO) – Ungheni (MD) gas interconnector.

The extension of the gas pipeline was declared project of national importance but its effective implementation is also confronted to endemic domestic vectors: the monopoly of Moldovagaz, political commitment, or the application of the European energy legislation. Moreover, the appraisal phase of Ungheni-Chisinau gas pipeline project was marked by intense negotiations regarding the environmental and social guarantees to be ensured by the construction company. To this purpose, the national authorities in charge undertook an environmental and social impact assessment and various public debates.

Taking into consideration the above mentioned remarks, the EIB presence and activity in Moldova may be the victim of an insecure domestic investment environment and weak governance. Since the bank fraud scandal, the EIB re-engage in supporting Moldova's essential development sectors but seemingly with a double dose of cautions.

## **Conclusion**

Following the findings of this policy paper the EIB has to take proactive steps towards elimination of corruption loopholes and transparency issues in the Eastern Partnership countries.

In Georgia, for instance, the Nenskra HPP project underscored the failure of the bank to involve with local communities and stakeholders in the early stages, and to address the controversies in the ESIA. The original documentation lacked assessment of the project's impacts on livelihoods which further undermines the credibility of the project and contradicts with the idea to conduct

affairs as open as possible. Therefore, it would be beneficial to strive for more involvement and dissemination of information.

In Ukraine the biggest problem found out is the financial intermediation. The limited number of financial intermediaries that distribute credit lines to private sector can lead to improper use of funds with purposes not related to the EIB strategies and guidelines. Concentration of power in the hands of two state-owned banks is very risky taking into account the connections of bank's management with political figures.

To strengthen the credit lines transparency, the EIB is recommended, first, to disclose formula or details of a credit line size definition to allocate the financial resources to the countries according to the credit demand. Second, the procedure of selection and approval of financial intermediaries should be made more transparent and based on the competition grounds. Third, the EIB should oblige financial intermediaries to be accountable for their credit activities by means of disclosing data on loans provision from the EIB credit lines.

In Moldova, the EIB operations could be undermined and put at risk by the domestic environment for investments characterized by a lack of confidence and deficient banking transparency and regulation, especially in the context of the bank fraud scandal. One of the main recommendation would be to enforce the regulatory framework and the political will in order to create an attractive environment for investments.

All the recommendations provided in this policy paper should be applied to all the Eastern Partnership countries, as their economic and political environment have a lot of similarities. The implementation of these recommendations will improve transparency of EIB operations leading to more efficient use of funds and achievement of the EU strategic objectives.