COMMISSION DECISION
OF 2000

Establishing a multi-beneficiary programme for the Small And Medium-Sized Enterprise Finance Facility Phase 2,

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EEC) No 3906/89 of 18 December 1989 on economic aid to certain countries of Central and Eastern Europe, as last amended by Regulation (EC) No 1266 of 21 June 1999, and in particular Article 9 thereof,

Whereas Regulation No 3906/89 lays down the rules and conditions for the granting of economic aid to certain countries of Central and Eastern Europe,

Whereas the measures provided for by this Decision are in accordance with the opinion of the Committee on Aid for Economic Restructuring in certain countries of Central and Eastern Europe,

HEREBY DECIDES AS FOLLOWS:

Article 1

The programme for the Small And Medium-Sized Enterprise Finance Facility Phase 2 as described in the Annex to the present decision is hereby adopted.

Article 2

The maximum amount of Community assistance shall be 21 MEUR to be financed through Budget line B7-030 in 2000.

Done in Brussels,

For the Commission
1. IDENTIFICATION

Countries: The 10 applicant countries from Central and Eastern Europe
Programme title: Small And Medium-Sized Enterprise Finance Facility Phase 2 (CEB/KfW)
Year: 2000
Cost: 21 MEUR
Implementing Authority: European Commission
Expiry Dates: Contracting - 31.1.2002
Disbursement - 31.1.2005
Sector: PR
Group: L
Budget Line: B7-030
Task Management: Bardo Gavazzoli (DG ELAR) - implementation will be assured through a sub-delegation arrangement with the ECFIN DG

2. SUMMARY

A strong small and medium-sized enterprise (SME) sector is an essential element in the ten applicant countries’ transition to a market economy and in their accession to the European Union.

Agenda 2000 and the Phare New Orientations identify the lack of a dynamic and sound SME sector as a key stumbling block to accession and note that one of the main factors preventing the growth of the sector is the reluctance and inexperience of the region’s financial sector to provide equity and debt finance to SMEs. In response, these two key documents call on the Phare programme to establish a new financial instrument - the SME Finance Facility - to induce financial intermediaries in the ten applicant countries from Central and Eastern Europe to expand and to maintain in the long term their debt and equity financing of SMEs.

A pilot Phase 1 of the Facility was launched by Phare in cooperation with the EBRD in 1999. Under that pilot Phase EBRD and Phare funds are jointly mobilised through a special fund to provide tailored SME loans, technical assistance, guarantee, equity and management support to financial intermediaries
(ie banks and investment funds) in the region, which then provide funding as sub-loans or equity to their SME clients.

Now that the pilot Phase 1 is fully operational, the Facility is entering into Phase 2, where additional sponsors are being attracted to join the programme. The Commission sought partners for this second phase from the signatories to the IFI Memorandum of Understanding.

As a result, this Financing Proposal represents the first new arrangement under Phase 2 of the SME Finance Facility. It covers the participation of the Council of Europe Development Bank (CEB) in the Facility under the Loan and Guarantee Window. CEB intends to cooperate on its participation with Kreditanstalt für Wiederaufbau (KfW) due to their extensive experience in the CEEC.

The Phare contribution will be 21MEUR, CEB and KfW will jointly contribute to the Facility 113MEUR. Detailed procedures for implementing this Financing Proposal will be set down in a Contribution Arrangement to be signed following the approval of this Financing Proposal.

3. STRATEGY

It is widely recognized that SMEs play a vital role in the generation of a dynamic economy and in particular in the creation of new employment in the EU as well as in the candidate countries. However SMEs are often undercapitalized and face significant problems in raising debt finance and in obtaining risk capital, or subordinated debt.

3.1. The Policy Framework

Financing problems of SMEs in the accession countries are becoming increasingly serious because of the rapid growth in the sector combined with the continued reluctance and inexperience of banks and investment funds to provide finance to the sector.

According to EUROSTAT surveys, in most of the candidate countries between 70-85% of the SMEs indicated that a lack of funds is a primary constraint on their development.

It is usual for most emerging SMEs, especially the small ones, to have no access to risk capital other than the personal resources of the founders. The raising of debt finance is also difficult for SMEs as banks are often reluctant to lend to them. The lending risk inherent in new firms and expanding SMEs is high and difficult to assess, and is increased by their usual low capitalisation. Loans are often not available to SMEs because of lack of collateral, making new projects particularly difficult to finance. Also, there is frequently a perception that the costs of administering small loans are disproportionately high and that larger loans generate a higher income stream, leading banks to concentrate their efforts on larger companies.
Experience in most industrialised countries shows that unless stimulated through focused schemes such as the SME Finance Facility, banks tend to focus on large companies, thereby undermining SME and micro enterprises financing. The New Orientations of Phare specifically call for the establishment of a horizontal SME Facility for the region as a whole: “A horizontal facility for small and medium enterprises (SME) will be available to remedy the shortage of investment capital available to SMEs.”

In response to these policy indications, the Commission launched the SME Finance Facility approved by the Phare Management Committee on 19th November 1998.

3.2. **The SME Finance Facility Overall**

The SME Finance Facility objective is to persuade financial intermediaries in the CEEC to expand and sustain their business to SMEs through providing incentives and other support to overcome their lack of experience and to cover the special administrative costs and risks involved.

A SME Finance Facility project is defined as a tailored package of financial incentives (including Phare and IFI funding) to a financial intermediary (ie. investment fund or bank) which are combined where applicable to additional co-financing from that financial intermediary, to be channeled onto individual microenterprises or SMEs (termed sub-projects) as equity or loans.

As for the eligible support envisaged, the specific incentives financed through the Phare programme on specific projects may be through two coordinated windows.

**A SME Equity Window** through which the Commission is willing to finance the following types of incentives:

1. equity co-investment with a view to share the overall investment risk with the co-investing IFI and investment fund;
2. funding of management fees for the investment fund managers on a grant basis.

**A SME Loan and Guarantee Window** through which the Commission is willing to finance the following types of incentives:

1. performance incentives on loans or credit lines provided by IFIs to banks for on-lending to SMEs;
2. a partial first-loss guarantee on the SME loan portfolio;
3. technical assistance to strengthen the bank's capacity to service microenterprises and SME customers on a grant basis;
other types of incentives which can be proposed by sponsors as far as they meet the objectives and enhance the Facility.

3.3. Phase 2 of the SME Finance Facility

After the launch of the operations with EBRD under Phase 1, the Commission carried out a marketing initiative to elicit additional interest and possible commitments to Phase 2 of the Facility.

The Commission therefore extended the invitation to participate in the Facility Phase 2 to the Nordic Environment Finance Corporation (NEFCO), the Nordic Investment Bank (NIB), the Council of Europe Development Bank (CEB), the European Bank for Reconstruction and Development (EBRD) and to the International Finance Corporation (IFC). These IFIs have been invited to the Facility because already contacted in the preparation of Phase 1, as well as in quality of signatory bodies of the Memorandum of Understanding on Cooperation for Pre-Accession Preparation of Central and East European Countries. In addition the EIB was also invited to participate in the Facility.

Besides the EBRD also IFC, NEFCO, NIB and CEB expressed their interest in joining the Facility Phase 2 and preliminary discussions have been held with all these IFIs.

So far the negotiations have led to an agreement with the Council of Europe Development Bank (CEB) for its participation to the Facility under the Loan and Guarantee Window.

Through this Financing Proposal on the SME Facility Phase 2 (CEB/KfW) the Commission intends to further expand the existing operations under the same window of the Facility to meet the new and maturing needs of SMEs in the applicant countries.

4. OBJECTIVE OF THIS FINANCING PROPOSAL

The primary objective of the SME Finance Facility Phase 2 with CEB (in cooperation with KfW) is to induce financial intermediaries in the ten applicant countries from Central and Eastern Europe to expand and to maintain in the long term their financing operation to SMEs.

Secondary objectives of this Financing Proposal are:

1. to leverage the largest amount of cofinancing with the Commission grant through cofinancing with CEB in cooperation with KfW

---

1 To be noted that a new Memorandum of Understanding was signed with these IFIs on 30th March 2000.
(2) to ensure greatest efficiency of the management of these complex financial schemes by delegating implementation to CEB in cooperation with KfW whose expertise is extensive in these areas.

The means to achieve these objectives is to mobilise financing through a special fund in the CEB to provide tailored credit lines to support banks in the Eligible Countries which then provide sub-loans to their SME clients.

5. DESCRIPTION OF SME FACILITY PHASE TWO (CEB/KfW)

5.1. The Partners

5.1.1. The Council of Europe Development Bank

The Council of Europe Development Bank (CEB) is a multilateral development bank with a social vocation. As from 1 November 1999 the CEB replaces the Council of Europe Social Development Fund created in 1956.

CEB operates under the authority of the Council of Europe, although it has full legal independent status and it is financially autonomous. CEB is indeed a major instrument in the policy of solidarity developed by the Council of Europe.

CEB has adopted a development strategy directed towards three major orientations:

(1) extending activity to central and eastern european countries;

(2) re-focusing activity on Council of Europe’s mission (aid to refugees and migrants, aid to regions hit by natural or ecological disasters);

(3) striving for a better geographical and financial distribution of the loans portfolio.

CEB’s action mainly concern the financing of projects for job creation and maintenance in small and medium sized enterprises (23% of disbursements) and for infrastructures linked to the protection of the environment (16%) and education (14%).

In 1999, CEB approved 30 projects representing a total of 2,052,000,000 EUR. Loans amounted to 1,700,000,000 EUR. In January 2000 a total of 291 MEUR was approved.

CEB grants loans to its member countries, to local communities or to approved financial institutions, for the purpose of financing social projects.

CEB projects involve, among other things, support to small and medium sized enterprises, education and vocational training, protection of the environment, rural
modernisation. Within the framework of its projects, CEB strives to promote and develop job creation.

As for the candidate countries, CEB sees the Commission’s Facility as an important tool for providing support to the small enterprises in the region.

5.1.2. Co-operation with Kreditanstalt für Wiederaufbau (KfW)

In order to maximise the success of the operations, CEB will cooperate with the Kreditanstalt für Wiederaufbau (KfW).

KfW is the Germany’s promotional bank for the domestic economy and the official development bank for countries in transition and developing countries. The German federation and the federal states (Länder) own the bank.

KfW was founded by law in 1948 as a corporation under public law domiciled in Frankfurt am Main / Germany. Its functions are those of a promotional bank for the domestic and increasingly for the European economy and a development bank for the developing countries. KfW is preparing and financing projects with an approach similar to the one of the IFIs (international know-how in the entire project cycle, non-profit-orientation).

KfW has been active in the EU Candidate Countries for many years and its activities comprise a wide range of promotion measures.

KfW has developed and is still developing promotional credit programmes either with promotional banks (partly previously advised by KfW on a broader basis) or with commercial banks doing business with the target group (especially local SMEs) in the EU Candidate Countries of Central and Eastern Europe. KfW’s assistance is not limited to giving advice, but includes also refinancing of the co-developed credit programmes at attractive conditions. Under the Financial Cooperation between the Federal Republic of Germany and the candidate countries, KfW is currently implementing projects in the financial and trade sectors in Bulgaria and Romania. Furthermore KfW is active as a Twinning partner in an environmental project in Hungary.

Finally KfW also runs coordination offices in Warsaw, Budapest, Luljana, Bratislava, Riga and Vilnius.

The Commission will also invite the CEB to take into consideration other national financial institutions as possible partners for future similar collaborations under the Facility.

5.2. The Contribution Arrangement

Implementation of this programme shall be undertaken on the basis of a Contribution Arrangement signed between the Commission and the CEB in co-operation with KfW.
To maximize the efficiency of the programme’s implementation, the Commission has agreed with CEB that the latter will establish and administer the Fund for the Phare contribution and KfW will manage and supervise the Projects co-financed under this programme.

The Contribution Arrangement shall cover only the Loan and Guarantee Window (LGW) activities of the SME Finance Facility, since CEB has no equity activity and will therefore not be financing activities in this area.

Under the framework of this Arrangement the Commission will finance the following types of incentives in parallel to the CEB/KfW credit lines:

1. Performance incentives on loans or credit lines provided by CEB and KfW to Participating Banks (PBs) for on-lending to SMEs and where applicable on loans or credit lines provided by PBs to On-lending Banks (OLBs),

2. A partial first-loss guarantee on the SME loan portfolio of PBs and/or OLBs;

3. Technical assistance to strengthen banks capacity to service microenterprise and SME customers;

4. Other types of incentives which can be proposed by CEB and KfW as far as they meet the objectives and enhance the Facility.

CEB and KfW will contribute to the programme 113MEUR. The corresponding contribution of the Commission under this Contribution Arrangement will be 21MEUR.

5.3. The Operations to be Financed

The SME Facility’s operations involving CEB and KfW in Phase 2 are described in the diagram overleaf.

Phare and CEB in cooperation with KfW are designating a total of 134 MEUR for Projects supported under the Facility. These funds will finance Projects that are defined as SME loans and credit lines to Participating Banks in the applicant countries and shall generally be 5-15 MEUR in size.

The Participating Banks will then on-lend funds as Sub-Projects to the final SME’s (possibly through On-Lending Banks).

CEB and KfW often have existing channels with a Promotional Bank (i.e a bank with economic policy objectives in the eligible country) that have been used successfully in the past to channel credit. The SME Facility will use such tried and tested channels where they exist as they obviously will be far faster and efficient implementors of the projects than if new relationships with untried banks are established each time. In such cases, the sub-loans to SMEs will be granted either
directly or through commercial On-Lending Banks which shall establish Sub-Projects (under an agreement with a Participating Bank).
Project description

Projects financed under the Facility will involve provision of Phare funds and CEB/KfW resources through specific agreements with Participating Banks (PBs), which shall lend directly to SMEs or lend to on-lending commercial banks for retail to SMEs.

The resources will be attributed to each Project with local PBs with a leverage not lower than 3/1 in favour of Phare.

The size of each project agreed with the PB will be, in principle, between 5-15 MEUR and the maximum size of loans per SME beneficiary shall be euro 250,000.

The project with the PBs supported under the Facility will include CEB/KfW loan or credit line and a contribution from Phare, which may be used for one or more of the following components in varying proportions depending on the Project’s specific needs:

(a) Performance fee

in the form of a grant partly compensating for the interest to be paid by the PBs to CEB or to KfW and by the OLBs to the PBs. The Phare incentive will be paid only in relation to actual SME lending.

No more than 50% of overall Fund Resources may be used for performance fees. This 50% ceiling may be raised by the Co-financing Members if considered as necessary for the objectives of the Facility. The specific portion of performance fee may vary between Projects.

(b) Technical assistance

Phare resources may be provided to PBs for institution building purposes. The aim of TA is among other things to:

• install management information systems specifically geared towards SME portfolios;

• recruit and train PBs and/or OLBs staff in SME customer support and small loan appraisal, supervision and loan administration skills;
• assist in the introduction and implementation of organisational and managerial procedures and practices involved with SME lending;

• strengthen administrative, credit and management capacities.

No more than 50% of Fund Resources may be used for technical assistance. This 50% ceiling may be raised up to 70% by the Co-financing Members if considered as necessary for the objectives of the Facility. The specific portion of technical assistance may vary between Projects.

(c) Loan Guarantee

Phare contribution may be used, where appropriate, to provide a partial guarantee on the SME sub-loan portfolio managed by the PBs or the OLBs. This guarantee is limited to a maximum of 40% of the loss per Sub-Project.

(d) Other approved incentives

Subject to specific approval of the Co-financing Members, other appropriate incentives for the benefit of PBs and OLBs may be granted.

KfW shall prepare the Project proposals for support under the SME Facility with the relevant Participating Banks in the applicant countries.

The Co-financing Members representing the Commission, CEB and KfW shall approve the Project proposals and supervise the implementation of the activities to be carried out under the Facility through a Steering Committee, reports and audits.

The Facility’s support to Projects shall be provided through loan and credit lines for Participating Banks combined with the incentives provided from the Fund (performance fee, guarantees, technical support, and others). The On-Lending Banks may also benefit from these incentives.

There shall be a maximum investment per SME beneficiary of 250,000 EUR, thereby establishing a clear additionality vis-à-vis existing financial instruments available to SMEs in Central and Eastern Europe.

In accordance with standard practice, KfW shall manage the Projects and will engage the Participating Banks in the applicant countries to provide finance to SMEs (ie Sub-Projects) on a day to day basis (either directly or through On-Lending Banks).
SMEs eligible for support through Sub-Projects are enterprises employing not more than 250 people².

The SME Facility Phase 2 (CEB/KfW) is expected to realise Projects with, in principle, all 10 applicant countries of central Europe. The amount involved in each Project is estimated to vary between 5 MEUR and 15 MEUR. Obviously, each Project with the Participating Bank shall finance many more Sub-Projects in individual SMEs.

The procedures and guidelines outlined in this Financing Proposal - including eligibility criteria applied, support offered, financial intermediaries used, final SMEs selected and the implementation conditions and approaches adopted - shall be followed as a general rule. Given that the particular requirements of Projects may differ considerably depending on the country concerned and the SME market segment being targeted, KfW may also propose to the Co-financing Members of the Steering Committee other appropriate incentives for the benefit of PBs. These incentives may benefit from Phare support subject to unanimous specific approval of the Co-financing Members.

The Steering Committee of the Facility will be kept informed of those other incentives.

CEB and KfW shall provide the loan funds or credit lines to the Participating Banks at market rates. Where applicable, Participating Banks will also lend to On-Lending Banks at market conditions. The Phare Contribution to the Loan and Guarantee Window of the SME Facility will provide interest rate incentives, guarantees, technical support and other incentives to stimulate local Participating Banks and On-Lending Banks to developing and sustaining their loan operations with SMEs.

A typical arrangement offered to a Participating Bank on a Project may consist of:

1. A loan or credit line for on-lending to the SMEs. The combination of CEB–KfW loan funds with a Phare interest rate incentive shall produce the attractive margin required to induce Participating Banks to take the loan and undertake the necessary organisational changes, most notably the specialisation of loan officers and branches to SME lending.

2. Where justified, a partial first-loss guarantee for a fixed percentage of losses on the SME loan portfolio managed by the Participating Bank.

3. Technical assistance to perform institution building in the Participating Banks (e.g. adjust organizational structure, train loan officers in appraisal and supervision, introduce new management information systems, etc.) to

² The definition of eligible SMEs derives from Commission Recommendation 96/280/EC of 3 April 1996.
meet the special administrative needs of lending to the SME sector, which is very different from the requirements of lending to a small number of large clients.

In addition CEB and KfW may suggest other types of incentives during the development of this programme. The Commission may consider them while granting Phare contribution.

The precise mix of the support offered under individual Projects will vary country by country, and will depend on the Project’s specific circumstances. Where On-Lending Banks are involved they will partly benefit from the Phare grant

5.4. The Administrative Structure

5.4.1. The Fund

The Commission and CEB have agreed that a Fund receiving the Phare Contribution shall be established and administered in CEB in accordance with CEB’s Articles of Agreement and the decision of its Governing Board dated as of 17/04/2000.

5.4.2. The Steering Committee

With this proposal, the SME Facility enters into Phase 2, where different partners are involved in the financing operations to the SMEs in the candidate countries. It is therefore important to ensure the necessary co-ordination between the different IFIs involved so as to avoid overlaps of activity and all risk of duplication of funds to the same Participating Banks or On-Lending Banks.

A Steering Committee will ensure co-ordination and complementarity between the Projects supported with the Phare contribution under the Facility.

The Steering Committee will comprise three representatives of the Commission and one representative each, respectively, of other IFIs having signed similar Contribution Arrangements with the Commission. In particular, one representative from CEB and one representative from KfW will attend the Steering Committee meetings.

All decisions of the Steering Committee shall be made by unanimity. The Steering Committee shall convene at the request of any of its members, but shall meet at least twice per year.

A representative of the Commission shall chair Steering Committee meetings.

In particular the Steering Committee shall:

(1) supervise the implementation of the Facility, monitor financial and operational progress of Projects supported under the Facility;
(2) review, as appropriate, publications reporting on the Facility;

(3) review the experiences of the Facility overall with a view to proposing improvements;

(4) co-ordinate activities of the Facility so as to avoid duplication and overlap.

Projects proposals will be submitted to and agreed only by the Co-Financing Members i.e. Members of the Steering Committee representing the organisations involved in the co-financing of the Project (two representatives of the Commission, one representative from CEB and one representative from KfW under the present Financing Proposal).

5.4.3. The Secretariat

The Secretariat shall be administered by the Commission (DG ECFIN) and shall ensure the coordination between the Commission and all the sponsors for matters related to Projects, Steering Committee organisation and administration of the Fund.

6. BUDGET

This Financing Proposal has a budget of 21 MEUR from the Community budget.

Figure 5a: Phare Contribution

<table>
<thead>
<tr>
<th>Sector</th>
<th>Allocation</th>
<th>Investment*</th>
<th>Institution Building</th>
<th>TA*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan/Guarantee/</td>
<td>21</td>
<td>21</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>TOTAL of the FM 2000</td>
<td>21</td>
<td>21</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

* Investment Support and technical assistance cannot be separated out as distinct Phare actions under the SME Facility but are considered as integral components of each investment support project financed under the Facility.

The Commission shall pay to the CEB a management fee equal to 1.25 percent of each tranche of the Contribution released to the Fund towards covering the cost of implementing all CEB and KfW tasks under the Arrangement. The Commission shall not provide any additional amount to support the Partners’ costs resulting from this Arrangement.

Figure 5b: Co-Financing to SME Facility

<table>
<thead>
<tr>
<th>Window</th>
<th>Phare</th>
<th>CEB/KfW</th>
<th>Financial Intermediary*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Window</td>
<td>0</td>
<td>0</td>
<td>+/-</td>
</tr>
<tr>
<td>Loan and Guarantee Window</td>
<td>21</td>
<td>113</td>
<td>+/-</td>
</tr>
<tr>
<td>Total</td>
<td>21</td>
<td>113</td>
<td>+/-</td>
</tr>
</tbody>
</table>

* Cofinancing from the Financial Intermediary in the loan and guarantee window will vary depending on the circumstances of the Project but shall be pushed to the maximum possible.
7. IMPLEMENTATION ARRANGEMENTS

Implementation shall be delegated to CEB in cooperation with KfW on the basis of a Contribution Arrangement.

Commission supervision will be exercised throughout the duration of the programme through the Steering Committee and through monitoring and evaluation, various reports and audits.

Building on the general description of the programme in section four of this financing proposal, this section explores in greater detail implementation principles.

7.1. Implementation Principles

As well as the basic aspects of the Facility set out in this Financing Proposal, there are certain principles of implementation that can be highlighted here:

(1) The financial and operational management of Commission funds under the SME Facility shall be delegated to CEB. To this end, the Commission Contribution shall be paid into an interest bearing account termed the SME Facility Special Fund in CEB. The modalities shall be set down in a Contribution Arrangement agreed between the Commission, CEB and KfW which shall comply with this Financing Proposal and which shall specify the modalities for implementation, for funds flow and for the Rules of Procedures relating to the SME Facility Special Fund. KfW at the request of CEB will manage and supervise the Projects co-financed under the Arrangement.

(2) After an initial advance, the Commission shall approve the release of further funds to the SME Facility Special Fund in tranches. All funds remaining unused or revolving within the Special Fund will be reused for the purpose of the SME Facility according to the same rules and procedures.

(3) No Phare funds will be used for the purposes of a Project without prior approval of that Project by the Co-financing Members.

(4) At a minimum, CEB and KfW will provide three times the financial contribution of Phare to a project financed through the Loan and Guarantee window.

(5) Projects will be particularly welcomed which address key problems in the relevant country’s National Programme for the Adoption of the Acquis and which focus on microenterprises as well as larger SMEs.

(6) The Commission shall exercise its responsibility over the use of its funds for the duration of the Facility on the basis of monitoring reports and accounts provided by CEB and KfW in accordance with the rules set down in the Contribution Arrangement and the Rules of Procedures.
The Facility will be available for all applicant countries from Central and Eastern Europe and an effort will be made to reach a balanced country usage although, of course, final Project selection must be on the basis of the quality of the proposals.

The specific procedures relating to the implementation of the Project will be set down in Project agreements with the Participating Bank. Project agreements will specify the terms and conditions applicable to the use of Partners and Fund Resources and will ensure that relevant provisions will be incorporated in the agreements respectively with Participating Banks and On-lending Banks.

Interest earned on the account and possible funds paid out from the Fund and recovered from Projects shall be returned to the SME Facility Special Fund for use again on new Projects, until termination of the SME Facility Special Fund’s activities. CEB is also committed to the continuation of the operations until the termination of the SME Facility Special Fund’s activities provided that it is consistent with CEB’s policies. Any funds remaining at termination shall be returned to the Commission.

7.2. Eligibility Criteria

Eligible Participating Banks

Selection of PBs will include assessment of their creditworthiness, geographic coverage, financial soundness, management competence, commitment to SME lending, openness to new technology and willingness to devote personnel.

A state–owned bank which on-lends to SMEs mainly through private commercial banks may participate in the Facility Phase 2. In case of direct lending to SMEs, state-owned banks must have a demonstrable financial and commercial autonomy in addition to the criteria mentioned above.

Eligible SMEs

Enterprises eligible for Sub-Projects must comply with the definition of SME as per Commission Recommendation of 3 April 1996 (OJ L 107 of 30 April 1996). The term SME includes the individual entrepreneur. Eligible SMEs must:

- have majority private ownership and control or be in the final irreversible process of privatisation;

- not be conducting business in activities such as gambling, real estate, banking, insurance or financial intermediation, and the manufacture, supply or trade in arms and other activities excluded by the CEB and KfW.

Eligible Expenditure at SME level
The loan utilisation by SMEs shall be for the financing of investment in fixed assets and, when financed by KfW alone, working capital subject to the Agreement on Responsibilities between CEB and KfW, and shall involve new projects, or the modernisation or expansion of existing business within sectors in the following non-exhaustive list: manufacturing industry, agro-allied business, hotel, tourism, energy, environment, construction, trade and services.

Eligible Countries

The financing under the Arrangement is open to Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia (collectively, the "Eligible Countries").

CEB and KfW shall endeavour to reach a balanced country coverage under the Facility.

### 7.3. Project Selection and Approval

After preparation by CEB and KfW, Project proposals will be presented to the Co-financing Members representing the Commission, CEB and KfW. The approval will be given through written procedure. The unanimous agreement from the Co-financing Members is required.

A secretariat organised by the Commission shall ensure the co-ordination of the written procedure.

Acceptance or rejection of a Project proposal by the Co-financing Members will be confirmed within twenty (20) working days of its submission.

Subject to the legal obligation of bank secret and the rules of confidentiality, the Commission shall have access to all relevant information in connection with the Project proposal. The Co-financing Members shall assess Project proposals according to their compliance with the following criteria:

1. the compliance with the Arrangement and its appendices, including degree of compliance with eligibility criteria;
2. the impact of the proposed Projects on accession and on SME development in Eligible Countries;
3. the country in which the Project is located, taking into account the objective of the Facility to be implemented over time in all Eligible Countries;
4. the degree to which the requested grant leverages additional funds from Partners and PBs and OLBs;
the coherence of the proposed allocation of Fund Resources with other approved Projects. By their approval of the Project, the Co-financing Members authorize the mobilization of Fund Resources.

7.4. Implementation of Projects

The administration of the Phare funds shall be undertaken by the CEB and KfW, under monitoring of the Commission, and shall not be implemented according to the standard Phare Decentralised Implementation System.

The Commission shall exercise its responsibilities over use of funds throughout the duration of the programme and implementation shall be assured through a sub-delegation arrangement with DG ECFIN/SOF.

The precise procedures for implementation of the Projects shall be set down in the specific Project agreements (i.e. contracts) signed between the KfW, CEB and the Participating Bank. These Project agreements will specify the terms and conditions applicable to the use of funds. Subject to the rules of confidentiality, the Secretariat of the Steering Committee shall be provided with copies of these Project agreements including general conditions for on-lending in due course. Those documents will be available only to the Co-financing Members.

Project agreements will specify the terms and conditions applicable to the use of Partners and Fund Resources and will ensure that relevant provisions resulting from the Arrangement will be incorporated in the agreements respectively with PBs and OLBs.

Project agreements will encompass specific, objectively verifiable criteria by which Sub-Project compliance with agreed rules will be controlled.

In the case of default on Project agreements, KfW will undertake recovery proceedings in respect of Fund Resources on the best efforts basis. The incremental cost incurred by KfW will be borne by the European Communities, on the basis of the Commission’s prior approval of such costs.

8. MONITORING, ASSESSMENT AND EVALUATION

The Partners are responsible for monitoring the implementation of actions under the Contribution Arrangement and for providing the following reports.

(1) Monthly financial statements – a summary statement of the Fund account shall be prepared by CEB indicating the situation of the Fund, at the beginning and the end of the month, indicating any transaction (with value date) and providing explanation and justification of any transaction.

(2) Quarterly pipeline report – a summary of the Projects in the pipeline and a forecast of commitments and disbursements from the Fund.
(3) Semi-annual progress report: this will be a substantial assessment of activities under the Arrangement for the first six months including:

(a) all financial matters relating to the Arrangement’s operation, including duration of sub-loans and relation of other loan terms to general market conditions in the country concerned;

(b) compliance of Sub-Projects with Project agreements and articles of the Arrangement;

(c) information on Sub-Projects including, as a minimum, numbers of Sub-Projects, sectors covered, number of employees per beneficiary SME and total assets and turnover and interest rates. To meet confidentiality requirements, data may be provided on an aggregated basis.

(4) An annual report on the Arrangement’s operations from the end of each year. It will include for the second half of the year the same kind of information as requested above to assess the activities under the Arrangement and also cover as a minimum:

(a) contribution of activities under the Arrangement to pre-accession efforts of the country concerned;

(b) the leverage achieved by Fund Resources on additional Partner and private sector funds. The number of PBs and/or OLBs still maintaining their SME operations after termination of support from the Fund;

(c) any other information deemed useful to measure the impact of the Facility in terms of its original objective "to alleviate the financing problems of small and medium-sized enterprises in the Phare eligible countries".

(5) A final report established at the termination of the Arrangement shall include information deemed necessary to assess the overall impact of the Arrangement since its commencement.

The Commission may also carry out, from time to time, assessments of the activities under the Arrangement.

The Commission shall exercise its responsibilities through reviewing the audited accounts and reports produced by KfW and CEB and through its own independent assessment and audits.
9. **AUDIT**

The Commission shall have the right to send its own agents or duly authorised representatives to carry out any audit necessary to verify the use of Fund Resources. In carrying out its inspections, the Commission may verify the conformity of Sub-Projects with the terms of the Arrangement. The same rights shall be extended to the Court of Auditors of the European Communities in accordance with its mission as laid down in article 87 of the Financial Regulation applicable to the General Budget of the European Communities. The Project agreements to be concluded by KfW with the PBs, the agreements between the PBs and their OLBs as well as agreements between PBs or OLBs and beneficiaries of Sub-Projects, shall contain provisions to this effect. Relevant documentation available for audit should be maintained by all parties involved in Projects and Sub-Projects for a period of five years after closure of each Project.

There shall be full co-ordination between CEB, KfW, the Commission and the Court of Auditors to minimise any potential disruption to activities of all parties involved, including the provisions of appropriate advance notice of inspections.

The loan or credit line agreement signed by KfW with the Participating Banks under the Facility will encompass specific, objectively verifiable criteria by which sub-loan utilisation for the agreed purposes and Sub-Project compliance with the agreed rules will be controlled.

10. **VISIBILITY**

All Projects financed under the Facility Phase 2 (CEB/KfW) shall reflect explicitly the input of the European Community through announcements by KfW and the Commission in the country concerned.

KfW will inform each PB of the European Community's Contribution to the SME Facility Phase 2 (CEB/KfW) and shall ensure that OLBs and the beneficiary of each Sub-Project shall be made aware of the European Community's Contribution.

CEB and KfW shall report on the activities under the Facility Phase 2, informing on the co-operation with the Commission, in their usual respective Annual Reports.

11. **SPECIAL CONDITIONS**

The Arrangement shall terminate 10 years from the date of receipt by CEB of the first tranche of the Contribution.

No disbursements from the Fund to Projects shall be authorised after the termination of the Arrangement. The loans granted to PBs and financed from
Partner Resources may have maturities exceeding the termination of the Arrangement.

Without prejudice to the rights and obligations set forth elsewhere in the Arrangement, the Commission, CEB or KfW may terminate the Arrangement if one party fails to perform any of its material obligations under the Arrangement and such failure to perform shall have continued for a period of thirty days after written notice thereof shall have been given to the non-performing party by the notifying party.

The Contribution Arrangement will specify the provisions which shall apply with respect to the resources related to the Contribution upon termination.

Until final distribution of the assets of the Fund, all rights and obligations of the parties to the Arrangement shall continue unimpaired.

The right for the Court of Auditors and the Commission to perform Audit and Evaluation shall continue to exist unimpaired for five years after the termination of the Arrangement.

12. RISKS AND ASSUMPTIONS

At the operational level, the principal risk is that the Participating Banks Funds supported by the SME Facility will not continue their operations once the SME Facility support has ended. This risk is considered very low, since experience with similar programmes elsewhere clearly shows that financial intermediaries tend to continue on their own once they have the capacity to administer such loans, have gone through the learning curve and have realised the profit potential of such SME operations.

At the policy level, the Facility assumes a sustained effort by applicant countries to press ahead with making further progress in relation to SME regulations and laws, most particularly in the adoption of the acquis communautaire as it relates to SMEs.

A further risk is that projects financed will have limited impact on SME development. Given the experience of the JOP and other SME programmes and the changes which the Facility plans to introduce, the risks of poor impact would seem reduced.