COMMISSION DECISION
OF 2002

Establishing a Phare multi-beneficiary programme on “The SME Finance Facility with the CEB and KfW” in 2002,

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EEC) N° 3906/89 of 18 December 1989 on economic aid to certain countries of Central and Eastern Europe\(^1\), as last amended by Regulation (EC) N° 2500/2001\(^2\), and in particular Article 8 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,

HAS DECIDED AS FOLLOWS:

Article 1

The programme described in the Annex to the present decision is hereby adopted.

Article 2

The maximum amount of Community assistance shall be 15 MEUR to be financed through Budget line B7-030 in 2002.

Done in Brussels,

For the Commission

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\(^1\) OJ n° L375 of 23/12/1989

\(^2\) OJ n° L342 of 27/12/2001
FINANCING PROPOSAL

1. IDENTIFICATION

Beneficiary Countries: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia, Slovakia

Programme: SME Finance Facility 2002 with the Council of Europe Development Bank in co-operation with Kreditanstalt für Wiederaufbau

CRIS-Number: 2002/000-622

Year: 2002

Cost: €15 million

Expiry Dates:
- Contracting: 30.11.2005
- Completion: 30.06.2012
- Disbursement: 30.11.2012

Sector: PR

Group: L

DAC Code: 25010

Budget Line: B7-030

Programming Task Manager: Judith Novak (DG ELARG)

Implementation Task Manager: Raul Gomez-Hernandez (DG ECFIN Unit L2; Programme Management)

2. SUMMARY

In the context of the Copenhagen economic criteria, both the Accession Partnerships and the Regular Reports 2001 call for a strengthening of institutions in the area of financial inter-mediation. The reform and strengthening of the financial sector is an issue likewise addressed in the June 2002 “Action Plan for Administrative and Judicial Capacity”.

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1 This is the latest date by which the Contribution Arrangement and all Project Agreements must be signed.
The provision of equity and debt finance to small and medium-sized enterprises (SME) is an important aspect of the functioning of the financial sector in the candidate countries. Moreover, the reluctance of the financial sector to engage in such activities and its inexperience is one of the main factors preventing the strengthening of the SME sector in the candidate countries. SME’s access to finance is a key building block for a functioning market economy and for the candidate countries’ capacity to cope with competitive pressure and market forces within the Union.

The overall objective of the Programme is to assist the candidate countries in meeting the Copenhagen economic criteria and to contribute to the reform and strengthening of the financial sector.

To this end, the Council of Europe Development Bank (CEB) and Kreditanstalt für Wiederaufbau (KfW) will co-operate under the Facility and combine loans from their resources with non-reimbursable Phare support in order to provide incentives for banks and leasing companies in the candidate countries to expand their offer of finance to SMEs, and to enhance their capacity to assess and monitor the related risks and to manage their exposure.

After two earlier Financing Proposals for a total of €51 million, this Programme makes available a further €15 million for this purpose. The CEB and KfW in turn will increase their contribution to the Programme’s objectives by at least an additional €75 million.

3. **Strategy and Background**

*Strategy*

The revised Accession Partnerships adopted in November 2001 define, for each chapter, priorities for the adoption and the enforcement of the Acquis in the candidate countries. They are in line with the Regular Reports 2001, which assessed the progress made by the candidate countries, as well as the overall situation in terms of the adoption of the Acquis and the capacity to enforce it. The Accession Partnerships include the priorities which the candidate countries are expected to take forward within the next two years.

In the context of the Copenhagen economic criteria, both the Accession Partnerships and the Regular Reports 2001 call for a strengthening of institutions in the area of financial inter-mediation. The reform and strengthening of the financial sector is an issue likewise addressed in the June 2002 “Action Plan for Administrative and Judicial Capacity”.

The provision of equity and debt finance to small and medium-sized enterprises (SME) is an important aspect of the functioning of the financial sector in the candidate countries. Moreover, the reluctance of the financial sector to engage in such activities and its inexperience is one of the main factors preventing the strengthening of the SME sector in the candidate countries. SME’s access to finance is a key building block for a functioning market economy and for the candidate countries’ capacity to cope with competitive pressure and market forces within the Union.
It is widely recognised that SMEs play a vital role in the generation of a dynamic economy and in particular in the creation of new employment. However, EUROSTAT surveys indicate that in most of the candidate countries for between 70-85% of the SMEs the lack of funds is a primary constraint to their development. SMEs are often undercapitalised and face significant problems in raising debt finance and in obtaining risk capital, or subordinated debt.

The Commission and the CEB working in co-operation with KfW (CEB/KfW) have therefore decided to combine Phare grant money with CEB/KfW financing in order to help the financial sector in the central European candidate countries develop its SME business. From the Commission point of view the combination with CEB/KfW funding will bring additional leverage to grants from Phare and therefore substantially broaden the reach of the Programme.

**Background**

The Commission launched the SME Finance Facility with the EBRD in 1999. Since then, similar programmes have become operational with CEB/KfW (2000) and most recently with the European Investment Bank (2001). Funding from the International Financial Institutions (IFIs) has been used to provide loan and equity finance to SMEs; since 2001 SME leasing operations of local banks and leasing companies have also been supported.

To date, CEB/KfW has approved €263 million (see table below) for the SME Facility and committed €160 million in Projects.

<table>
<thead>
<tr>
<th>Loan, Guarantee and Leasing Window</th>
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<tbody>
<tr>
<td>CEB/KfW resources</td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td>Financing in 2000</td>
</tr>
<tr>
<td>Financing in 2001</td>
</tr>
<tr>
<td>Total with CEB/KfW</td>
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</tbody>
</table>

Notes: amounts in € million

One of the objectives set by the Commission was to ensure a balanced country coverage of the SME Finance Facility. By July 31, 2002, 13 Projects have been approved and signed covering all candidate countries with the exception of Bulgaria. The total value of the Phare Contribution committed to these Projects is €27 million. This represents 52% of the total available Phare Contribution since 2000.
4. **OBJECTIVES AND DESCRIPTION**

4.1. **Objectives**

The **overall objective** of the Programme is to assist the candidate countries in meeting the Copenhagen economic criteria and to contribute to the reform and strengthening of the financial sector.

The Programme’s **specific objectives** are to

- build further the confidence of financial intermediaries to engage in financial operations with SMEs.
- enhance further the capacity of financial intermediaries to assess and monitor the related risks and to manage their financial exposure;
- deepen country coverage at a regional level by concluding more Projects within each country;
- sustain and maximise the impact of existing Projects under the Loan, Guarantee and Leasing Window by providing additional credit lines to the financial intermediaries concerned

and thereby to continue to induce financial intermediaries to expand and maintain in the long term their financing operations with SMEs.

4.2. **Results**

It is expected that financial intermediaries in the candidate countries will have expanded capacities to service the financial needs of SMEs, and that SMEs will have greater access to finance, as witnessed by

- the degree to which Participating Banks or Participating Leasing Companies will have a clear strategy for supporting SMEs;
- the degree to which SME credit or lease processing times will have shortened significantly;
- the degree to which credit and leasing application procedures will have been simplified;
- the amount of staff from banks or leasing companies that will be familiar with the concept of lending/leasing to SMEs and its implication for their business;
- the increase in the volume of loans/leases of Participating Banks/Participating Leasing Companies to SMEs compared to the present;
- the increase in the number of SME clients of Participating Banks or Leasing Companies compared to the present;
- the increase in the number of small loans or leases to SMEs compared to the present.
4.3. Activities

4.3.1 Summary

Phare funds will be transferred in tranches to an interest bearing Special Account at the CEB.

The KfW will identify local financial intermediaries in the candidate countries, which have the capacity, interest and willingness to expand their SME financing operations.

An agreement on a financial package between the KfW and the local financial intermediary providing CEB/KfW funds together with a Phare Contribution will represent the “Project”. Before signing this agreement CEB/KfW has to propose the Project to the competent Commission services for their approval. In its proposals the CEB/KfW will inform the Commission about the total resources allocated to the financial intermediary and the corresponding Phare Contribution. The CEB/KfW will provide the loan funds or credit lines to the local financial intermediaries at market rates.

Upon approval the KfW will sign the “Project Agreement” with the local financial intermediary, which then becomes the Participating Bank (PB) or Participating Leasing Company (PLC).

The Participating Bank or Leasing Company will, in turn, engage in the promotion of the Facility amongst SMEs, and conclude loan or financial lease agreements with individual SMEs or award them overdraft facilities (Sub-Projects). The Participating Banks may also implement the Project through agreements with On–Lending Banks (OLB) or Intermediary Leasing Companies (ILC), who will engage in concluding loan (possibly including overdraft facilities) or financial lease agreements with the individual SMEs.

Examples

As an example of an arrangement offered to a Participating Bank on a Project for on-lending to SMEs:

(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; where the On-lending Banks (OLB) are actually on-lending to SMEs, part of the performance fee will benefit to the OLB.

(2) Where justified, a partial first-loss guarantee for a fixed percentage of losses on the SME loan portfolio managed by the Participating Bank and the On-lending Bank;

(3) Technical assistance to perform institution building in the Participating Banks (e.g. adjust organisational structure, train loan officers in appraisal and supervision, introduce new management information systems, etc.) to 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;
Similarly, an arrangement offered to a PB for refinancing an ILC, which ultimately will establish financial lease contract to SMEs, may consist in the combination of a KfW refinancing with Phare incentives to be shared between the PB and the ILC.

The type and the precise mix of the support offered under individual Projects may vary country by country and may depend on the Project’s specific circumstances.

4.3.2. Phare Contribution

The €15 million allocation to this Programme and all income (including interest) generated under the Special Account represent the Phare Contribution. They may be used for

(1) **Technical Assistance to the Participating Banks (PB), Leasing Companies (PLC), On Lending Banks (OLBs) or Intermediary Leasing Companies (ILCs)**

For institution building purposes, notably with the aim to:
- install management information systems specifically geared towards SME portfolios;
- recruit and train staff of PBs, PLCs; OLBs or ILCs in SME customer support and small loan/lease appraisal, supervision and loan/lease administration skills;
- assist in the introduction and implementation of organisational and managerial procedures and practices involved with SME lending/leasing;
- strengthen administrative, credit and management capacities.

(2) **Performance fee to the Participating Banks (PB), Leasing Companies (PLCs), On Lending Banks (OLBs) or Intermediary Leasing Companies (ILCs)**

In the form of a grant partly compensating for the interest to be paid by the PBs or PLCs to CEB/KfW. The Phare incentive will be determined on a downward sliding scale and be paid only in relation to actual performance of the PB or PLC on the SME lending/leasing. Where applicable a Performance fee will be paid on loans/leases and credit lines provided by PBs to OLBs or to ILCs.

(3) **Loan Guarantee to the Participating Banks or On-Lending Banks**

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.

**Exit strategy for Loan Guarantees:**

If in a Project, the Phare funds dedicated to the Loan Guarantee are not fully used at the end of the guarantee period agreed between CEB/KfW and the PB, this amount will be recovered by the Commission.

(4) **Management fee**

It shall be paid to CEB/KfW as 1.25% of each tranche transferred to the Special Account and corresponding to a maximum amount of €187,500. The annual auditing costs are included in the management fee. The Commission shall not provide any additional amount to support the ordinary CEB/KfW cost resulting from the implementation of this Programme, except where duly justified.
Upon proposal of the CEB/KfW and subject to approval by the Commission other appropriate incentives for the benefit of PBs, PLCs, OLBs or ILCs may be granted.

4.4.  Financial Support Ratios and Benchmarks

Programme Leverage
The overall ratio between the CEB/KfW resources and the Phare allocation for this Programme shall be equal or higher than 5/1. The CEB/KfW will provide at least €75 million in the form of loans and the EC will provide a maximum of €15 million.

Project Leverage
For each Project, the ratio between CEB/KfW resources and the Phare Contribution will not be lower than 3/1.

Project and Sub-Project Size
The size of each Project will be, in principle, between €5 - 15 million and the maximum size of a loan or lease per SME (Sub-Project) shall be €250,000. Each Project will therefore cover a number of Sub-Projects.

Performance Fees
No more than 60% of the overall Phare Contribution may be used for performance fees. Upon proposal of the CEB/KfW and subject to approval by the Commission, this ceiling may be raised up to 70% if considered as necessary for the objectives of the Facility. The share of performance fees in the Phare Contribution to specific Projects may however vary between Projects.

Technical Assistance
No more than 70% of the Phare Contribution allocated to the LGLW may be used for TA. The share of TA in the Phare Contribution to specific Projects may however vary between Projects.

4.5  Eligibility and Selection Criteria

4.5.1  Participating Banks and Participating Leasing Companies

Eligible Participating Banks or Leasing Companies are those operating in the beneficiary countries including locally registered, licensed or incorporated entities and subsidiaries or branches of EC banks.

Participating Banks and Leasing Companies will be selected on the basis of their capacity, financial strength, branch networks and regional presence, and their interest to participate in and promote the Facility and its objectives. The selection will also take into account the possible previous involvement in institution building programmes.

The selection criteria include the geographic location, market competition between banks/leasing companies, business potential, branch management competence, commitment to lending or financial lease to SMEs, openness to new technology and willingness to devote personnel.
4.5.2 SMEs

Enterprises eligible for Sub-Projects must comply with the definition of SME as per Commission Recommendation of 30 April 1996\(^2\). The term SME includes the individual entrepreneur. Eligible SMEs must:

1. have majority private ownership and control or be in the final stage of the process of privatisation;
2. not be conducting business in activities such as, gambling, real estate, banking, insurance or financial intermediation and the manufacture, supply or trade in arms, as well as activities excluded by the CEB or KfW.

4.5.3 Eligible Expenditure at SME level

Funds utilisation by SMEs may be for the financing of investment in fixed assets and working capital and may 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 saving and environment, construction, trade and services.

5. Budget

The European Commission will support the Loan, Guarantee and Leasing Window of the SME Finance Facility 2002 with €15 million.

Figure: Co-Financing to SME Facility

<table>
<thead>
<tr>
<th>WINDOWS</th>
<th>PHARE</th>
<th>CEB/KfW</th>
<th>Financial Intermediary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Window</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Loan /Guarantee/Leasing Window</td>
<td>+</td>
<td>+</td>
<td>+/-</td>
</tr>
<tr>
<td>Total</td>
<td>+</td>
<td>+</td>
<td>+/-</td>
</tr>
</tbody>
</table>

Co-financing from the PBs and PLCs in the Loan, Guarantee and Leasing Window will be encouraged, but will vary depending on the circumstances of the Project.

6. Implementation Arrangements

The Commission will entrust the CEB/KfW with the implementation of this Programme by amendment to the Contribution Arrangement currently in force between the Commission, the CEB and KfW. The management of the Programme by the Commission will continue to be sub-delegated to Directorate General Economic and Financial Affairs.

The Commission shall exercise its responsibility over the use of funds through the duration of the programme in accordance with its Financial Regulation applicable to

\(^2\) OJ L 107; 30/04/1996
the General Budget of the European Communities of 21st December 1977 as amended. It will be replaced by the Financial Regulation applicable to the General Budget of the European Communities of 25 June 2002 upon its application as of January 1, 2003.

The provisions of article 167 of the Financial Regulation of June 25, 2002 shall apply to KfW procurement of services financed by Community funds.

It shall be ensured the Community state aid rules are respected.

6.1 Implementation Principles

(1) No Phare funds will be used for the purposes of a Project (under the LGLW or the EW) without prior approval of that Project by the Commission and the CEB/KfW (the Co-Financing Members).

(2) Those Projects that address key priorities defined in the updated Accession Partnerships 2001 and the relevant country’s National Programme for the Adoption of the Acquis will be particularly welcomed, as well as those focusing on micro-enterprises and those encouraging investments which aim at protecting the environment (e.g. encouraging the introduction of cleaner technologies).

(3) An effort will be made to reach a balanced country coverage although final Project selection will be made on the basis of the quality of the proposals.

(4) The specific procedures relating to the implementation of the Project will be set down in Project Agreements with the Participating Bank or the Participating Leasing Company. Project Agreements will specify the terms and conditions applicable to the use of CEB/KfW resources and the Phare Contribution and will ensure that relevant provisions will be incorporated in the corresponding agreements between the Participating Banks and Leasing Companies on the one hand and the SMEs on the other.

(5) Project Agreements shall encompass specific, objectively verifiable criteria by which Sub-Project compliance with agreed rules will be controlled.

6.2 Project Selection and Approval

Project proposals shall be assessed as to their compliance with the following criteria:

(1) the compliance with the Contribution Arrangement including their compliance with eligibility criteria;

(2) the impact on SME development in the beneficiary countries;

(3) the country in which the Project is located;

(4) the degree to which the requested grant leverages additional funds from CEB/KfW and PBs or PLCs.

Subject to the legal obligation of bank secrecy and the rules of confidentiality, the Commission shall have access to all relevant information in connection with the Project proposals.
Given that the particular requirements of Projects may differ considerably depending on the country concerned and the SME market segment being targeted, the CEB/KfW may propose to the Commission exceptions to the general principles and eligibility criteria. The CEB/KfW shall highlight the particular exceptions and provide justifications, so that the Commission may consider the proposals on their own merits and on a case by case basis.

By its approval of the Project, the Commission authorises the mobilisation of the Phare Contribution held in the Special Account with the CEB.

6.3 Co-ordination

The Commission co-operates under the SME Finance Facility with three Sponsor groups: CEB/KfW, EBRD and EIB. CEB/KfW and the other Sponsor groups are authorised to commit Phare Contribution into Projects that meet the Facility requirements under a co-ordinated approach. This implies defining mechanisms that are applicable to all three Sponsor groups for:

(a) the approval of Projects proposed by the Sponsors;
(b) the co-ordination of the implementation of the Facility to make sure that:
   • there is no overlap between the Projects of the respective Sponsors;
   • there is complementarity between the Projects proposed by different Sponsors;
   • an appropriate country coverage is reached between the Sponsors.

The necessary co-ordination between the different Sponsors is ensured by a Steering Committee composed of representatives of the Commission and each Sponsor. The Steering Committee convenes at the request of any of its members, but meets at least twice per year under the chairmanship of a representative of the Commission in order to

(1) monitor financial and operational progress of 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, where necessary.

The decisions of the Steering Committee are taken by unanimity.

The Commission endeavours in particular to facilitate the necessary co-ordination between the Sponsors within the Steering Committee, while ensuring the confidentiality of the operations of each Sponsors with the Participating Financial Intermediaries.

6.4 Secretariat

The Commission (DG ECFIN/L) provides the Secretariat of the Facility. The Secretariat assists the flow of information between the Commission and all the Sponsors for matters related to Projects, Steering Committee organisation and the administration of the Special Account.
6.5. Interest earned on the Special Account

The CEB will continue to manage a separate interest bearing Special Account for this Programme. Interest will be reported to the European Commission and used for the purpose of the Programme set out in section 4.3.2. and after approval of the competent Commission services in accordance with sections 6.1. (1) and 6.2.

The modalities for managing the Special Account will be set in the Contribution Arrangement.

6.6. Recovery of Funds

In the case of default on Projects, the CEB/KfW will undertake recovery proceedings in a manner consistent with the care and diligence applied in CEB/KfW projects financed out of its ordinary resources. The Commission will assist in this process where required.

Fund recovered from Projects will be credited to the Special Account and may be used for the purpose of the Programme as set out in section 4.3.2.

7. Monitoring and Evaluation

At operational level, the implementation of this Programme will be monitored through technical and financial reports to be submitted by the CEB/KfW and through the Steering Committee referred to above.

Moreover, the accounts and operations of all activities carried out under the Programme may be checked at regular intervals by an outside auditor contracted by the Commission without prejudice to the responsibilities of the Commission and the Court of Auditors. Also the Commission may carry out any necessary audits and on-the-spot checks necessary to verify the correct use of the Phare Contribution.

To facilitate this, the CEB/KfW, Participating Banks, Leasing Companies, On-Lending Banks, Intermediary Leasing Companies will keep accounting, financial and operational documents concerning all activities financed by the Phare Contribution under this Programme, and will make available to the competent bodies of the European Commission and the European Court of Auditors on request all relevant information.

The Commission may also carry out, from time to time, assessments of the activities under the Arrangement. To this purpose Commission’s agents or duly authorised representatives may pay monitoring visits down to the Sub-Project level. The Commission also exercises its responsibilities through reviewing the audited accounts and reports produced by the CEB/KfW and through its own independent assessment and audits.

The Commission services shall ensure that ex-post evaluation is carried out after completion of the Programme.
8. **Audit and Anti-Fraud Measures**

The Financing Decision for this Programme as well as the utilization of the Phare Contribution in Projects are subject to supervision and financial control by the Commission (including the European Anti-Fraud Office, OLAF), and the Court of Auditors. In order to ensure efficient protection of the financial interests of the Community, the Commission can conduct check-ups and inspections on site, in accordance with the procedures foreseen in Council Regulation (Euratom, EC) No 2185/96, concerning on-the-spot checks and inspections carried out by the Commission in order to protect the European Communities’ financial interests against fraud and other irregularities.

The procedures foreseen in Article 15 of the Commission Regulation (EC) No 2222/2000 of 7 June on the communication in case of irregularities and the putting in place of a system to administrate the information in this field shall apply.

Project Agreements to be concluded by the KfW with the financial intermediaries, as well as agreements between the latter and beneficiaries of Sub-Projects, shall contain provisions to this effect. Relevant documentation should be maintained at all levels for a period of at least five years after closure of the Project.

There shall be full coordination between the CEB/KfW, the Commission and Court of Auditors to minimize any potential disruption to activities.

9. **Visibility**

All Projects financed under the Facility involving Community funds shall reflect explicitly the input of the Commission through: (i) announcements in the national press of the country concerned; and (ii) inclusion of specific clauses promoting visibility in the Sub-Projects supported at the FI level. Phare visibility measures are based on the provisions of the regulations and decisions applicable to the Structural Funds.

In addition, CEB and KfW will report on the activities under the SME Finance Facility, informing on the co-operation with the Commission, in their usual respective Annual Reports.

10. **Special Conditions**

In the event that agreed commitments are not met for reasons which are within the control of the CEB/KfW, the Commission may review the programme with a view, at the Commission’s discretion, to cancelling all or part of it and/or to reallocate unused funds for other purposes consistent with the objectives of the Phare programme.

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3 OJ L 292; 15/11/1996; p. 2-5