COMMISSION DECISION
OF 2003

Establishing a Phare multi-beneficiary programme on the “Municipal Finance Facility with the Council of Europe Development Bank in co-operation with Kreditanstalt für Wiederaufbau” in 2003,

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\(^1\), as last amended Regulation (EC) No 807/2003\(^2\), and in particular Article 8 thereof,

Whereas:

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

(2) 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 \(€5\) million to be financed through Budget line B7-030 in 2003.

Done in Brussels,

For the Commission

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\(^1\) OJ no. L375 of 23/12/1989
\(^2\) OJ L 122, 16.5.2003, p.36
FINANCING PROPOSAL

1. IDENTIFICATION

Beneficiary countries

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

Programme

Municipal Finance Facility with the Council of Europe Development Bank in co-operation with Kreditanstalt für Wiederaufbau

CRIS-Number

2003/005-788

Year

2003

Cost

€5 million

Expiry Dates

Contracting: 30 November 2004
Execution of Contracts: 30 November 2011

Group

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Sector

FI

DAC Code

24030

Budget Line

B7-030

Task Manager:

Judith Novak (DG ELARG, Unit D.3, Implementation, Contracts and Nuclear Task Force)

2. SUMMARY

The depth and strength of the municipal credit markets is an important aspect of the functioning of the financial sector in the acceding and the candidate countries. There are numerous municipalities in these countries, which have investment needs in areas such as water supply, sewerage, roads, public transport, solid waste, heating etc. At the same time, in particular, smaller municipalities have still a limited access to long term credits needed for infrastructure investment, even in countries with more advanced financial markets. Market-based municipal lending broadens the range of finance available to municipal authorities for ensuring sustainable living conditions to their populations.

The overall objective of the Facility is to assist the acceding and the candidate countries in contributing to the reform and strengthening of the financial sector.

To this end, Council of Europe Development Bank (CEB) and Kreditanstalt für Wiederaufbau (KfW) will co-operate under the Facility and combine loans from their

1 Date by which the Contribution Agreement with the CEB/KFW must be concluded.
resources with non-reimbursable Phare support in order to motivate banks in the acceding and the candidate countries to expand their lending to municipalities for the financing of small infrastructure investments, to extend loans over longer maturities, and to enhance their capacity to assess and monitor the related risks and to manage their loans.

After one earlier Financing Proposal for a total of €14 million, this Programme makes available a further €5 million for this purpose. Concerning the acceding countries this is the last allocation to the Municipal Finance Facility under the Phare Programme. The CEB and KfW will increase its contribution to achieve the Programme’s objectives by at least an additional €25 million.

3. **Strategy and Background**

**Strategy**

The Regular Reports 2002 assessed the progress made by the acceding and the candidate countries, as well as the overall situation in terms of the adoption of the Acquis and the capacity to enforce it.

In the context of the Copenhagen economic criteria the Regular Reports 2002 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 Plans for Administrative and Judicial Capacity”.

The depth and strength of the municipal credit markets is an important aspect of the functioning of the financial sector in the acceding and the candidate countries. Moreover, market-based municipal lending broadens the range of finance available to municipal authorities for ensuring sustainable living conditions to their populations.

The European Commission and CEB working in co-operation with KfW (CEB/KfW) have therefore decided to combine Phare grant money with CEB/KfW lending, where possible, in order to help the financial sector in the Eastern and Central European acceding and candidate countries develop its municipal lending business. From the European 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 relationship between the European Commission and the CEB in the field of cooperation for pre-accession preparation of the Central and Eastern European acceding and candidate countries is based on the *Memorandum of Understanding of March 31, 2000.*

This Memorandum underlines the shared desire to foster the reform process in the candidate countries. In this context the European Commission and the CEB seek to cooperate and co-finance suitable projects and programmes in the candidate countries, taking into account accession priorities i.e. building up the administrative and institutional capacities of these countries and financing investments to help them comply with EC law as soon as possible.
In order to maximise the success of the operations under this Programme, CEB co-operates with the Kreditanstalt für Wiederaufbau (KfW). 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 candidate countries for many years and its activities comprise a wide range of promotional measures.

KfW has developed and is still developing promotional credit programmes either with promotional banks or with commercial banks doing business with the target group in the countries of Central and Eastern Europe. KfW’s assistance is not limited to giving advice, but includes also re-financing of the co-developed credit programmes at attractive conditions.

In the context of the Phare programme, co-operation between the European Commission and the CEB/KfW includes in particular the promotion of lending to small and medium-sized enterprises in the candidate countries under the SME Finance Facility.

The Municipal Finance Facility was launched in 2002 with a first EC allocation of €14 million to the CEB and KfW and committing CEB and KfW resources of at least €75 million. During the first half of 2003 the Commission, CEB and KfW negotiated the Contribution Agreement i.e. the contract determining the implementation arrangements in detail. It is expected that the first Project with local financial intermediaries will be launched during the last quarter of 2003.

4. OBJECTIVES AND DESCRIPTION

4.1. Objectives

The overall objective of the Programme is to assist the acceding and the candidate countries in contributing to the reform and strengthening of the financial sector.

The Programme’s specific objective is to:

- build the confidence of commercial banks to extend loans to municipalities and their utility companies for the financing of small infrastructure investments;
- increase the willingness of banks to extend such loans over long-term maturities;
- enhance the capacity of banks to assess and monitor the related risks and to manage their loans;
- enable municipalities to present loan applications that demonstrate the feasibility and financial soundness of the planned infrastructure investments.

and thereby to strengthen and deepen the municipal credit markets in the long term, and in particular lending to smaller municipalities, in the candidate countries.

4.2. Results

Results obtained under this programme include:

- staff from banks will be familiar with the concept of lending to municipalities and its implications for their business;
- bank management will appreciate the benefits of long-term lending to municipalities;
- the volume of bank loans extended to municipalities will be larger than at present;
• bank loans extended to municipalities will have longer maturities than at present;
• staff from municipal borrowers will be experienced in financial management and the development of bankable projects.

These results will be particularly pronounced regarding lending to small or medium-sized municipalities that do not have the capacity to tap the capital markets.

4.3. Activities

4.3.1. Summary

The Phare allocation will be paid in one or several instalments to an interest bearing Special account at the CEB.

The CEB/KfW will identify local financial institutions in the designated candidate countries as partners under this Programme. The CEB/KfW will provide loans on market terms to these institutions, which, in return, will engage in lending operations to municipalities or private or public companies providing a municipal service.

Building the network of financial intermediaries and creating the “Projects”

The KfW will select local financial institutions, which have the capacity, strength and interest to expand their operations to financing small municipal infrastructure investments in the candidate countries. An agreement on a financial package between KfW and the local financial institution providing a CEB/KfW loan together with a Phare Contribution will represent the “Project”. Before signing this agreement the CEB/KfW has to propose the Project to the competent Commission services for their approval. In its proposal the CEB/KfW will inform the Commission about the total loan amount allocated to this local financial institution and the corresponding Phare Contribution. Upon approval, the KfW will sign a Project Agreement with the local financial institution, which then becomes the Participating Bank under this Programme.

Creating the “Sub-Projects”

The Participating Bank will engage in the promotion of the Facility among municipalities and aim at receiving loan applications for small infrastructure investments. On the basis of a thorough analysis of the applications, the Participating Bank will sign a Loan Agreement with a municipality or utility company providing a municipal service (hereinafter referred to as the Promoter). This Loan Agreement becomes the “Sub-Project”.

4.3.2 Phare Contribution

The Phare Contribution represents €5 million allocated to this Programme and all income (including interest) accruing to the Special account. These monies may be used for the following purposes:

(1) Technical Assistance to the Participating Banks

Technical assistance may include activities such as the training of staff in supporting municipal clients and in the appraisal, supervision and administration of loans extended to municipalities, or the introduction of the related organisational and managerial procedures and practices.
(2) **Technical Assistance to the Municipal Promoters**

Technical Assistance to Promoters would help the Participating Banks in creating effective demand from the municipal market, by, for example, strengthening their capacity to prepare bankable loan applications and to monitor the progress of Sub-Projects.

(3) **Performance Fee for Participating Banks**

As an incentive to the Participating Banks to meet the objectives of the Programme, performance fees may be paid in proportion of the number and the volume of Sub-Projects financed and completed.

(4) **Financial Incentives for Participating Banks**

These incentives will allow the Participating Bank to increase effective demand by introducing cost reducing elements into the Sub-Projects. The disbursement of these incentives to the Participating Bank will be linked to the signature of Sub-Projects, their completion and the loan conditions offered.

(5) **Loan Guarantee**

To cover the risks involved in municipal project lending the Participating Bank may benefit from a partial guarantee on their portfolio of loans subject to the definition of appropriate limits.

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 KfW and the PB, this unused amount will be recovered by the Commission.

(6) **Management Fee**

A management fee shall be paid to the CEB/KfW as 1.25% of each tranche transferred to the Special account and corresponding to a maximum amount of €62,500. The annual cost for auditing the Special account is 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.

The mix and level of the different components (1) to (5) will be tailored by the CEB/KfW to the particular national or regional markets in which the Programme will operate.

Moreover, in addition to the items listed above, and with a view to enhancing the implementation of the Programme, the Commission may in light of experience agree to other appropriate incentives for the benefit of Participating Banks in the framework of a Project Proposal from CEB/KfW.

### 4.4. Financial Support Ratios

1. The **overall ratio** between the CEB/KfW resources and the Phare allocation for this Programme shall be equal to or higher than 5/1. The CEB/KfW will provide at least €25 million in the form of loans and the EC will provide a maximum of €5 million.

2. The ratio between the CEB/KfW loans and the Phare Contribution allocated to one **Project** will be equal to or higher than 4/1 except for Romania and Bulgaria where
it will be equal or higher than 3/1. The ratio shall be equal to or higher than 8/1 if no Technical Assistance is financed by the Phare Contribution.

3. The size of each Project will be, in principle, between €5 - €15 million and the maximum size of an investment financed with a loan will be €5,000,000. Taking the co-financing ceiling of the CEB/KfW into account, each Project will, therefore, cover several Sub-Projects.

4. For each Project the average amount of Technical Assistance to municipalities will not be higher than €25,000 except in Romania and Bulgaria where this limit will be €50,000.

4.5. Eligibility Criteria

4.5.1 Eligible Participating Banks (PB)

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

Participating Banks will be selected on the basis of their capacity, financial strength and interest to participate in and promote the Facility and its objectives. Selection of Participating Banks will also take into account their credit worthiness, their previous record in municipal lending and, in general, their sound banking practice. In principle, those banks that CEB/KfW considers to fulfil these requirements based on an ongoing relationship with CEB/KfW, are eligible to participate in the Facility.

4.5.2 Eligible Promoters

Eligible Promoters are municipalities or private or public companies delivering municipal services, who are directly responsible for the implementation of the Investments. They are, generally, the owners of the assets of the Investment.

4.5.3 Eligible Investments

Eligible investments relate to the building, upgrading or refurbishing of small municipal infrastructure.

The total cost of an investment is less than €5 million.

4.5.4 Eligible Sectors

Investments are eligible in the sectors involving municipal infrastructure except for sectors included in the KfW exclusion list.

4.5.5 Eligible Investment Costs

Eligible components of investment costs will be determined by KfW eligibility criteria.
5. **Budget**

The European Commission will support the Municipal Finance Facility with €5 million.

<table>
<thead>
<tr>
<th>Phare Funding in million €</th>
<th>IFI</th>
<th>Total</th>
</tr>
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<tbody>
<tr>
<td>Institution Building (IB)</td>
<td>INV</td>
<td>Phare Total I+IB</td>
</tr>
<tr>
<td>5</td>
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<td>5</td>
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(The figures in the budget table are indicative only)

Co-financing for Institution Building projects is provided by the beneficiary bearing certain infrastructure and operational implementation costs, through financing the human and other resources, required for effective and efficient absorption of PHARE assistance.

6. **Implementation Arrangements**

6.1. Financial and Project Management

This Programme will be implemented on a centralised basis by the Commission in accordance with Council Regulation 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the General Budget of the European Communities. To this end, the Commission will conclude a grant agreement with CEB and KfW.

The provisions of Part 2, Title 4, Chapter 3 of Council Regulation 1605/2002 apply to KfW procurement of works, services and supplies financed by Community funds.

6.2. Deadline for contracting and execution of contracts between KfW and Participating Banks

All contracts between KfW and the Participating Banks must be concluded by 30/11/2006. Execution of these contracts must end by 30/05/2011.

The contract of execution period exceeds the average length allowed for the execution of contracts. The length of the execution period is justified due to a number of steps involving the Municipal Finance Facility mechanism. The length is required to allow the Programme to develop its full impact.

As from the signature of the Contribution Agreement KfW has to carry out due diligence on local financial intermediaries and sign a Project Agreement with them.

The deadline for signing these Project Agreements has been set at 30/11/2006 (3 years). For each Project selected, KfW and CEB provide credit lines to local financial intermediaries with a duration of several years (normally 4 years or more). The execution of contract period has been set to allow an implementation period of the last Project of 5 years.

Should KfW manage to sign Project Agreement well before 30/11/2006, e.g. by end of 2005, an early termination of the Facility is possible.
6.3. Recovery of Funds

In the case of default on Projects, the Commission will initiate recovery from KfW or CEB. KfW will undertake recovery proceedings in a manner consistent with the care and diligence applied in 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.

The Phare Contribution, which has not been allocated to a Project by 30/11/2006 (contracting expiry date between KfW and PBs), will be de-committed by the Commission.

The Phare Contribution allocated to a Project and not disbursed from the Special Account of the CEB by 30/11/2011 (overall end of the contract execution period) will be recovered by the Commission.

6.4. 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 as set out in section 4.3.2. and after approval of the competent Commission services in accordance with section 6.5.

The modalities for managing the Special account will be set in the Contribution Agreement.

6.5. Process of Project Approval

The CEB/KfW will prepare a Project proposal for each new or amended Project Agreement with a Participating Bank and submit it for the approval by the competent Commission services. The CEB/KfW will provide all relevant information to assess the Project proposals including information on the selected bank, amounts from CEB/KfW and Phare Contribution allocated to the Project, type of incentives provided, compliance with eligibility criteria, indicators of achievement for monitoring and evaluation and disbursement schedule. A standard project proposal format will be included in the Contribution Arrangement.

The Commission shall assess Project proposals according to their compliance with the following criteria:

- the compliance with the Contribution Arrangement and its annexes, including the degree of compliance with the eligibility criteria;
- the degree to which the requested Phare Contribution grant leverages additional funds from the PBs;
- the justification of the need of the particular Participating Bank;
- the additionality and sustainability of the Project;
- the expected quantitative and qualitative results of the Project;
- the Project’s impact on SME development in the beneficiary countries.
By their approval of the Project, the Commission authorises the mobilisation of the Phare Contribution from the Special account set up at the CEB. The Commission also ensures the confidentiality of the Projects proposed by the CEB/KfW.

Each Sub-Project must have received the authorisation of the CEB/KfW after verification that the relevant eligibility criteria are met.

The Contribution Agreement will specify a limited time period between the signature of the Project and the signature of individual loan agreements (i.e. Sub-Projects). Beyond that limit, the CEB/KfW may allocate the uncommitted resources to other Projects subject to the agreement of the Commission.

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.

6.6. Environmental Impact Assessment and Nature Conservation

The procedure for environmental impact assessment as set down in the EIA-directive are fully applicable for all investment projects under Phare. If the EIA-directive has not yet been fully transposed, the procedures should be similar to the ones established in the above-mentioned directive. All investment projects will be carried out in line with the relevant EU environmental legislation. Project proposals will contain information on specific clauses on compliance with the relevant EU legislation in the field of environment to be included in the legal documentation implementing the Project proposal.

6.7. Secretariat

The Commission (DG ECFIN/L) provides the Secretariat of the Facility. The Secretariat co-ordinates the flow of information between the Commission and all the Sponsors for matters related to Projects, Steering Committee and technical meeting organisation and the administration of the Special Account.

7. MONITORING AND EVALUATION

7.1. Monitoring

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 a Steering Committee including representatives of the Commission, CEB/KfW and any other institution that will have signed a Contribution Agreement with the Commission under the Municipal Finance Facility.

After an initial advance payment, the payment of instalments will be conditioned to the presentation to the Commission of a semi-annual or annual operational progress report and a financial report and their subsequent approval indicating the progress of operations and of expenditure of the Special Account.

The Steering Committee will be chaired by a representative of the Commission and will monitor the implementation of the Facility, in particular it will:

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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 and propose improvements;
4. co-ordinate activities of the Facility, where necessary.

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 to verify the correct use of the Phare Contribution.

To facilitate this, the CEB/KfW, Participating Banks and Promoters will keep accounting, financial and operational documents concerning all activities financed from the Phare Contribution, and will make available to the competent bodies of the European Commission and the European Court of Auditors on request all relevant financial information.

7.2. Evaluation

The Commission may also carry out, from time to time, assessments of activities under the Agreement. 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 and KfW and through its own independent assessments and audits.

The Commission may carry out interim evaluations and shall ensure that ex-post evaluation is carried out after completion of the Municipal Finance Facility.

8. AUDIT AND ANTI-FRAUD MEASURES

The Financing Decision for this Programme as well as the utilisation of the Phare Contribution in Projects and Sub-Projects are subject to supervision and financial control by the European 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 European 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 para. 3 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 KfW with the financial intermediaries as well as agreements between the financial intermediaries and beneficiaries of Sub-Projects, shall contain provisions to this effect. Relevant documentation should be maintained at

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3 OJ L 292; 15. 11. 1996; p. 2-5
appropriate levels for a period of at least five years after closure of the Project or the Sub-Project.

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

9. **VISIBILITY/PUBLICITY**

The CEB/KFW will be responsible for ensuring that the necessary measures are taken to ensure appropriate publicity for all activities financed from the programme. This will be done in close liaison with the Commission Delegation. Phare visibility measures are based on the provisions of the regulations and decisions applicable to the Structural Funds\(^4\).

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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