COMMISSION DECISION
OF 2005

establishing a Phare multi-beneficiary programme on the SME Finance Facility with the Council of Europe Development Bank in cooperation with Kreditanstalt für Wiederaufbau in 2005, for Bulgaria, Romania, Croatia and Turkey

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EEC) No 3906/1989 of 18 December 1989 on economic aid to certain countries of Central and Eastern Europe¹, and in particular Article 8 thereof,

Having regard to Council Regulation (EC) No 2500/2001 of 17 December 2001², concerning pre-accession financial assistance for Turkey,

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, and Regulation No 2500/2001 lays down the rules and conditions for the granting of economic aid to Turkey;

(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 €9 million to be financed through Budget line 22.02.10 of the 2005 General Budget of the European Union.

Done in Brussels,

For the Commission

ANNEX

1. IDENTIFICATION

**Beneficiary Countries**  Bulgaria, Croatia, Romania, Turkey

**Programme**  SME Finance Facility 2005 with the Council of Europe Development Bank in co-operation with Kreditanstalt für Wiederaufbau

**CRIS-Number**  2005/017222

**Year**  2005

**Cost**  € 9 million

**Implementing Authority**  European Commission on behalf of the beneficiary countries

**Expiry Dates**
- Execution of Contracts: 30.11.2014

**Sector**  PR

**Group**  L

**DAC Code**  25010

**Budget Line**  220210

**Task Manager**  Nathalie Boutin (DG ELARG, Unit D3, Horizontal Programmes and Contracts; payments and recoveries are sub-delegated to DG ECFIN)

2. SUMMARY

The development of the private sector is crucial for a stable and functioning market economy, where companies have to meet competitive pressure from within the EU. In the enlarged EU there are about 16 million enterprises, most of them of micro size and SME’s account for 72% of employment in the EU. As on average at least two thirds of economic output and employment can be attributed to SMEs in the beneficiary countries, it is important that SMEs can rely on a good level of financial intermediation to support their growth.

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3 This is the date by which the Contribution Agreement between the Commission and the CEBKfW must be signed.
The financial sector acts as an important catalyst in providing growth opportunities through external finance to enterprises. The financial sectors of Bulgaria, Romania, Croatia and Turkey have all undergone substantial reform during the past years and at the same time the macroeconomic situation in these countries are on its way to stabilisation. Nevertheless, the degree of financial intermediation remains low compared to the EU.

Therefore, this Programme combines resources from the Council of Europe Development Bank (CEB) in co-operation with KfW 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 earlier Financing Proposals for a total of € 86.5 million in the New Member States, Bulgaria, Romania and Turkey this Programme makes available a further € 9 million, with a focus on deepening financial intermediation in Bulgaria, Romania and Turkey and rolling out the Facility in Croatia for the first time. The CEB and KfW in turn will increase their contribution to the Programme’s objectives by at least an additional € 45 million.

3. Background and Strategy

3.1. Background

3.1.1. Bulgaria

Overview of the banking sector

In January 2005 there are 35 registered commercial banks in Bulgaria with 6 of them being branches of foreign banks. After a successful stabilisation of the Bulgarian economy and reform efforts undertaken, the Bulgarian banking system appears to be evolving into a stable, well capitalised, and profitable sector able to absorb significant credit risk. The Regular Report 2004 confirms that supervisory structures are well equipped and oversee commercial banks with a view to prudential regulations. With regards to banking services, the transposition of the acquis is also quite advanced. However, it is also indicated that commercial banks are in need of guidance and further capacities to assess risks and to develop internal controls and banks’ IT systems. Since 1998, banking sector credit to the private sector has been gradually increasing and is now more than double the level in Romania but remains low compared to the EU average. The chapter concludes that sustained effort over several years are necessary before Bulgaria’s financial system would be able to sustain the impact of integration into the internal market.

Need to improve access to finance to SMEs

Economically active SMEs (approx. 210,000) represent 98.99% of the total number of active companies in Bulgaria. This illustrates the importance of SMEs for the Bulgarian economy.

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4 Register of Commercial Banks at the National Bank of Bulgaria

5 Survey of EBRD on Access to Finance for SMEs

6 National Bank of Bulgaria is the supervisory authority

7 Euro Info Centre Working Group Market Access, December 2002
The Regular Report 2004 indicates that Bulgaria has made further progress with regard to improving their business environment including access to finance. But there is scope for increasing the availability for, in particular, non-banking financial instruments.

Despite the positive trend of deepening bank intermediation, SMEs consider the cost of and access to capital as major potential obstacles to doing business. The entrepreneurs value the reforms undertaken to strengthen the banking system and adapt it to domestic needs. However, the general view remains that the banking system is not yet fully responsive to the needs of SMEs. Credit application procedures are too cumbersome and costly and banks need to become less conservative and more pro-active in their SME lending practices. Banks are also still not perceived to be very willing to supply credit to SMEs. The main sources of finance for the Bulgarian SMEs are internal funds and loans from family/friends. Among commercial sources local commercial banks are the most important, although only few players effectively target the micro and SME sector, in particular the partner banks of the SME Finance Facility. External non-banking sources of finance, such as leasing or venture capital, are so far insignificant for SME financing needs. However the potential for growth of some of these such as leasing companies is critical in trying to boost the development of the SME sector at a time when banking intermediation is still low. Accessing bank loans for the financing of new investments is relatively more difficult than accessing working capital loans from banks.

The overall conclusion is that the availability of sources of finance alternative to internal funding is still very limited, although improving. Access to bank lending remains difficult for Bulgarian SMEs, in particular to small borrowers, in remote regions, for new investments and for longer term maturities.

3.1.2. Romania

Overview of the Banking Sector

In January 2005, there are 39 commercial banks currently registered with the National Bank of Romania, who is supervising them. The Regular Report 2004 confirms that the banking sector reform has progressed during the past years. In particular since 1999 the financial system underwent major restructuring due to the closure of the largest state owned bank (Bancorex), the transfer of non performing loans to the Asset Recovery Agency, the tightening of banking supervision and substantial capital injections into the banking system. In the area of financial services good progress has been made in the banking sector with the adoption of significant amendments to the banking law and legislation in various areas such as consolidated supervision, legal requirements for credit institutions to properly manage interest rate risks and operational risks, capital adequacy, solvency, large exposures, reorganisation and winding up of credit institutions.

Nevertheless, the degree of financial intermediation in the economy remained low not only compared to EU average but also compared to other candidate countries such as Bulgaria.

As regards non banking financial intermediation, the Romanian leasing market started to grow after 1997, when it became recognised and regulated. At present the Romanian leasing market is fragmented with only a small number of players having access to funding.

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9 EBRD’s survey on access to finance for SMEs in Bulgaria, 2002
10 EBRD’s survey on access to finance for SMEs in Romania, 2002
Access to Finance for SMEs

Approximately 357,000 SMEs of which 88% are micro-enterprises account for 55% of GDP\textsuperscript{11} and employ 40% of Romania’s workforce.\textsuperscript{12} In 2003, SMEs generated 54.4% of jobs.\textsuperscript{13} According to the Regular Report 2004 access to finance continues to be a major problem for SMEs. Although banks are more open towards SME financing in general, start up and micro enterprises have problems in raising capital from the commercial banking system.

The launch of the SME Finance Facility in Romania has contributed to accelerating active lending to SMEs in Romania. Owners of SMEs in Romania seem particularly concerned with cumbersome credit application procedures, sometimes taking several months. Banks are perceived as discriminating against small firms compared to larger firms. Individual/family capital is the main funding source for start ups, followed by equity participations of other businesses in a new firm. SME’s access to commercial loans is hindered by the perception that interest rates are high, maturities too short and collateral requirements too high. Overall the level of intermediation is low, the situation of banking intermediation is improving while the non-banking financial intermediation, such as leasing, is still underdeveloped.

3.1.3. Croatia

Overview of the Banking Sector

According to the Opinion of the Commission in 2004 on the application for Membership of Croatia to the EU the Croatian banking sector has been gradually consolidating through mergers and acquisitions with a steady increase of subsidiaries of EU credit institutions. Today eight foreign banking groups control over 90% of total market assets of which the two largest hold about 50%. (Unicredito/Allianz Group Holding through Zagrebacka Banka (33%), Intesa-BCI through Privredna Banka (20%). In terms of regulatory environment the banking sector appears quite advanced but further improvements are necessary with a key challenge being a better access to finance for enterprises\textsuperscript{14}.

Access to Finance for SMEs

SMEs constitute the large majority of enterprises in Croatia representing 99.6% of the total number of companies (EU average 98%) and 65.7% of employment (EU average 66%). Access to finance by SMEs has improved during the last 2 years as the banking system has become more liquid and competition among banks has increased. Consequently banks offer low interest rates but collateral requirements are in excess of the value of the loan and SMEs suffer from a poor quality of their financial accounts.

\textsuperscript{11} Gross Domestic Product


\textsuperscript{13} Annual Report of the SME sector in Romania 2003, published in October 2004 by the National Agency for SMEs

\textsuperscript{14} EBRD country strategy for Croatia 2004
3.1.4. Turkey

Overview of the Banking Sector

Turkish economic development has been unstable in recent years with subsequent phases of both high positive and negative economic growth. The foreign exchange crisis of 1994 and the politically induced financial crisis of 2000/2001 demonstrated the structural weakness of Turkey’s economy following which the government initiated reforms in the banking sector. These included improved bank supervision and the restructuring of the banking system by preparing the grounds for the privatisation of state owned banks and introducing stricter rules in relation to risk control. The very high degree of cash circulation in the economy\(^{15}\) (92%) and low financial intermediation\(^{16}\) are a sign that the financial sector is underdeveloped compared to countries with comparable economic development\(^{17}\). At the same time there are 82 banks operating in Turkey of which 4 are state owned banks. This can be explained by the fact that high profits could be earned by banks through investing in government bonds and granting export loans to large conglomerates. With an increasing privatisation of the economy the financial sector’s profit margins are decreasing and a consolidation and restructuring of the banking system is inevitable. To stay competitive and have new income sources financial institutions must turn to the private sector.

Access to finance for SMEs

More than 90% of all Turkish private sector enterprises are SMEs. They represent 77% of Turkish employment and contribute 25% to the GDP. Despite of their rising economic importance, lending to SMEs remains insignificant with less than 10% of overall lending. Most SMEs finance their investments from own returned earnings or “informal” external sources with high effective interest rates.

Although commercial banks are forced to look at serving SMEs as a new client segment, the process is hampered by a lack of domestic long term re-financing, foreign exchange risks and banks’ limited know-how in SME lending. In addition the SME lending business is unevenly developed and dominates Western Turkey with Istanbul and Ankara receiving 60% of credits. In conclusion, maturities of loans are extremely short, due to the FX risk credits are provided in foreign currency and therefore the SME without export revenues bears the FX risk, credit application procedures are long and cumbersome and there is a regional gap. With an increasingly stabilising economy it is important to support the development of the financial sector to enable it to expand and maintain lending to SMEs in the long term.

3.1.5. Overall results of the SME Finance Facility

Bulgaria

By the end of 2004 KfW signed project agreements with 2 partner banks (Pro Credit Bank, Raiffeisen Bank) for a total amount of € 15 million in credit lines and € 1.7 million in EC

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\(^{15}\) Cash circulation/bank transfers –sign that banks are not fulfilling their function as paying agents

\(^{16}\) Credit to private sector/GDP–sign that banks are not fullfilling their function as financial intermediaries

\(^{17}\) Measured in GDP/capita
incentives. These funds have induced 279 loans\(^{18}\) or leases worth € 11 million to SMEs. This corresponds to an average loan size of € 39,437. About 59\% of all loans represented micro loans\(^{19}\). More than half of the loans (52\%) were provided to SMEs outside Sofia. Technical assistance provided to Pro-Credit Bank facilitated the opening of two branches with loan officers having been trained\(^{20}\).

**Romania**

KfW has signed projects with 2 banks (Banca Romanesca, Unicredito) for a total amount of €10 million in credit lines and € 2 million in EC incentives. Concerning the type of EC incentives KfW did not opt to use technical assistance in Romania but offered Performance Fees, Small Loan Fees and Loan Guarantees to support institution building in SME lending. The credit line and the EC incentives have induced 92 loans worth € 7.8 million to SMEs with an aggregate average loan size of € 84,782. Out of total loans 17 were micro loans with an average loan size of € 22,050. About 80\% of loans could be provided to SMEs outside Bucharest.

**Turkey**

KfW signed one project agreement with Türkyie Sinai Kalkinma Bankasi in 2002 (TSKB) for on-lending in Turkish Lira through at least three commercial banks to SMEs. This project involved a credit line of € 21 million and EC incentives worth € 4 million to be granted in the form of an exchange risk cover fund (ERCF) and technical assistance. The ERCF is an institution building measure that allows the involved on-lending banks to get more familiar with hedge instruments and can initiate the development of a hedging market. The take off of the project in Turkey has so far been difficult. No concrete results have been achieved in terms of SME lending yet, since the signing of on-lending agreements and the subsequent set up of the exchange risk cover fund took more time than expected. Today there is one on-lending agreement signed between TSKB and Disbank and an agreement on an exchange risk cover fund is signed between Disbank and KfW.

**Overall results of SME Finance Facility with CEB/KfW**

The Commission launched the SME Finance Facility with the CEB and KfW in 2000. As per June 2004, the total loan and leasing window portfolio amounted to € 375.5 million in CEB/KfW loans committed to 24 banks and leasing companies in the New Member States, Bulgaria, Romania and Turkey. Out of € 86.5 million in EC resources € 55 million were committed to signed Projects. More than 3,800 loans to SMEs amounting to € 230 million were disbursed to SMEs. Concerning the promotion of leasing, KfW has mostly been working directly with banks, who would on-lend part of the funds to leasing companies. There are only three projects that directly concern leasing companies. Since 2002 they have been generating 912 leasing transactions.

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\(^{18}\) This figure refers to loans generated by Pro Credit Bank only, since other two Projects were signed in 2004 and the results were not yet available in the last semi-annual progress report.

\(^{19}\) The average number of employees that received micro loans was 13 with an average annual turnover of €620,000. The average number of employees that received small loans was 19 with an average annual turnover of €1,930,000. This data is retrieved from KfW’s semi-annual progress report 2004.

\(^{20}\) Semi Annual Progress Report 30 June 2004
### Loan, Guarantee and Leasing Window

<table>
<thead>
<tr>
<th></th>
<th>CEB/KfW resources</th>
<th>EC Contribution</th>
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</thead>
<tbody>
<tr>
<td><strong>Financing in 2000</strong></td>
<td>113</td>
<td>21</td>
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<tr>
<td><strong>Financing in 2001</strong></td>
<td>171(^{21})</td>
<td>34(^{22})</td>
</tr>
<tr>
<td><strong>Financing in 2002</strong></td>
<td>75</td>
<td>15</td>
</tr>
<tr>
<td><strong>Financing in 2003</strong></td>
<td>90(^{23})</td>
<td>16.5(^{24})</td>
</tr>
<tr>
<td><strong>Total with CEB/KfW</strong></td>
<td>449</td>
<td>86.5</td>
</tr>
</tbody>
</table>

### 3.2. Strategy

#### 3.2.1. Justification for the monopoly situation of CEB and KfW, EBRD and EIB

The technical nature and the multi-country approach of the SME Finance Facility required the involvement of highly-specialised financial institutions, with a long track record in international finance and SME development. Also the preference was for financial institutions with the status of international public-law bodies, which shared the values of the EU, in particular, in relation to enlargement and had similar public policy objectives, rather than private-sector financial institutions looking for commercial investment terms. Hence discussions started in 1997 with the EBRD and EIB as the only institutions considered able at the time to fulfil these criteria and showing a clear interest to support the Facility’s implementation. Following these discussions, the first SME Finance Facility was launched in 1999 with the EBRD. Discussions also started with the Council of Europe Development Bank in 2000, which through its unique character as an International Financial Institution under the supreme authority of the Council of Europe, made it a suitable partner for the Facility. The first SME Finance Facility with the Council of Europe Development Bank became operational in 2000 involving the Kreditanstalt für Wiederaufbau (KfW) as a partner. Finally, the European Investment Bank (EIB) joined as a partner in 2001.

In terms of the Financial Regulation applicable to the general budget (Art.110), and its Implementing Rules (Art.168), the characteristics of these financial institutions as public-law bodies, pursuing European public policy objectives not just for profit, as well as their track-

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\(^{21}\) included €20 million in CEB/KfW resources for Turkey

\(^{22}\) included €4 million from EC resources for Turkey (Meda budget line)

\(^{23}\) included €15 million in CEB/KfW resources for Cyprus

\(^{24}\) included €1.5 million in EC resources for Cyprus
The record and specialisation in financing international development, therefore put them in a monopoly situation leaving no other choice as partner for the Commission in these actions.

### 3.2.2. Co-operation with CEB and KfW

The relationship between the European Commission and the CEB in the field of co-operation for pre-accession preparation of the Central and Eastern European candidate countries is based on the **Memorandum of Understanding amended on May 20, 2003**.

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 co-operate 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.

The co-operation with CEB and KfW allows the Commission, in line with the principle of sound financial management, (1) to pursue important political objectives, (2) to make the beneficiary countries to benefit from a considerable leverage effect of EC grant funding (6:1 up until now), (3) to implement the Programme with economy of resource by benefiting from KfW’s extensive experience in programme management and financial sector know-how in the candidate countries and CEB’s support in credit lines.

In the context of the Phare Programme co-operation with the CEB and KfW has been extended from the promotion of lending to small and medium-sized enterprises under the SME Finance Facility to promote the municipal lending market under the Municipal Finance Facility since 2002.

### 3.2.3. Strategy for Bulgaria, Croatia, Romania and Turkey

The two interim evaluations that have been conducted so far have come to the conclusion that the SME Finance Facility is a good concept and one of the most successful of the Phare Programmes in the sector. The results of projects in Bulgaria and Romania almost 371 loans have been issued to SMEs by 3 banks. While these results, together with other IFI’s support under the SME Finance Facility in the region, have helped to kick-start the development of a proper SME lending market, only a limited number of financial market participants have been reached so far in Bulgaria, Romania and Turkey. An increased number of Projects can only enhance competition between financial institutions and create a sustainable momentum on the whole sector. In particular, non-bank financial intermediation such as leasing is as yet underdeveloped and requires particular attention due to its high growth potential.

The SME Finance Facility is going to be rolled out in Croatia for the first time. KfW will be able to make use of its experience (1) of the SME Finance Facility and of (2) ongoing co-financing with donors and international financial institutions in Croatia.
4. Objectives and Description

4.1. Objectives

The overall objective of the Programme is to assist the candidate countries in strengthening their financial sectors in order to cope with the competitive pressure and market forces within the Union.

In view of the importance of the enterprise sector for a functioning market economy, the Programme’s specific objectives are focusing on strengthening financial intermediaries in expanding and maintaining in the long term their financing operations with SMEs and are as follows:

- Build further the confidence of financial intermediaries to engage in financial operations with SMEs, including leasing;
- Enhance further the capacity of financial intermediaries to assess and monitor the related risks and to manage their financial exposure;
- Promote geographical diversification of the SME loan portfolio and improve financial intermediation at regional level;
- 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;

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 and procedures 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 small loans or leases to SMEs compared to the present;
- the increase in the number of loans provided to SMEs outside the capital.

4.3. Activities

4.3.1 Summary – Loan, Guarantee and Leasing Window

Phare funds will be paid in instalments 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 KFW and CEB funds together with a Phare Contribution will represent the “Project”.

Before signing this agreement KfW has to propose the Project to the competent Commission services for their approval. In its proposals the KfW will inform the Commission about the total resources allocated to the financial intermediary and the corresponding Phare Contribution. The CEB and 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).

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 performance fee 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 € 9 million allocation to this Programme and all income 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 PBs’ or PLCs’ staff in SME customer support including in 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, management and marketing capacities;

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

In the form of a grant, as an incentive to the intermediaries to expand and maintain their SME financing. The Phare incentive will be determined on a downward sliding scale and be paid only in relation to actual performance of the PB/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 KfW and the PB, the Commission will recover this unused amount.

(4) **Management fee**

It shall be paid to CEB/KfW as 1.25% of each instalment paid to the Special Account and corresponding to a maximum amount of €112,500. 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 to or higher than 5/1. The CEB/KfW will provide at least €45 million in the form of loans and the EC will provide a maximum of €9 million.

**Project Leverage**

The ratio between CEB/KfW resources and the Phare Contribution allocated to one individual Project will be equal or higher than 5/1. The ratio shall be equal to or higher than 8/1 if no Technical Assistance is financed by the Phare Contribution.

**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.
4.5 Eligibility and Selection Criteria

4.5.1 Participating Banks, Participating Leasing Companies, On-Lending Banks or Intermediary Leasing Companies

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

They 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 6 May 2003. The term SME includes the individual entrepreneur. Eligible SMEs must:

1. have no more than 249 employees and
2. no more than an annual turnover of €50 million or;
3. no more than a maximum annual balance sheet of €43 million;
4. have majority private ownership and control or be in the final stage of the process of privatisation;
5. not be conducting business in activities such as, gambling, real estate, banking, insurance or financial inter-mediation and the manufacture, supply or trade in arms, as well as activities excluded by the CEB and 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, services and farming.

5. Budget

The European Commission will support the Loan, Guarantee and Leasing Window of the SME Finance Facility 2005 with €9 million.

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25 OJ L 124; 20/05/2003, p.36
<table>
<thead>
<tr>
<th>Institution Building (IB)</th>
<th>INV</th>
<th>Phare Total I+IB</th>
<th>IFI</th>
<th>Total</th>
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<tbody>
<tr>
<td>9</td>
<td>-</td>
<td>9</td>
<td>45</td>
<td>54</td>
</tr>
</tbody>
</table>

(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

The programme will be implemented by the European Commission following Article 53.1 (a) of the Council Regulation (EC, Euratom) Nr. 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Commission (the Financial Regulation: FR) as further detailed in the rules for the implementation of Council Regulation on the Financial Regulation applicable to the general budget of the EC (Implementing Rules: IR). To this end, the Commission will conclude a contribution agreement with the CEB and KfW.

DG Enlargement will be sub-delegating the execution of payments and recoveries to DG Economic and Financial Affairs.

The provisions of Part Two, 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 (PBs) or Participating Leasing Companies (PLCs)

All contracts between KfW and PBs or PLCs must be concluded by 30/11/2008. Execution of these contracts must end by 30/06/2014.

The execution of contract 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 SME 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 30/11/2008 (2 years). For each Project selected, CEB and KfW 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 6 years.

Should KfW manage to sign Project Agreement well before 30/11/2008, e.g. by end of 2007, leading to the termination of all Projects in 2010 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 CEB and KfW. CEB and 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 for final recovery to the Commission. 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 30/11/2008 (contracting expiry date between KfW and PBs or PLCs) will be de-committed by the Commission.

The Phare Contribution allocated to Projects and not disbursed from the Special Account of the CEB by 30/11/2014 (overall end of 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 sections 6.5. (1) and 6.6.

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

6.5. Implementation Principles

(1) No Phare funds will be used for the purposes of a Project without prior approval of that Project by the Commission and the CEB/KFW.

(2) 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.

(3) 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.

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

(5) CEB and KfW shall have appropriate internal control systems in place to ensure the correct implementation of Projects.

6.6. Project Selection and Approval

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

(1) the compliance with the Contribution Agreement in particular with eligibility criteria;
(2) the need of a particular beneficiary must be justified;
(3) the specific objectives of the Project must be mentioned and be adjusted to the specific needs of the beneficiary;
(4) the additionality and likely sustainability of the Project must be explained including the Project’s impact on the financial sector;
(5) the expected quantitative and qualitative results of the Project must be described;
(6) the proposal must include appropriate indicators of achievement to allow measuring project progress;

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 including interest.

6.7. Co-ordination

The Commission co-operates under the SME Finance Facility with three Sponsor groups: EBRD, CEB/KfW and EIB. The CEB/KfW and the other Sponsor groups are authorised to commit the 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 Sponsor with the Participating Financial Intermediaries.
6.8. 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 all matters related to Projects, the Steering Committee meetings and any technical meeting 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 KfW and through the Steering Committee referred to above and monitoring visits.

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.

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 and 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.

7.2. Evaluation

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

Two interim evaluations have been carried out since the launch of the SME Finance Facility in 1999. Their recommendations have been discussed in the Steering Committee and have been taken into account for the drafting of the financing proposals and Contribution Agreements with the CEB/KfW. Following a recommendation of the first interim evaluation the development of a leasing market has been included as an objective under the Facility and leasing companies may now also benefit from EC support. Following recommendations of the second interim evaluation IFIs have provided the Commission with studies on the needs for finance of SMEs in Bulgaria, Romania and Turkey, which have been used for the preparation of this financing proposal. In addition, the objectives have been specified in greater detail as from 2002 onwards as a consequence of the evaluation towards capacity building of the selected financial intermediaries, and a clause on co-financing EC support through the final
beneficiary has been introduced. Furthermore, additionality and sustainability must be clearly demonstrated in each individual project proposal presented by IFIs.

As provided for in the Implementing Rules of the above mentioned Financial Regulation, the Commission services shall ensure that this Programme will be subject to further interim and/or ex-post evaluations.

8. Audit, Financial Control, Anti-Fraud Measures, Preventive and Corrective Actions

The accounts and operations in relation to the utilization of the Phare Contribution under this Programme 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 2185/9626, 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 controls and audits described above are applicable to all contractors and subcontractors who have received Community funds. 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 minimise any potential disruption to activities.

CEB and KfW shall inform the Commission services without delay of any element of information indicating the possible existence of irregularities or fraud.

Irregularity shall mean any infringement of the Financing Proposal, resulting contracts or Community legislation resulting from an act or omission by an economic operator, which has, or would have, the effect of prejudicing the general budget of the Communities or budgets managed by them, either by reducing or losing revenue accruing from own resources collected directly on behalf of the Communities, or by an unjustified item of expenditure.

Fraud shall mean any intentional act or omission relating to:

i. The use or presentation of false, incorrect or incomplete statements or documents, which has as its effect the misappropriation or wrongful retention of funds from the general budget of the European Communities or budgets managed by, or on behalf of, the European Communities,

ii. Non-disclosure of information in violation of a specific obligation, with the same effect;

iii. The misapplication of such funds for purposes other than those for which they are originally granted.

26 OJ L 292; 15/11/1996; p. 2
The procedures foreseen in Commission Regulation N°1681/1994 of 11 July 1994 on the communication in case of irregularities and the putting in place of a system to administrate the information in this field shall apply.

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/KFW will report on the activities under the SME Finance Facility in its Annual Report at the same visibility level granted to other special funds.

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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27 OJ L178; 12/07/1994; p. 43