COMMISSION DECISION
OF PH/2006/1169

establishing a Phare multi-beneficiary programme on the SME Finance Facility with the Council of Europe Development Bank in co-operation with Kreditanstalt für Wiederaufbau in 2006, 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 Europe\(^1\), and in particular Article 8 thereof,
Having regard to Council Regulation (EC) No 2500/2001 of 17 December 2001\(^2\), 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 **€ 20 million** to be financed through Budget line 22.02.10 of the 2006 General Budget of the European Union.

Article 3

The programme described in the Annex to the present decision forms an integral part thereof. The monopoly situation of the Council of Europe Development Bank in co-operation with Kreditanstalt für Wiederaufbau is justified in accordance with Article 168(1) (c) of the Implementing Rules, in section 3.2.1 of the programme.

Done in Brussels,

For the Commission

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1 Identification

<table>
<thead>
<tr>
<th>Beneficiary</th>
<th>Romania, Bulgaria, Croatia, Turkey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Programme</td>
<td>SME Finance Facility 2006 with the Council of Europe Development Bank in co-operation with Kreditanstalt für Wiederaufbau</td>
</tr>
<tr>
<td>CRIS number</td>
<td>2006/18156</td>
</tr>
<tr>
<td>Year</td>
<td>2006</td>
</tr>
<tr>
<td>Cost</td>
<td>€ 20 million</td>
</tr>
<tr>
<td>Implementing Authority</td>
<td>European Commission on behalf of the beneficiary countries</td>
</tr>
<tr>
<td>Expiry Date Contracting</td>
<td>31/12/2007</td>
</tr>
<tr>
<td>Expiry Date Execution of Contract</td>
<td>31/12/2015</td>
</tr>
<tr>
<td>Sector Code</td>
<td>25010</td>
</tr>
<tr>
<td>Budget lines</td>
<td>22 02 10</td>
</tr>
<tr>
<td>Task Manager</td>
<td>Nathalie Boutin DG ELARG</td>
</tr>
</tbody>
</table>

2 Summary

The development of the private sector is crucial for a stable and functioning market economy, where companies have to cope with competitive pressure and market forces within the EU. Considering the weight of the SMEs in the beneficiary countries, it is important that SMEs can rely on a good level of financial intermediation to support their growth.

- The financial sector acts as an important catalyst in providing growth opportunities through external finance to enterprises. In Bulgaria, Romania, Croatia and Turkey, the financial sector has undergone substantial reform during the past years, nevertheless, the degree of financial intermediation remains low compared with the EU25. The financial intermediation is measured by the volume of loans to non-banking institutions divided by the Gross Domestic Product (GDP).

Figures of financial intermediation at 31/12/2004

<table>
<thead>
<tr>
<th>%</th>
<th>Bulgaria</th>
<th>Romania</th>
<th>Croatia</th>
<th>Turkey</th>
<th>EU25</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans*/GDP*</td>
<td>36,33</td>
<td>16,8</td>
<td>62</td>
<td>22</td>
<td>122,64</td>
</tr>
</tbody>
</table>

- In the beneficiary countries, the micro and small business sector is dominating and the eligible sectors for the financing of investments within this Programme cover a large part of employment.

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3 Date by which the Contribution Agreement between the Commission and the CEB/KfW must be signed.
4 -Budgetary commitments which have not given rise to payments during three years counted from the date of the legal commitment will be decommitted (Art. 77 (3) FR)
5 European Banking Federation (2004)
<table>
<thead>
<tr>
<th></th>
<th>Number of SMEs</th>
<th>% of small business (1-9 employees)</th>
<th>% of total employment in eligible sector of the Programme</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Industry</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>218,601</td>
<td>87,94</td>
<td>27,3</td>
</tr>
<tr>
<td>Romania</td>
<td>314,488</td>
<td>83,31</td>
<td>26,0</td>
</tr>
<tr>
<td>Croatia</td>
<td>67,195</td>
<td>79,61</td>
<td>22,0</td>
</tr>
<tr>
<td>Turkey</td>
<td>210,124</td>
<td>94,65</td>
<td>18,3</td>
</tr>
</tbody>
</table>

- This Programme combines resources from the Council of Europe Development Bank in cooperation with Kreditanstalt für Wiederaufbau (CEB/KfW) with non-reimbursable Phare support in order to provide financial intermediaries\(^{11}\) (FI) in the candidate countries with incentives to:
  - expand their offer of finance to SMEs including farms and rural business,
  - enhance their capacity to assess and monitor the related risks,
  - and manage their risk exposure.

- This Programme includes a Rural Sub-Window (RSW) aiming at strengthening the financial sector's capacity to increase access to finance for farmers and rural businesses (FRBs). The RSW was launched in 2003 for the first time.

- After five earlier Financing Proposals within the framework of the SME Finance Facility, for a total amount of Phare contribution of € 90 million in the New Member States, Bulgaria, Romania, Croatia and Turkey (those 2 countries since 2005), this Programme makes available a further € 20 million, from which a maximum of €5 million could be used under the RSW, with a focus on deepening financial intermediation in Bulgaria, Romania, Croatia and Turkey. The CEB/KfW contribution to the Programme’s objectives is at least € 100 million.

## 3 BACKGROUND AND STRATEGY

### 3.1 Background

#### 3.1.1 Bulgaria

**Overview of the banking sector**

The fully privatised **banking system** is generally considered as one of the strongest in the region. Foreign-owned banks account for some 75%-80% of the banking system’s assets.

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\(^7\) Eurostat (2003)

\(^8\) 2005 comprehensive report for Bulgaria and Romana, 2005 progress report for Croatia

\(^9\) Croatian Chamber of Commerce (end-2003)

\(^10\) OECD (end-2001), only in the sector of Industry

\(^11\) Financial intermediaries consist of banks, on-lending banks, leasing companies, and intermediary leasing companies.
### Main figures\textsuperscript{12} at 31/12/2004

<table>
<thead>
<tr>
<th>Number of banks</th>
<th>Number of branch offices</th>
<th>Inhabitants/branch offices</th>
<th>Financial intermediation (loans / GDP)</th>
<th>Financial intermediation in EU25 (loans/GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>35</td>
<td>684</td>
<td>11,375</td>
<td>36.33%</td>
<td>122.64%</td>
</tr>
</tbody>
</table>

**Regulatory framework:** Until now, the level of reserve requirement has been at 8% and has not been an obstacle to the banks seeking funding for their lending business. But in order to control the fast growth of the banks’ loan books and the widening current account deficit, mainly triggered by the increase in consumer loans (usually used to purchase imported goods), the Bulgarian National Bank has introduced a number of restrictions. This has led to a slowdown of the level of lending and could restrict the borrowing possibilities of the Financial Intermediaries.

#### 3.1.2 Romania

**Overview of the Banking Sector**

The Romanian banking system has currently 39 commercial banks, with the top 10 banks holding 79.7% of the sector’s assets at end September 2005 (2004: 80.3%), led by Banca Comerciala Romania which had a dominant but sliding 24.8% market share. The Romanian banking market is still fragmented and there is room for further consolidation. Despite the progress achieved, banks and other financial institutions have to further improve their levels of efficiency as their cost-to-income ratio is high compared to other Western European banks.

The level of financial intermediation is the lowest among the eligible countries for the Programme.

**Main figures at 01/12/2004**

<table>
<thead>
<tr>
<th>Number of banks</th>
<th>Number of branch offices</th>
<th>Inhabitants/branch offices</th>
<th>Financial intermediation (loans / GDP)</th>
<th>Financial intermediation in EU25 (loans/GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>39</td>
<td>2,898</td>
<td>7,482</td>
<td>16.8%</td>
<td>122.64%</td>
</tr>
</tbody>
</table>

**Regulatory framework:** The National Bank of Romania increased the minimum reserve requirement from 35% to 40% on foreign exchange-denominated liabilities in March 2006, in an attempt to limit the growth in credit, which was especially consumption driven. The Central Bank is concerned about inflation and the trade balance. This may lead the banks into limiting their business or passing the increased cost of funding on to the customers both individuals and companies.

#### 3.1.3 Croatia

**Overview of the Banking Sector**

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, and the two largest groups hold about 50%: Unicredito/Allianz Group Holding through Zagrebacka Banka (33%), Intesa-BCI through Privredna Banka (20%).

\textsuperscript{12}Unless otherwise specified, number of banks, branch offices and loans and advance to non-bank customer come from the European Banking Federation, population and GDP come from Eurostat
According to the 2005 Progress Report\textsuperscript{13} for Croatia, “the Croatian Bank for Reconstruction and Development (HBOR) continues to administer a range of financial schemes for small business. The National SME Agency (HAMAG) issues credit guarantees. Given a positively developing banking sector, a change of strategy should be considered, where credits are increasing left to the banking sector.”

The level of financial intermediation is the highest within the countries covered by this Programme.

**Main figures at 01/12/2004**

<table>
<thead>
<tr>
<th>Number of banks</th>
<th>Number of branch offices</th>
<th>Inhabitants/branch offices</th>
<th>Financial intermediation (loans/GDP)</th>
<th>Financial intermediation in EU25 (loans/GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>37</td>
<td>1,037</td>
<td>4,284</td>
<td>62%</td>
<td>122.64%</td>
</tr>
</tbody>
</table>

EBRD’s country strategy report confirms that in terms of its regulatory environment the banking sector appears advanced, but further improvements are necessary with a better access to finance for enterprises as a key challenge.

**3.1.4 Turkey**

**Overview of the Banking Sector**

There are a total of 48 banks operating in Turkey including 18 private, 3 state-owned, 13 foreign and the Special Deposit Insurance Fund (bank established in 1999 to manage bankruptcy of financial institutions). These 35 banks are commercial banks. The banking sector is open to foreign operators; until 2005 HSBC and Unicredito were the only foreign banks with an important presence, but since then BNP Paribas, Fortis and ING have purchased shares in major Turkish banks resulting in a foreign stake in the total assets of Turkish banking sector of 12%.

The 2005 Progress Report\textsuperscript{14} on Turkey states in its assessment of Copenhagen criteria: “the banking sector has strengthened considerably, but still cannot provide sufficient intermediation between savers and investors…. (and) state-owned banks account for around one third of total assets of the banking sector.” In order to be prepared to compete within Union, “all enterprises need to invest to improve their efficiency. Furthermore, the more access enterprises have to outside finance and the more successful they are in restructuring and innovating, the greater will be their capacity to adapt.”

The level of financial intermediation is still low.

**Main figures at 31/12/2004**

<table>
<thead>
<tr>
<th>Number of banks</th>
<th>Number of branch offices</th>
<th>Inhabitants/branch offices</th>
<th>Financial intermediation (loans/GDP)</th>
<th>Financial intermediation in EU25 (loans/GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>48</td>
<td>6,106</td>
<td>11,652</td>
<td>22%</td>
<td>122.64%</td>
</tr>
</tbody>
</table>

On the regulatory side, progress has been posted. In October 2005, a new banking law was adopted to increase transparency and disclosure requirements for banks. Banks are regulated by the Banking Regulation and Supervisory Agency (BSRA) and non-bank financial institutions like leasing companies are regulated by the General Directorate of Banking and Exchange of the Undersecretary

\textsuperscript{13} Com(2005)561 final – Sec(2005)1424

\textsuperscript{14} Com(2005) 561 final – SEC(2005) 1426
of Treasury. The fragmented nature of supervision and regulation is still a significant problem in the area of financial services.

3.1.5 Past experience

Overall results of the SME Finance Facility with the 3 International Financial Institutions

From 1999 to 2003, under Phare, the Facility covered 10 countries, the Czech Republic, Estonia, Latvia, Lithuania, Poland, Slovenia, Slovakia, Hungary, Bulgaria, and Romania. Since 2005, the eligible countries for the Programme are: Romania, Bulgaria, Croatia, and Turkey.

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. 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.

The results of CEB/KfW Projects in Bulgaria and Romania, together with EBRD's and EIB’s support under the SME Facility in the region have helped to kick-start the development of a proper SME lending market and enhance the financial intermediation. The rate of financial intermediation measured by the total loans to non-banking institutions divided by the GDP increased from 26.58 % to 39.30 % between 1999 and 2004 for the 10 countries covered by the Programme, and from 12.27% to 26.56 % for Bulgaria and Romania.

As of end-February 2006, 165 Projects involving a similar number of FIs were set up over the 10 countries for a total amount of Phare incentives of €268.4 million, and a total amount of IFI credit lines of €1,850 million. This result was achieved owing to the close monitoring of the Programme through:

(i) a Steering Committee composed of representatives of the Commission and each Sponsor to analyse and solve potential problems of implementation; the Steering Committee meets twice a year and the IFIs give explanation of the results obtained and their future strategy;
(ii) the Commission Services; in particular when the uptake of finance under a Project is slower than expected or if the environment has changed, the IFIs are induced to submit Project amendments to the Commission Services that are better tailored to meeting the objectives than the initial Project.

The two interim evaluations that have been conducted so far have come to the conclusion that the SME Facility is a good concept and one of the most successful Phare Programmes. A third evaluation is under way. The continuation of the Programme will allow increasing the number of Projects and consequently to enhance competition between financial institutions and create a sustainable momentum that will benefit to the SMEs.
Overall results of the SME Finance Facility with CEB/KfW
(rural sub-window included)

<table>
<thead>
<tr>
<th>EUR million</th>
<th>Phare Allocation</th>
<th>Minimum amount of CEB/KfW loan</th>
<th>Phare Incentives earmarked into Projects</th>
<th>CEB/KfW loans earmarked into Projects</th>
</tr>
</thead>
<tbody>
<tr>
<td>SME FF 2000</td>
<td>21</td>
<td>113</td>
<td>47.6</td>
<td>374.75</td>
</tr>
<tr>
<td>SME FF 2001</td>
<td>30</td>
<td>150</td>
<td>15.5</td>
<td>142</td>
</tr>
<tr>
<td>SME FF 2002</td>
<td>15</td>
<td>75</td>
<td>3.5</td>
<td>35</td>
</tr>
<tr>
<td>SME FF 2003</td>
<td>15</td>
<td>75</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SME FF 2005</td>
<td>9</td>
<td>45</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>90</td>
<td>458</td>
<td>66.6</td>
<td>551.75</td>
</tr>
</tbody>
</table>

As of end-February 2006, the CEB/KfW had committed €551.75 million in 39 Projects. 4 Projects in Romania account for a total amount of EU incentives of €5.4 million and for CEB/KfW loans worth €50 million. 3 Projects in Bulgaria account for a total amount of EU incentives of €4.3 million and for CEB/KfW loans worth €37 million. Under the 2003 rural sub-window, the CEB/KfW has committed 2 projects for a total amount of €35 million together with €3.5 million of EU incentives.

3.2 Strategy

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

The technical nature and the multi-country approach of the SME Finance Facility require the involvement of highly specialised financial institutions, with experience in international finance and strong involvement in implementing the European Community objectives in relation to enlargement. Preference is therefore given to financial institutions with the status of international public-law bodies in which the EC is represented through the Member States and/or the European Commission.

The EIB is the financing institution of the European Union at the service of the Union, establishing its policy in close coordination with the Member States that are the shareholders of the bank. The EBRD was established in 1991 with the purpose to foster the transition towards market-oriented economies and to promote private sector development in Central and Eastern European countries. Its creation was endorsed by the European Council in 1989. Both Member States and the European community are shareholders, members of the board of governors, and members of the board of directors. Member states are also shareholders in the Council of Europe Development Bank (CEB), which contributes to strengthening the social integration in the less advantaged region of Europe. CEB co-operates with Kreditanstalt für Wiederaufbau (KfW) for the implementation of the Programme.

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-record and specialisation in financing international development, therefore put them in a de facto 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 Amended Memorandum of Understanding on co-operation in (i) economic development of the new
EU Member States of Central and Eastern Europe, Cyprus, Malta, and (ii) accession preparation in the EU candidate and potential candidate countries, in its version signed on 26 April 2006.

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, (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 other Phare Programmes, the CEB/KfW has committed €125 million of loans and € 12 million of EU incentives under the Municipal Finance Facility as of end-February 2006.

4 OBJECTIVES AND EXPECTED RESULTS

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 the capacity of financial intermediaries to expand and maintain 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.

With reference to the Rural Sub-Window, a particular focus will be on reaching the following specific objectives:

- Help financial intermediaries to provide appropriately structured, including long-term financing to rural businesses;
- Help financial intermediaries develop a clear strategy to support the rural economy;
- Help financial intermediaries adapt products and risk assessment procedures to circumstances of the rural economy and thereby make available credit financing to rural businesses at more affordable rates;
• Improve services of financial intermediaries towards rural sector borrowers.

4.2 Expected results

It is expected that financial intermediaries in the candidate and acceding countries will have expanded capacities to service the financial needs of SMEs including farms and rural businesses, 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.

With reference to farms and rural businesses a particular focus will be on achieving the following results:

• Financial intermediaries will have a clear strategy for supporting farmers and rural businesses,
• Product and risk assessment procedures will have been adapted to the specific group of clients;
• The total volume of loans/leases to farmers and rural businesses will have increased compared to the present;
• The quality of loans/leases extended to farmers and rural businesses will have improved;
• Services, conditions and terms of loans will have improved for borrowers with farms and rural businesses.

5 Description of the Programme

5.1 Implementation

5.1.1 Selection of Financial Intermediaries (FI) and building of Projects

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

With reference to the Rural Sub-Window, KfW will select local FI that are willing, interested and capable to expand their rural financing operations.

A Project is defined in an agreement between the KfW and the local financial intermediary on a financial package comprising two components:

1. A credit line of KfW together with CEB providing long term funding at market rates repayable at maturity. The credit line is used by the Financial Intermediary to extend sub-loans to eligible SMEs with whom sub-loan agreements are signed (Sub-Projects).

2. Phare Resources that may be used in several ways such as:
   (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 including FRB portfolios;
- recruit and train PBs’, PLCs’, OLBS' or ILCs' staff in SME customer support including in particular FRB clients 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 including in particular FRB clients;
- strengthen administrative, credit, management and marketing capacities;
- in the case of the Rural Sub-Window, help local Financial Intermediaries strengthening awareness and demand for rural credit through the organisation of workshops and training seminars for SMEs and in particular farmers and representatives of rural business.

(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 including FRB 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.

Concerning Loan Guarantees for the Rural Sub-Window, the guarantee will be limited to 50% 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) 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.

- The size of each Project shall be, in principle, between €5 and €15 million.
- All the Projects are submitted to the Commission for approval following a standardised template. In its proposals the CEB/KfW will inform the Commission about the total resources allocated to the financial intermediary and the corresponding Phare Resources.
- Upon approval the CEB/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 or as the case may be the OLB or the ILC will, in turn, conclude loan or financial lease agreements with individual SMEs or award them overdraft facilities. (Sub-Projects). Each Project will cover in principle a number of Sub-Projects.
- The maximum size of a sub-loan or lease contract per SME (Sub-Project) shall be €250,000.
- 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.
5.1.2 Special Account

The following scheme will be implemented.

- The Phare contribution to this Programme will be paid by the Commission to CEB in instalments to a interest-bearing Special Account held with the CEB for this Programme. The Commission shall pay to CEB/KfW a 1.25% management fee on each instalment with a limit set at €250,000 for the Programme. The annual auditing costs are included in the management fee. The Commission shall not provide any additional amount to support the ordinary cost resulting from the implementation of this Programme, except where duly justified.

- Interest earned will be reported to the European Commission and used for the purpose of the Programme. The Phare resources are made of Phare contribution and the interest earned.

5.2 Eligibility Criteria

5.2.1 Financial Intermediaries

Eligible Financial Intermediaries are banks, leasing companies, on-lending banks, or intermediaries leasing companies operating in the beneficiary countries including locally registered, licensed or incorporated entities and subsidiaries of EU 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.

5.2.2 SMEs

Enterprises eligible for Sub-Projects must comply with the definition of SME as per Commission Recommendation of 6 May 2003\(^\text{15}\). 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 KfW.

5.2.3 Beneficiaries under the Rural Sub-Window

The creation of the Rural Sub-Window allows to specifically addressing the financing needs of a special group of beneficiaries of SMEs. The beneficiaries of the Rural Sub-Window fall into two groups:

1) Farmers: Farmers are “registered agricultural producers” according to the registration method used for farmers under national legislation.

\(^{15}\) OJ L 124; 20/05/2003, p.36
2) Rural Businesses: Rural Businesses are businesses located in rural zones. The indicators used to define an eligible “rural zone” will be based on appropriate criteria, like e.g. population density or location, and will be derived, as far as possible from the rural zone specifications under national legislation.

Both groups of beneficiaries will be identified using the limitations specified under (1) to (5) of Section 5.2.2 on the basis of equivalent information collected by the PBs or PLCs.

5.2.4 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.

5.2.5 Financial support ratios

Programme Leverage

The overall ratio between the CEB/KfW resources and the Phare Contribution for this Programme shall be equal to or higher than 5/1. The CEB/KfW will provide at least € 100 million in the form of loans and the EC will provide a maximum of €20 million.

Project Leverage

For each Project, the ratio between the CEB/KfW resources and the Phare Resources shall be equal to 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 resources.

6 BUDGET

The European Commission will support the Loan, Guarantee, and Leasing Window of the SME Finance Facility 2006 with €20 million. On this total amount, a maximum amount of € 5 million could be used under the Rural Sub-Window.

<table>
<thead>
<tr>
<th>Phare Funding in million €</th>
<th>IFI</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institution Building (IB)</td>
<td>INV</td>
<td>Phare I+IB</td>
</tr>
<tr>
<td>20</td>
<td>-</td>
<td>20</td>
</tr>
</tbody>
</table>

(The figures in the budget table are indicative only)

Co-financing for Institution Building Projects is provided by the beneficiary (Participating Bank, On-Lending Bank, Leasing Company, Intermediary Leasing Company) bearing certain infrastructure and operational implementation costs, through financing the human and other resources, required for effective and efficient absorption of Phare assistance.

7 IMPLEMENTATION ARRANGEMENTS

7.1 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 Communities (the Financial Regulation: FR) as
further detailed in the rules for the implementation of Commission 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/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 IV, Chapter 3 of Council Regulation 1605/2002 apply to KfW procurement of works, services, and supplies financed by Community funds.

7.2 Contracting and execution deadlines

The contract between the Commission and the CEB/KfW shall be signed by 31/12/2007.

All Project agreements between KfW and the Financial Intermediaries must be concluded by 31/12/2010.

All disbursements of the credit line by the IFIs to the Financial Intermediaries shall be done by 30/06/2015. The maturity of the credit line granted under the project agreement signed between the CEB/KfW and the Financial Intermediary can go beyond 31/12/2015.

The execution period of the contract signed between the Commission and the CEB/KfW exceeds the average length normally allowed because of the two-level mechanism of the implementation (IFI level, FI level). The length is required to allow the Programme to develop its full impact.

7.3 Recovery of Funds

In the case of default on Projects, the Commission will initiate recovery from the CEB and KfW. The 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.

The Phare Resources that have not been allocated to a Project by 31/12/2010 will be de-committed by the Commission.

The Phare Resources allocated to Projects and not disbursed from the Special Account of the CEB by 31/12/2015 (date by which the contract between the Commission and CEB/KfW is terminated) will be recovered by the Commission.

7.4 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 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 Resources 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.
7.5 Project Selection and Approval

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

- compliance with the Contribution Agreement in particular with eligibility criteria;
- the need of a particular beneficiary;
- the extent to which the specific objectives of the Project are adapted to the specific needs of the beneficiary;
- the additionality and likely sustainability of the Project, including the Project’s impact on the financial sector;
- the expected quantitative and qualitative results of the Project;
- the quality of the proposed indicators for 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 Resources held in the Special Account with the CEB.

7.6 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:

- the approval of Projects proposed by the relevant Sponsors;
- 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 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 FIs.
7.7 Environmental Impact Assessment and Nature Conservation

The procedure for environmental impact assessment as set down in the EIA-directive is fully applicable for all investment projects (in this case sub-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.

If a project is likely to affect sites of nature conservation importance, an appropriate assessment according to Art. 6 of the Habitats Directive must be documented.

7.8 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.

8 MONITORING AND EVALUATION

8.1 Monitoring

At operational level, the implementation of this Programme will be monitored through (i) technical and financial reports to be submitted by the KfW to the Commission, (ii) a Steering Committee composed of representatives of the Commission and each International Financial Institution taking part in the Programme and assembled at least twice a year, and (iii) monitoring visits.

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 Resources.

To facilitate this, the CEB/KfW, PBs, PLCs, OLBs and ILCs will keep accounting, financial and operational documents concerning all activities financed by the Phare Resources 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.

8.2 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/KfW and through its own independent assessments and audits.

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 evaluations and/or ex-post evaluations.

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9 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 2185/96\(^{17}\), 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 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.

The 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.

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.

The applicability of the Financial Regulation includes the application of administrative and financial sanctions, as provided for in Articles 93 to 96 and 114 of the Financial Regulation, and Article 133 of the Implementing Rules.

10 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.

\(^{17}\) OJ L 292; 15/11/1996; p. 2-5
Phare visibility measures are based on the provisions of the regulations and decisions applicable to the Structural Funds\textsuperscript{18}.

In addition, the 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.

11 **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.