EUROPEAN PARLIAMENT

REPORT

Policy Department
Economic and Scientific Policy

WORKSHOP

Microcredit in Europe

Presentations and Briefing notes

IP/A/ECON/WS/2008-13

PE 408.564

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Microcredit in Europe

Programme

18 September 2008
European Parliament, Brussels, Room: PHS 4B001, 9.30-13.00h

Chaired by Pervenche Berès, ECON Chairwoman

9.30-9.35 Introduction by the Chair of the ECON Committee - Ms. Pervenche Berès
9.35-9.45 Introduction by Mr. Zsolt Becsey (Rapporteur Microcredit)

9.45-10.05 **Introductory Session:**
Microcredit in the context of financing in Europe

Guest speaker: Andras Ujlaky, Chance for Children Foundation, Budapest, Hungary

10.05-11.35 **Session 1**
Information of consumer/credit takers, protection of vulnerable clients, turning of clients into bankable clients, life-cycle of microcredit, employment creation

Guest speakers:
1) Maria Nowak, European Microfinance Network and ADIE, Paris, France
2) Representatives of a microfinance institution (MFI) and representative of a bank from a country with a relatively strong tradition in microfinance
Mr Josa Francisco Conrado de Villalonga, President of Microbank, La Caixa, Spain
Mr Angel Font, Director, Area Social Inclusion of Foundation Caixa Catalunya, Spain
3) Representative of a microfinance institution from a country with a less strong tradition in microfinance
Mr Gábor Winkler, Mikrohitel Rt, Budapest, Hungary
4) Mr Rudolf Niessler, Director, European Commission, DG REGIO

11.35-11.45 Break

11.45-13.00 **Session 2**

Methodologies of micro-credit, models of micro-financial institutions with a view to special target groups;
The role of collateral and securitisation

Guest speakers:
1) Mark Lyonette, Chief Executive Officer, Association of British Credit Unions Ltd
2) Joachim Bauer, Sparkasse Offenbach, Germany
3) Christa Karis, Deputy Head of Guarantees and Securitisation, European Investment Fund, Luxembourg
4) Michael Schneider, Director, Asset Finance & Leasing, Deutsche Bank AG, Frankfurt, Germany

Curricula Vitae

Introductory Session

András Ujlaky

Date of birth: 15th January 1949
Nationality: Hungarian / British

Education:

1967–71	Karl Marx University of Economics, Budapest
1963–67	II. Rákoczi Ferenc Gimnázium (Grammar School), Budapest

Employment:

2004– to date	**Chance for Children Foundation, Budapest** Founded organisation with mission to improve school success for Roma children. CFCF sues segregating Education Authorities at the High Court and is using court cases to raise awareness of the Roma and general public on the effects of ethnic discrimination. CFCF works with different Initiatives of OSI.
2003–04	**Ministry for Education of Hungary, Budapest** Administering EU funding to programmes for schools teaching Roma children.
2001–03	Freelance activities with various Roma rights groups
2000–01	**Trigon Bank AG, Vienna** Director, crisis management

Session 1 - Speakers

Maria Nowak

A graduate of the "Institut des Etudes Politiques", Paris (1956) and postgraduate of the London School of Economics (1959), Maria Nowak has pursued a career in the development field working for the "Agence Française de Développement". As Director of Policies and Research, she tranferred in the eighties the Grameen Bank approach from Bangladesh to West Africa.

Seconded to the World Bank in Washington, in 1991, she started the first microlending programmes in Central Europe while at the same time initiating a similar programme in France in the framework of the "Association à l'Initiative Economique" which she founded and of which she is Chairwoman on a voluntary basis.

She was co-founder and the first president of two resource centers the Microfinance Center for Central and Eastern Europe and the NIS countries, (1996) and the European Microfinance Network (2003) of which she is still president.

Between 2000 and 2002, she was a Special Adviser to Laurent Fabius, Minister of the Economy, Finance and Industry.

She is author of « La Banquière de l'espoir » – (The Banker of Hope), Albin Michel 1994.and « On en prête(pas) qu'aux riches » (Lending not only to the rich), JC Lattès, 2005.

Among other awards, she received the "Human Rights Prize" awarded by readers of the newspapers "La Croix" and "Liberté de Fribourg" for her work in favour of "microcredit development" in France and was selected in 2007 «European of the year » by Reader'sDigest.

She is also Officier de la Légion d'Honneur (2008) and Officier de l'Odre du Mérite (2005).

Àngel Font Vidal

Born 1965, he has a BA in Chemistry from the University of Barcelona and a MBA from EADA Business School. Àngel Font started his professional trajectory in environmental engineering, although he soon joined Intermón Oxfam where he spent 8 years by performing co-ordination functions of projects in Latin America, communication and fundraising as well as functions as Deputy General Director.

Since 2000 he is Director Area Social Inclusion of Caixa Catalunya, from where he promotes projects of labour insertion for underprivileged groups as well as the development of microfinance's in Spain, Latin America and Africa.

He is Vice-President of the European Microfinance Network and member of the Co-operation Council for the Development of the Regional Government of Catalonia. He also collaborates in different business schools by teaching on subjects related to the management of non-profit organisations.

Gábor Winkler

2004-	Director of Mikrohitel Rt. As the leader of the financial company my main task is to set up and run the company in a profitable way. I keep contacts with the owners, clients partners and donors. I have to manage the self sustainable operation, but in the meantime I'm responsible for the accessible product to our special clientele.

2001-	Working for BB Enterprise Development Foundation as the manager director. My main tasks are to develop the longterm strategy of the foundation, to coordinate with the board, to develop and manage projects, and to write applications for grants. I keep the contacts with our clients and donors.
1993 - 2001	Worked for BB Enterprise Development Foundation as a financial manager. Main tasks were to develop and implement the long and short term financial plans, write reports, to develop the Budapest Microloan scheme. I did the financial advice for the clients also.
1992 - 1993	Worked for Budapest Credit and Development Bank as an operations specialist. Main responsibility is to develop organizational procedures for stocks and bank card transactions.

Education

1997	Budgeting and Financial Planning Directory of Social Change, London
1996	Management Simulation Training Program USAID, Bratislava
1993	Official stock exam Budapest Bank
1989 - 1992	Received my degree on the Organization and Informational Developments at Bánki Don't Machine Industrial and Technical College
1985 - 1988	Studied transportation engineering Technical University of Budapest

Mikrohitel Rt was founded in 2004 with the aim of ensuring the organisational frame for a microcredit programme in Hungary. The company was founded by two organisations: BB Foundation having been present in the field of enterprise development for more than ten years, and having practice of many years in microcredit; and Autonomia Foundation, which extended partly repayable subsidies to the income-generating activity of local Roma communities for several years since 1990.

Dr Rudolf Niessler

Born 1956, Austrian

Director, Policy Co-ordination, Directorate General Regional Policy, European Comission.

Earlier positions include

- Several postings in the Regional Policy Directorate of the European Commission as Director and Head of Unit e.g. for urban actions and impact assessment of regional policy (Brussels, Belgium)
- Councillor at the OECD for Trade Policy, Environment Policy and Territorial Development (Paris, France)
- Deputy Director at the Federal Institute for Less Favoured and Mountainous Areas – Affiliate to the Ministry of Agriculture in Austria (Vienna, Austria)
- Research Fellow at the Institute for Advanced Studies (Vienna, Austria)

Session 2 - Speakers

Mark Lyonette

Mark has been with the Association of British Credit Unions Limited (ABCUL) for ten years; the last four of them as Chief Executive. He has played a leading role in developing ABCUL into a full service trade association for British credit unions.

Mark has been closely associated with many of the reforms in the credit union sector in recent years. These include working closely with the World Council of Credit Unions to introduce the PEARLS Financial Monitoring system into Britain and more recently the launch of the Credit Union Current Account.

Mark is a member of the UK Government's Financial Inclusion Taskforce. He is currently working as part of a sub-group of the taskforce which is investigating how banks can help with a major scaling up of credit unions in Britain. He also sits on the Consumer User Forum of the UK Payments Council.

Prior to working for ABCUL he spent 15 years in a variety of training and management roles in the voluntary and community sector. Mark worked for the Tenant Participation Advisory Service, England between 1990 and 1997. TPAS is the national membership organisation for social housing tenants and landlords. As Director of Training and Conferences he led the organisation to develop the first nationally accredited training qualification for tenants.

Joachim Bauer

1989 – 1991	Ausbildung bei der Sparkasse Offenbach a.M. zum Bankkaufmann mit Übernahme in das Angestelltenverhältnis
1992– 1993	Kundenberater Filiale Tempelsee
1993 – 1998	Sachbearbeiter Marktfolge Kredit
1998 – 2002	Privat- und Gewerbekundenberater
2002 – heute	Leiter Geschäftskundencenter
	Sparkassenfachwirt
	Sparkassenbetriebswirt
	Vertreter der Sparkasse Offenbach im Projekt Gründerstadt
	Verwaltungsratsmitglied Ostpolkredit

Christa Karis

Christa Karis is Deputy Head of the Guarantees & Securitisation Team at the European Investment Fund, which she joined in 1995. She has a long experience with guarantee transactions with different financial institutions (such as guarantee schemes, public and private banks, micro lenders) and asset classes in all EU Member States plus Turkey and Norway.

Guarantees are either provided under mandate (SME Guarantee Facility since 1998) or using EIF's own resources.

For the latter, guarantees are always tailored to the specific transaction and can be provided for certain tranches in securitisation transactions, or (partially) for each loan in a portfolio. EIF's guarantee instruments are implemented on commercial terms.

EIF is a public-private institution, aiming at enhancing access to finance to SMEs. At the end of 2007, the outstanding guarantee commitments reached some EUR 12bn.

Michael Schneider

Michael Schneider has been a Director of Asset Finance & Leasing at Deutsche Bank, Frankfurt since 2006. Having joined Deutsche Bank in 1994 as an apprentice and then being employed as an analyst, Michael Schneider completed an exclusive four-year executive training programme, taking on responsibilities in a variety of departments, including Public Sector Clients, Retail and Private Banking, and Credit Risk Management. Between 2000 and 2005 he served as Associate and later Vice as per May 4th 2008 President of Asset Finance & Leasing in New York. Applying his extensive knowledge of structuring, he was Deutsche Bank's lead structuring executive in charge of the world's first securitisation of subordinated microfinance credits with external rating "db Microfinance-Invest Nr. 1". Michael Schneider holds a degree in banking from Bankakademie Leipzig.

Directorate-General for Internal Policies
Directorate A - Economic and Scientific Policy
Policy Department A.: Economic and Scientific Policy and Quality of Life Unit

Workshop Summary

Microcredit methodologies - some case studies

Case study 1: Creation of a Grameen-style organization, Hungary

In his speech, Mr András Ujlaki presented plans to create a Grameen-style organization, especially for the marginalized Roma in Hungary by employing a small number of field workers, living directly within the community. This seems the only possibility to compete with village money lenders and shop keepers. Alongside microcredit products the organization plans to offer a range of complementary services, such as business consulting and training. The initial ambition would be 200-400 clients, for this 20-30 field workers would be trained.

Why a Grameen-style initiative? Grameen-style initiatives have a special way to choose their target group. Grameen Bank in Bangladesh, for instance, is not about helping small enterprises, but delivering microcredit to the poorest of the poor who want to get away from their miserable situation. Grameen-style initiatives also are successful: a high percentage of the clients are lifted out of poverty, their life style alongside with their long term family planning habits noticeably change.

Case study 2: La Caixa Cataluña: MikroBank, Spain

La Caixa is a European example of how microcredit can be part of the banking system. The association allocates a high percentage of the annual profit to community work, where the microcredit programme MikroBank is also allocated. This initiative focuses on self-employment and microcredit is seen as a financial instrument to help the non-bankable people ('social assistance under a financial jacket').

MikroBank offers a diversified portfolio of financial products and services tailored with the needs of microcredit takers and with costs in line with their financial capabilities using the sales network of la Caixa branches and in collaboration with non-profit organizations.

La Caixa recently started a new way of delivering microcredit by supporting regional non-profit organizations oriented to self-employment in order to allow them to become MFIs. La Caixa delivers financial resources (loans, subsidiaries), but also technical resources (software) and shares both risk and management with these organizations. Thus, it is expected that within the next couple of years, La Caixa Cataluña will have no more direct microcredit clients, but these clients will be part of the MFI-network.

The social impact of microcredit delivered is good: 2/3 of the supported microenterprises survive the first 3 years of activity and ¾ of the clients in general improve family income and job stability.

Case study 3: Mikrohitél, Hungary

Considering the fact that banking law in Hungary is rather strict and does not allow non-profit organizations to give loans, two non-profit organizations had to join their forces in order to found Mikrohitél as a financial institution.

Mikrohitél wants to contribute in developing entrepreneur culture in Hungary by helping clients to become bankable through building up a positive credit history.

The main targets are existing micro enterprises and start-up enterprises. Currently, 50% of the portfolio represents personal loans to Roma. Mikrohitél maintains personal contact to all clients, visits them personally to evaluate their problems and their ability to pay back and collateral is only asked for as a moral collateral.

Case study 4: Ostpol-Kredit, Sparkasse Offenbach, Germany

In this project, Sparkasse Offenbach works in a district of the city with high unemployment rate, where services and commerce are absent, and provides credit exclusively to people who want to start a business in this district in order to stimulate urban development. The Ostpol-Kredit caters for people who have difficulties in getting traditional bank credit.

The credit is delivered by the Sparkasse, after recommendation by a committee of allocation, which evaluates the business concept. The potential credit-taker has to present and defend his/her project in front of this committee. Risks are partially taken over by the German Microfinance Fund.

Microcredit can be considered an add-on product for savings banks: By the time that businesses grow and need further credit they have become interesting clientele for the savings banks. At the same time the product plays a crucial role in urban development.

Case study 5: Credit Unions in Britain

Credit Unions in Britain originated in the 1960s, where immigrants having difficulties to access financial services, decided to join together in financial cooperatives to provide these services. Membership in credit unions as well as the amount of savings has increased considerably over the last 20 years and Credit Unions are now offering an ever larger range of financial services, including microcredit and financial education.

Credit Unions are therefore of particular interest for immigrants. They cooperate for instance with agencies and employers to facilitate the way out of the vicious circle of not having a bank account and thus no employment. They also help members accessing bank credit by building up a credit file with credit reference agencies and provide a number of money transfer services.

Thanks to recent agreements with the UK government for new, more flexible legislation, the availability of remittance products will increase further and the development of an even larger range of products will be possible.

Issues discussed

Definition of microcredit

The definition of microcredit commonly used in the EU (loans below EUR 25.000) may be considered not specific and not flexible enough. Bankable clients (mainly SMEs) and unnameable clients (disadvantaged persons) need a differentiated approach as they do not present the same characteristics and needs. The definition of microcredit may therefore need to be adapted accordingly. SMEs might even be excluded, as since by their definition they can not be called 'micro'.

Funding

The process of business development and innovation most often takes place in SMEs that represent a huge sector in terms of their numbers and of employment for Europe. In the period 2007-2013, European cohesion policy appropriates about EUR 55 billion to business development, 50% of which supports SMEs.

Currently, European regional policies support SMEs primarily with grants, with some moderate support through loans. he Commission's ambition is to offer a more sophisticated package of financial support, including instruments such as venture capital, loans, guarantees, etc. and also business support services.

The JEREMIE initiative is meant to develop a sector of institutions which could specialize in providing microlending in order to facilitate SMEs’ access to finance. However, JEREMIE funds are managed directly by the Member States. This makes it hard to focus on providing microcredit There may therefore be a need to develop a more coherent legal institutional environment, also for non-banking intitutions, in order to bring them to professional level by setting standards and making them sustainable partners in a long term perspective.

The newly initiated JASMINE initiative puts special emphasis on microcredit, distinguishing it from JEREMIE and introduces two elements: the provision of technical assistance (mentoring, training, information tool kits, etc) and the setting up of a code of conduct for MFIs.

There is a certain degree of confusion between the different possibilities of EU funding and different solutions might have to be combined (JEREMIE, CIP, EIF, etc).

Microlenders are all different which makes it difficult to provide a general solution. Specific needs of different MFIs have to be identified and addressed in particular. As microcredit is a local business, initiatives have to be routed in local communities.

Microcredit is a key tool in the overcoming of possible market failures in providing access to finance and thus needs to be further developed. Financial support to MFIs should be encouraged and Member States’ sensibility needs to be raised in order to develop community initiatives with a long term prospective.

The possibility to involve the private sector in microfinance was also discussed. Subsidiaries may not be sufficient to fill the funding gap in microfinance. Therefore private investors may need to be attracted into the sector. At the same time, representatives of the private sector warned not to oversubsidize institutions and thus crowd out the private sector.

Securitization was presented as a good example of how public funds can be leveraged, with operations need more transparency because of the high reputational risk.

Legislation

Banking regulation was mentioned as being too strict for the need of microfinance. In Hungary, for example, non-profit organizations are not allowed to give loans. For such a purpose a financial institution needs to be set up, which implies high costs and impedes the actual delivery of microcredit as it may become too expensive. France is an example of a country where the law has already been changed for the benefit of MFIs and associations and foundations are now allowed to borrow from banks and lend the money on to people that the banks do not want as direct clients.

Interest rate caps also represent a particular problem for microfinance and MFI representatives support them to be set higher or removed. People often think that interest rates should not be too high, especially for the type of client's microcredit targets. But microcredit is about small loans for a short period of time and the impact of high interest rates on the customer is thus rather small. The real problem for microcredit clients is not a high interest rate but the actual access to credit. Interest rates need thus, on the contrary, to be increased, because this is the only way to create a real market, a real offer of microcredit, permitting MFIs to cover their costs in the long term.

Another issue in legislation is so-called 'borrower regulation': Disadvantaged persons mainly live of social benefit. However, once they receive microcredit, they fall out of the criteria for receiving social benefit which is demotivating. A possible solution might be a derogation that temporarily permits credit-takers to still be eligible for social benefit while receiving the mirocredit.

Legal derogation might also be a solution for the problem of business regulation of microcredit-takers: microcredit clients can often not be expected to fulfil administrative requirements such as tax certification or book keeping. On the one hand a substantial part of the concerned target group may be illiterate, unskilled and lacking the necessary education. On the other hand, the clients may not be motivated to comply with business regulation as this would imply additional costs. The informal sector in Europe represents about 10-15% of the national gross product. Microcredit can help the clients to afford legal expenses (registration, social contributions, etc) and at the same time to increase total revenue. This motivates them to legalize their activity. The clients need to be assured appropriate technical assistance and education. There is a need to practice active inclusion policy. People have to be convinced that their business initiatives will get the necessary support, both financial (microcredit) and educational (business consulting, administration).

With regard to taxes, it was discussed whether or not to introduce tax incentive for microcredit suppliers and takers. Tax incentive at EU level might motivate the legalization of informal activities. On the other hand, microcredit is a risk return business and may have to be addressed as such. There were also opinions that tax advantages and a possible Basel II exception or the reduction of capital requirement may be counterproductive.

Intermediation between target group and MFIs

Vulnerable groups in the population (e.g. women, immigrants, Roma) area target group for microfinance. It is an important question who can intermediate between these people and the MFIs. For instance, traditional 'leaders' may or may not be the right persons to intermediate. Attention needs to be paid not to ethnicise the issue. Experience in Spain shows that the implication of ethnical leaders is positive: They boost security and trust and foster integration of the community. Upcoming troubles can be resolved thanks to the close contact with the clients.

Collateral

In microcredit, clients in most cases do not have the necessary resources to provide classical bank collateral. Therefore, alternative forms of collateral have to be developed. In third world countries, for instance, knowing the clients personally and installing a confidence-based relationship with them successfully replaces bank collateral, as moral and group pressure encourages the clients to pay their loans back.

Role of the European Parliament

The EP can play a role in informing governments about microcredit and its role in job creation and economic growth in Europe. Microcredit has to become more visible by integration in official texts for example.

Legal obstacles to the provision of microcredit have to be clearly identified and addressed (see issues discussed above).

Best practices in matters of legislation and regulation could be promoted.

The different European institutions need to cooperate to make it possible for microcredit projects to become realistic, to make them show in the media and finance them adequately.

Slides

Session 1

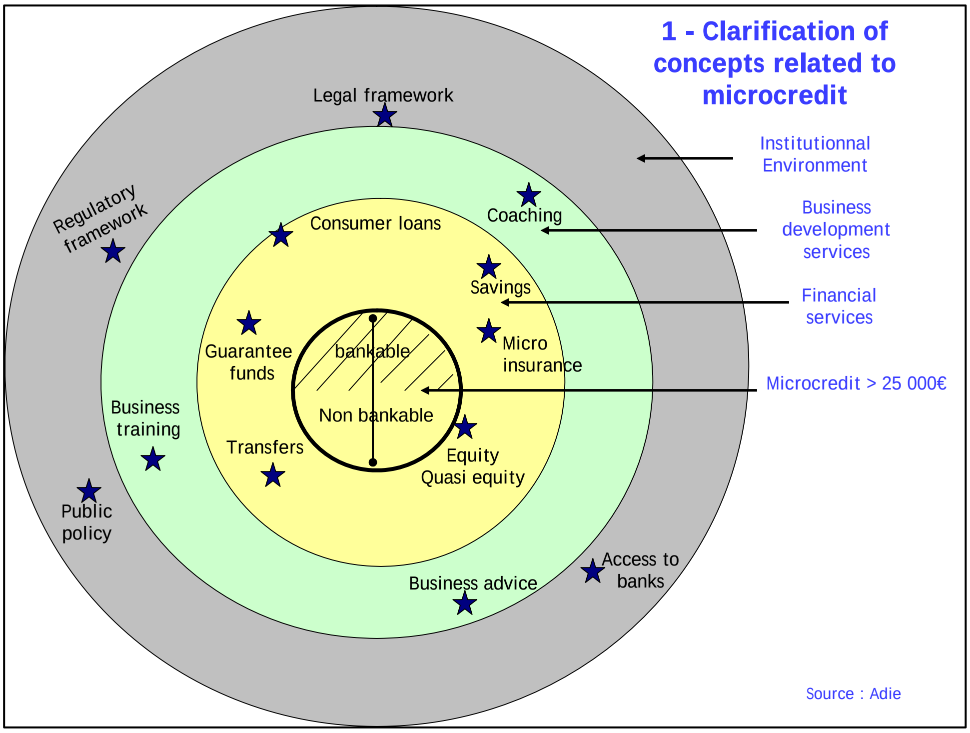
Information of consumer/credit takers, protection of vulnerable clients, turning of clients into bankable clients, life-cycle of microcredit, employment creation

Presentation by
Maria Nowak,
ADIE, Paris, France

Microcredit in Europe

European Parliament's Committee on Economic and Monetary Affairs

Brussels, September 18, 2008



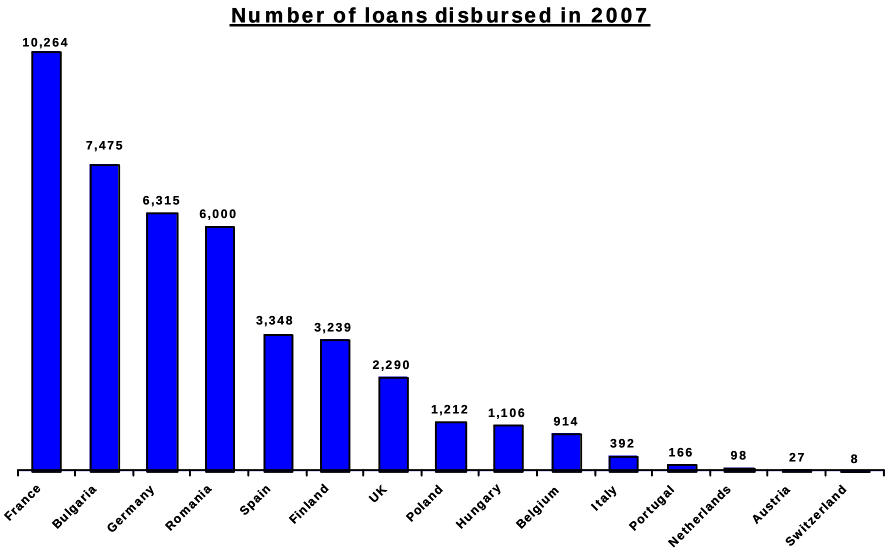
2 - Estimated supply

	2005	2006	2007
Number of loans	27 000	35 602	42 854
In million of euros	210	295	394

Not included Fundusz Mikro, ProCredit Banks, Commercial Banks

(Source : overview of the microcredit sector in the EU 2006 - 2007)

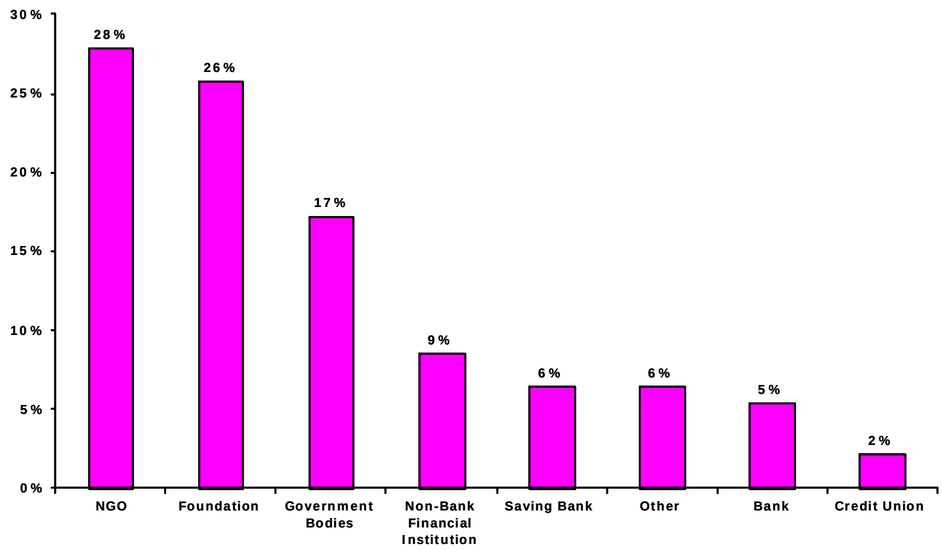
3 - Microcredit in the Member States



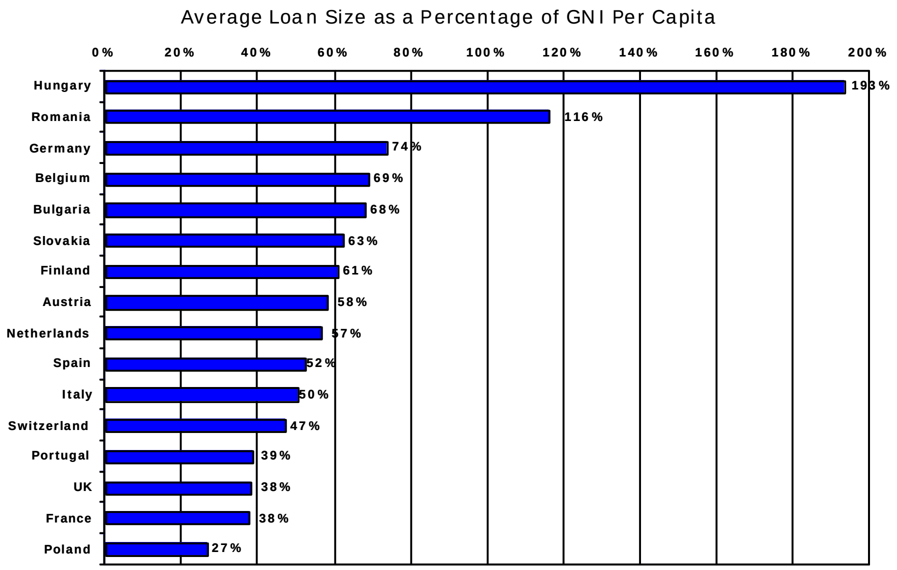
Not included Fundusz Mikro and ProCredit Banks

(Source : overview of the microcredit sector in the EU 2006 - 2007)

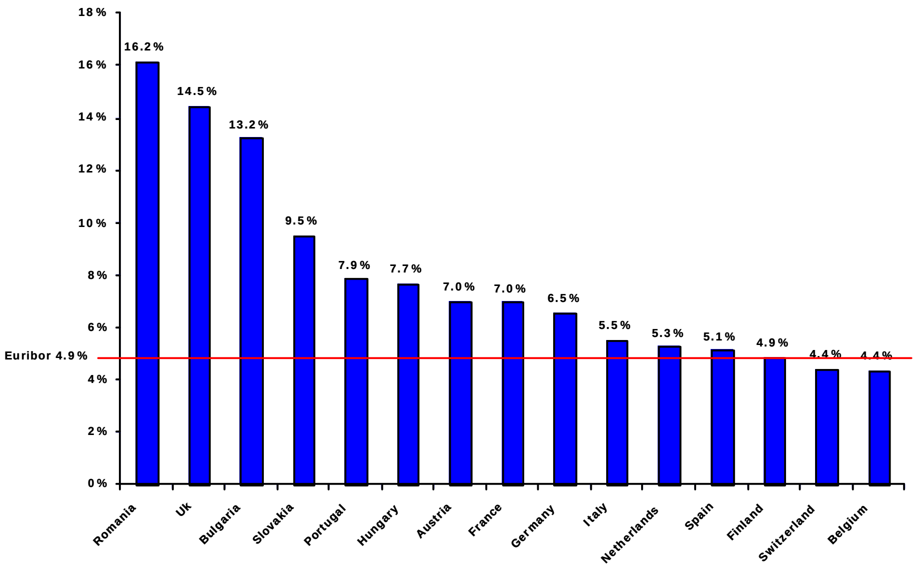
4 - Percentage of microlenders by institutional type



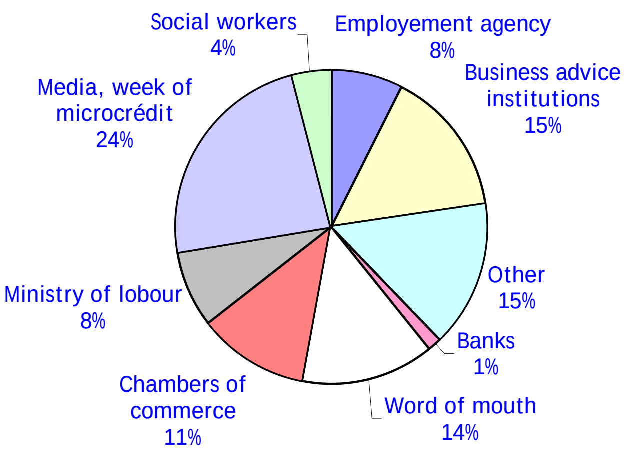
5 - Depth of outreach



6 - Average interest rate by country



7 - Information of credit-takers



8 - Protection of vulnerable clients or active inclusion policy ?

(Exemple of Adie France)

- Business development services free of charge for all clients :
  - Training
  - Business advice
  - Coaching
  - Hot line for specific advice
  - Microentrepreneurs circles
- Special programs for youth in poor communities (CREAJEUNES), immigrant women etc…
- 1000 volunteers + close relations with social workers, and specialised NGOs

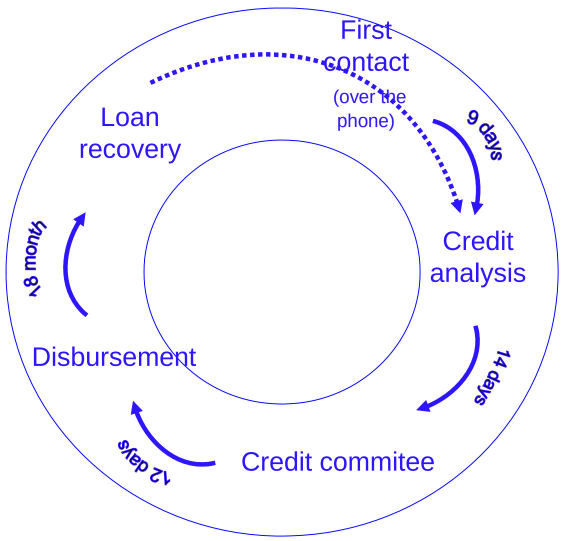
9 - Turning clients, into bankable clients : responding to clients and banks' needs

- Clients → - financial education
  - business development services
  - strong loan recovery policy (3% loss rate) but rescheduling the loans it necessary
- Banks → - reliable accounts
  - credit history

The process may take one year or more according to the profile of the client (20% almost illiterate) and the development of the microentreprise

10 - Life-cycle of the microcredit

(exemple of Adie France)



11 - Employment creation

(exemple of Adie France)

- 25% of the microentreprises develop, become rapidly bankable and create up to 300 jobs per enterprise
- 25% create 2 jobs
- 50% of Adie clients earn less than minimum wage but prefer work to unemployment
- 80% of clients get out of unemployment

12 - The crucial role of the EU Parliament

- Information of the MPs and of the Governments
  - About the potential role of microcredit and microenterprises in the realisation of the Lisbon strategy
  - About the major legal obstacles to its development
    - cap on interest rate
    - non bank institutions not allowed to disburse microcredit
    - welfare bridge
    - entrepreneurial context
- Promotion of best practices in legal and operational field
- Interaction with the EC as regards visibility and development of microcredit
  - integration of microcredit in all relevant reports and legal initiatives
  - cofinancing of the pilot project

Presentation by
Àngel Font Vidal
Foundation Caixa Catalunya, Barcelona, Spain

Caixa Catalunya's Microcredit Experience

From non-bankable people to microenterpreneurs

Microcredit in Europe
European Parliament
Workshop
18 September 2008, Brussels

CAIXA CATALUNYA
OBRA SOCIAL

CAIXA CATALUNYA

- An Spanish Savings Bank, non-for-profit financial institution, which attracts, manages, and invest depositors resources in order to promote economic development and welfare.
- Founded in 1926, by the Province Government of Barcelona.
- Established in all provinces of Spain, particularly those of Catalonia within a network consisting of 1.192 branches (37% outside Catalonia).
- 7.500 employees; 3,2 million customers; 56.000 million euros from client resources
- Allocates 20%-25% of the year's profit to Community work.

CAIXA CATALUNYA
OBRA SOCIAL

Social Microcredit for Self-employment

Main Objective

- Support income generating activities in order to improve job opportunities

Target

- Entrepreneurs with viable business ideas
- Without collateral and no credit access.

CAIXA CATALUNYA
OBRA SOCIAL

Social Microcredit for Self-employment

Financial conditions

- **Up to 25.000 euros (Average: 10.000 euros)**
- **Annual Interest rate: 5%**
- **Maximum 5 years return period (Average: 3,5 years)**
- **No collateral but social commitment**

Business Support

- **Support to the business plan (previous to the microcredit)**
- **Follow-up during the first 3 years**

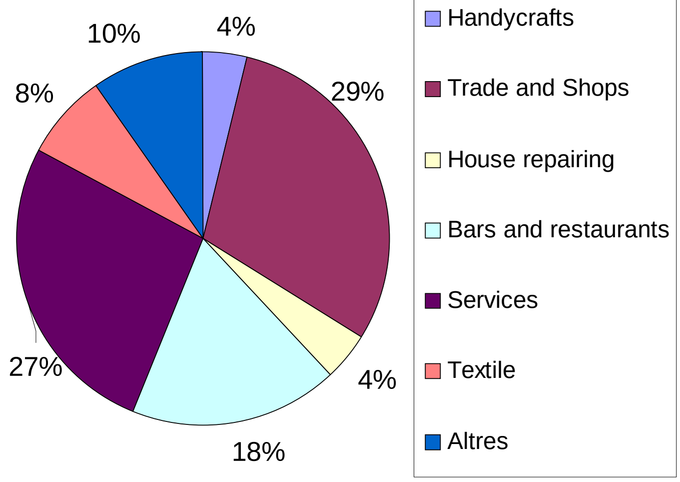
Social impact

- **Good survival rate : (first yr. 80%; 70% second yr; 63% third yr.)**
- **85% Jobless and Job precariousness**
- **74% improves job stability**
- **80% improves family income**

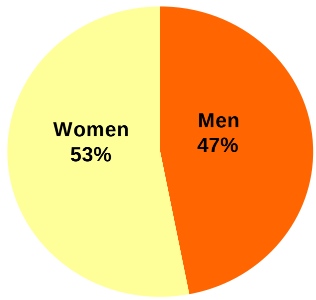
CAIXA CATALUNYA
OBRA SOCIAL

Social Microcredit for Self-employment

Distribution by sectors



Gender



CAIXA CATALUNYA OBRA SOCIAL

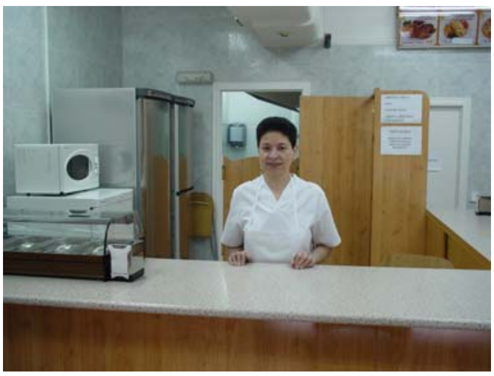
Social Microcredit for Self-employment

75% entrepreneurs are immigrants

Nationality	%
Argentina	13,84
Colombia	9,60
Bolivia	8,93
Equator	6,47
Peru	5,58
Morocco	5,36
Uruguay	4,24
Brazil & Cuba	3,13

Results

- 1.320 microcredits
- 12.350.000 €



CAIXA CATALUNYA OBRA SOCIAL

Social Microcredit for Self-employment

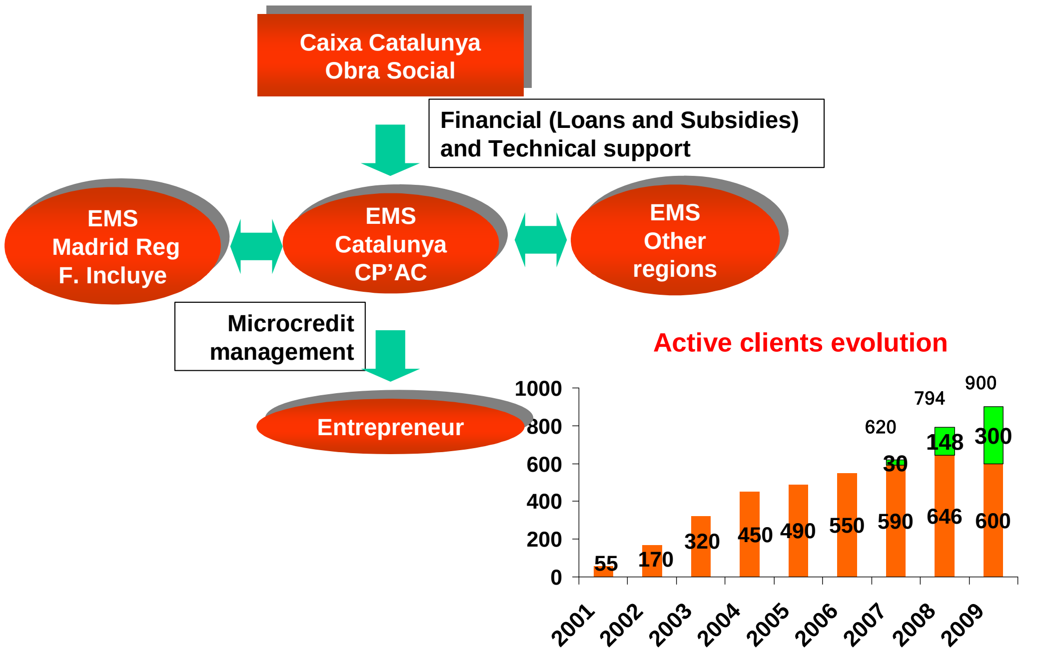
2008 New microcredit role: Promote Regional Non-banking Non-for-profit Microcredit institutions

Entitats de Microcrèdit Social (EMS)

EMS's Role:	CAIXA CATALUNYA'S Role:
• Entrepreneur direct attention • Credit decision • Local coordination with social services • Repayment management	• Leverage Financial resources • Deliver Systems and procedures • Business support models • Microcredit Promotion at national and international level

CAIXA CATALUNYA OBRA SOCIAL

Social Microcredit for Self-employment



CAIXA CATALUNYA OBRA SOCIAL

Contact:

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Obra Social Caixa Catalunya

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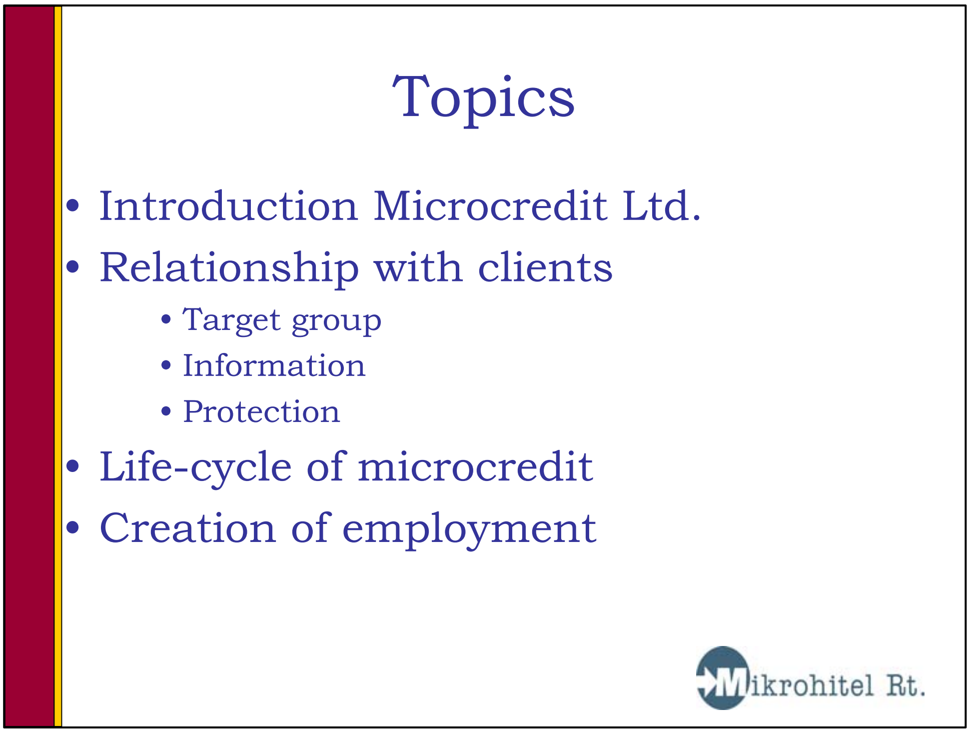
+34 934 848 111

CAIXA CATALUNYA
OBRA SOCIAL

Presentation by

Gábor Winkler,
Mikrohitel Rt, Budapest, Hungary



Founders

- **BB Foundation**
  - Business development
  - Loan product for micro-businesses
  - Non-profit loan
- **Autonómia Foundation**
  - Income generating program for Roma NGOs
  - Interest-free loans for Roma NGOs

Mikrohitel Rt.

Reasons to establish a financial company

- Institutional
- Mission
- Target group

Mikrohitel Rt.

Introduction 4/3

Institutional reason

– Hungarian Bank-low
– Donors' plans and requirements
– Strategic plans of the 2 foundations contained the establishment of the company

Mikrohitel Rt.

Introduction 4/4

Mission

- To serve non bankable enterprises, organizations
- To develop the entrepreneurial culture
- To develop the financial capacity of the non-profit organizations

Mikrohitel Rt.

Relationship 3/1

Relationship

Target group
- Micro-enterprises
- Start-up enterprises (focus on Roma communities)
- Non-profit organizations (bridge loans)
- Community-based enterprises (focus on Roma communities)
- Refugees

Mikrohitel Rt.

Relationship 3/2

Portfolio - September 2008

	loan product	# of loans	# groups	disbursed loan (HUF)	disbursed loan (EUR)	financial sources
2008	**Entrepreneur**	54	0	153 144 000	638 100	core capital (OSI)
	NGO	132	0	364 776 000	1 519 900	TRUST Fund/LOAN
	House reparing	13	0	5 016 000	20 900	UNDP-AGFUND
	Group lending	154	23	46 608 000	194 200	UNDP-AGFUND

Mikrohitel Rt.

Relationship 3/3

Protection

Protection

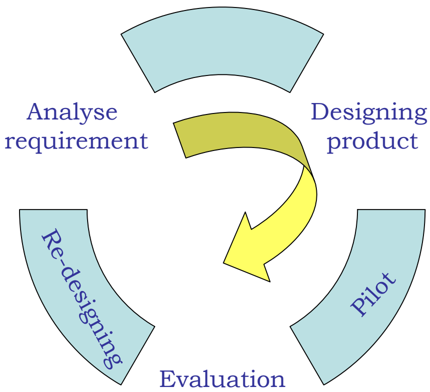
- Present
  - Personal meetings
    - » Visiting
  - Cash-flow planing
  - Monitoring
    - » Group meetings
    - » Phone calls
- Future
  - Marketing policy
  - Mentor network

Mikrohitel Rt.

Life-cycle of credit 2/1

Life-cycle of credit

Life-cycle of credit as a product



Mikrohitel Rt.

Life-cycle of credit 2/2

Loan products

- Small entrepreneurial loan
- Loan for nonprofit organisations
- Group-based micro- and start-up loan
- Loan for house reparing

Mikrohitel Rt.

Eployment creation 1/1

Employment creation

- Micro-entrepreneurs
  - cooperation multinational companies
    e.g. Michlein Ltd.
- Roma start-up bussinesses
  - Self-employment
    - Barriers
      - Lack of administration
      - Low business knowledge
      - Special activities (harmonised with traditions)

Mikrohitel Rt.

Thank you for your attention!

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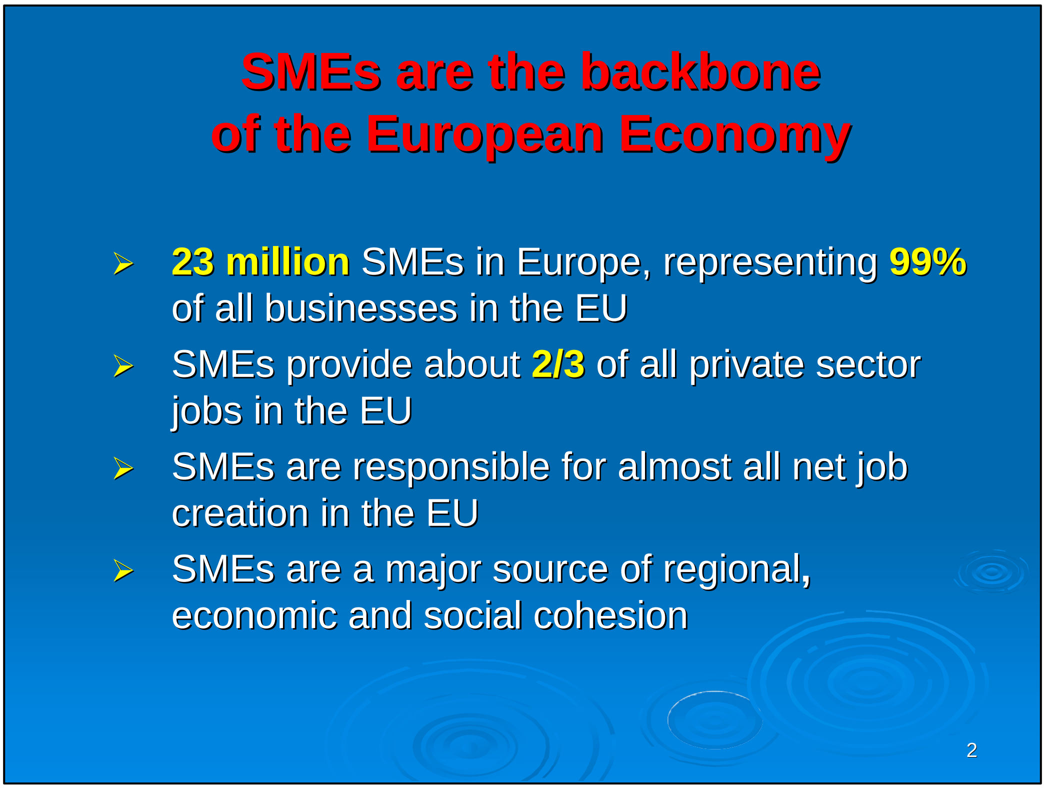
Presentation by
Rudolf Niessler
European Commission
Directorate General for Regional Policy



Small businesses are top priority of Cohesion Policy 2007-2013

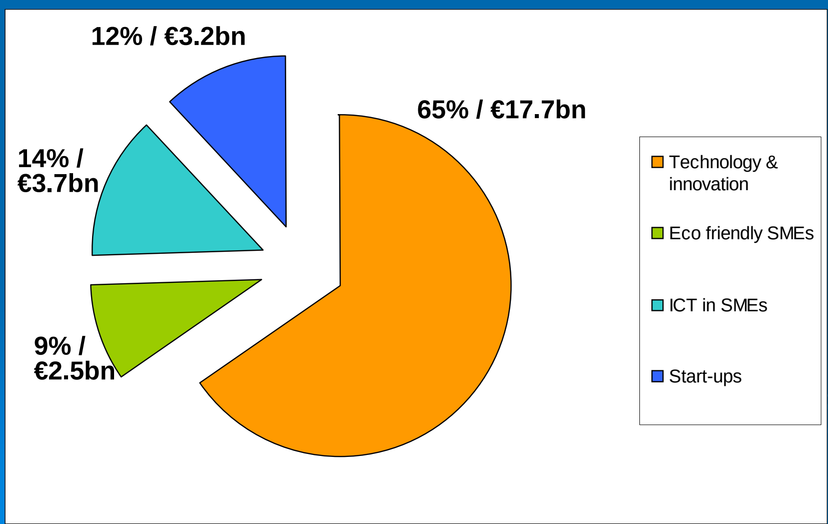
- Cohesion policy strongly supports the Lisbon Agenda goals of growth and jobs
- Cohesion Policy is the biggest provider of EU funds supporting Small Businesses
- Total business support 2007-2013:

€ 55.000.000.000

of which 50% is directly targeted to support for small businesses, including micro-businesses

3

€ 27 billion of support specifically dedicated to Small Businesses



4

JEREMIE and Micro-credit

- **JEREMIE**: A new financial engineering instrument designed in the framework of the new regulations on Structural Funds
- **JEREMIE** is aimed to assist managing authorities of European programmes in providing access to finance for SMEs and micro-enterprises in the Member States and regions
- **JEREMIE** uses EU funds to lever other financial resources for creating financial engineering products like venture capital, loans, guarantees, seed capital, etc., or a combination of them
- **JEREMIE** can be used to provide also micro-credits in the European Union

5

Why do we need to do more in the field of micro-credit?

- An important gap in the market
- A high potential demand for micro-credit estimated to some 700 000 loans amounting to some € 6 billion
- Potential entrepreneurs with no collateral can not obtain loans through traditional channels
- Not enough micro-credit intermediaries providing mentoring on the market

6

Why a micro-credit initiative?

- Actions have already been taken at EU level and in Member States to support micro-credit (CIP, EQUAL, PHARE, ESF, …), but this is not enough to allow for sustainable development of micro-credit in Europe
- Micro-credit operations need to be seen in a broad support framework in line with the principle of subsidiary
- A more favourable environment is essential

COM/2007/708 of 13 November 2007

7

What is the purpose of the micro-credit initiative?

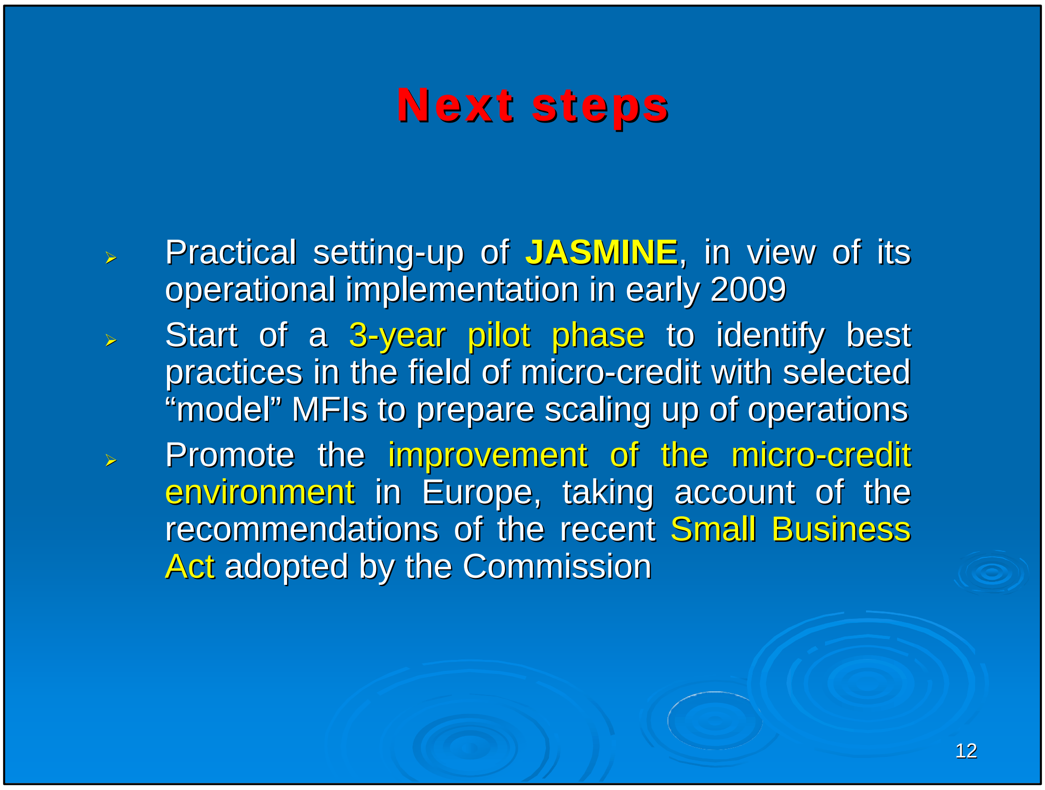
- To promote a favourable legal and institutional and environment for micro-credit in Europe
- To help non-bank financial intermediaries who want to act on the microcredit scene reach a high standard in terms of governance and lending practices
- To help them raise funds on the private capital market and attract borrowers in confidence
- To help them grow and reach sustainability

8


Two important issues:
1. Setting up, in inter-institutional partnership with the European Investment Bank group, a new European facility, JASMINE, to provide to MFIs
• Operational technical assistance like mentoring, training, information, toolkits, etc.
• General support measures like a code of conduct, a quality label, etc.
2. Provide flexible funding to selected MFIs (equity, loans, grants, or their combination) through a co-financing facility established by the EIB and involving EIB, European Parliament and private financial partners (+/- €50 m)
9


Important practical aspects
JASMINE will draft a code of good conduct for MFIs to spread ethic and customer-friendly best practices among MFIs.
JASMINE will design a micro-credit quality label which will be awarded under strict conditions to MFIs to acknowledge their reliability, to help them attract borrowers in confidence and to raise funds on the private capital market.
Grants to be used as start-up "equity" to help MFIs cover their operational costs and become sustainable.
The need for a pilot project to gain experience in delivering Funds and support to non-bank MFIs.
10


Designing a quality label for MFIs
Criteria :
Good governance
Financial performance
Social performance
Results compliant with business plan
Distance to sustainability
...
11


Next steps
Practical setting-up of JASMINE, in view of its operational implementation in early 2009
Start of a 3-year pilot phase to identify best practices in the field of micro-credit with selected “model” MFIs to prepare scaling up of operations
Promote the improvement of the micro-credit environment in Europe, taking account of the recommendations of the recent Small Business Act adopted by the Commission
12

Conclusions

- Access to finance is an essential element for promoting growth and jobs
- There is an important market failure in the field of micro-credit in Europe.
- The Lisbon Agenda and the Small business Act offer a unique opportunity to develop micro-credit in Europe
- Strong political support from EP, EU-Presidencies
- Cohesion Policy can provide an important contribution – TA and support schemes
- Strong financial support from EIB-group
- Particular attention is to be paid to the mentoring
- Non-bank MFIs seem better positioned than banks to deliver micro-loans to non-bankable entrepreneurs
- Sustainability, reliability and good governance of MFIs are key to attract private capital
- Grants are necessary to help non-bank MFIs cover their costs in the starting phase
- Micro-credit can be a win-win process. Good co-operation is the key to success.

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Who can help ?

An number of stakeholders

- Member States (improve the micro-credit environment)
- The Commission (Cohesion Policy, JEREMIE,, Guarantee window of the Competitiveness and Innovation Programme, …)
- The European Parliament (preparatory action to reinforce the financing capability of the MFIs)
- The European Investment Bank Group (financial expertise, fund raising and leverage effect)
- EUROFI (Expertise, toolkit, funding, good practice)
- Micro-finance Networks (on the ground knowledge, dissemination of information, best practices)
- Private and public investors, retail banks (funding and expertise)
- Donors
- **You ?**

14

Thank you

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Session 2

Methodologies of micro-credit, models of micro-financial institutions with a view to special target groups;
The role of collateral and securitisation

Presentation by
Mark Lyonette
Association of British Credit Unions Ltd

ABCUL Credit Unions

September 2008

Credit unions in Britain
helping immigrants access financial services

Mark Lyonette
Chief Executive
Association of British Credit Unions Ltd

ABCUL Credit Unions

Summary

- How have credit unions in Britain developed
- What the British credit union sector looks like now
- How credit unions work with immigrants
- What else could we be doing; what are credit unions doing around the world

How did credit unions develop

- Immigrants in 1960s struggled to access financial services
- Credit only available at high cost
- Experience of credit unions from home countries – e.g. Jamaica, Ireland
- Joining together to provide financial services they needed – *people helping people* in financial co-operatives
- Despite rise of live or work credit unions, credit unions for specific communities still in existence – Caribbean, Sikh, Church based groups

ABCUL Credit Unions

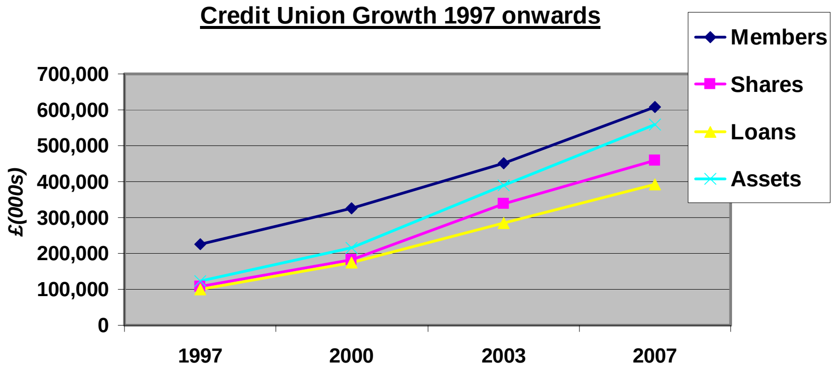
Growth of British Credit Union Movement

- 1980 – less than 10,000 members
- 2008 – nearly 750,000 people in credit unions
- 1980 – just over £1 million in savings (€1.3 million Euros)
- 2008 – nearly £1/2 billion in savings (€ 633 million Euros)
- Also significant Growth in last ten years…

ABCUL Credit Unions

ABCUL Credit Unions

Credit Union Growth



- **Over 700,000 members -** up from 365,000 in 2001
  - **Over £1/2 billion in assets -** up from £263,000 in 2001
  - **Over £420 million out on loan -** up from £205 million in 2001
  - **Over £480 million in savings -** up from £223 million in 2001

ABCUL Credit Unions

What services do credit unions provide

Inclusive financial services:

- **Affordable credit**
- **Safe savings**
- **Life insurance**
- **Financial Education**

Increasingly offering larger range of services including:

- **ISAS (tax free savings)**
- **Child Trust Funds (Government assisted saving scheme for all new babies)**
- **Insurance**
- **Mortgages**
- **Credit Union Current Account**

ABCUL Credit Unions

Responding to the needs of migrants

- helping them open accounts to receive wages when they struggle to open bank accounts – working with agencies and employers

- providing information in different languages – leaflets, multilingual staff, working with community organisations to spread the word

- helping members access future credit including mortgages by helping them build up a credit file with credit reference agencies.

- developing Sharia compliant products to specifically meet the needs of Muslim members (in progress)

- providing money transfer services through Western Union – ABCUL affinity scheme.

ABCUL Credit Unions

Credit unions – an international movement

- 97 countries
- 46,000 credit unions
- 172 million credit union members
- Over $1 trillion in assets

- World Council of Credit Unions has developed IRNet, a remittance based service which allows credit unions to transfer money around the world in partnership with organisations such as Coinstar Money Transfer, MoneyGram and Vigo

ABCUL Credit Unions

Next steps

Stronger credit unions in Britain because of: -

- **new legislation – more flexibility around products, services etc**
- **more sharing of services through back office – increased availability of Credit Union Current Account**

Will lead to: -

- **increased availability of remittance products in credit unions (as recommended by a recent report to the UK Remittances Taskforce)**
- **a wider range of products to meet the needs of even more people**

ABCUL Credit Unions

Thank you

Thank you

Presentation by
Joachim Bauer
Sparkasse Offenbach, Germany

Sparkasse

‚Ostpol-Credit'

Presentation

Sparkasse Offenbach am Main

Brussels

16.09.2008
page 1

‚Ostpol-Credit' Sparkasse Offenbach Actors:

German Microfinance Fund

- Takes over the „last"80% of risk
- Controls the quality of micro finance institutes with a „monitoring-system"
- Financier/investor: GLS Bank, KfW, BMWI, BMAS

Microfinancier

- Implements the system at local level
- The Customer´s contact point beginning at the initial stage of engagement until repayment
- Winds up process of approval

Local funds / Loan Allocation Committee

- Pose the loan allocation committee and the policy of the whole fund
- Take over the „first" 20 % of risk (first-loss liability)
- Members: City of Offenbach, Chamber of commerce (IHK), KIZ GmbH (microfinancier), Sparkasse (savings bank)

German Microfinance Institute

- Coordinates/ developes the system
- Service provider (know-how, contacts and service)

Sparkasse Offenbach

- Provides the credit
- Undertakes banking transaction

16.09.2008
page 2

‚Ostpol-Credit‘ Sparkasse Offenbach Conditions:

– First credit between € 1.000 - € 10.000, interest rate nom. 10% p.a./ duration max. 36 months

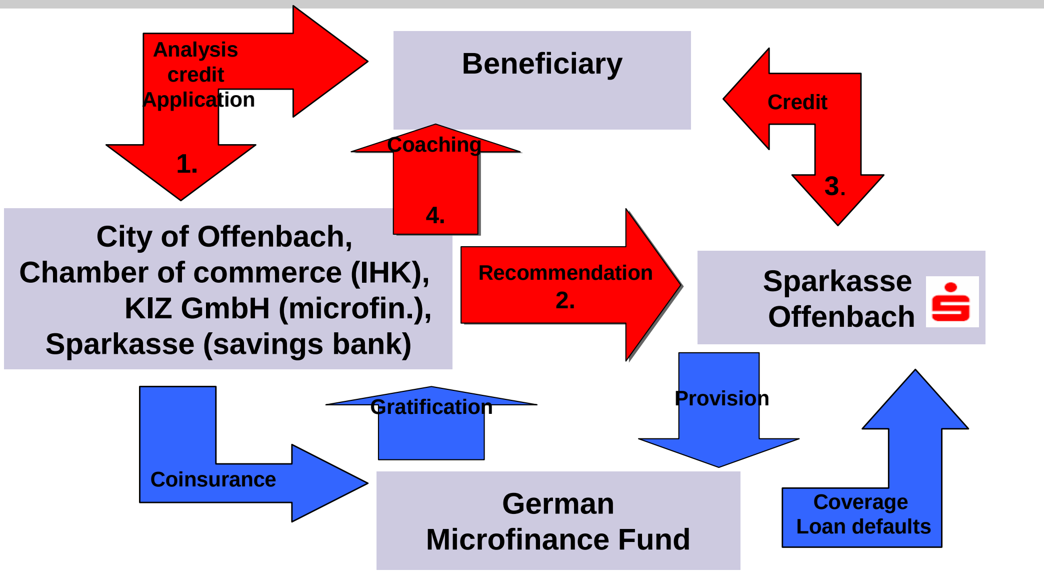
– **Prerequisites:**
  - persuading business concept and submission online-application,
  - voluntary disclosure of confidential information,
  - latest disclosure of business information (Schufaauskunft),
  - business location within the inner city of Offenbach (urban development).

– Presentation of the business concept to the loan allocation committeewhich than immediately takes a decision on commitment

– Savings bank provides the credit after recommendation of the committee of allocation

16.09.2008
page 3

‚Ostpol-Credit‘ Sparkasse Offenbach operating mode:



16.09.2008
page 4

‚Ostpol-Credit' Sparkasse Offenbach Examples:

Mr. Abbas K. (Iran): Carrier service

Amount of financing: appr. € 6.000
Investment: second-hand truck

Ms. Simona M. (Romania): Cleaning service and sale of beverage

Amount of financing: appr. € 5.000
Investment: the first warehouse

16.09.2008
page 5

‚Ostpol-Credit' Sparkasse Offenbach Conclusion:

– Founder of a new business get access to microcredit loans

– Microfinance as an add-on-product for savings banks

– Microfinance as a crucial element for urban development

– Savings bank as regional financier fulfills the role as financial service provider at local level and ensures banking transaction

– To sum up: It is of utmost importance to hold people in the banking system whenever it is possible and to avoid downgrading customers to „non-bankables".

This is an important part of the mission of local banks!

16.09.2008
page 6


Sparkasse
Sparkasse Offenbach
Thank you for your attention!
16.09.2008
page 7

Ostpol loans for the eastern inner city of Offenbach

I. Background

Generally speaking, anyone in need of credit in Germany goes to a banksavings bank. It may become difficult if that person is a migrant, cannot produce a credit history or where extending a loan is not economically reasonable for the lending bank on account of the scale of the desired loan commitment. These aspects occur frequently in the case of microenterprise start-ups.

The Ostpol loan of the City of Offenbach, in cooperation with the local savings bank, demonstrates that it is nevertheless possible for funds to be made available. The name of the Ostpol loan is attributable to the targeted deployment of the funds in the structurally weak eastern inner city area, where this micro-loan is granted to businesses and entrepreneurs of the "Ostpol" business start-up centre, i.e. of the eastern inner city, and graduates of the Hochschule für Gestaltung (HfG – University of Art and Design) Offenbach. The "Ostpol" business start-up campus (www.ostpol-gruendercampus.de) is a complex of buildings which was founded as an urban upgrade and for the economic and cultural revival of the eastern inner city of Offenbach. An interesting mix of learning, work, living and leisure time has been incorporated in this new urban infrastructure, which contributes to a revival of the structurally weak part of the city. Here, micro-entrepreneurs are offered offices and workshops, networks and service, advice, training, events, contacts and, in cooperation with the Offenbach Savings Bank, the Ostpol loan.

Gaining acceptance for Ostpol loans involved not only the district and city authorities, but also the promotion of trade and industry of the city of Offenbach, young entrepreneurs and intercultural and industry-related associations. They act as multipliers in the market.

An important factor for product development was that Ostpol loans are transacted transparently, simply and quickly. The easy access via the Internet (www.ostpolkredit.de) is not constrained by opening hours. Borrowers can obtain a first loan of maximum EUR 5,000. It is deliberate policy to grant micro-loans to start with (from EUR 1,000) in order to build up the businesses gradually. In this way, it is easy to learn from mistakes made and borrowing is closely related to requirements. Following the motto "if others believe in you, so do we", the volume of the micro-loan is determined by doubling the sum of the guarantees put up. A person who can supply a guarantee for EUR 2,500, for example, is granted a loan of EUR 5,000; however, a sustainable business idea is a prerequisite here too.

II. Operators

In Offenbach, a regional network has been formed, consisting of the City of Offenbach, the Chamber of Commerce and Industry (IHK) of Offenbach, the non-profit-making Baugesellschaft mbH (GBO), the Stadtwerke Offenbach Holding (SOH) and the Hochschule für Gestaltung (HfG), and a special Ostpol loan has been developed to meet the special regional conditions and needs.

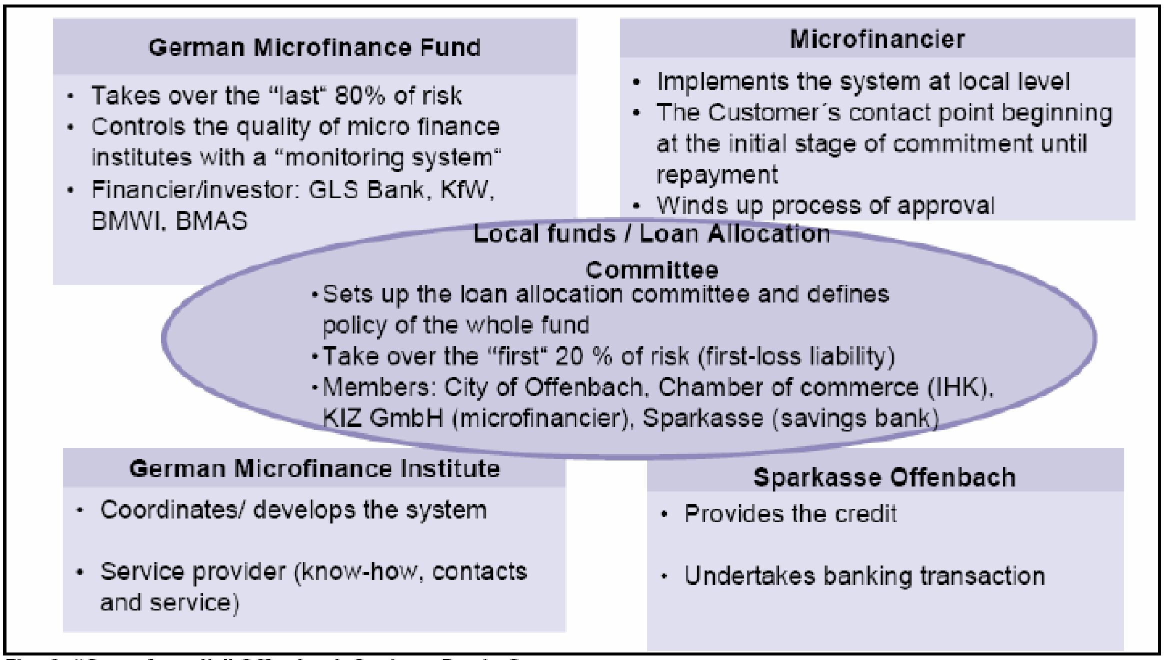


Fig. 1: "Ostpol credit" Offenbach Savings Bank: Operators

The second step was to create the regional Offenbach microfinance fund, which, together with the German microfinance fund, takes charge of the necessary asset-backing for the Ostpol loans, i.e. the necessary 20% first-loss risk capital for the German microfinance fund. The Offenbach Savings Bank plays an important role here: as local bank in the context of the DMI cooperation model, it makes micro-loans granted available directly on the spot and also undertakes the banking transaction.

III. Sequence

A credit application includes information disclosed by the customer, the current Schufa (credit information exchange) information and a business concept and planning of how the loan is to be utilised and repaid. Then, in a personal interview, the applicant convinces the Loan Allocation Committee of its project and on this basis immediately receives a credit commitment or rejection. Following a positive recommendation by the Credit Allocation Committee, the loan is made available by the Offenbach Savings Bank. If the enterprise needs a follow-up loan as a further cash injection and if it has repaid the first Ostpol loan, a higher volume of credit, i.e. the first loan plus 60%, can be granted.

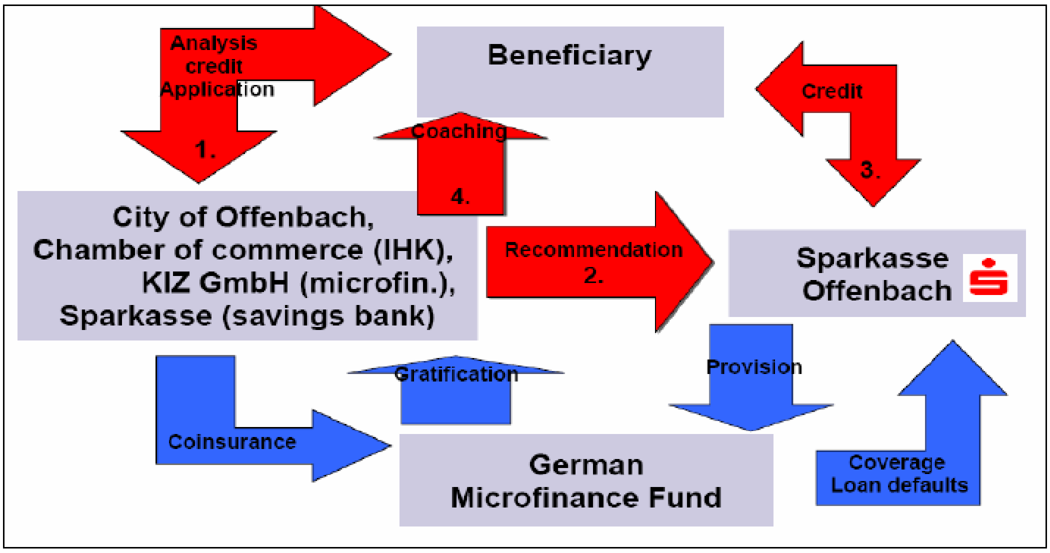


Fig. 2: "Ostpol loan" Offenbach Savings Bank: operating mode

IV. Conclusion

To sum up, the Ostpol loan of the City of Offenbach offers the following advantages:

• Entrepreneurs have access to small-scale loans.

• Microfinance is to be considered as a supplement to savings bank products.

• Microfinance can be introduced as a component in the development of city districts.

• The savings bank, as regional financier on the spot, continues to act as lender and takes care of the banking transaction.

• The project of the City of Offenbach (representing the German model), whereby loans are granted by the local credit institution, which for this purpose in turn cooperates with the local operators (local CCI, Crafts Chamber, the City, etc.), is **transferable** and can be applied as a **pan-European approach**.

To sum up:

• It is of utmost importance to retain people in the banking system whenever it is possible and to avoid downgrading customers to "non-bankables".

• This is an important part of the mission of local banks!

Presentation by
Christa Karis
Guarantees and Securitisation, European Investment Fund, Luxembourg

18 September 2008

Christa Karis

Deputy Head of Guarantees & Securitisation

EP Workshop Microcredit

EUROPEAN
INVESTMENT
FUND

EIF at a glance

EU specialised financial institution for SMEs,
acting through: **Venture Capital** (fund-of-funds),
Guarantees for SME portfolios and financial engineering

AAA/ Aaa/ AAA

- **MDB** (multilateral development bank) status
- **0% weighting** (CRD/ Basle II)

Subscribed capital: EUR 3 bn

- EIB: 66 %
- EU: 25 %
- Fin. institutions: 9 %

Aaa-rated European institution with MDB status
Need to generate return on equity

2

CIP Micro Credit Window (micro-enterprises)

- Investment finance, working capital (mainly for start-ups)
- Minimum loan maturity: typically 12 months; max. 5 years of guarantee cover
- Maximum loan amount: EUR25,000
- EC Guarantee Rate: up to 75%
- Guarantee Cap Rate: up to 20%
- Technical support: up to EUR50 k
- Enhanced Access to Finance!
- Special rules for public schemes

3

Experience with EU support (1)

- MAP Microcredit window: 8 agreements signed in 7 countries
- More than 40,000 micro enterprises guaranteed
- Promotional banks, commercial lenders, micro-lending institutions
- Competitiveness and Innovation Framework Programme (CIP) successor of MAP (2007-2013)
- Key EC requirements: Enhanced access to finance

4

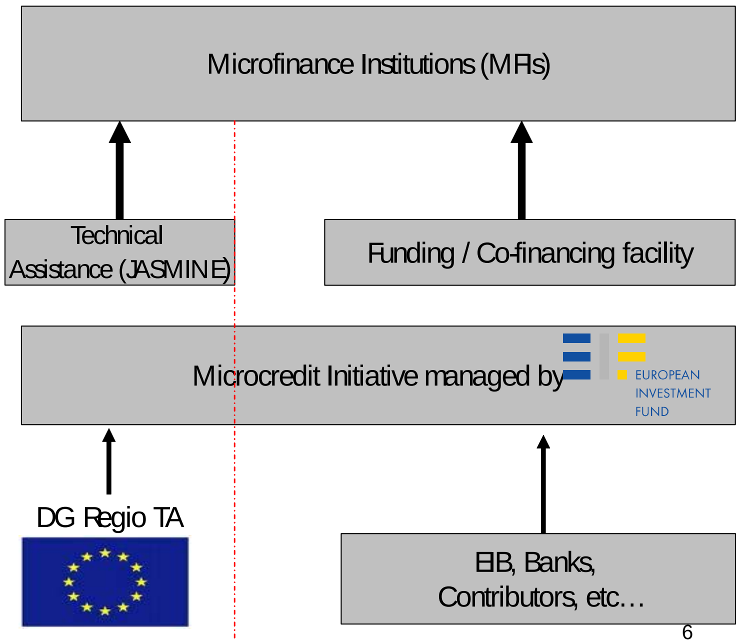
EUROPEAN INVESTMENT FUND

Experience with EU support (2)

- Important: individual solutions to different needs – MFIs differ substantially (between countries, size, level of self sustainability…)
- Strong need to be able to combine different EC measures and have clear rules for each product
- Guarantees are useful - especially for promotional lenders
- Small MFI: clear need for long-term funding to be able to provide loans to be guaranteed
- Different new initiatives to address such gap; recently launched – Microcredit Initiative

5

EUROPEAN INVESTMENT FUND



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EIF own risk transactions

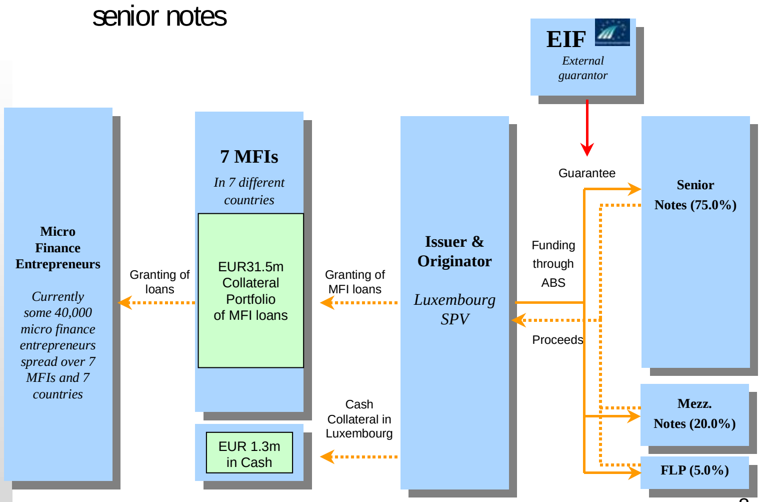
Involvement in 3 micro loan transactions in Eastern Europe on a commercial basis

- MFI Loan Obligation (2005): loans securitised for 7 MFIs (Western Balkans)
- Procredit Bulgaria (2006) portfolio of micro loans (Bulgaria)
- ProCredit Serbia (2008) portfolio of micro loans (Serbia)

7

Example: EIF's involvement:
MFI loan obligation 2005

EIF structured the transaction and provided a guarantee on the senior notes



8

Presentation by
Michael Schneider
Asset Finance & Leasing, Deutsche Bank AG, Frankfurt, Germany

Securitizations and Microfinance

Uniting Social and Financial Returns

Presentation to the European Parliament's Committee on Economic and Monetary Affairs (ECON), Brussels
September 18, 2008

Michael Schneider, Asset Finance & Leasing

Deutsche Bank

1998 - 2008: From Philanthropy to Business Case

DB Microcredit Development Fund (DBMDF)
- Invested 4.2m to 40 MFIs in 25 countries with an impact of USD 55m

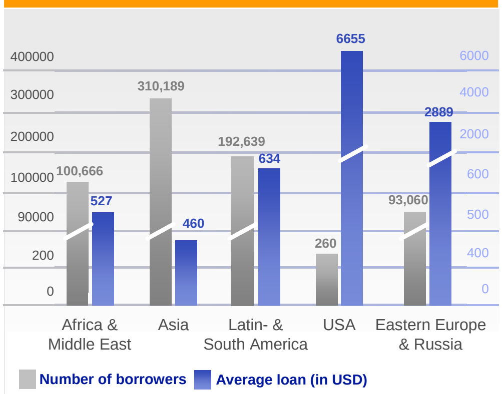
DB Microfinance Start-Up Fund
- Supports MFIs in early stages

Global Commercial Microfinance Consortium
- Total capitalization of USD 80 million
- Investors: AXA, Munich Re, Merill Lynch

EFSE
- Subscription of EUR 50 million

db Microfinance-Invest
- First rated securitisation of fully subordinated debt issued by MFIs
- First and second loss with private sector investors

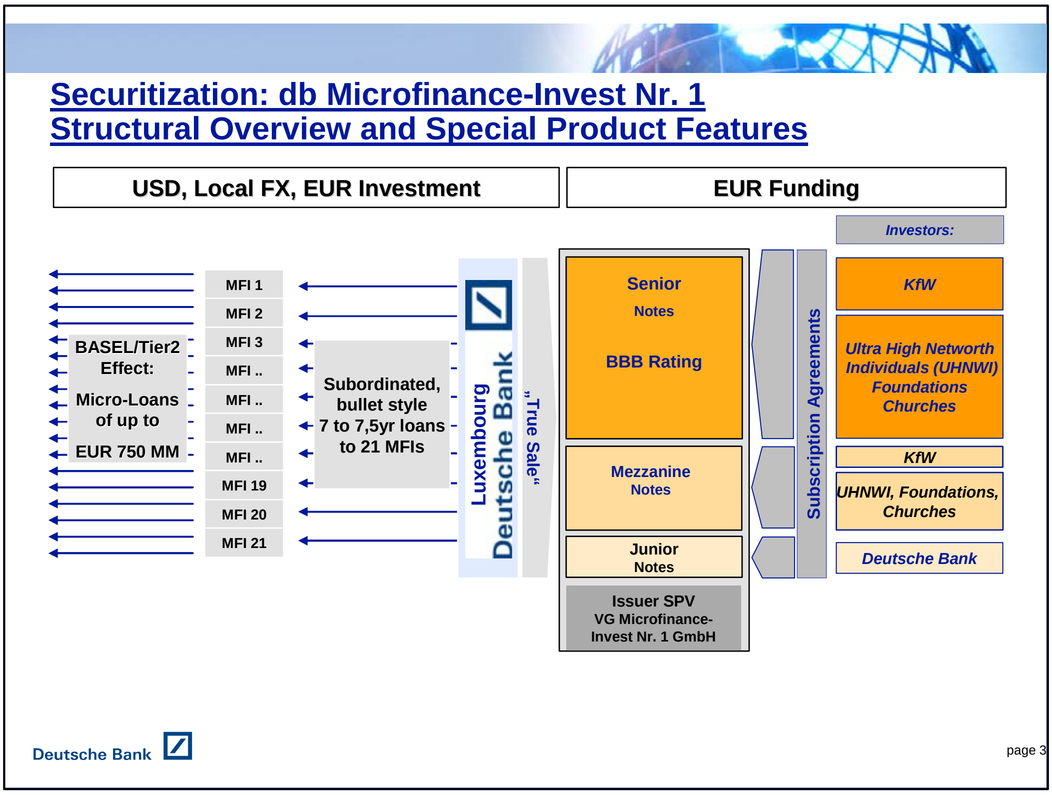
Impact of DB's microfinance activities

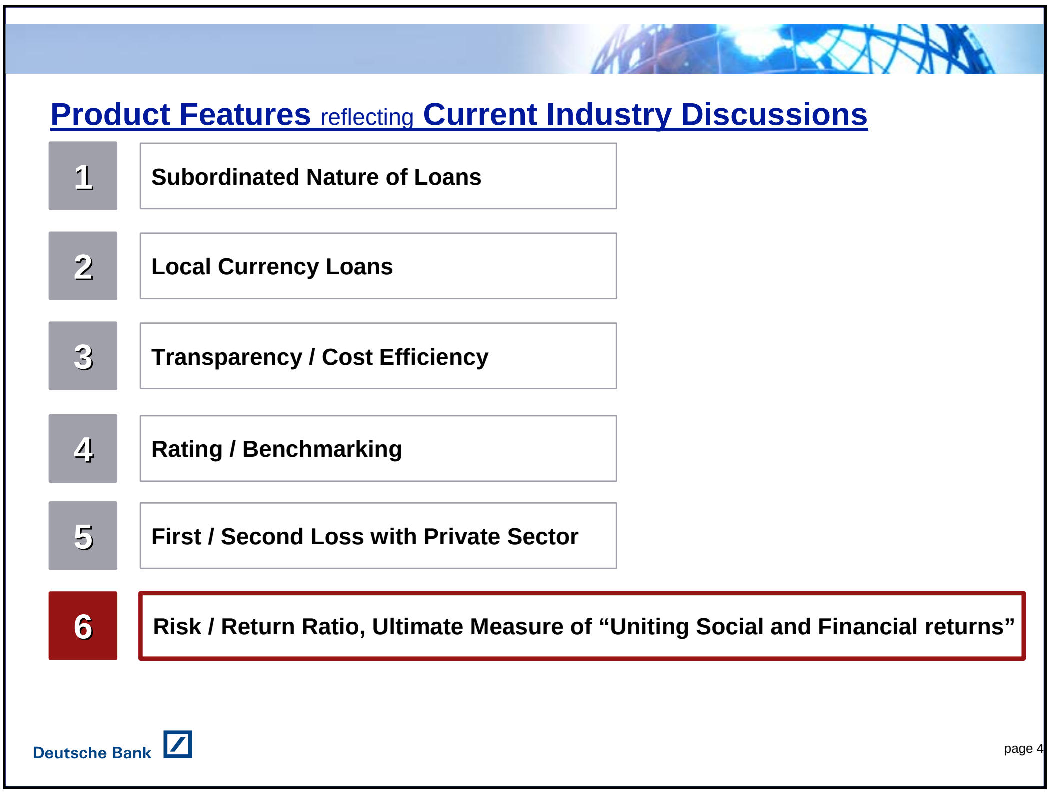


Thanks to the first three funds 700.000 people received microcredits totaling up to USD 309 million

Deutsche Bank

page 2


Securitization: db Microfinance-Invest Nr. 1
Structural Overview and Special Product Features
USD, Local FX, EUR Investment
EUR Funding
Investors:
BASEL/Tier2 Effect:
Micro-Loans of up to
EUR 750 MM
MFI 1
MFI 2
MFI 3
MFI ..
MFI ..
MFI ..
MFI ..
MFI 19
MFI 20
MFI 21
Subordinated, bullet style 7 to 7,5yr loans to 21 MFIs
Deutsche Bank Luxembourg
„True Sale"
Senior
Notes
BBB Rating
Mezzanine
Notes
Junior
Notes
Issuer SPV
VG Microfinance-Invest Nr. 1 GmbH
Subscription Agreements
KfW
Ultra High Networth Individuals (UHNWI)
Foundations
Churches
KfW
UHNWI, Foundations, Churches
Deutsche Bank
Deutsche Bank
page 3


Product Features reflecting Current Industry Discussions
1
Subordinated Nature of Loans
2
Local Currency Loans
3
Transparency / Cost Efficiency
4
Rating / Benchmarking
5
First / Second Loss with Private Sector
6
Risk / Return Ratio, Ultimate Measure of "Uniting Social and Financial returns"
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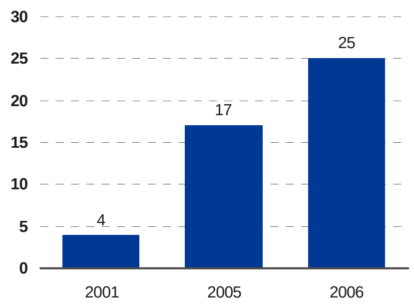
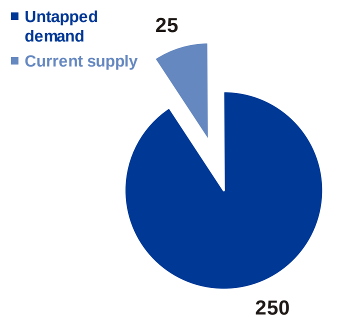
Funding gap of 250 bn USD:
Sector only meets fraction of potential total demand

Total volume of microloans
Estimation in USD bn



Funding gap of microfinance of ~250 bn USD
Estimation in USD bn



Sources: DB Research, The MIX, McKinsey

Deutsche Bank

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Outlook:

1	Microfinance is an emerging niche investment opportunity whose full potential just got started to become explored by investors.
2	We forecast private and public sector investments to rise to USD 25bn by 2015, with the reasons being: • General sharp rise in social investments as external growth impetus • Regulatory changes – e.g. in Germany – attract retail investors and will make it a niche investment product • Joint investment activities of public and private investors act as multiplier • More commercial investors will discover microfinance • Market participants are increasingly willing to invest in first loss pieces • More MFIs becoming capable of absorbing commercial funding
3	Unique opportunity that microfinance receives larger share of the market for socially responsible investments

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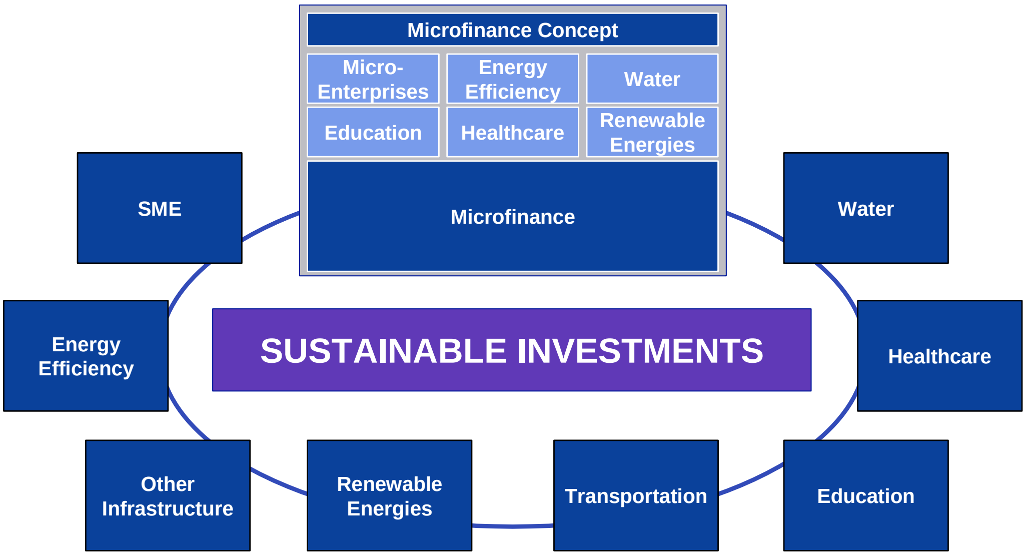
Vision:
Microfinance, Part of a Larger Sustainable Investment Universe



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Thank you for your attention!

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Intervention by Baeva, Mariela Velichkova, MEP

Let me shed light on the current state of affairs, principles and practices in my country with reference to the issue under discussion.

At present, 29 commercial banks operate on the Bulgarian market, 24 of them with a local license and 5 being subsidiaries of foreign banks.

A few years ago the Bulgarian National Bank launched a Central Credit Register serving as an information system of existing bank credits.

In the last few years the banks revised their policy toward the big corporate clients. The relatively limited amount of such clients pre-defined the strong competition among banks and the development of new financial schemes.

The micro and SMEs segment represents an attractive business opportunity for the banks in the country to accrue value. The trend of growth of those enterprises has been well above 10% on an annual basis with a payback period of investment ranging between 35 and 45 % before taxes.

The bank institutions on the domestic market utilize a set of criteria for segmenting their clients, a basic criterion being the annual sale revenues. The maximum volume of those varies between 1 million to 2.5 million Euro. The choice of these concrete financial parameters is due to the specific profile of the clients and their pursued strategic objectives.

Additional corrective criteria are the credit exposure and deposits of the clients.

The territorial structure of the annual sale revenues reflects the level of development and economic activity of the 6 separate economic regions of the country.

Microcredit compared to consumer credit is not subjected to a specific legal regulation in the country. Moreover, the commercial banks follow their internal rules, guidelines for their credit activities.

A criterion for the bank to classify a credit as a Microcredit is its size varying from 15 000 to 25 000 Euro. Usually the banks have simple procedures to assess and provide micro credits and they target the micro and SMEs with a wide range of schemes and short provision terms. As examples - unsecured overdraft - up to 25 000 Euro, for 5 years, interest rate 12.95 %; longterm credits, up to 40 000 Euro, for 25 years, but with a mortgage; swift credits for micro-enterprises - up to 50 000 Euro, for 7 years, interest rate 6.75 %. As a bonus the banks provide additional products and services at preferential prices - bank cards, life or accident insurance.

For the second quarter of this year microcrediting amounts totally to appr. 500 million. Euro. Most of the microcredits have been provided for trade and maintenance of cars, followed by the processing industry.

However, due to the current financial turmoil, entering its second year, the Bulgarian National Bank last year raised the minimum reserves of the commercial banks and the reaction of the banks to the unfriendly economic environment was to slightly raise the interest rates of the credits only provided in the national currency.

In parallel to the economic aspect of microcrediting during the last years a social aspect was performed as well and particularly a guaranteed fund for microcrediting was established by the Ministry of labour and social affairs with objectives such as facilitating investments and job creation by easy access to financing, with an interest rate between 6 and 8%. The scheme covers producers in the agriculture sector, freelancers, etc.

Good opportunities for microcrediting are available in the operative programmes and structural funds of the EU, amongst other, in the form of grants for micro and SMEs to cover their investment expenses and to obtain better liquidity, to finance pre-feasibility studies, etc.

Another form are the bilateral credit agreements between a bank and an international financing institution focusing on direct by subsidising the end-borrower.

The expectations of the sector of financial services in the country are to achieve growth in absolute terms as well as a share of the GDP in the next 3 to 5 years. And the scope will be broadened to get involved non-bank institutions as well. That will be the logical consequence stemming from the overall economic development of the country.

Directorate-General for Internal Policies
Directorate A - Economic and Scientific Policy
Policy Department A-Economic and Scientific Policy and Quality of Life Unit

Microcredit in the EU:

Briefing Note

Definition of Microfinance

Microfinance is a broad concept and refers to the provision of financial services, including not just credit, but all financial products, such as savings, microinsurance, guarantees and fund transfers, to low-income clients, who usually have no access to traditional banking services. Some Microfinance institutions also offer business advice and counselling.

Microcredit is defined as loan below 25.000,00 Euro (Council Decision 2000/819/EC) to individuals who do not qualify for traditional bank loans. It can be an effective measure in the ongoing struggle against poverty, enabling those without access to lending institutions to borrow at bank rates, and start or extend small, self-sustaining business.

Target groups

Microcredit in Europe mainly addresses 2 target groups:

- Small and medium sized enterprises (SMEs):

  The category of micro, small and medium sized enterprises is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding 50 million Euro and/or an annual balance sheet total not exceeding 43 million Euro.

  Within the SME category, a small enterprise is defined as an enterprise which employs fewer that 50 persons and whose annual turnover and/or annual balance sheet total does not exceed 10 million Euro.

  Within the SME category, a microenterprise is defined as an enterprise which employs less than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed 2 million Euro. (Commission Recommendation 2003/361/EC)

  Micro, small and medium-sized enterprises are socially and economically important, since they represent 99 % of all enterprises in the EU and provide around 65 million jobs and contribute to entrepreneurship and innovation.

- Disadvantaged persons:

  The persons that mainly fall under this category are unemployed or inactive people, those receiving social assistance, immigrants and women.

  In developed economies intense competition within the financial sector, combined with a diverse mix of different types of financial institutions, ensures that most people have access to some financial services.

However, traditionally banks do not provide financial services to clients with little or no income due to the high risks involved and to client account managing costs. There is a break-even point in loan and deposit sizes below which banks lose money on each transaction they make and poor people usually fall below it.

In the EU, microcredit mostly regards SMEs, whereas the segment of disadvantaged people as target for microcredit has only been addressed marginally. In fact, over the last decades, the EU economy has evolved towards a greater dependence on smaller businesses, including one-person business, mostly in services. This has led to increased demand for microcredit that largely exceeds the present existing supply.

This market niche for microcredit is due, in most of the European countries, to the fact that many credit institutions think that providing microcredit is risky and unprofitable.

To compensate this market gap at least partially, most Member States provide public funds that should increase the willingness of financial institutions to offer microcredit.

In its Green Paper on Entrepreneurship in Europe released in 2003 (COM(2003) 27 final), the EU Commission panders to particularly focus on the facilitation and the acceleration of business start-ups, the access to competitive capital and the encouragement of entrepreneurship in young people. For this reason the Commission attaches considerable importance to the offer of microcredit to new or young companies. The offer of microcredit is supposed to contribute to the renewal and the further development of industrial economy and to strengthen entrepreneurial initiative in the member states.

Governments can encourage financial institutions even more to offer microcredit by setting favourable conditions for microfinancing, allowing direct financial support or drafting specific social protection regulations for small and start-up businesses.

Microfinance providers

1. Informal financial service providers:

Examples for such providers are: moneylenders, pawnbrokers, saving collectors, money-guards, and input supply shops.

The main advantages of informal financial service providers are that they are flexible and convenient and mostly provide fast services.

On the other hand they are extremely costly and the choice of financial products is rather limited and short term.

2. Member owned organizations:

Member owned financial institutions in microcredit are private business organizations owned and controlled by the people who use its products, supplies or services.

This kind of organization is generally small and local which permits low operation costs and certain flexibility. But since providers often have little financial skills they can run into trouble when the economy turns down or operations become too complex. Some examples are: self-help-groups, credit unions, local saving associations (CVECAs).

Member-owned financial institutions face three challenges:

1. effective internal management of the operations,
2. monitoring and enforcement of loan contracts, and
3. building mutual trust and relationships with the community by offering their member owners value propositions that can meaningfully translate into improved lives.

The extent to which they meet these challenges is largely determined by a variety of economic, social, and moral incentives.

3. Non-governmental Organizations (NGOs)

NGOs are legally constituted organizations created by private organizations or people with no participation or representation of any government. In the cases in which NGOs are funded totally or partially by governments, the NGO maintains its non-governmental status insofar as it excludes government representatives from membership in the organization. A large number of the NGOs have engaged in purveying micro credit outside the orbit of the banking system.

NGOs offer innovative pioneering banking techniques like solidarity lending, village banking, and mobile banking that have overcome barriers to serving poor populations. However it has to be taken in account that their governance structure can be fragile and they can become overly dependent on external donors.

Some examples: Grameen Bank, BRAC (Bangladesh), Prodem (Bolivia), FINCA INTERNATIONAL (Washington)

<u>Example: Grameen Bank</u>

The Grameen Bank is a microcredit organization and a community development bank started in Bangladesh that makes small loans to the impoverished without requiring collateral. A group-based credit approach is applied, which utilizes the peer-pressure within the group to ensure repayment, which eventually allows the borrowers to develop good credit standing. The bank also accepts deposit, provides other services and runs several development-oriented businesses. A distinctive feature of the bank's credit programme is that a significant majority of its borrowers (97%) are women.

The origin of the Grameen Bank can be traced back to 1976, when Professor Muhammad Yunus from the University of Chittagong launched a research project to design a credit delivery system to provide credit and banking services to the rural poor. As a result of its success, the Grameen Bank was transformed into an independent bank by government legislation in October 1983. Today the Grameen Bank is owned by the rural poor whom it serves. Borrowers of the bank own 90% of its shares, while the remaining 10% is owned by the government. The organization and its founder were jointly awarded the Nobel Peace Prize in 2006.

4. Formal financial institutions

Formal institutions involved in microcredit are for example: commercial banks, state banks, agricultural development banks, rural banks, non-bank financial institutions

These institutions, due to the fact that they are regulated and supervised, offer a wide range of financial services but they are often reluctant to adopt social missions and present high costs of operation.

Formal banks are not only directly involved in microcredit by providing it, but also play an indirect role by supplying credit lines to NGOs engaged in microcredit, who on-lend the money to their clients. Banks have indeed a particular interest in such investment activities because they can obtain specific information about this customer segment and outsource their operating costs. Moreover, they have the possibility to take over the clients from MFIs, once they have turned 'bankable'. MFIs on the other hand learn techniques such as customer evaluation methods and scoring from banks.

Partnerships may also develop through sharing of operating costs, risk hedging and securitization.

Collateral in Microcredit

One of the distinctive features of microcredit is that it is accessible also to financially disadvantaged people who are most of the time not able to give sufficient collateral and/or to demonstrate a positive credit history.

Despite the lack of 'classic' collateral in the microcredit sector, the following mechanisms, varying depending on different countries and different microcredit models, have been developed to guarantee the reimbursement of the credits:

- Strict screening of credit applications:

  The loss rate can generally be lowered by a more strict screening of credit applications, approving only 4-5% of the requested loans in order to make sure that only reliable clients get credit.

  However, according to the EU Commission, it is the goal of microcredit initiatives to address especially disadvantaged target groups who do not fulfil classical conditions to get credit and therefore represent a bigger risk for banks. Those groups would be disadvantaged by a more severe application screening.

- Group credit and group collateral:

  This method represents a step towards making credit low-risk and less time-consuming for the banks. It consists in making all group members pay into a common fund before the assignment of the credit. If one group member gets into delay of payment, the other members can decide whether to pay his debt with the thus accumulated budget or not.

  This procedure represents a safety-factor for the bank because on the one hand there is a fall back budget and on the other hand the loss rate lowers automatically because of the group pressure.

> Example: Women's Employment, Enterprise and Training Union (WEETU), UK
> WEETU is a non-profit institution that has developed the Full Circle Fund for women in Norfolk and Waveney. The ambition of the fund is to support women with low income in starting small businesses by providing access to credit. To raise a credit, participants have to form peer groups of five to seven women on a voluntary basis and to vote chairperson, record taker and credit controller within the group. The credit takes the form of a group credit, which means that the members of the group get access to financing one after another and each group member only gets her financing when her predecessor has amortized her reimbursement for the most part.

- 'Private' Underwriter for the credit taker:

  According to this methodology, private underwriters can cover a certain percentage of the requested collateral by engaging to step into the breach in case of delay of payment.

  The idea is to perform a pressure on the debtor to reduce the probability of delay or loss, just as for the group collateral. In patriarchal cultures for example, credits that are underwritten by the father, are largely refunded because of the great familial pressure.

Example: Siebte Säule, Germany
The loan value has to be granted for 50% by a third party underwriter who should help out the credit taker in financial crisis situations to maintain a positive balance of payments.

- Acquisition of risk and loan guarantee by institutions external to the bank:

  Different institutions can facilitate the access to microcredit by providing part of the collateral or complete missing collateral by underwriting.

Example: Association pour le droit à l'initiative économique (ADIE), France
ADIE is entitled to receive credit lines from commercial banks and to on-lend the money to its clients. Beneficiaries are mainly unemployed or welfare recipients. 70% of the approved loans is disbursed by banks. The risk is spread between ADIE (70%) and the bank (30%). In case of delay in payment of 3 credit cards, ADIE entirely buys the credit from the bank and assumes the debt collecting and thus the risk.

- Step-lending:

  In these cases there is an initial disbursement of only a subtotal of the approved loan, all other subtotals being disbursed only under condition that the previous sum has been successfully paid back. This helps the client in creating a positive credit history.

Example: Monex, Germany
The regional orientated microcredit fund Monex exists without proper legal structure. The main target are unemployed who want to start their own business. To participate in the programme, they have to develop a business plan which undergoes a qualified evaluation and to follow a coaching and control programme.
All credits are provided in form of step-lending, which consists in initially disbursing a subtotal of the loan, the other subtotals being disbursed only under condition that the previous subtotal has been successfully paid back.

- Symbolic value:

  Credit takers can give as collateral items with no high monetary value but with a high personal value for them.

- Ongoing supervision:

  Supervise and provide advice to clients, even after the business start-up, to detect potential financial crisis situations in time and to optimize this way the probability of a high success rate.

European Fund Raising for Microfinance Institutions

In the banking model as well as in the non banking model, public intervention is often necessary to bridge gaps or failures of the market. This support is provided at EU, national and regional level by promotional or state-owned banks, special funds and public guarantee mechanisms.

At EU level, the following mechanisms have been put in place:

Microcredit window of the SME Guarantee Facility

This window is managed by the European Investment Fund (EIF) on behalf of the European Commission. Since June 2002, a SME guarantee facility has been available within the multiannual programme for the promotion of entrepreneurship and enterprise (MAP). As of march 2003, five microcredit institutions already signed an agreement with EIF.

The MAP has also been opened to Candidate Countries.

EIF fee policy

Beyond the risk sharing method used by EIF in the MAP microcredit, a fee is awarded to the microcredit institution for each microloan provided. The support is available in the form of a lump sum, in order to partially offset the relatively high administrative costs inherent to microcredit. It does not exceed EUR 200 per loan granted and is payable to the financial intermediary, subject to the intermediary's representation that it has not granted or guaranteed any other loan to the same final beneficiary. The maximum aggregate amount of technical support payable to one intermediary is EUR 100.000.

CIP (Competitiveness and Innovation Framework Programme)

Insufficient innovation is considered a major cause of Europe's disappointing growth performance. In order to stimulate growth and employment in Europe, the Competitiveness and Innovation Framework Programme has been adopted for the period 2007-2013. It aims to help enterprises innovate by providing access to finance and to encourage the competitiveness of European enterprises. With SMEs as its main target, the programme will support innovation activities, provide better access to finance and deliver business support services. The CIP is proposed to become one of the main Community measures contributing to generating economic growth and creating more jobs.

The CIP is divided into three operational programmes, of which the entrepreneurship and innovation programme (EIP) is of particular interest for microcredit:

- entrepreneurship and innovation programme (EIP)
- information communication technologies policy support programme (ICT PSP)
- Intelligent Energy Europe (IEE)

New actions in CIP:

CIP will add a new risk capital instrument (High growth and innovative company facility, GIF2) to foster SME start-ups. GIF2 will leverage private capital to overcome the lack of capital in innovative and high growth SMEs at their most crucial growth phase.

The SME Guarantee Facility alleviates access for SMEs to financing, microcredit and equity or quasi-equity. This facility also includes a new instrument for securitization of bank loan portfolios that will free up further SME loan capacity amongst smaller and regional banks. This is important to develop availability of proximity financing for more traditional small businesses.

Euro Info Centre and Innovation Relay Centre networks will be developed to offer one-stop-shops for services in support of business and innovation.

JEREMIE (Joint European Resources for Micro and Medium Enterprises)

JEREMIE is an initiative of the European Commission together with the European Investment Bank (EIB) and the European Investment Fund (EIF) in order to promote increased access to finance for the development of micro, small and medium-sized enterprises in the regions of the EU.

Economical growth, jobs and the availability of capital for new business formation are problematic fields in Europe. JEREMIE is designed to help overcome these difficulties, by creating a framework for cooperation with specialised financial institutions, the EIF and EIB. Financial resources are derived from EU Structural Funds and monies issued by the Commission to EU Member States and their Regions of development. The initiative offers new opportunities for Member States and Regions to invest and re-invest Structural Funds using a range of financial instruments, instead of grants. This means that funds are used to maximum advantage and also that they can be used for a longer period for the benefit of SMEs.

JEREMIE's financial instruments draw on the EIB Groups' expertise in SME finance, notably guarantees, venture capital, securitization and loans. The products operate on market terms to encourage the participation of private as well as public financial institutions.

JASMINE (Joint Action to Support Microfinance Institutions in Europe)

The Commission and the EIB Group have decided to create JASMINE as a new tool with a special emphasis on microcredit, as other community initiatives appear to have a wide application range that makes the objective to specifically focus on the support of microfinancial institutions difficult to achieve. JASMINE is supposed to structure and finance the technical assistance offered to MFIs and banks in order to ensure the lasting appropriation of these practices. This tool should identify opportunities for growth for MFIs in all of the European countries.

The initiative should furthermore define the best practices for accelerating the distribution of microcredit and should promote financial inclusion in the EU. In the framework of this project, a code of conduct will be drawn up for MFIs and banks by the end of this year.

The objective of these programs is to encourage intermediaries to provide microcredit financing and to assist in mitigating the fact that microcredit financing typically involves proportionately higher unit handling costs.

Synergies and complementarities between the new Community financial instruments for microcredit

(E.g. loans < EUR 25 000)

	CIP **Competitiveness and Innovation Program** **SME guarantee facility for microcredit**	**JEREMIE** **Joint European Resources for MIcro to medium Enterprises**	**JASMINE** **Joint Action to Support Microfinance Institutions in Europe**
Funding	European Commission (DG ENTR)	Structural Funds (e.g. ERDF)	European Investment Bank, banks, DG REGIO, cooperation with European Parliament
Management	EIF	Decision by Managing Authorities (Member states, Regions): EIF / Other financial institutions	EIF
Target	Financial institutions including MFIs	Financial institutions including MFIs	Non-banking MFIs, financial institutions
Financial instruments	Guarantees + technical support	Toolbox (equity, guarantees, etc)	Co-investment facility and Technical assistance
Final beneficiaries	Micro enterprises with a focus on financing of entrepreneurs starting their business	Micro enterprises	Entrepreneurs starting their business, entrepreneurs excluded from the banking sector
Geographical scope	EU 27 + Candidate countries + EFTA	EU 27 (only in those countries where MA have signed a JEREMIE agreement)	EU 27

Source: European Investment Bank

Microcredit - Legislation in the EU

The European Union aims to make its economy more dynamic and inclusive. SMEs play an important role in this issue as providers of employment opportunities and key players for the wellbeing of local and regional communities. Self employment and micro-enterprises could therefore be supported with specific policy measures that make the entrepreneurial environment easier to access.

Raising the right kind of finance is still one of the major difficulties for many entrepreneurs and SMEs and microfinance could be one of the tools to resolve this situation.

Microcredit is diversely dealt with in the Member States of the Union, depending on the policy framework and the legislation in place. Some Member States have already taken measures to promote microcredit, but these measures appear to be quite specific and sometimes only regionally applicable.

In Europe, only France and Romania have specific legislation on microcredit. In other countries microcredit is regulated under the laws governing the institutions that provide it.

The regulation concerning the banking sector is clear and harmonised to a certain extent by European banking law, whereas the regulatory approach to microcredit provided by non-banks differs from country to country.

Special regulatory cases are credit unions and financial co-operatives (regulated by own laws) The main supplier of microcredit to small firms is the banking system. Microcredit providers operating under banking law have to fulfil all the requirements of banking legislation (European banking legislation and national banking laws).

Regulation in France:

According to the French Banking Act, only banks may engage in credit transactions. However, there are a few exceptions to this principle, one concerning microcredit: Voluntary associations are allowed to grant loans from their own funds and from funds borrowed from banks, for the creation and development of businesses by unemployed or by social benefits recipients. The Microcredit Committee licenses and controls these voluntary associations, who must prove experience in supporting start-up projects. The individual loans accorded must not be larger than EUR 6000 and are limited to the first five years of the business since its creation.

So far ADIE is the only organization that makes use of this special window

Regulation in Romania:

In 2005, Romania adopted a law in order to create a legal framework for the organization, operation and development of 'microfinance commercial companies'. These institutions grant microcredits but are not allowed to take deposit. They can also offer business services such as consulting and training. Funding can come from internal sources, banks, donors or public funds. The foundation of an MFI must be notified to the National Bank of Romania after its registration in the trade register and the minimum share capital is EUR 200.000. MFIs must establish internal rules for the provision of credit, ensuring data protection and certain prudential standards, and concerning internal control. The MFI must be audited by an external contractor.

MFIs have to provide an annual report on the microcredit portfolio structure to the National Bank of Romania and they have to inform the Central Banking Risks Office and the Credit Office about risk and granted credits.

Rules on interest rates or usury:

Usury laws are state laws that specify the maximum legal interest rate at which loans can be made. In Europe interest rate caps or rules on usury exist in order to protect consumers from overindebtedness and predatory lending practices. As regards the microcredit sector, considering the absence of a unitary legal framework, this is an important concern as Member States should ensure that certain minimum quality standards for the pricing of microcredit are applied. Transparent information and understandable conditions for microloans must be taken as preventive measures against usury. However, setting a maximum limit to interest rates can be a problem, because the relatively higher risk and administrative costs may not be covered. Interest rates on microloans should make risk-adjusted, cost-covering lending to business possible.

In some of the Member States, rules on interest rates already exist:

Belgium for example, regulates usury rates for instalment credit according to loan amount and reimbursement period.

In Germany maximum interest rates are limited by a usury law that forbids charging more than double the average interest rate in the sector or exceeding it by 12 percentage points.

In Italy an interest rate is usury if it exceeds by more than 50 % the average annual effective global rate applied by banks and financial intermediaries.

Poland limited the maximum interest rate on consumer credit to four times the Central Bank Lombard rate.

It can be observed that, whereas, for instance, the Italian and Polish interest rate caps could be limiting factors for risk adjusted lending and cost coverage, the German system, for example, delivers consumer protection but at the same time leaves room for some interest spread.

Rules on tax:

A complementary way to foster the supply for microcredit could also be to setup a favourable fiscal status for microcredit institutions (tax waivers or incentives) and tax incentives for investors supplying funds to microcredit retailers. At the present time, only few countries favour investment in small companies with a special tax regulation.

In Ireland, employees who leave employment, as well as unemployed, who start a new business can get a tax refund. The Seed Capital Scheme foresees a refund that can be as high as all of the income tax paid over six years, if the investment is high enough.

In the UK individuals and companies are encouraged to invest in disadvantaged communities with a community investment tax relief scheme. Tax relief is available to individuals and companies and is worth up to 25% of the value of the investment. The relief is spread over five years, starting with the year in which the investment is made.

Securitization

There are different ways for credit institutions to spread and diversify the risk of their portfolios. One of the methodologies that have particularly evolved in the last years is securitization.

Securitization is a structured finance process, which consists in pooling and repackaging of cash-flow producing financial assets into securities that are then sold to investors.

Advantages of securitization:

The securitization process permits the credit institution to change the configuration of its balance sheet: the credit is moved 'off balance sheet' and is transformed in liquidity. Banks can thus expand the amount of credit available using the same capital base and, on the other hand, clients have access to a corresponding larger pool of credit.

Moreover, securities issued in the Securitization are more highly rated by participating rating reducing the cost of funds in comparison with traditional forms of financing, because investors have access to a better diversified portfolio of assets.

These advantages are tempered by the fact that the Securitization structure results in higher costs than traditional forms of financing, which means that the value of a pool of Receivables must be significant to justify securitization. Securitization has also been severely criticised for increasing market opacity.

Securitization and Microfinance:

As a sub investment grade product, microcredit is often financed by securitization; this practice has increased more and more over the last years.

The process of securitization of microfinance results in the transfer of SME loans to the capital market, by transforming claims into securities, which may be able to be sold and traded on the capital markets.

Securitization can provide access to the capital markets for smaller banks that can club together, pool their portfolios and get capital market funding. This is particularly relevant in the case of microcredit which is traditionally the preserve of smaller banks.

Inclusion in the capital requirement directive (CRD):

To improve disclosure and transparency in the securitization process, the Commission recently proposed a far reaching amendment to the CRD, which would have the effect of preventing EU regulated banks from investing in securitizations where the originator held less than 10% of the 'net economic interest' of the relevant tranches of instruments.

This proposal met with hard criticism. Responders reproach that it would induce a false sense of security in investors, who would simply substitute reliance on the 10% requirement for reliance on credit ratings. It would thus not force investors to do their own due diligence. Securitization procedures would not be secure enough and would not be subject to appropriate control mechanisms.

As a result of the global credit crisis, the market in securitized credit in general and in microcredit in particular has been severely damaged. When the process of securitization goes 'wrong', the microcredit as underlying asset faces the risk to get a bad reputation, although the microfinance product itself is uncoupled from the bank's balance sheet.

The future for securitization of microcredit would appear to depend on the degree to which the market can establish a separate identity, free of the abuses which have characterised the rest of the securitised market and the extent of investor appetite for ethical investment

Measuring the success of microcredit:

To measure the performance of microcredit, the following indicators can be relevant:

- Pay back rate of credit-takers related to the number of credit-takers
- Survival rate of the funded companies

- Employment creation
- Loss rate
- Operative and financial profitability

The last 3 factors along with the pay back rate provide information about whether a microcredit programme pays for itself in financial terms.

To achieve a profitable allocation of microcredit, expensive cost structures should be avoided. The amount lent, the duration and holdback payment should be geared to the expected cash flow of the credit taking company. Risk- refinancing- and administrative costs can be covered by higher interests and fees.

In the EU about 50% of start-up companies don't survive the first 5 years of existence. This rate is lower in those Member States that make available high quality assistance - also facilitation to access funds - for young entrepreneurs in the start-up phase, but also for already existing small enterprises.

Only the individual selection and consulting of microcredit takers makes it possible to identify those who are most likely to pay their credit back, in order to lower loss rates. A common problem in Europe is the standardisation of evaluation and selection procedures. Standardizing evaluation and selection instruments in order to gain time and money means the loss of the possibility to diagnose out of experience if a business-starter is credible, if he will be able to transpose his idea successfully.

It therefore seems essential that the involved bank employees get trained especially for the selection of microcredit takers or that the bank allows a selection consulting by trained personal.

Short Criticism

Microcredit is often considered one of the most effective and flexible strategies in the fight against global poverty.

However, some aspects have been severely criticised, inter alia the level of interest rates that appears to be high. The nature of microcredit - small loans - is such that interest rates need to be high to return the cost of the loan.

A micro-finance institution (MFI) has to cover 3 kinds of costs: cost of the money that it lends, cost of loan defaults (proportional to the amount lent) and transaction costs (not proportional to the amount lent)

When loan sizes get very small, transaction costs loom larger because they can't be cut below certain minimums.

On the other hand, it must be kept in mind, that without microcredit, clients would rely on moneylenders who lend at even higher interest rates, or would not have any access to credit at all.

Microcredit in Europe

Briefing papers by members of the Financial Services Experts Panel

Microcredit in Europe

Microcredit in banking

Briefing Paper for the Workshop on Microcredit, 18 September 2008, held by the Committee on Economic and Monetary Affairs of the European Parliament

International Training Center for Bankers Ltd, Hungary

I. Executive summary

Microcredit is an important means to address various social problems like poverty and unemployment, and to foster economic growth. However, due to market imperfections possible demand for microcredit cannot be satisfied with current supply. To reduce the gap between demands and supply the EU has already taken several steps; now the need for a regulation of microcredit at EU level is on agenda.

Ín out paper we argue that banking regulation should not be eased in order to promote microcredit. A relaxation in the requirements for microcredit lending would increase systematic risks in the banking sector, which is not in line with the idea of protecting the interests of depositors.

Bankable clients do have access to microfinance to date, whereas non-bankable clients represent too high risks and costs for commercial banks. We believe that commercial banks should refrain from financing non-bankable individuals and enterprises directly, on a social basis.

Nonetheless, this does not mean that commercial banks should not be involved in the microcredit business. We support public schemes to promote microcredit. Commercial banks can play an intermediary role in its provision; therefore it is vital that the institutional framework of cooperation between the various actors in microcredit exists.

While we do not see any possibility for a relaxation in the banking regulation, EU regulation on nonbank microfinance institutions would create a level playing field on the microcredit market; it would increase transparency and enhance coordination between initiatives to support micro-, small and medium enterprises. Cooperation and coordination is a key factor in a successful program in our opinion.

It is a feature of microcredit that local information plays a substantial role both in its distribution and in managing its risks. In many cases it is the lack of information about clients that hinders the expansion of microcredit. While there is often an existing infrastructure with the necessary knowledge about local businesses and markets (e.g. Savings and Loans Associations in Hungary), Member States and the EU should strive for a more complete coverage of concerned regions with local microcredit providers.

Obtaining this information and in general microcredit requires personal contact with clients and therefore it is a labour intense activity. This is also magnified by the fact that a successful microcredit program requires a lot of counselling to and training of entrepreneurs. The question arises whether the effects of high labour cost on microcredit institutions' budgets can and should be mitigated.

The Expert Group Report on the Regulation of Microcredit in Europe aptly recognizes that there is a wide spectrum of goals and target groups of microcredit, and that it "is reflected in the variety of legal forms of microcredit providers and the regulations that cover them".

As a result, different kinds of microcredit should not be treated identically; every aspect of microcredit should be investigated from the point of view of all major types of microcredit.

The two main segments we identified are the socially excluded and start-up and non-bankable enterprises. A prospective regulation of microcredit in Europe should also reflect this variability.

II. Background

Many Member States and the Commission of the European Communities discovered the importance of microcredit in the development of the SME sector which can be a means to move towards the Lisbon targets. Another aspect of microfinance is that it can help promote self-employment and as a result reduce unemployment, poverty and ethnic disparities.

While a lot has been done in fostering microfinance (e.g. the JEREMIE program), further efforts should be done to promote microcredit, and the need for an EU level regulation has also emerged. Following a series of Communication papers and Expert Group Reports, the Committee on Economic and Monetary Affairs requested a series of briefing papers in view of the ECON Workshop on Microcredit in Europe. In this paper we respond to the request of the Committee.

In preparation for a common regulation of microcredit in Europe, several questions have emerged in connection with the banking sector, such as:

- What role should the banking sector play in the provision of microcredit?
- Is microcredit lending a retail or wholesale activity?
- What kind of techniques do currently banks use to assess, monitor and manage their microcredit exposure?
- How should the training of bankers take microcredit into account?

Below, we will first introduce our general view on microcredit, and then in the rest of the paper we provide answers to the questions above. We would like to stress the following: when investigating current banking practices in microcredit lending, the spectrum of the investigation can only cover those clients that banks accept. As a result, the relevance of our answers to the questions can only be limited; they are not necessarily true for nonbank clients.

III. General statements on microcredit

In this paper we define microcredit – following the Commission's definition – as loans less than €25 000. We distinguish between three different types of microcredit:

- social loans to individuals;
- loans to individuals with a purpose of starting up an enterprise;
- loans to small and medium enterprises.

These types of microcredit differ significantly in many ways e.g. in terms of size, target group, possible distribution channels. As a consequence different measures have to be taken to tackle problems that hinder the provision of these kinds of microcredit. In the following we will discuss the three types in details:

1. Consumer credit to non-bankable individuals

One specific target group of microcredit can be the poor regardless of the definition: those who live under living standards, do not have permanent job and regular income, live in regions economically lagging behind, etc.

Traditionally, this group of people did not belong to the target of commercial banks due to the high risk of default and high costs of monitoring. Therefore these people did either not receive loans, or they received them from non-bank institutions, or other sources at a very high expense.

The example of Provident

In Hungary in compliance with the EU regulation financial institutions are classified as financial service providers if they lend money regardless that they do or do not take deposits, and they are regulated by the Financial Supervisory Authority. One of these institutions is Provident, one the most well-known non-bank institutions in Hungary providing microcredit to non-bankable individuals. The key of their success is a country-wide network of agents. Agents deliver microcredit personally in cash, and they also visit debtors to collect repayments weekly.

One can draw the conclusion that

- personal contact with clients is essential for this kind of lending, and as a result
- it is a highly labour intense activity.

Because there are no collaterals behind these loans, the success comes to a high price of a

- typical APR between 200 and 300%. (These high rates are due to the short maturity of loans, the lack of collaterals and the high level operational costs.)

We would also like to point out that traditional risk management tools such as statistical models and scorecards do not perform as good as in the commercial banking practice considering the lack of information about clients.

The reason we explicitly deal with this kind of loan is that it can push the poor into a debt spiral. Even if they can avoid this vicious circle, high costs of borrowing can prevent them from breaking out of poverty. Therefore different tools should be considered to tackle this problem:

- applying guarantees to lower interest rates
- applying interest rate caps
- lowering interest rate by subsidising

In our view the role of the public sector is essential in social microcredit lending, and so the regulation should primarily concentrate on choosing the best instruments and appropriate institutional forms.

In the rest of the paper we do not deal with this type of lending, however we believe that because of its relevance to poverty the EU should initiate steps towards a socially more responsible personal micro-lending.

2. Enterprise start-up loans to individuals

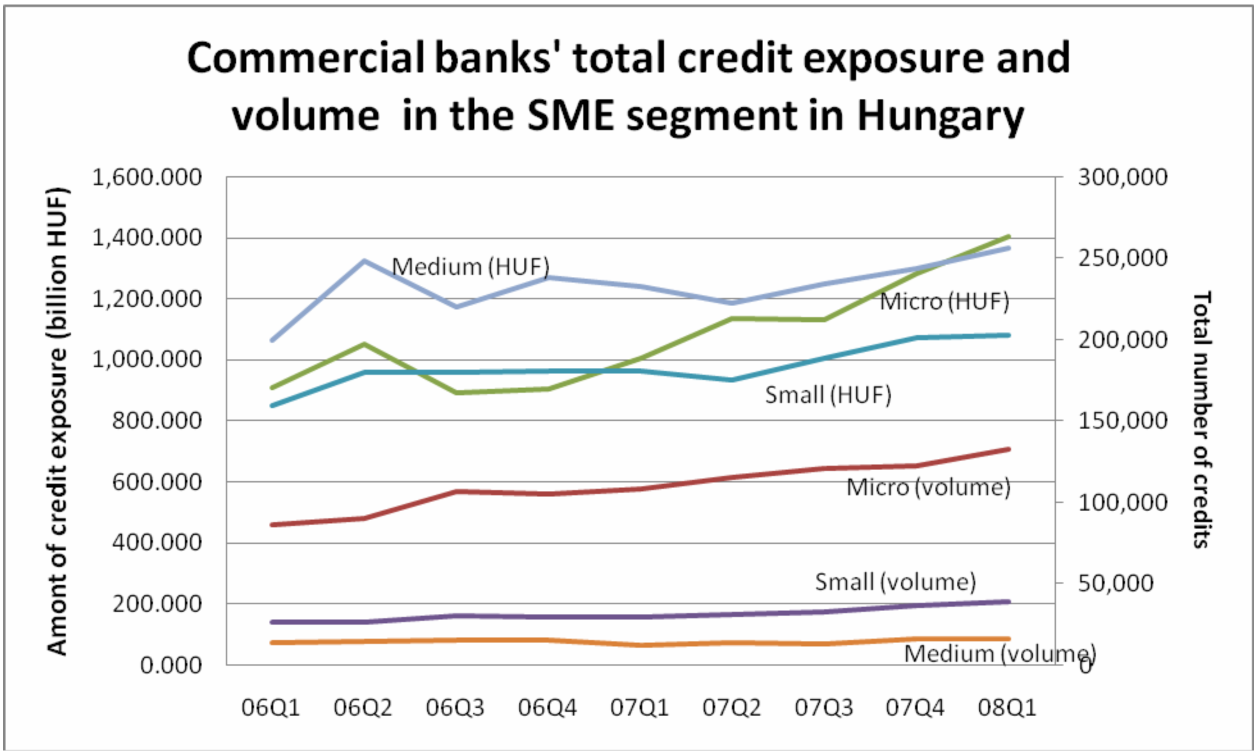
Since start-up enterprises have no track records, risks and costs prevent commercial banks from providing such loans under pure market conditions. At the same time, this kind of loans can help tackle unemployment through promoting self-employment, therefore enterprise start-up loans should receive the greatest attention when trying to reduce unemployment or integrate ethnic groups.

3. Microcredit to SMEs

We recognize a growing attention from commercial banks to this sector due to a growing demand from bankable enterprises for microcredit.

Expansion of microcredit in Hungary

The following figure shows that there was an extensive growth in both the volume and exposure of credits in the SME segment in Hungary over the last two years (exposure on the primary vertical axis, volume on the secondary axis; source: Hungarian Financial Supervisory Authority).

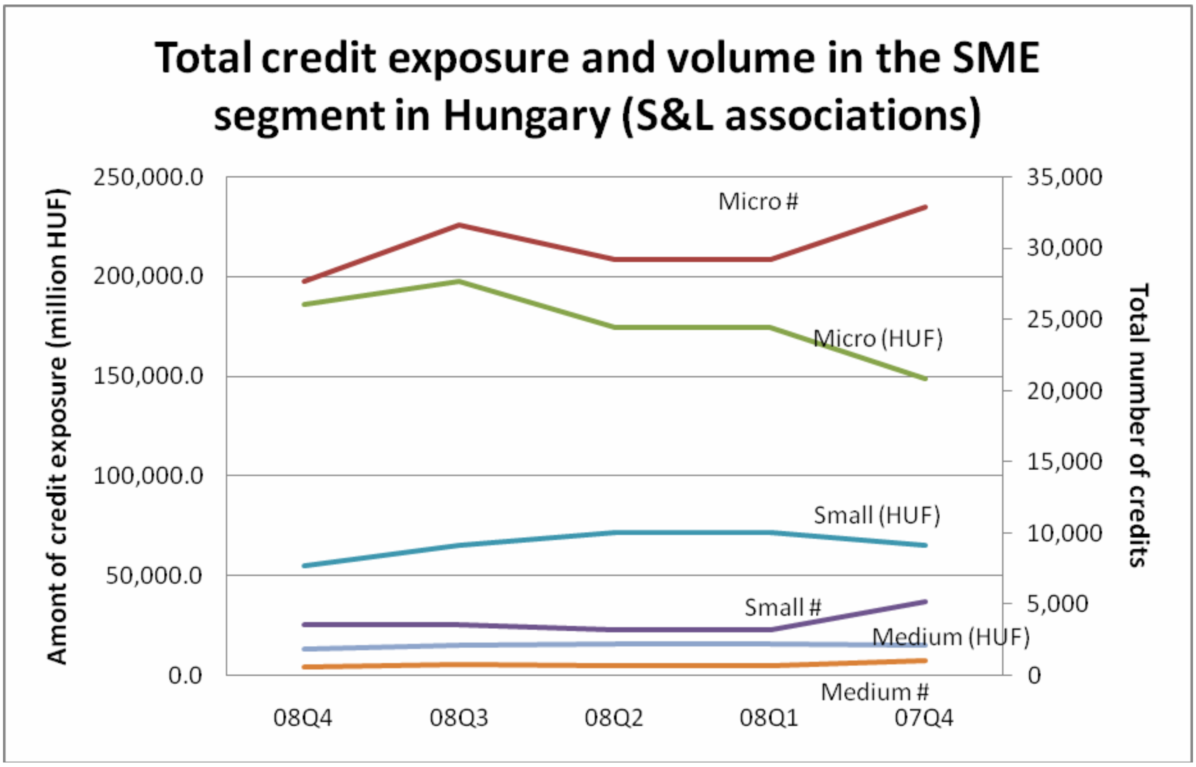


(The Hungarian National Bank's official currency exchange rate is 214.99 HUF/EUR valid on 5th September, 2008.)

In the SME sector microenterprise financing experienced the fastest growth; total exposure of the Hungarian commercial banks to this sector grew by more than 50% over the last two years.

We have to add that not all credits provided to microenterprises are microcredit. This is a consequence of a difference in definitions: microenterprises are defined as enterprises with an annual net income of less than HUF 500 million (€2 million), and the average amount of loans in this sector is app. €40,000 which exceeds the limit of microcredit in our definition. Nevertheless, we believe that these figures still show the right tendencies in micro-financing.

Local information is very important factor in the provision of microcredit and therefore it requires a broad network whose members are close to the target groups. Such a network exists in Hungary in the form of Savings and Loans Associations. These institutions possess a lot of local information and are able to finance clients that commercial banks would not do. In the micro segment the average loan size is smaller than in the case of commercial banks, thus their activity is closer to what we call microcredit lending. As it can be seen on the following figure, S&L Associations increased the volume of their microcredit lending, however, the average loan size and their total exposure decreased. This also shows that these Institutions have better opportunities to provide small size loans than commercial banks.



However, there is also a big group of microenterprises that are facing difficulties when applying for loans. Key features of this kind of loans are:

- scoring systems do not assess these enterprises appropriately,
- a microcredit scheme performs better if there is state aid included,
- commercial banks have the incentive to accept SMEs because they earn good profits on other financial services like account maintenance.

Széchenyi Card – working capital financing for SMEs

In Hungary KA-VOSZ designed a product named Széchenyi Card to ease the access to loans for micro, small, and medium enterprises. KA-VOSZ Financial Services Trading Close Co., a sponsored institution, is a joint corporation of the National Organization of government Entrepreneurs and Employers and the Hungarian Chamber of Commerce and Industry.

Up till now, Széchenyi Card is the most (and only) successful effort in Hungary to provide microcredit to a wide range of SMEs with relatively light conditions.

The applicants have the right to choose the bank to contract with, among those participating in the programme. There are five commercial banks involved in the program, representing 75% of the Hungarian banking sector.

The revolving credit limit for the Széchenyi Card can be either 500,000 HUF (€ 2,000) or any round million amount between 1 million and 25 million HUF (€ 100,000), based on the applicant's choice, the pre-qualification of KA-VOSZ, and the Bank's client qualification.

This revolving credit is guaranteed by Garantiqa, a partly state owned company, and counter guaranteed by the Government Treasury.

The product is successful, but it comes to a price of:

- state aid in the form of interest rate subsidising and a 50% repayment from the guarantee fee payable by the debtor,
- a high rate of default (4% since inception in contrast to an average rate of default of 1,5-2% in the SME sector),
- a high rate of credit fraud (nearly half of the defaulted credits was related to fraud in at least two large commercial banks).

Our general point of view is that microcredit is a powerful tool to promote SMEs development, and to fight poverty and unemployment through self-employment, but it should not be regulated under banking regulation. Our main points regarding microcredit are:

- without state contribution microcredit schemes are likely to underperform;
- local networks, knowing the local economic and social circumstances are of great importance when lending to micro enterprises;
- microcredit lending is highly labour intense;
- micro-financing can only be successful if it is supported with sufficient training of and counselling to entrepreneurs;
- microcredit facilities should support SMEs to qualify for other EU sources;
- a credit register (positive and negative) would serve well the expansion of microcredit;
- microcredit initiatives should be consistent.

Uncoordinated microcredit programs

We believe that there are too many institutions in Hungary working independently on the provision of microcredit, and it would be beneficial if these efforts were coordinated.

The following institutions are all either fully or partly state owned, and their purpose is to promote economic development mainly in the SME sector. Promoting microcredit is a purpose of all of them. These institutions are:

- Hungarian Development Bank (MFB): provides different kinds of microcredit to SMEs and start-up ventures.
- Garantiqa Creditguarantee Co.: provides guarantees to SMEs, most of their products are state-granted
- Rural Credit Guarantee Foundation (AVHGA): aims at improving rural SMEs access to financing and ensuring their financial viability by issuing guarantees
- Venture Finance Hungary Private Limited Co. (MV Zrt.): the main activity of the Company is providing guarantee/collateral, in addition to which it acts as intermediary for assistance funds. Moreover, it also runs a microcredit and a venture capital program.

As mentioned, these institutions are all government-backed, but their operation needs more coordination since there are many ad hoc initiatives and overlapping areas in their activities.

IV. Specific questions

1. How do commercial banks active in the microcredit business assess, monitor, manage and control the risks of these exposures?

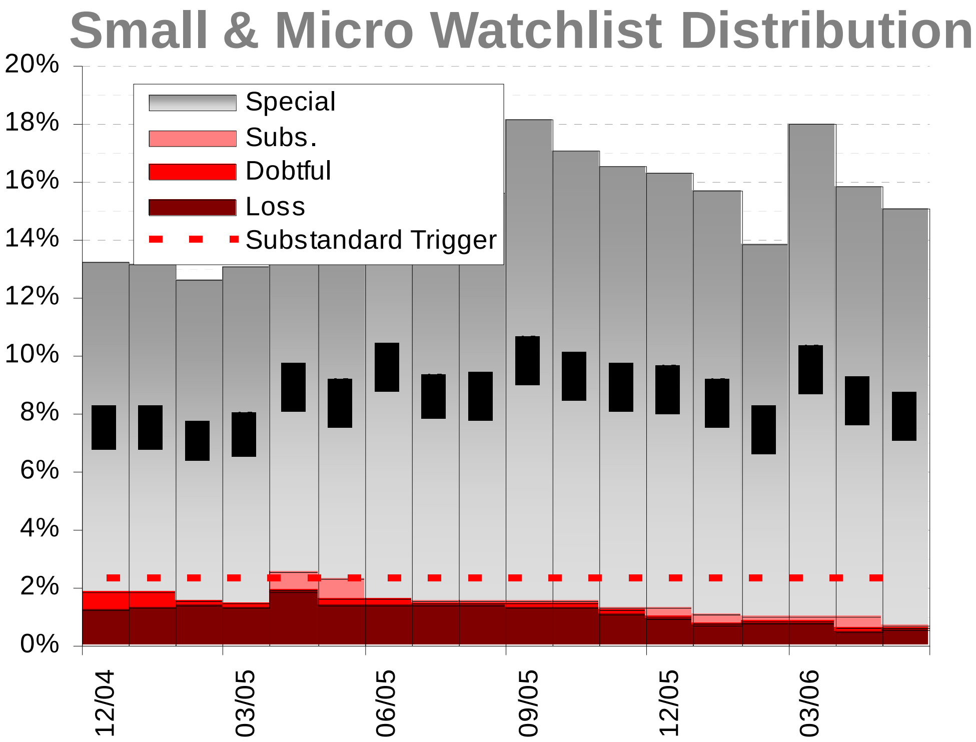
Banks active in the microcredit business most commonly use scorecards to assess the risks of their credit exposure. Scorecards are a combination of statistical and expert methods used to rank clients in an order of creditworthiness. This way banks sort clients into good and bad debtors and they refuse the bad ones.

Microcredit exposures are monitored on a portfolio level with Portfolio Quality Reports. Monitored indicators are usually the following (among others):

- Number of clients on Work-Out unit,
- 12 month Gross/Net Write Off,
- Work-Out recovery,
- Industry concentration,
- Ratio of portfolio with a delinquency of over 30/60/90 days.
- Work-Out cycle time.

Portfolio quality – an example

Portfolio Quality Reports usually comprise a lot of visual information; hereby we introduce an example from the Report of a representative Hungarian commercial bank. The diagram shows the ratio of loans classified by quality.



As opposed to large loans, microcredit exposures are monitored and managed in a mass-like manner, however special reports aim at screening out bad or doubtful loans, which will then be treated with special attention.

To control the risks of their microcredit portfolio banks adjust their standard product offering. As such, they adjust:

- the level of collaterals required,
- data on clients required,
- the speed of administration,
- the minimum level of gross income to qualify for credit.

The other way to control microcredit exposures is to transfer risks. It is common that banks accept certain groups of clients only if the credit deal is guaranteed by other banks, state or a guarantee institution.

Personal contact with clients can reduce the risk of non-performance at redemption:

Provident's practice to collect repayments – the role of personal contact

As mentioned above, Provident uses regular and personal contact with their clients to collect repayments. This personal contact provides a strong control over default and strengthens the institution's monitoring activity.

We would like to underline that the lighter the requirements for application are, the higher the risk to fraudulent activity is. This can be observed in the case of the already mentioned Széchenyi Card as well: since anyone who fulfils a few administrative conditions can claim this credit, supposedly many clients use this credit with a purpose of intentional default.

2. Is it seen as a retail or wholesale activity and does this have implications for the expansion of microcredit?

Microcredit is normally seen as a retail activity, and we see no implications for its expansion. Moreover, commercial banks treat microcredit as a retail product, and they use similar techniques in its provision.

As mentioned above, knowing the local socio-economic environment and the local businesses is very important in the dispersion of microcredit. Banks are well aware of that, thus in acquiring clients they usually rely on a wide network of agents. This network then ensures that the necessary information is at hand.

Another way of distributing microcredit can be through regional "credit-boutiques", in which case it would be a wholesale activity from the bank's point of view. However, this should not have any effect to the expansion of microcredit; it is a matter of size, whether it is more efficient to run this business with retail or wholesale techniques.

3. How should the training of bankers take microcredit into account? What basic messages on microcredit should be transmitted to professionals?

Since we believe the banking community should reserve to a more conservative behaviour, we suggest that the following messages should be transmitted to professionals:

- Banks should not get involved in financing those enterprises/individuals that they cannot monitor with traditional banking tools.
- Although micro-enterprises are more and more important clients for traditional commercial banks, socially driven micro-financing provides no direct benefits for banks. Nonetheless, the SME sector is important for the economy as a whole, and thus banks can benefit indirectly from strengthening the SME sector.
- Microcredit can help SMEs to stabilise their market situation and later become good clients for banks.
- Risk-mitigation techniques should be introduced to those professionals who want to be engaged in micro-financing, e.g. group-lending, stepped lending.
- Micro-financing should be part of a complex service: counselling and training of new entrepreneurs is an essential tool to help enterprises be successful and thus good debtors.
- Social micro-financing can not work under pure market conditions, but there are existing banking and non-banking models that do work.
- Bankers can contribute to a broader promotion of microcredit to non-bankable enterprises and individuals through cooperation with other partners and through transmitting know-how to these partners.
- In microcredit lending local information is substantial: knowing the client personally, knowing the local market and products can help reduce risks.

- By extending the traditional client segmentation practice (retail/corporate), professionals should be get acquainted with the SME sector as a further segment along with its own specialities regarding risks, features of SME products, etc.

4. There are specific target groups of microcredit, such as immigrants, women, Roma. How can these groups and their need for microcredit be best served by the banking community?

We find it problematic that commercial banks could directly support specific target groups with microfinance due to problems with the identification of target groups. For example in some Member States privacy regulation prohibits data handling on ethnic origin for banks. Moreover, in our opinion the conservative banker’s view cannot be accommodated with lending on a social basis, because of the high costs and risks.

However, public support schemes proved to be very efficient in promoting microcredit. Apart from central government initiatives, the role of the local governments is especially important, because they possess a lot of local information.

Cooperation between banks, microfinance institutions (MFIs), local governments and local venture development institutions could be a key factor in a successful microcredit scheme. The banking community can contribute to this cooperation in the following ways:

- Transferring know-how to MFIs (Microfinance Institution) on
    - how to manage risk exposure (different types of risks: primarily credit and operational risk);
    - fraud management;
    - scorecards.
- Create a public Credit Register
    - Banks can also help create a public Credit Register used by micro-finance institutions. The existence of negative credit registers are already wide, however positive credit registers could significantly increase the creditworthiness of individuals belonging to target groups considered.
    - A problem has to be tackled though: already defaulted entrepreneurs should get a second chance to restart the business, so that they will not be excluded from the labour market as self-employed.

A credit register already exists in Hungary but only bad creditors are recorded. A positive credit register would certainly contribute to the provision of microcredit in Hungary. Credit registers have a stronger effect for relatively small firms and in low-reform countries, those that probably have the biggest need for microcredit (Jappelli, Tullio: Information sharing and credit market performance ITCB Conference on Credit Bureaus and Credit Registers, Budapest, 2 April 2007).

- Financing MFIs
    - Banks can provide cheap funding to MFIs, but it has to be ensured via guarantees that depositors balances are not at risk.
- Design special products for specific groups with the intention to start up enterprises
    - In cooperation with private equity funds and guarantee institutions banks can support start-up enterprises by providing funding.
    - Because of the high risks public contribution is probably necessary.

V. References

Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions – “Think Small First”; A “Small Business Act” for Europe; 25.6.2008; Brussels (COM2008 394)

Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions – A European initiative for the development of micro-credit in support of growth and employment; 13.11.2007; Brussels (COM2007 708)

Expert Group Report – The Regulation of Microcredit in Europe; April 2007.

Microcredit in Europe
What Community Action for Micro-Credit?

Briefing Paper for the Workshop on Microcredit, 18 September 2008, held by the Committee on Economic and Monetary Affairs of the European Parliament

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Executive summary

The Committee requested an opinion on which aspects of micro-credit could be regulated at European level. This briefing paper endeavours to answer to this complex question and is organized as follows. Paragraph 2 provides a brief overview of the development of micro-credit and microfinance within and outside Europe and shows its current and expected impact on the economy. Paragraph 3 describes the Commission's action plan. Paragraph 4 offers some recommendations on how to possibly fine-tune the proposed EU action plan distinguishing between banks and non-banks MFIs.

a) As regards the banking model of micro-credit (i.e. micro-credit provided for by commercial banks, savings banks, credit cooperatives and micro-finance banks), the focus of community or national legislative initiatives should be, in my view, on the specificities of risk management for micro credit and on the incentives to be given to banks to support financial inclusion and small businesses. I welcome, therefore, the Commission initiative to establish wider provisions on loan guarantees (which should operate, however, according to rules and practices, to be duly supervised, directed at minimizing moral hazard of the borrowers), whereas I am sceptical on securitisation of micro-credit loans portfolios, considered also that micro-loans are often without a formal rating. In addition to that, regulators should endeavour to foster the use of alternative methods and more appropriate credit scoring techniques for assessing the credit risk of micro-credit, recognizing a more favourable treatment under CRD to those micro-credit loans which historical records indicate as less risky (see e.g. loans extended to non profit institutions). In turn, as regards the incentives to be given to existing (small, medium size and big) banks to engage in micro-credit programmes to promote grass-roots entrepreneurship, useful lessons can be drawn from the US 1977 Community Reinvestment Act and its anti-redlining provisions, which proved effective in downscaling the banking activity (both directly and through the Community Development Finance Institutions and Corporations) in the best interest of local communities and of low income borrowers (today 20% of the total loans granted to private clients in the US).

b) As regards non bank providers of micro-credit, the focus should be, in my view, on a (ideally harmonized) regulation of the entities (MFIs). Hard and soft regulation should both be in place and converge and should be directed at instituting appropriate management and internal control systems for MFI, at establishing an adequate public supervision, at fostering networking (also through the establishment of "second level" MFIs federal organizations providing regional and/or national coordination and technical assistance and support to their members) and at developing best practices for lending. There is also a clear need to push MFIs towards optimal scale reorganization, long term self-sustainability and portfolio growth. MFIs should moreover be regularly subject to performance rating.

Although MFI do not pose a problem of protection of depositors, a sound regulatory and supervisory framework is nevertheless recommended, in my view, to enhance the protection of the public funds, the protection of borrowers and the trust of donors, banks and other financial institutions on which MFIs rely, at least partially, for their funding and which in turn must rely on the MFIs to overcome informational asymmetries and access segments of clients which, in many circumstances, would not be bankable without the “intermediation” (in terms of credit assessment and mentoring) of the MFIs. Regulation and supervision should obviously be proportionate refraining from imposing unnecessary costs.

The paper concludes considering also a recent Italian experience deserving, in my opinion, the full attention of European regulators.

1.- The Committee requested an opinion on the following question: "Which aspects of micro-credit could be regulated at European level in order to support growth and employment? What form should a European initiative take? Should existing financial services legislation take micro-credit into account (e.g. the proposed revision of CRD)? If so, what form should it take and if not should an explicit exclusion of micro-credit be stated?". This briefing paper endeavours to answer to these (complex) questions in the few pages requested and is organized as follows. Paragraph 2 provides a brief overview of the development of micro-credit and microfinance within and outside Europe and shows its current and expected impact on the economy. Paragraph 3 describes the Commission's action plan. Paragraph 4 attempts at answering to the questions raised, considering also some insights from an innovative approach to micro-credit and social banking recently emerged in the Italian practice deserving, in my opinion, the full attention of European regulators.

2.- Micro-credit is the extension of very small loans (micro-loans) to entrepreneurs, to social economy enterprises, to employees who wish to become self employed, to people working in the informal economy and to the unemployed and others living in poverty who are not considered bankable according to prevailing commercial banking standards ([1]). It has become a popular, albeit controversial ([2]), method of facilitating development, not only in poor countries but also in the poorer segments of the richest societies, especially to provide financial support to start ups or micro enterprises, to non profit organizations and to "unbanked" people and other disadvantaged persons. Indeed, traditional commercial banks, with few exceptions ([3]), have failed so far to meet adequately the demand for credit by those who cannot offer physical collateral, but may be nevertheless creditworthy, especially in the light of the entrepreneurial projects they intend to pursue and finance. Responding to such market failure, the last twenty-five years or so have witnessed a rapid expansion, worldwide, in the number and size of micro-finance and micro-credit institutions ([4]), often encouraged by public support mechanisms (some of which offered also at the European level: see in particular EU PHARE, European Investment Fund and European Bank for Reconstruction and Development programmes).

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[1] European Commission, *A European initiative for the development of micro-credit in support of growth and employement*, COM (2007) 708 final, Brussels, 13 November 2007.

[2] For a critical assessment of micro-credit as a suitable development instrument for developing countries see for example R.Dyal Chand, *Reflection in a Distant Mirror: Why the West has Misperceived the Grameen Bank's Vision of Microcredit*, Northeastern University School of Law, Working Papers Series no. 13, 2007 (available at http://ssrn/abstract=962374); for the lessons to be learnt from the failure of the Canadian Calmeadow Metrofund experience, T.Williams, *Requiem for microcredit? The decline of a romantic ideal* (2001), available at http://ssrn/abstract=976211 (showing how peer lending did not work in the US and Canada and advocating for "the imposition on financial institutions of strictly regulated duties to serve disadvantaged communities", albeit at the same time recognizing that "strict regulation is unlikely to happen in Canada given the political economy of the financial services sector and the long-lasting tradition of soft law, codes of practice and other voluntary initiatives")

[3] Some illustrative examples in ABI – Fondazione Giordano Dell'Amore, *Banche e microfinanza*, Bancaria Editrice, Roma, 2006, p. 30-36

[4] Literature is extremely rich: compare at least *From Microfinance to Small Business Finance*, eds. Leleux and Constantinou, Palgrave Mc Millan, 2007, *passim*; *Microfinance for Poverty Reduction: Building Inclusive Financial Sectors in Asia and the Pacific*, UN ESCAP, Development Paper no. 27, New York, 2006, *passim*; ABI – Fondazione Giordano Dell'Amore, *Banche e microfinanza*, Bancaria Editrice, *passim*; M.Novak, *Non si presta solo ai ricchi – la rivoluzione del microcredito*, Einaudi, 2005, passim;, passim; M.Schreiner, *Rural Microfinance in Argentina After the Tequila Crisis*, Edwin Mellen Press, 2004, *passim*. N.Uddin, *Regional Rural Banks and Development*, Mittal Publications, New Dehli, 2003 *passim*. More recently see J.Midgley, *Microenterprise, global poverty and social development, International Social Work*, 2008, p. 467-479; R.Mendoza, N.Thelen, *Innovations to Make Markets More Inclusive for the Poor, Development Policy Review*, 2008, p. 427-458, especially at 444-448

Nature, size, operational features and economic and financial outcomes of these micro-finance and micro-credit institutions vary significantly from country to country and from institution to institution. Nevertheless, it is well recognized that today micro-finance and micro-credit institutions are already numerous in many developing and developed countries, herein included all Member States ([5]), and in aggregate serve a large number of clients (according to CGAP by 2000 they already served worldwide about 12,5 million individuals) ([6]). Certainly, it is not to believe that micro-credit is a new phenomenon in Europe; on the contrary, it has a lengthy and distinguished history embracing the early English lending charities, the Irish Loan funds and, above all, the savings banks and credit cooperatives dating back to the *19th* century ([7]). Interestingly enough, a look at history reveals, however, that organizations that depended on charitable (external) funding were more fragile and tended to lose their focus more quickly that those that obtained funds from depositors ([8]). A lesson which could prove useful in tackling today the regulation of the industry.

There are obviously significant differences in the patterns of micro-credit and micro-finance developed in Europe and in developing countries (first of all the Grameen Bank of Bangladesh and the BRI Bank in Indonesia). Existing literature on micro-credit in Europe shows indeed that in Europe: a) potential clients are only a (relatively) small fraction of the overall population; b) the average number of active clients of each institution is low (about 400) and these clients tend to passively respond to micro-credit offers rather than to actively search for a credit opportunity; c) group lending and other peer lending practices used in developing countries and based on community control are not applicable; d) micro-credit and micro-finance institutions are much more financially included in Europe and are therefore exposed to the competition of commercial and cooperatives banks, which are increasingly applying risk management methods less based only on physical collaterals (they increasingly evaluate also the creditworthiness of entrepreneurial projects and the client's re-payment track record); e) micro-loans are usually of significant amount (up to Euro 25.000,00), thereby diminishing the dissemination of risk especially for thinly capitalized institutions; f) average interest rates are around 10/15% (as opposed to the 40-60% in developing countries); g) operating and transaction costs are high; h) only a small percentage of the institutions other than banks operating also in the micro-credit sector reaches economic self-sustainability. As a consequence, given their tendency to make losses or earn below market returns on capital, many and perhaps most of the micro-finance institutions other than banks are associated with NGOs and/or rely on support from their (public or private) donors: subsidies can take various forms form initial capital injection or loans at preferential terms to operational subsidies in cash or in kind to the provision of training and/or technical assistance ([9]).

[5] For an overview of European experiences, compare L.Viganò, *Microfinanza in Europa*, Fondazione Giordano dell'Amore, Milano, Giuffré Editore, 2004, *passim (*where detailed information on more than 50 significant institutions active in the EU-15 Member States).

[6] D.C.Hardy, P.Holden, V. Prokopenko, *Microfinance Institutions and Public Policy*, IMF Working Paper, September 2002, p. 3.

[7] A.Hollin, A.Sweetman, *Microcredit: What Can we Learn form the Past*, 26 *World Development* (1998), p. 1875. As opposed to the US experience of credit unions, European credit cooperatives are generally subject to general banking law and supervision: see however, for an exception, the 163 long lasting "casse peote" (informal credit associations) still existing in the Italian Veneto and Friuli Venezia Giulia.

[8] A.Hollin, A.Sweetman, *Microcredit: What Can we Learn form the Past,* at p. 1877.

[9] Records on the increasing role of MicroFinance Investment Funds in ABI, Fondazione Giordano Dell'Amore, *Banche e microfinanza*, especially at p. 41-70 and A.Latortue, E.Littlefield, H.Siedek, K.McKee, *Managing the Floodgates? Making the Most of International Flows of Microfinance Funding*, working paper 2007 (available at ssrn). Compare also D. von Stuffenberg, Rating *Microfinance Institutions in Latin America and Africa*, in *From Microfinance to Small Business Finance*, p. 169 (explaining that private investment funds are often seduced by the fact that "MFI are nearly always very liquid. Their portfolio quality is very good compared with commercial

These specificities must certainly be taken into consideration in a European regulatory perspective. It should be acknowledged, at the same time, that Europe is also going through several very successful experiences of micro-credit and micro-finance in recent years (to mention but a few: Etimos, Banca Etica, CGM Finance, SEFEA in Italy, Oikokredit in the Netherlands, La Nef in France, GLS in Germany, CREDAL in Belgium). These experiences show that micro-credit and micro-finance succeed where providers are able to build a strong and effective network of on going social controls over the borrowers: a feature which is often reflected also in the risk management techniques applied (see for instance the "VARI" method applied by Italian Banca Etica coupling ordinary risk management methods with additional social indicators). The "know your customer" principle matters here at the utmost: delinquency rates are strictly correlated, indeed, to the effectiveness of *ex ante* and *ex post* social controls over the borrowers. Social proximity and a rigorous and effective creditworthiness assessment are essential.

3.- The Commission, following its Staff Working Document of 2004 on "Microcredit for European small businesses" ([10]) and the works and recommendations of its Expert Group ([11]), with its Communication on "A European initiative for the development of micro-credit" acknowledged that "in the Member States and regions of the European Union micro-credit is often used as a means of encouraging the growth of self-employment and the formation and development of micro-enterprises. As such micro-credit can play an important role in the realisation of the Lisbon strategy for growth and jobs and the promotion of social inclusion". It also recognized that: a) whilst there is an active micro-credit sector in many Member States and a number of actions have been taken, there is clear evidence that much more can be done"; b) "evidence suggests that banks engage in micro-credit activities (directly or more often in partnership with non bank institutions) where they are encouraged to do so by public support mechanisms"; c) there is scope for Community action in the field, first of all, to improve the legal and institutional environment. In this respect the Commission, blaming that "the institutional framework in the Member States appears to be often ill-suited to the development of micro-credit" due to the fact that micro credit is not specifically addressed in the national or Community legislation, proposes: a) to encourage banks to develop micro-credit operations, directly or through non bank MFIs through a wider provision of loan guarantees and, as portfolio develop, by securitisation; b) to help micro-credit to become sustainable by relaxing interest caps for micro-credit operations; c) to allow MFIs access to borrower databases on default and losses related to micro finance (individuals, enterprises and MFIs);

d) to reduce operating costs applying favourable tax schemes; e) to confirm existing EU prudential regulation and supervision for institutions engaged in micro-credit when receiving deposits and other repayable funds from the public and to adapt national regulation and supervision to micro-finance institutions not taking customer deposit so as to ensure that it is proportionate to its costs and to the risks MFIs pose, "so that it does not put a brake on the supply of micro-credit and the growth of specialist MFIs"; f) to examine the needs for a European passport for MFIs other than banks engaged in the micro-credit sector; g) to avoid regulatory overkill (as it would be the case if new rules would overly limit the necessary flexibility of operations and impose high burden to the lenders), "by making a prior inventory of best practices and by confronting the proposed legislative framework with the reality of the national micro-credit operations".

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banks in the same countries. In addition, leverage is low. To top it all off, MFI tend to be much more profitable than banks")

[10] SEC (2004) 1156 of 11 September 2004

[11] Expert Group Report, *The Regulation of Microcredit in Europe*, Brussels, April 2007.

In addition to that the Commission intends to promote the spread of best practices. In fact, it rightly points out that "if non bank organisations have much to learn from the banks, the opposite is also true, as methods developed for providing and recovering micro-credit differ from traditional banking techniques. This exchange of know how would allow inter alia better integration of quantitative methods such as scoring, which are beginning to extend to micro-credit and trust generating contacts, on which the micro-project and its reimbursement depends". To this purpose the Commission identifies the need for a "central body with financial and social expertise and the ability to monitor and coordinate action in support of micro-credit and to act as a permanent discussion partner for those in the field".

Finally the Commission calls for a specific micro-credit facility providing funding and technical assistance to new and non-bank MFIs to enhance the supply of micro-credit. In fact, as correctly noted already in the Staff Working Document of 2004, "in addition to micro-loans, the provision of non-financial services, in particular mentoring, is essential to increase the chance of survival of start-ups and small enterprises".

The Commission's action plan seems to me generally appropriate. I agree, nevertheless, with part of the industry ([12]) that in implementing such action plan there is a need for additional fine-tuning.

On one hand, legislation must be effectively proportionate to the "wide ranging variety of institutions offering micro-credit in Europe, whether they are banks, non banks of other types of institutions". This means, that regulatory challenges are different for banks and non-banks providing micro-credit and micro-finance.

a) As regards the banking model of micro-credit (i.e. micro-credit provided for by commercial banks, savings banks, credit cooperatives and micro-finance banks, where they exist as it is the case of ProCredit in Bulgaria and Romania), since banks are already strictly regulated and supervised, the focus of community or national legislative initiatives should be, in my view, on the specificities of risk management for micro credit and on the incentives to be given to banks to support the growth of small businesses. As already pointed out by the Commission's Expert Group, "in the banking model it was not so much regulation that hindered the provision of micro-credit but risk and costs. Financial institutions regard microloans as risky if there is no collateral. This combined with asymmetric information effect and the fact that processing microloans involves a certain amount of fixed costs, means that the smaller the loan, the less profitable the loan is likely to be to the lender. There are however, at least in some Member States, systems in place to address these problems. Business support services help to reduce transaction costs. The risk of having no collateral is mitigated by a guarantee consortium or a guarantee fund". I certainly welcome, therefore, the Commission initiative to establish wider provisions on loan guarantees: these guarantee funds should operate, however, according to rules and practices to be duly supervised which should be directed at minimizing moral hazard of the borrowers. On the contrary, I am sceptical, and even more so following the recent financial crisis, on securitisation of micro-credit loans portfolios, considered also that micro-loans are often without a formal rating. In addition to that, as already noted in the literature ([13]), regulators in developed countries, where peer lending and social collateral is rarely viable, should endeavour to foster the use alternative methods and more appropriate credit scoring techniques for assessing the credit risk of micro-loans.

[12] *ESBG's views on the European Commission Communication*, Position Paper, Brussels, 14 February 2008.
[13] N.Bhatt, S.Tang, *Making Microcredit Work in the United States: Social, Financial and Administrative Dimensions*, in 15 *Economic Development Quarterly* (2001), p. 229, at p. 236

As it has been rightly said ([14]), “such methods could include landlords references, savings records, and proofs of car payments or utility bill payments. Although it may somewhat increase program administrative costs to access such records, the strategy may help to identify low income individuals who lack a strong credit history but have demonstrated reasonable repayment discipline in the recent past. In addition, programs might secure their loans with items such as television sets, stereo units, furniture, pieces of equipment or cars. Although such non-traditional or creative collateral might not have significant market value compared to the loan amounts disbursed, they are often important to individual borrowers and have been known to serve as effective security against wilful default for some of the more prominent US programs”. If the use of more appropriate credit scoring techniques coupled with historical records show that the credit risk diminish, it could be recognized to such less risky micro loans a more favourable treatment under CRD (see e.g. loans extended to non profit institutions). In turn, as regards the incentives to be given to existing banks to engage in micro-credit programmes to promote grass-roots entrepreneurship, useful lessons can be drawn from the US 1977 Community Reinvestment Act and its anti-redlining provisions, which proved effective in downscaling the banking activity (both directly and through the Community Development Finance Institutions and Corporations) in the best interest of local communities and of low income borrowers (today 20% of the total loans granted to private clients in the US).

b) As regards non bank providers of micro-credit, the focus should be, in my view, on a (ideally harmonized) regulation of the entities (MFIs). Hard and soft regulation should both be in place and converge and should be directed at instituting appropriate management and internal control systems for MFI, at establishing an adequate public supervision, at fostering networking (also through the establishment of “second level” MFIs federal organizations providing regional and/or national coordination and technical assistance and support to their members according to organisational model successfully experienced for instance by credit cooperatives in most Member States) and at developing best practices for lending. There is also a clear need to push MFIs towards optimal scale reorganization, long term self-sustainability and portfolio growth. Electronic platforms where supply and demand of small micro-credits could meet should also be encouraged (along the lines of a few pioneering projects already in place) to respond to transaction costs. MFIs should moreover be regularly subject to performance rating: it is essential indeed to measure on an on going basis and through already existing specialised entities (like MicroRate) if the MFIs personnel is successful in conducting needs assessment, in analyzing and approving loans, in developing information systems for tracking repayments, to administer technical assistance to the borrowers and collection procedures, in a word how good is the institution in providing micro-credit. Although MFIs do not pose a problem of protection of depositors, a sound regulatory and supervisory framework is nevertheless recommended, in my view, to enhance the protection of the public funds, the protection of borrowers and the trust of donors, banks and other financial institutions on which MFIs rely, at least partially, for their funding and which in turn must rely on the MFIs to overcome informational asymmetries and access segments of clients which, in many circumstances, would not be bankable without the “intermediation” (both in terms of creditworthiness assessment and mentoring) of the MFIs. Regulation and supervision should obviously be proportionate refraining from imposing unnecessary costs.

[14] N.Bhatt, S.Tang, *Making Microcredit Work in the United States: Social, Financial and Administrative Dimensions*, p. 236.

On the other hand, I would advocate some caution in relaxing too much interest caps for micro-credit operations. Whilst it is clear that interest rate must be fairly related to risk and that anti-usury caps could in some circumstances prevent micro-credit and micro-finance institutions from attain self-sustainability, it should be also considered that micro-credit patterns which proved successful in developing countries are not “exportable” as such in Europe and that excessive interests rates would prevent micro-credit from effectively deliver its expected beneficial social effects. I would spend therefore more regulatory efforts on guarantee funds and other similar arrangements to limit the risk as well as on efforts towards the standardisation of lending practices (to decrease transaction costs) rather than on excessive relaxation of interest rate caps.

4.- To conclude, I believe that in devising an appropriate regulatory response to micro-credit at the European level, it should be considered, first, that micro-credit and microfinance are certainly essential to economic and social development and must be promoted, therefore, also through appropriate public intervention and tax incentives. Second, that microcredit and microfinance institutions should attain economic sustainability and should not be based solely or principally on grants or on any other form of paternalistic philanthropy. In this respect, history shows that deposit taking, self-help (as it is the case of cooperatives and credit unions) and/or strong local bonding (as it is also the case of investments in micro-credit made by established banks or financial institutions - herein included savings foundations - as a firm and long term commitment to their community) matter to ensure sustainability and success in the long run. Third, that both banks (specialized or not specialized) and non banks should be very active in the field: in many circumstances, to be successful both actors must pool their specific knowledge and act together, networking also with external training structures, like Universities or private and public small business development centers (as it has been rightly said, “micro-enterprise development experiences from around the world provide few examples of good lenders being good trainers and vice versa) ([15]).

I also believe that banks are called to upgrade the degree of financial inclusion and that it is even in their best economic interest to do so, as many examples of recent years show. This can be done through different business models: from the simple extension of loans to MFIs to the creation by a bank or by a banking group of a business unit or even a specialized bank devoted to micro-credit. A remarkable example of this latter model is represented by a recent innovative Italian bank (called “Prossima s.p.a.”), incorporated in May 2007, which started operation on October 2007. This initiative is noticeable in size and in character. It is noticeable in size, because “Prossima s.p.a.” is a fully owned subsidiary of “Intesa San Paolo”, a major Italian player in the national banking industry. As such, it has been adequately capitalized from its very outset and operates nationally and internationally also through the existing network of “Banca Intesa San Paolo”. Noticeable in character, because the new venture features a remarkable market response to increasing social demand for more financial inclusion. This new venture is thus interesting, in our perspective, under several aspects.

a) First of all, because it has been grounded on the Italian existing regulatory framework for banks and joint stock companies (rather than on that of credit cooperatives) whereby making it clear that the bank, notwithstanding its social orientation, is designed to operate as a viable and lasting economic venture for profit.

[15] N.Bhatt, S.Tang, *Making Microcredit Work in the United States: Social, Financial and Administrative Dimensions*, p. 239.

At the same time, however, the articles of association voluntarily and deliberately depart from profit maximization, by explicitly stressing – already in Article 6 – that the company shall necessarily reconcile between its economic and social performance. As set out in Article 6:

> In order to achieve the purposes listed under article 4, the Company shall carry out its lending activities as economically as possible, in order to generate annual profits and to create and add value to the Company and its shareholders. One of its main purposes shall be the provision of favourable lending conditions to social enterprises and other non-profit organisations operating in Italy and/or abroad. The Company shall also engage in lending to micro and small businesses or first-time home buyers and support health, care or training programmes by granting loans to individuals who, because of their race, nationality, social class, sex, age or financial position do not enjoy adequate access to credit. The Company shall provide finance to public or private initiatives promoting support, cooperation and development and contribute to trust funds or other revolving credit facilities for financing or development. The Company shall also be entitled, either individually or in partnership with public or private entities, to set up companies or joint ventures aimed at promoting development. The Company shall support direct and indirect micro loans and micro-credit initiatives in Italy and abroad, partly by pursuing ongoing technical assistance programmes aimed at furthering the creation and development of self-help and micro-credit organisations.

In turn, the same provision is very explicit in excluding from the bank's corporate scope any confusion between social banking and granting and/or charitable activity.

> The Company shall not engage in granting donations or gifts, as it wishes to operate as a going concern over the mid-to-long term in order to gradually increase its customer base, assets and share capital so as to achieve the purposes set out under article 4 above

This would in fact contradict economic sustainability in the long run and would "dissipate" in a one shot game resources which, on the contrary, are intended to be accumulated and serve as an intergenerational engine for social change. The bank, in other terms, does not represent a new vehicle set up to concentrate "in a single shop" all the philanthropic and charitable activities that were and still are carried out by "Intesa San Paolo" group or by its controlling savings foundations. Instead, what is being established is a proper new bank that is willing to profitably operate with the non profit sector and all those who do not have, or have insufficient recourse to credit, for the benefit of its shareholders, stakeholders (herein included its clients) and the community at large. As set out in Article 4 (which posits the foundations of the bank's social mission):

> Subject to articles 5 and 6 of these articles of association, the Company's purpose shall be the creation of value for its shareholders, ensuring at all time the sustainability of its operations in compliance with the law and the criteria of sound and prudent management.

> To this end, the Company shall finance the most deserving non-profit initiatives aimed at providing services to individuals, disseminating culture and education, promoting access to and safeguarding the environment and the arts and providing access to credit and employment. The Company shall cooperate with public and/or private entities on initiatives aimed at promoting the common good by making available its human and financial resources. In order to promote the growth of the social economy in Italy and understand and respond to its challenges, the Company shall avail itself of the advice of a dedicated group of representatives of non-profit organisations who shall provide guidance in its solidarity and development initiatives.

Another remarkable feature of this ambitious program is its international reach which is not confined to Italian territory. The closing paragraph of Article 4 recognizes indeed that:

> The Company shall undertake to make its products, services and funding schemes available in Italy, as far as possible, and subject to the necessary modifications, to the overseas countries where the "Intesa Sanpaolo" banking group is present.

b) Secondly, the mediation between the reasons of capital and the expectations of the community (in other terms: the mechanism that bridges between the shareholders' expectations for profit and the social expectations of other stakeholders) is translated into an innovative (so, at least, to the best of my knowledge) legal provision concerning the allocation of yearly profits. As it can be read under Article 28 of the by-laws:

> "The net profits shown in the accounts, net of the legal reserve and of any other provisions which the Company is required to set aside under the applicable laws in force at the time, shall be distributed as follows:
> a) a share equal to the cost of capital invested by the Bank shall be allocated to a non-distributable statutory reserve to be calculated in accordance with the accounting methods generally employed by the market;
> b) the net yearly dividend allocated to shareholders shall not exceed 50% of the profits approved by the shareholders' meeting, net of the provisions set out under letter a) above;
> c) all remaining profit shall be set aside for solidarity and development initiatives and allocated to a specific Fund for Development and the Social Enterprise. This risk and contingency Fund shall be employed – according to the procedure described here below – to cover losses arising from solidarity and development loans granted by the Company at below-market rates or to persons who do not have, or have only limited access to traditional credit facilities.
> If at the end of the financial year the Company should record losses attributable, in full or in part, to solidarity and development programmes, any such losses shall be fully covered by the Fund for Development and the Social Enterprise. If the above losses, being too great to be covered by the above Fund, the net profit generated by the Company in the following financial years shall be set aside, after the mandatory legal reserve provision, to bring the shareholders' equity back to its previous level, net of the above Fund.

> If, conversely, the operating losses are due to other causes and do not arise from solidarity and development initiatives the Fund under point c) above may be used to cover such losses only after all other voluntary and statutory reserves have been used to this end, including the reserve under point a) above. If the Fund under point c) above is used to cover losses which do not arise from solidarity and development programmes, the net profit of the next two financial years, net of any legal reserve provisions, shall be used to bring the above Fund back to its previous level.
>
> Any dividends which have not been claimed within the prescribed time limit shall be retained by the Company and allocated to the statutory reserve".

This indicates that yearly disposable profits shall be divided into two principal parts. One part devoted, in a specific amount set by the Articles of association, to the further capitalisation of the bank through a net worth reserve not distributable until dissolution. Whereas the remaining part is virtually shared between shareholders and stakeholders on an equal footing (unless shareholders agree to accept less than the maximum amount of dividends to which they are entitled in principle, leaving more resources to the reserve used for corporate social responsibility operations). Shareholders are indeed free to resolve in their ordinary shareholders' meeting a distribution of dividends up to the 50% of such remaining net profits. Stakeholders shall benefit from all the remaining part <u>through the accumulation of such amount in a specific reserve, the (so called) "fund for the development and social undertakings"</u>. This fund does not result in a separate legal entity (as would have been the case if the accumulated amount was segregated in trust or allocated to an external charitable foundation) but remains under the management of the bank's board of directors. <u>However, this fund is specifically designated to "face the risks and cover the losses" stemming from the social banking activities undertaken by the bank in favour of its social constituencies</u>. In particular, when the bank, in conformity with the aims set out in Articles 4-6, lends with interest rates which are below custom market interest rates, the "day one loss" (should this loss become a yearly loss) shall be covered by the fund. Similarly, if the bank lends to a person who, according to custom market practices on risk management, is not "bankable" (or is not entitled to receive a loan, according to ordinary practices, in the amount needed), in case of default of such borrower, the loss is covered by the fund. Clearly enough, due to the coexistence of some corporate and non segregated funds for the benefit of shareholders and some other corporate and non segregated funds for the benefit of stakeholders within a single entity, the proper satisfaction of the expectations of all these different constituencies – as well as the fulfilment of the additional corporate mission to perpetuate this banking model through time in an intergenerational bond, on top of that - relies, in this model, on corporate governance devices. It remains, in other terms, under the responsibility of the board of directors to align the behaviour of the company – profitable banking and social banking for the present and the years to come – along the lines of this nexus of multi-stakeholders' expectations. Losses deriving from for-profit banking and/or social banking are in principle to be resented each by its relevant constituency, as it is shown by the rules concerning coverage of losses which distinguish among the different sources of losses to consistently identify the funds to be used for their coverage.

This is true however only if the yearly bottom line is negative (on the contrary it has been set in the Articles that, as long as the company concludes the year with a profit, no constituency should blame the other if profits are less than they would have been if the bank had not operated in the other sector) and it remains true only if and when the constituency being affected by the loss is in condition to face alone such loss or to repay it in due course. This is obviously so, because – as indicated- there is no asset partitioning and segregation.

c) In order to facilitate the board of directors in duly performing its difficult task – being an active and profitable banker on the one hand and, at the same time, a respectable social banker on the other hand - the corporate governance of the bank is enriched with a new and innovative organ: the committee for the solidarity and development (hereinafter – Committee). This Committee comprises of 6 members with staggered office (in order to ensure continuity of action), 3 of which are appointed by the shareholders' meeting and the other 3 designated by 3 separate external appointing authorities (herein included the President of the EU Parliament), all among candidates possessing consistent professional qualifications. Article 29 sets out in fact that:

> "The Company shall set up a Solidarity and Development Committee comprising six members, who shall be authoritative and independent individuals chosen from among former senior officers of Italian or foreign institutions or non-profit organisations, academics, senior managers of private companies or successful entrepreneurs with relevant experience in the non-profit, cooperation and development, microcredit and microfinance sectors".

The most relevant innovation concerning this new organ refers to its functions. The Committee does not limit itself to advisory functions with respect to the "ethical" profile of the venture (as it is to be found in other cases of corporate social responsibility). Instead, albeit without interfering with the exclusive competence of the board in the management of the company – the Committee provides framework principles and general indications and recommendations to the board with respect to social banking, focusing in particular on the use of the fund for the development considered above. As stipulated by Article 32:

> "in accordance with the purposes listed under article 4 and with the provisions of article 6, the Committee shall issue general or specific guidelines, if necessary by regulation, on the solidarity and development activities to be undertaken by the Company, without prejudice to the powers exclusively reserved to the Board of Directors and in accordance with the criteria of sound and prudent management. In addition, subject to the powers exclusively granted to the internal and external auditors of the Company, the Committee shall monitor the Company's administrative activities relating to solidarity and development initiatives in order to ensure that they are carried out in accordance with the criteria of sound administration, prudent management and transparency, prioritising the use of the Company's resources for solidarity and development programmes according to long-term economic sustainability but with the exclusion of gifts and donations. In performing its technical audit functions, the Committee shall avail itself of the Company's administrative staff and shall notify the outcome of such audits to the chairman and the managing director of the Company.

> The chairman or the managing director shall report to the Committee, generally every other month, on the solidarity and development initiatives implemented by the Company upon the recommendations of the Committee and on any issues which may have emerged.

Under Article 34, the same Committee is responsible for the social balance sheet and is subject to a transparency requirement:

> “The Committee shall report to the shareholders’ meeting on its activities at least annually on the approval of the accounts for the financial year and shall periodically inform, with the agreement of the chairman of the Board of Directors, the markets and the general public of activities carried out and projects approved. Each year the Committee shall draft and issue a year-end report on the achievements and nature of the programmes implemented, which shall be made available to the general public.”

The articles of association discussed herein mark, in my view, an advance in the field and deserve close scrutiny. Indeed, <u>in a regulatory perspective, they call for more attention</u>, on one hand, on the tax incentives which should be granted in order to exempt from taxation profits allocated to the internal guarantee fund; on the other hand, on the specific enabling provisions on corporate governance which might necessary to allow banks to adapt – as it is here the case through the Solidarity and Development Committee – to the specificity of an activity pooling together profitability, sustainability and social mission.

Microcredit in Europe
Securitisation aspects

Briefing Paper for the Workshop on Microcredit, 18 September 2008, held by the Committee on Economic and Monetary Affairs of the European Parliament

Jane Welsh

Executive Summary

1. As a result of the global credit crisis, the market in securitised credit has been severely damaged. It is too early to assess the knock-on impact on specialised markets such as the microcredit market or to guage whether the various proposals by the Financial Stability Forum and the EU in the aftermath of the market turmoil will fully restore market confidence ; the possible timescale for such recovery is unknown.

2. There are advantages for banks, SMEs and investors in securitised products, when the system works smoothly. The advantages for banks are that they can expand the amount of credit available, using the same capital base. SMEs have access to a corresponding larger pool of credit, but are not affected by the securitisation in so far as their relationship with the lending bank remains unaltered. Investors have access to a better diversified portfolio of assets though securitisation.

3. On the other hand, banks have made use of off-balance sheet funding and investment vehicles, which benefited from regulatory and accounting incentives but which operated in an environment where market participants severely underestimated default risks, concentration risks , market risks and liquidity risks. Investors for their part failed to exercise due diligence when investing in structured products, and relied blindly on credit ratings.

4. The Credit Rating Agencies proved to be deficient in performing their key role in the securitisation process. There were weaknesses in rating models and methodologies, inadequate due diligence with regard to the collateral pools underlying rated securities, insufficient disclosure of the assumptions, criteria and methodologies used in rating structured products and inadequate information was provided about the meaning and risk characteristics of structured finance ratings.

5. The future for securitisation of microcredit would appear to depend on the degree to which the market can establish a separate identity, free of the abuses which have characterised the rest of the securitised market and the extent of investor appetite for ethical investment.

Introduction

1. Microcredit is defined as loans to SMEs and individuals of up to Euro 25,000. The process of securitisation of microfinance results in the transfer of SME loans to the capital market , by transforming claims into securities (bonds , notes) which may be able to be sold and traded on the capital markets. A pool of suitable SME loans is selected by the bank or financial institution ("the originator") and sold to a special purpose vehicle (SPV) set up specifically for this purpose . In order to finance the purchase of the loan portfolio, the SPV issues bonds or notes (asset backed securities) on the capital market. ABS are dependent on the performance of the asset portfolio bought by the SPV and investors in the notes are backed by the incoming cash flows of the original loans. The incoming cash flows are allocated to the notes according to a scale of priorities which determines which investors get paid first. This is called the "waterfall" or "tranching" principle. At the top of the structure the notes may be triple AAA rated, which are low risk and are best protected against shortfalls in incoming cash flows. At the bottom end of the structure, the most junior tranche bears the most risk; losses and shortfalls in income will be allocated to this group first.

2. There are two main types of securitisation structure:

- A true sale securitisation, where the portfolio of assets belonging originally to the bank- the originator- is sold to the SPV and does not remain on the balance sheet of the originator.
- A synthetic transaction whereby the portfolio remains on the balance sheet of the originator. The risk is transferred to the capital markets but there is no transfer of the ownership. Protection is bought by credit derivatives.

Pros and Cons of Securitising microcredit portfolios

3. The market perception of securitisation has changed markedly since the beginning of the global credit crisis. It is too early to say whether the negative publicity which securitisation has attracted, generated by the sub-prime crisis, has damaged confidence in all markets, including the embryonic market in microcredit portfolios. What follows assumes that the securitisation market is not fatally damaged – at least for microcredit.

Banks

4. The main advantage of securitisation from the point of view of the bank lender is that the bank can advance more credit, with the same capital base, because it is transferring credit risk and freeing up capital. The advantages of securitisation appear to be even greater for riskier and longer-term loans which demand corresponding long term funding capacity and excess economic capital to support potentially deteriorating credit quality over the lifetime of such loans. With the implementation of Basel II/CRD, loans with a default probability and rating below investment grade are likely to be costly for banks in terms of risk weighting and regulatory capital. Securitisation can help in this respect.

5. Another advantage of securitisation for banks is that it can provide banks with access to alternative long term funding at better rates than they can obtain by issuing bonds in their own name. Securitisation can also provide access to the capital markets for smaller banks that can club together, pool their portfolios and get capital market funding. This is particularly relevant in the case of microcredit which has traditionally been the preserve of the smaller banks.

6. However, the incentive provided by Basel I for securitisation may have disappeared with Basel II/CRD and there are now proposals to strengthen Basel II further, in the light of its perceived shortcomings in relation to risk sensitivity and inflexible approach to rapid innovation. Basel II should, however, result in regulatory capital requirements mirroring more closely actual economic risks. But again it is too early to assess its impact on provision of microcredit. When the global credit outlook improves, the revised risk weightings may also create an incentive for banks to transfer or securitise new types of credit risk. Securitisation may mitigate the adverse impact on the loan supply of banks having to increase their capital and write-offs more quickly than in the past.

7. Although the Originate- to -Distribute (OTD) model of securitisation has worked well over many years, many of the benefits of securitisation were reduced in the years leading up to the credit crisis. Risks that should have been widely dispersed turned out to have been concentrated in entities such as conduits and SIVs which proved unable to bear the risk. Banks ended up with significant exposure to many of the conduits through "contingent credit lines , reputational risks, revenue risks and counterparty credit exposures."[16]In addition, the banks assumed continuing access to funding liquidity and asset market liquidity, which turned out not to be the case. Those financial institutions which supposedly packaged and sold on their credit exposures , in fact retained a significant proportion of these exposures , without adequate risk assessment or planning for the possibility that the market for these instruments could evaporate overnight.

8. To address these problems, the FSF recommended an improvement in disclosure and transparency. The FSF concluded that, because some market participants were better able to weather the shocks resulting from the market turmoil, the problem lay less in the OTD model or securitisation itself than in incorrect incentives for the firms in the securitisation chain, including at the originator and at the CRA level.

Investors

9. From the point of view of investors, the asset-backed securities created by securitisation of loan assets give investors access to a much wider range of assets, which should mean better diversification of investment portfolios. Whereas it would be risky to invest in a single SME, it is more prudent to invest in notes backed by a portfolio of SMEs. But securitisation has been severely criticised for increasing market opacity.

10. All too often, investors have been unaware of the nature and quality of the assets underpinning a securitisation, and have been willing to take on unknown risks, relying almost exclusively on credit ratings, rather than doing any due diligence themselves. Investor oversight has been weak through a combination of complacency and lack of understanding of the complex structures involved. Investors did not question CRAs' methodologies, nor did they fully understand the purported purpose of ratings.

[16] Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, April 2008.

11. Although there was general support within the EU for the approach adopted by the FSF to address this problem – to improve disclosure and transparency in the securitisation process, the Commission recently proposed a much more far-reaching amendment to the CRD ,17 which would have the effect of preventing EU regulated banks from investing in securitisations (and indeed all kinds of credit risk transfer) where the originator held less than 10% of the “net economic interest” of the relevant tranche of instruments. This proposal has been widely criticised and it is not clear whether the Commission intends to proceed.

12. One of the criticisms of the 10% proposal was that it would induce a false sense of security in investors and that investors would simply substitute reliance on the 10% requirement for reliance on credit ratings. It would not force investors to do their own due diligence. It would seem that the market turmoil has been more effective in this respect by making investors extremely cautious and risk averse in relation to securitised products. This should mean that they will demand the improved disclosure and transparency proposed, before investing in securitised products in the future.

SMEs

13. From the point of view of the SMEs, the availability of credit is increased by higher volumes of securitisation. Moreover, securitisation does not affect the relationship between the SME borrower and the lending bank. The loan conditions are unaltered and the servicing of the loan remains in the hands of the bank- indeed the SME may be totally unaware that the loan has been securitised. Investors have no recourse to the SME.

Poblems associated with securitisation of Microcredit portfolios

14. The problems associated with securitisation of micro credit portfolios can be divided in to two- 1) those relevant to microcredit specifically and those relating to the problems associated with securitisation generally, as a result of the recent market turmoil.

Cost of Securitisation

15. The costs of the securitisation process should not be underestimated. These can be summarised as follows:

- Transaction costs
- Market entry costs for smaller banks which are the main lenders to SMEs
- Each securitisation transaction involves additional costs- fees paid to lawyers, arrangers, credit rating agencies, trustees for the SPV and for its management. These fees will increase substantially with any complications in the transaction structure or the rating process. This can mean that the size of the transaction needs to be several hundred million Euro to be cost-efficient. One solution can be to pool portfolios but this is not without its difficulties. On the other hand, the Deutsche Bank securitisation of microcredit described below in para.29 amounted only to 60 million euro, though it should be pointed out that the bank and legal advisers did not charge their normal fees.
- Because SME loans are more varied in nature that other types of credit such as mortgage credit, banks need an extensive data base, which entails start-up costs.

[17] Second Public Consultation on Possible Changes to the Capital requirements Directive concerning Securitisations.

16. *Variations in Banking Relationships*

The wide variations in the relationship between banks and their customers in the EU may affect the potential for securitisation in different Member States and mean that no single model of structured finance is likely to be suitable for all Member States.

Legal Environment

17. Securitisation requires adequate legal backing to work properly. It needs a transparent legal framework, clear accounting principles and regulatory support. Securitisation developed first in common law jurisdictions which allowed for the sale of lending contracts and future payment rights.

18. Some Member States such as Italy, Spain, Luxembourg and France passed special securitisation laws some years ago. Changes to tax laws can be needed to make true sale securitisations economically viable. Other Member States may need to amend their laws to facilitate securitisation.

Securitisation and Credit Risk Transfer

19. The global credit crunch has demonstrated dangers of securitisation in excessive leverage or regulatory capital arbitrage. Securitisation has also been criticised for increasing market opacity, but on the other hand a Bank for International Settlements analysis[18] has emphasised the positive influence which securitisation could have on the financial system because of its ability to transform illiquid or risky assets into more liquid or less risky assets. It thus offers an alternative source of long-term funding in both domestic and cross-border markets and can foster the development of domestic bond markets. In turn this could promote greater bank and financial market efficiency as it implies greater competition to meet customer financing needs. Similarly the Joint Forum Report of 200819 takes a positive view of securitisation and credit risk transfer.

Securitisation and Loss of Market Confidence

20. The global credit crisis has resulted in a widespread loss of confidence, not only in the subprime market where crisis originated, but much more widely There was a failure of market valuation mechanisms for many structured transactions. Not only could many of the structured transactions not be valued, but no one could say with any confidence where the risks lay, leading to collapse of confidence in banks, counterparties and investors. The sudden downgrading of structured issues by the CRAs resulted in the collapse of liquidity in many structured finance and conventional financial markets.

21. It too early to predict how long the market for securitised assets and bank risk will take to recover, even if the FSF proposals for change are implemented. It seems safe to assume that the more complex structured products have lost their attraction for the foreseeable future.

[18] See the article by Scatigna and Tower in (2007) BIS Q. Rev 71.
[19] Joint Forum Report on Credit Risk Transfer : Developments from 2005-2007, April 2008.

22. The sub prime crisis suggests that it was predatory lending which was at the root of the problem rather than securitisation. Nevertheless, it has been argued that lack of transparency and asymmetry of information between lender and investor means that there is a risk that lenders have an incentive to securitise the less attractive parts of their loan portfolio and that investors cannot assess the quality of the original loans, nor whether they are likely to be maintained. This is where credit rating agencies can perform a valuable function.

How should microcredit portfolios be structured to ensure optimum securitisation?

Role of Credit Rating Agencies

23. CRAs have attracted much criticism because of their role in evaluating and disseminating information on structured credit products- criticism which needs to be addressed if the market for securitised credit is to recover. The Financial Stability Forum described the performance of the CRAs in respect of structured credit products as follows:

> "The sources of concerns about CRAs' performance included: weaknesses in rating models and methodologies; inadequate due diligence of the quality of the collateral pools underlying rated securities; insufficient transparency about the assumptions , criteria and methodologies used in rating structured products ; insufficient information provision about the meaning and risk characteristics of structured finance ratings ; and insufficient attention to conflicts of interest in the rating process."20

24. The FSF recommended that CRAs should implement the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies to manage conflicts of interest in rating structured products and improve the quality of the rating process. It also proposed that CRAs differentiate ratings on structured products from those on bonds and expand the initial and ongoing information provided on the risk characteristics of structured products. Structured finance ratings differ from traditional corporate debt ratings in the way they are model-based and assumption driven to a large extent. They tend to rely on unpublished information about the underlying assets and have the potential for much higher rating volatility in certain circumstances.

25. DG Markt has decided to go further and incorporate these proposals in EU legislation- one introducing an EU authorisation and supervision regime for CRAs, incorporating substantive requirements to be respected by CRAs- the other tackling the problem of excessive reliance on ratings , which has been reinforced by EU legislative requirements, most notably in the CRD. These proposals follow reports by CESR21 and ESME.22

26. DG Markt has published proposals for consultation23 which would curb what it sees as excessive reliance on ratings by investors, reinforced by regulatory requirements. The proposals put forward would require regulated and sophisticated investors to rely more on own risk analysis, especially for relatively large investments. They might also require all published ratings to include "health –warnings" informing of the specific risks associated with investments in these assets.

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[20] FSF report, see n. 1 above.
[21] CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code. The role of credit rating agencies in structured finance, CESR/08-277, May 2008.
[22] ESME Report on the Role of Credit Rating Agencies, June 2008.
[23] The deadline for consultation was September 5, 2008.

27. In particular, under DG Markt's initial proposals CRAs would not be allowed to become involved in the design of a structured finance instrument- an alleged practice which has generated wide criticism after the recent market turmoil, though the CRAs would deny that they are involved in the creation or design of structured transactions. The CRAs would be allowed to provide certain ancillary services such as the provision of pricing analysis for structured finance securities that do not have a liquid market.

28. To deal with the problem of conflicts of interest, the proposals recommend the establishment of internal controls to insulate those involved in the rating process from conflicts of interest, to disclose and keep records of conflicts of interest.

Does a portfolio of securitised microcredits appeal to a particular type of investor?

29. Deutsche Bank launched what was described as the "world's first securitisation of subordinated microfinance credits with an external rating "in Germany in September 2007. Investors subscribed for bonds to a total of 60 million Euro in three tranches, 36 million of which was subscribed by private customers of Deutsche Bank itself. According to the Bank, the product was primarily tailored to meet the needs of "high net worth individuals, foundations and church-affiliated institutions "serviced by the Bank's Private Wealth Management Unit. The trend towards ethical investment (backed by attractive returns) is likely to increase provided that it can be sustained. On the other hand, it is noted that the bank and its partners waived a proportion of their fees to get the securitisation off the ground and a major international law firm provided pro bono legal advice. It remains to be seen whether the predictions at that time will be born out viz. that, by 2015, funding requirements for microfinance will have increased to 300 billion euro.

Should rating agencies be better educated on the subject of microcredit so as to ensure a fair rating ?

30. There is considerable pressure for CRAs to be better informed about the underlying assets in securitisation generally and to take a more rigorous approach to the quality of the data input and of the due diligence performed on the underlying assets by originators, underwriters and issuers. CRAs were found by the FSF to have failed to review adequately the data input underlying securitised transactions, despite their central role in the OTD process. In particular the FSF recommended that CRAs should adopt reasonable measures to ensure that the information they use is of sufficient quality to support a credible rating. CRAs should establish an independent function to review the feasibility of providing a credit rating for new products materially different from those already rated.

DG Markt is now proposing to give legal force to the FSF recommendations by requiring a CRA to

> "ensure that the credit ratings it produces and disseminates are based on an analysis of all information available to it that is of relevance according to its published rating methodologies. It shall ensure that information it uses in assigning a credit rating is of sufficient quality to support a credible credit rating."24

[24] Art. 12(1) of the proposed Directive, July version.