

The importance of a Microfinance legislation for the development of the sector in Spain.

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LEGISLATION FOR THE DEVELOPMENT OF
THE SECTOR IN SPAIN**

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INTRODUCTION

The II National Microfinance Meeting took place on April 18, 19 and 20, 2012 at Universidad Pontificia Comillas de Madrid (ICAI).

The II National Microfinance Meeting was titled The New Spanish Microfinance Legislation. Experts both from the European Microfinance Network (EMN) and from European Institutions, such as the European Social Fund (ESF) and the European Investment Fund (EIF) attended the meeting. The objective of the meeting was to get to know experiences in other countries which could serve as a lesson for the development of our microfinance legislation.

Likewise, it served to reunite all the agents of the sector and give the last push for the development and conclusion of the first draft of the new Spanish microfinance legislation.

This Monograph of the Spanish Microfinance Forum compiles the work developed during these days.

The II National Microfinance Meeting is the continuation of the work developed from the conclusions of the I Meeting; it has been carried out by the Spanish Microfinance Legislation Group.

1. THE SPANISH MICROFINANCE LEGISLATION WORKING GROUP

Jaime Durán Navarro

Codirector at Foro de MicroFinanzas

The Microfinance Legislation Working Group was created by the Spanish Microfinance Forum, which has been working since 2003 to develop the microfinance sector both in Spain, and in other countries through International Cooperation. It is the first microcredit forum in Spain and it is a pioneer in raising awareness, studying, debating and researching microfinance.

It was created in 2003 in the framework of the cooperation and research agreement between the Nantik Lum Foundation, the Universidad Pontificia Comillas and the Universidad Autónoma of Madrid. At the moment, África Directo Foundation and the Foundation of the Official Credit Institute (*Fundación del Instituto de Crédito Oficial*) are also collaborating.

The creation of the Microfinance Legislation Working Group is the culmination of the work carried out by the Spanish Microfinance Forum to organize the Spanish microfinance sector, which is suffering a great crisis with the disappearance of most of its programs linked to Savings Banks.

The Spanish Microfinance Legislation Working Group was created as a result of the first National Microfinance Meeting organized by the Spanish Microfinance Forum, titled: “Microfinance in Spain. What are we talking about?” on September 15, 16 and 17, 2010 in Madrid.

The participants of this first National Meeting were university representatives, NGOs and foundations, financial institutions and the Public Administration, as well as microentrepreneurs and the general public. Its objective was to gather together all the agents in the sector to discuss the credit

granting model in our country and propose a new action plan. To achieve this, a SWOT analysis of the microfinance model in Spain was carried out, this is an inventory of all the Strengths, Weaknesses, Opportunities, and Threats of the sector and the institutions which make it up.

During the discussion, the participants of the Meeting expressed they considered a weakness of the Spanish microfinance sector, the absence of a legislation which allows real microfinance institutions to be created, increases their quantity and facilitates the existence of competition between them so that the sector can develop¹. They also highlighted the absence of an adequate regulatory framework to promote the creation of microenterprises, and support the *Entidades Sociales de Apoyo al Microcrédito* (Microcredit Support Social Entities, from now on referred to as ESAM) so they can provide more and better service.

As a result of having detected these weaknesses, a working group, made up of 50 institutions, was set up. Today, it is made up of more than 120 representatives which include all the elements of the sector: Savings Banks, ICO Foundation, European Social Fund, ESAM, universities, foundations, NGOs, beneficiary associations, consultants, public institutions (city halls, ministries, regions, etc.), among others.

The Spanish Microfinance Legislation Working Group represents more than 120 institutions which have a common social purpose: reducing poverty and recovering Spain's enterprising spirit. The work carried out is an example of Civil Society participation in Democracy with a constructive spirit and without any kind of exclusions or interferences.

They have always worked by consensus, with all the entities participating greatly to achieve an inclusive legislation which, over all, responds to the needs of those who will receive a microcredit in order to support their families.

The Microfinance Legislation Working Group has been collaborating with European Institutions which have participated in its meetings or have been informed of the results of the same, such as the European Social Fund and the European Investment Fund. The group has also participated

¹ Monographs numbers 15 and 16.

in European Networks on legislation and has therefore become a working group of reference for many European Countries which hope to develop a microfinance legislation.

We hope to culminate the job started and to respond to the needs of many people who want to work to support their families and do not have access to a small amount credit without collaterals or guarantees, which allows them to: a microcredit.

1.1. Work Methodology.

Up to now, the Spanish Microfinance Legislation Working Group has had face-to-face meetings quarterly. It has promoted networking through the creation of commissions (specialized working groups) to develop simultaneously and progressively the most important points of the future Spanish microfinance legislation; sharing all the documents in a system (a cloud) of shared folders.

1.2. Participation in International Networks.

The Spanish Microfinance Legislation Working Group includes international microfinance networks which give it support and advice. This was clearly seen with the attendance of representatives from Rumania, Italy, Hungary and France at the II National Microfinance Meeting.

The Group coordinator participates in the European Microfinance Legislation Group of the European Microfinance Network where the legislative work in all European countries is coordinated and experiences and lessons are shared and learnt.

During 2011 and 2012, representatives from the Spanish Microfinance Legislation Working Group have participated in meetings of the European Microfinance Legislation Group of the European Microfinance Network. Thanks to this, the EMN supports the work developed by the Spanish Group and this Working Group has consolidated its presence. In turn, it has participated in the meeting Improving the Regulatory Environment for Microcredit (Brussels, December 2, 2011) held by the European Commission with the main agents of the sector on a European level.

The Microcredit World Summit Campaign has also supported the work of the Group and understands the need of this legislation to develop the sector in Spain. On October 21, 2011 in Valladolid, Spain, the fourth meeting of the Working Group took place. The meeting was financed by the Microcredit Summit Campaign, and was one of the activities previous to the Summit.

The Spanish Microfinance Forum also participated actively in the Microcredit World Summit which took place in Valladolid, on November 14-17, where it had the opportunity to present the advances of the Working Group in the Spanish Track.

1.3. Agreements Reached.

To date, the Spanish Microfinance Legislation Group has carried out 10 face-to-face meetings.

During the first meeting the first task established was to detect the most important aspects the future microfinance legislation should provide for to:

- Support and make the work of the *Entidades Sociales de Apoyo al Microcrédito* (Microcredit Support Social Entities) easier.
- Support the appearance of Microfinance Institutions.
- Capitalize the experience and support the work of Savings Banks.
- Favor the positive impact of microcredits on beneficiaries in our country.

Working groups were established for this. In turn, microfinance legislations of other countries, such as France, Rumania, Italy and Peru were studied to determine the factors which adapt better to the reality and needs of the Spanish sector.

During the work carried out in the groups and in the meetings, the following agreements, which include several spheres of the future legislation, were reached:

Objective Sphere

- Maximum amount: Up to 25,000 €.

- Interest rate: Limited interest rate, using as a reference Euribor plus a spread to be determined statutorily. Without any collaterals or guarantees.
- Beneficiary: Natural person excluded from the traditional funding channels.
- Purpose: Mainly to implement productive activity, and any other activity which improves the living conditions of people.

There, the **definition** that microcredits have in Spain is:

Credits up to 25,000 Euros, without collaterals or guarantees, for natural persons who are excluded from the traditional funding channels in Spain, the purpose of which is to implement or reinforce productive activities, and/or improve living conditions.

Subjective Sphere

Characteristics:

- The entities which will grant microcredits, regardless their legal status, must necessarily be non-profit entities.
- All entities (regardless their legal status) must fulfill certain requirements to be able to grant microcredits.
- *The Comisión del Ámbito Subjetivo* (Subjective Scope Board), created on February 8, 2012, and headed by lawyer Pablo Serrano (Law firm Clifford Chance), studied the possible legal forms to find the most adequate one. The result of its work was²:

Fundación Microfinanciera (FMF) - Microfinance Foundation.

Supervisory Body:

Function: grant, renew and revoke microfinance licenses. An annual meeting of its members.

² See article about Recommended Legal Form for Microfinance Institutions contained in this same Monograph.

Composition:

- Ministry of labor, industry, health, social policy and equality, economy and finance, and rural and marine environment representatives.
- Sector experts.

From the work developed in the II National Meeting, it was decided to, instead of promote an independent legislation, try to be part of the development of an existing law. For this purpose, we will start consulting the different political formations to develop a communication and lobbying strategy.

2. RECOMMENDED LEGAL FORM FOR MICROFINANCE INSTITUTIONS

Pablo Serrano

Partner at Clifford Chance Law Firm

In the process of creating a new Spanish legislation for microfinance, one of the main points which should be taken into account is the typology of the institution we want to create to develop a microfinance activity. The correct analysis of the different institution typologies and the definition of the characteristics the institutions must have, will give us the reference framework of what in the future will be the sector in Spain.

A base line with established premises has been created to mark the form and the objective of microfinance in Spain.

Microfinance entities must be part of the market, carrying out the remunerated activity of granting loans. The collection of refundable deposits from the public is not considered, but the collection of resources from external investors to develop the activity is. Moreover, it is proposed that the institutions should be non-profit, in other words, that they do not have the ultimate objective of paying out dividends to shareholders.

Finally, during these initial suppositions it is of vital importance to point out the need, when determining a legal form, of paying special attention to independence regarding external liability of promoters and partners, and of the institution itself, in other words, that the promoters do not respond personally for the obligations of the microfinance institution. Furthermore, and as a last reference to the initial conception of the legal form of institutions, these institutions must be eligible for the aid programs of the European Social Fund (ESF) and other institutions such as the European Investment Bank (EIB).

Once this starting point is defined, the analysis will be based on the elements which determine the type of legal person and on the different existing options. It will not be necessary for microfinance institutions to register themselves as credit institutions, since we suppose they will neither collect deposits nor participate in activities of issuing electronic money. Not being set up as a credit entity does not present an obstacle when interacting with official organisms, as the case of Inicjatywa Mikro clearly shows in Poland. Moreover, since they do not carry out activities involving mortgage loans or mortgage lending they would be exempt from complying with the requirements provided by law 2/2009, according to which they should comply with a series of formal requirements, such as registration in the administrative registry, the provision of a guarantee or a liability policy, or everything disposed in the 22 articles which make up that law.

Due to this, when finally deciding the ideal legal person for the sector, the possibilities would be: Cooperative Society, Association and Foundation. We will next explain the reasons which made us opt for the form Foundation.

The main reason why the form Cooperative Society is not considered the most adequate is that the ultimate goal of a cooperative society is, by definition, to satisfy the collective interest of its members, and although they may carry out cooperative activities with third parties which are non-members, it can only be on an exceptional basis. Moreover, the demanding legislation regarding credit cooperatives could be a barrier to the development of the activity, since it imposes very rigid special regulation with demanding requirements, such as a very high minimum capital and other obligations comparable to those of credit institutions, which could represent a brake on development of the microfinance activity, something we hope to avoid from the start.

We also eliminated the alternative Associations as a desirable legal form because, although it would adjust to the model we wish to create, we would have to declare it specifically of “General Interest”, to distinguish it from those which only act in the interest of their members, and it would mean adjusting to the tax system of associations. Additionally, it raises the problem of complexity when it comes to differentiating itself from other associations. Since freedom of association is a fundamental right, there are wide range of associations with various objectives and this characteristic implies a failing in the ex ante control of associations. In addition to this, the process until the registration in the corresponding registry takes place is very long, and during

this process the promoters, or the members who claim to act on behalf of the association, are solidarity liable for the debts of the organization. Finally, this legal form could cause certain problems when applying for European funds, since this kind of organization is not the most typical applicant.

However, the figure Foundation seems to adapt itself to a large extent to the demands of the future Microfinance Institution (MFI). In their own definition under Law 50/2002 foundations are identified as non-profit organizations the equity of which, by the will of their creators, is devoted, in a lasting way, to the fulfillment of general interest.

In this same law, in the section purpose and beneficiaries, it is noted that foundations must pursue an aim of general interest, and there are several examples among those proposed which adapt perfectly to the mission of MFIs: social assistance and social inclusion, promotion of social action, promotion and attention to people who risk exclusion for physical, social and cultural reasons, as well as promotion of social economy.

Foundations will have legal personality since their registration in the Registry of Foundations, and only those registered can use the term "Foundation". From the moment of the registration onwards, they shall be subject to the control of the Foundations Protectorate, exercised by National State Administration, who will be in charge of supervising that the activity adjusts to the law and statutes, as well as solving certain issues which might arise specifically during organizational performance. This supervision, far from being a barrier to flexibility, gives a very beneficial exterior image to organizations, makes financial aid processes easier since it fulfills the requirements of the European Union (EU), and offers the possibility of counting with the support of the Spanish Association of Foundations.

Another of the advantages of choosing the legal form of Association is that they have a specific tax system, which we will explain in detail later on, that includes the exemption from paying the corporate income tax as its most remarkable feature.

Once we have mentioned the main advantages of this legal form, we will explain more specifically what registering as a foundation entails. Firstly, foundations are governed by a Board of Trustees, which is the main management and representation body. The Board of Trustees must be made

up of a minimum of three members, which may be natural or legal persons, in which case they must designate a natural person as a representative.

The duties of the Board of Trustees are very broad, since along with those of administration of assets, there are others, such as the approval of accounts and the action plan, the amendment of Statutes, the merger and liquidation of the foundation, and other which may require the approval of the Protectorate, which under no circumstance may be delegated. All these functions are unremunerated, although they shall be reimbursed for any duly justified expenses incurred in the performance of their functions, and its members shall only receive payment for the services provided to the foundation if they are different from those included in their position as part of the Board of Trustees, and always with prior authorization from the Protectorate.

The Board of Trustees will need to formalize, at least, the position of President and Secretary, but other members may be appointed, as well as executive committees and other posts on which to delegate functions which are different from those previously mentioned.

As for patrimony, it will be formed by all the assets, rights and obligations that are susceptible of economic valuation and are part of its endowment, as well as those acquired by the foundation after its constitution, whether they are affected to the endowment or not. As expressed in article 12 of Law 50/2002, the endowment must be adequate and sufficient for the achievement of its foundational purposes. An endowment of 30,000 Euros will be considered sufficient. This sum may be inferior when the Protectorate considers it necessary in reference to the specific purpose.

If the endowment is composed of capital contributions, the initial outlay shall be of at least 25%, and the rest must be outlay within a period of not more than five years. If the contribution is non-cash, a valuation carried out by an independent expert must be included in the act of incorporation.

We will see next the **principles of action of foundations**:

Continuing with what was mentioned before, we reaffirm the precept that foundations must effectively use their patrimony and income for foundational purposes. Likewise, they shall provide sufficient information on their purpose and activities so they are known by the eventual beneficiaries, with whom they must act with equality and non-discrimination criteria.

Regarding economic activities, the foundation may develop those activities the object of which is related to foundational purposes or complementary to the same, always following the rules on competition. In addition, they may engage in any economic activity through holdings in corporations as long as they do not personally respond for the social debts. When it is a majority holding they must inform the Protectorate as soon as that situation takes place.

Foundations may gain income from their activities, as long as it does not suppose any unjustified limitations in the scope of their beneficiaries. At least 70% of the profit from economic activity and any other income, deducting expenses incurred to obtain that income, must be dedicated to activities related to the organization's mandate and dedicating the remaining income to increase the Social Fund or to reserves, as decided by the governing body. Contributions and donations received in the form of equity endowment at the moment of constitution or later will not be included as income.

Regarding accounting, foundations shall keep orderly accounting records of its business activities which make it possible to follow its operations chronologically. To fulfill this obligation they must keep a Journal and an Inventory and Annual Accounts Book. The President or the person designated in the Status shall prepare the Annual Accounts which shall be approved within a maximum of six month as of the closure of the exercise.

The Annual Accounts, which include the Balance sheet, Profit and Loss Account and the Annual Report, form a single unit and must provide true and fair image of the assets and financial situation of the foundation. The Annual Report, apart from completing the information obtained from the other documents, will include the foundational activities, the changes in the governing, management and representative bodies, as well as the level of implementation of the action plan, indicating the resources employed, their origin and the number of beneficiaries in each of the activities carried out, the agreements reached with other institutions for these purposes, as well as the level of implementation of the rules concerning the purpose of the previously expressed economic exploitations.

Foundations may present their Abridged Annual Accounts when at the close of the financial year at least two of the following circumstances occur:

- That the total of the assets, according to the balance, does not exceed 150,000 Euros.
- That the total income for its own activity, plus, if applicable, the turnover of its commercial activity does not exceed 150,000 Euros.
- That the average number of workers during the financial year does not exceed five member-units.

Moreover, although it is advised to audit the accounts, it will be compulsory to submit them to an external audit if at the end of the financial year at least two of the following circumstances occur:

- That the total of assets exceeds 2,400,000 Euros.
- That the amount of revenue, plus the income resulting from the commercial activity exceeds 2,400,000 Euros.
- That the average number of employees during the financial year exceeds 50 member-units.

The Annual Accounts shall be approved by the foundation's Head of Trustees and shall be submitted to the Protectorate within ten working days following their approval. If there is an audit report, it shall also be attached to this document. Once they have been examined and their procedural appropriateness has been confirmed, the Protectorate shall deposit them in the Registry of Foundations, where anyone may obtain information on said documents.

The Board of Trustees shall draft and refer to the Protectorate, in the last months of each financial year, an action plan, in which the objectives and activities planned for the following financial year are reflected.

Tax benefits and regulatory proposals.

From Law 49/2002, of December 23, which regulates the taxation plan of non-profit entities and the tax incentives from patronage, we have extracted what the main advantages of choosing this legal form would be.

The main difference would be the exemption from corporate income tax incomes: proceeding from revenue obtained from non-exchange transactions;

proceeding from movable and fixable assets of the entity, such as dividends, interest, royalties and rents; derived from acquisitions or transfers, under any title, any assets or rights; resulting from their exempt economic operations; and, finally, those which according to the fiscal rules must be attributed or ascribed to non-profits organization. Likewise, there is an exception for income obtained from complementary and auxiliary exploitations to fulfill the purposes of these entities.

For those incomes which are not exempt, as mentioned above, the corporate tax base will be taxed with a single interest rate of 10%.

Regarding local taxation, the exceptions established by the previous law will be maintained, expanding their scope. This way, real estate taxes will be exempt as long as they are owned by non-profit organizations, with the exemption of those affected by the economic operations which are not exempt from corporate tax. Economic operations carried out by these entities which have been designated as exempt by the law itself will also be exempt from taxes of business capital. The exemption from Tax on Value Increase of Urban Land (*Impuesto sobre el Incremento de Valor de los Terrenos de Naturaleza Urbana*) is introduced when the legal obligation of paying the tax falls on a non-profit organization, as well as the donations given in favor of the entities which are beneficiaries of a sponsorship.

Finally, we will expose some *lege ferenda* proposals, for a future amendment of the law. From the Working Group of the Spanish Microfinance Forum it is proposed to expressly add in Law 49/2002, on the specific tax regime, Microfinance Institutions as a section of article 7.1 which details those economic operations and exploitations of delivery of services and social management. Although, as the Law is currently expressed, MFI could carry out work under the specific classification of section n: “social inclusion to which the previous sections refer to” highlighting section c: “assistance to people who are in risk of social exclusion or social problems”, it seems totally convenient to create a specification towards MFI which does not give rise to doubts.

The other main aspect of the legislation proposal would concern the exemption from withholding tax on income paid to contributors. Under the current regime, the payment of interest or other incomes to funds contributors by the MFI could generate the obligation to withhold the direct taxes of said contributors (income tax, company tax, etc.). In order

to simplify tax liability and other related formalities, we consider relevant to eliminate all obligations of withholding in this sphere.

Finally, it is noted that regarding the deductibility of VAT, in contrast to the two previous proposals, we do not propose a modification given its general nature in the tax framework of the Spanish tax system.

Conclusions.

It will not be necessary to set up a credit institution if the MFI will not be financed through repayable funds from public, that is, mainly through deposits. Due to the demanding legal requirements of these organizations, we recommend to avoid creating credits institutions.

The non-profit nature of MFI makes inadequate, and therefore non-advises, all forms of corporate entity.

The need to limit the responsibility of MFI leads to considering that the kind of entity which could be created would be a cooperative society, association or foundation, the latter being the one which seems to adjust itself better to the desirable future.

The main advantages of this form are:

1. The adequacy of the general interest purposes of foundation to the objectives of MFIs.
2. Limitation of liability to the assets of the foundation.
3. Previous tax advantages laid down by Law 49/2002 although, for clarity and legal security, it would be convenient to introduce changes in said law so it would expressly include MFIs.
4. Control by the Foundation Protectorate which gives assurance of the legality and the fulfillment of foundational purposes.
5. Similarity to the kind of organization frequently used by MFIs in other countries which receive support from European funds.

Once this proposal was analyzed by the members of the Working Group for the development of a microfinance regulation in Spain, the debate was

opened for discussion and listeners and actors of the microfinance sector were invited to participate. The major general concern was that if the organization was registered under the form of Foundation, would this not restrict the possibility of accessing funding MFIs. Some actors considered this form to be a barrier in terms of receiving private funds.

The formal difficulties some organizations which are already functioning would have when changing their legal form from Association to Foundation, was also put forward; this would entail several costs and a large amount of work, and would also raise doubts about if this new form would be more convenient.

Due to this, it was decided to opt for an open position in the election of the legal form would not be imposed; each organization would be able to pick the most convenient. They would either be Foundations or Associations, as long as the latter complied with the guideline of dedicating at least 70% of its patrimony to social purposes.

Finally, the convenience of creating a legislation was discussed; if the benefits of having a regulatory framework to refer to would be greater than the risk of limiting the forms of action. Furthermore, given the characteristics of the Spanish legal system, it seems that it would be more convenient, and more feasible, to modify an existing law than to create a new one.

3. THE EUROPEAN SOCIAL FUND AND MICROFINANCE. OPPORTUNITIES FOR THE SECTOR IN SPAIN

Esther Pérez Quintana
Fondo Social Europeo

At a time like the present, in which the economic context is marked by austerity and budgetary saving, while the increase of the social needs of the population is evident, the adoption of intelligent measures which allow the maximum efficiency and effectiveness in the use of available resources is even more necessary.

Seeing the economic and social scene, Spain and the European Union (EU) as a whole, offer us now, it seems clear that the microfinance sector is proving to be successful in supporting people with greater difficulties, and is susceptible of contributing directly to employment generation.

The European Social Fund (ESF), one of the structural funds which exists nowadays in the European Union and which will be maintained in the next programming period, 2014-2020, was created in 1957 by the Treaty of Rome and since then it has acted to support employability of people and the increase of their employment prospects, as well as other diverse objectives, such as gender equality, equal opportunities, non-discrimination, social inclusion and fight against poverty.

Thus, in view of what has been pointed out above, the existence of a direct link between the European Social Fund and the microfinance sector is undeniable.

In this context, the European Union, which knows the possibilities the microfinance sector offers as a mechanism for social inclusion and to fight poverty and unemployment, has propelled several initiatives, such as PROGRESS, JEREMIE and JASMINE, among others. Nevertheless,

although intense efforts are being put into the development of the sector, there is still much to do in this area, as the European Union itself has recognized. It is expressed in the European Parliament resolution of March 24, 2009 [2008/2122(INI)], in which the European Parliament acknowledged the problem and asked the European Commission to redouble its efforts to develop microcredits in the EU, to support growth and employment. In addition, the Report from the Commission to the European Parliament, the European Council, the European Social and Economic Committee and the Committee of the Regions, in relation to the implementation of the European Progress Microfinance Facility during 2010, recognized that the majority of microcredits in the EU are granted by non-commercial microfinance institutions (NGOs, foundations, government agencies, development banks from the Member States and non-banking financial institutions) which do not have the capacity and the resources to meet the great demand.

The ESF has had a very limited experience in the sphere of microfinance in Spain and it has been based mainly on microcredits. In this respect, there are previous experiences regarding microcredits in the framework of the community initiative EQUAL, running during the programming period 2000-2006. The activity of the *Instituto de la Mujer* (Institute for Women's Affairs) is particularly interesting; it has been developing a microcredit program since 2001.

One of the first issues we must consider in relation to the interaction between the ESF and microfinance is how this relation is actually carried out. Regarding the legal framework of the ESF which controls the current programming period 2007-2013, both EU Regulation N. 1083/2006 of the Council of June 11, 2006 (which established the general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund), and the EU Regulation N. 1081/2006 of the European Parliament and the Council of July 5, 2006 on the European Social Fund, provide for the use of financial instruments in the scope of the ESF. Furthermore, the proposals for regulations presented by the European Commission to the Council and the European Parliament, establish for programming period 2014-2020 a regulation of financial instruments which is very similar to the current one.

Under the provisions of the previously pointed out legal framework, the resources which come from the ESF may be used for any of the following purposes:

- The implementation of the financial instrument itself. This way, in the case of microcredits, the funds from the ESF may be used for the granting of the same. In this situation, it is necessary to consider that the entities which have traditionally managed the ESF are not, in most cases, experts in managing financial instruments. To all this, we must add the complexity and the high degree of specificity of the matter, which requires know-how. To overcome these obstacles it is necessary to seek the support and expertise of entities which are experts on financial instruments, by signing agreements and collaborations. This way, the ESF would provide all or part of the funding, while the management would be shared by the ESF and said entities.

- Interest rate subsidies. In this case, the ESF could finance all or part of the financial interests that the beneficiary must pay in the repayment of the microcredit. One of the obstacles to the development of microcredit is the high risk these operations entail, which may lead to too high interest rates for the beneficiaries. In this case, the help of the ESF by co-financing the interest rate could make microcredits accessible to a greater amount of people, while it would allow maintaining an adequate interest rate for the sustainability of said microcredit program.

- The implementation of the coaching measures. In this case, the action of the ESF would be based on activities, such as:
 - Development of its traditional activities to support entrepreneurship.
 - Supporting the beneficiaries both in the application and the management of the microenterprise.
 - Information and communication to potential beneficiaries.

The coaching actions of the ESF are especially important for the execution of the rest of the microfinancial facilities in the European Union. For example, in the case of the European Progress Microfinance Facility, the Decision by which this facility is approved established the need for a close collaboration with the entities which grant the microfinanciation, the organizations which represent the interests of the final beneficiaries of the microcredits and with organizations, especially those subsidized by the ESF, which offer mentoring and training programs to said final beneficiaries.

Since the people who will probably ask for a microcredit program find themselves in a difficult situation or are excluded or at risk of social exclusion, obtaining a microcredit would not make sense without the necessary coaching for these people and the provision of guarantees of viability for said project. The ESF can provide a great experience in this field and, therefore, create a greater added value.

Another fundamental issue will be determining who will be the potential beneficiaries of microcredits. There is a consensus around the idea that those people who are excluded from the traditional funding channels will be the beneficiaries. However, there are other additional issues which must be settled to define the beneficiaries. For example, may an immigrant who is in an irregular situation receive a microcredit? And also, may a person have access to a microcredit just because he or she is unemployed? These issues, as well as others, must be taken into account when drafting the future regulations for microcredits in Spain.

In the case of the European Union, the Decision by which the Progress Microfinance Facility is created established in its second article that the following groups may be beneficiaries:

- “a) persons who have lost or are at risk of losing their job, or who have difficulties entering or re-entering the labor market, as well as persons who are facing the threat of social exclusion or vulnerable persons who are in a disadvantaged position with regard to access to the conventional credit market and who want to start or further develop their own microenterprise, including self-employment;
- b) microenterprises, especially in the social economy, as well as microenterprises which employ persons referred to in point a).”

Moreover, the regulation proposal regarding the European Union Programme for Social Change and Innovation establishes in its recitals that:

“The efforts of the Union and its Member States in this sphere must be intensified to increase the offer of microfinanciation and meet the demand of those who need it most, specially, unemployed and vulnerable people who wish to create or develop a microenterprise, even on their own, but who do not have access to credit”.

It seems clear that, by using microcredits, the European Union seeks to create employment, while favoring social inclusion and the fighting against poverty. In this sense, it is very important to prevent what in the European context has been called “creaming effect”, this appears when the less problematic population is chosen from a group, to guarantee the best results. This effect produces, inevitably, a new exclusion process which hardly helps the poorest citizens.

When drafting the future Spanish microfinancial legislation, it is particularly important to seek harmonization among the national and Community legislation. The collision between these two legal areas may create great difficulties for the managing of these facilities. All this, taking into account the principle of primacy of Community law, which guarantees the superiority of European law over National law, in such way that, if there is a collision between national and Community legislation, the latter will be applied on a preferential basis. Therefore, it is necessary to develop a national legal framework which fits, as much as possible, in the Community legislation. This would make the managing of the instrument easier.

Moreover, aiming to reduce administrative burdens on beneficiaries, to encourage them to use this kind of initiatives, it is necessary to observe at all the times the principles of simplification. This is particularly relevant considering that microcredits are oriented to disadvantaged groups, which in most cases include low educational and training levels, so complexity and administrative burdens could be a barrier to access this kind of instruments. In this context, initiatives such as the *Plataforma Española de Microfinanzas*³ (Spanish Microfinance Platform) which centralize all resources and the information of the microcredit sector in Spain, encourage networking and make the access to microcredit programs much easier for beneficiaries.

In the case of Spain, the use of microcredits is particularly interesting for several reasons, among which we can highlight:

- The high unemployment rate, especially youth unemployment, which is the highest in the European Union, with a percentage close to 50%.

³ www.pem.es

The lack of access to credit is one of the main obstacles for the creation of businesses, which make job creation difficult.

- Within the scope of the ESF in Spain there is a multiregional operational program, *Lucha contra la Discriminación* (Fight against Discrimination), the results and achievements of which have been recognized on a European level. Several entities participate in this program, including *Fundación Secretariado Gitano* (Foundation for the Gypsy Secretariat), ONCE Foundation, the Spanish Red Cross, the Institute for Women's Affairs, *Cáritas* or the *Dirección General de Integración de los Inmigrantes* (Directorate General for Immigrant Integration), among others. The actions of these organisms include: the development of integrated itineraries of socio-labor insertion for people in socially excluded groups or in risk of exclusion; fostering and support to insertion companies and other initiatives which generate employment in the scope of social economy and fostering positive actions for social and labor market insertion of women of specific groups, which suffer double discrimination. As it can be observed, the potential of microcredits in the scope of this operative program is very high, since they would favorably influence the achievement of their objectives.
- From another point of view, microcredits are not only an instrument which has an influence on employment and social inclusion, but also a tool which allows the return on investment of the employed funds, in such way that the funds returned can be reused for the achievement of their purpose, with the advantages it represents given the existing budget restrictions. From this perspective, the microcredit alternative compared to a subvention may involve important advantages, not only because of the return and the reuse of the funds, but because the need of repayment may be an incentive for the beneficiary of the fund.

In short, the microfinance sector, and particularly the microcredit one, represents one of the intelligent measures we referred to in the first paragraph of this document. The microcredit is an instrument which is susceptible of being used as a mechanism for social inclusion and employment generation, while it allows an adequate use and maximizing economic and social profits of the available resources. Due to all this, the European Union, and particularly the European Social Fund, have been working in the development of this sector and will continue doing so in the near future.

4. THE ROLE OF THE EUROPEAN INVESTMENT FUND IN THE MICROFINANCE SECTOR IN SPAIN

Saiji Suzuki Navarro

Investment Manager, European Investment Fund

For some time now, microfinance has been recognized by European political leaders as a key instrument to support entrepreneurs and fight social exclusion and unemployment. Despite this recognition, the development level of the sector is still in its early stages compared to its potential, both in size and impact capacity over employment creation and social cohesion.

There is a clear gap between supply and demand in Europe today, and to reduce it, over the last decade the European Union has promoted a series of actions to support the European microfinance sector and help to reach its full potential. Said actions have focused on several areas, which include training programs, programs to improve operational capabilities, and programs to increase the number and volume of microcredits available to final beneficiaries of the EU. From all the programs launched in preceding years, we can highlight the MAP program (Multi-Annual Programme for the promotion of enterprise and entrepreneurship) and CIP (Competitiveness and Innovation Framework Programme), both managed by the European Investment Fund (EIF), and the object of which it to increase the access to credit of those parts of the society which have traditionally had greater difficulties in accessing it. Both programs were a success; they increased available credit for entrepreneurs, unemployed people, and microenterprises, and in turn, they were able to demonstrate that in the EU there is enough interest and potential to use microcredits in a successful way to fight unemployment and promote social inclusion.

In November 2007, the European Commission communiqué “European initiative for the development of microcredit in support of growth and

employment”, launched one of the broadest initiatives of the Union, the purpose of which is to use public funds to contribute to long-term development and sustainability of the microfinance sector. The aim of this initiative was to promote the development of the sector through the following activities:

- Improving the legal and institutional framework of the Member States.
- Improving the development scope to support entrepreneurs.
- Promote good practices through good conduct codes.
- Increase the funds available to microcredit institutions.

In turn, the communiqué highlighted the importance of the role of the institutions which provide microcredits for the development of the sector in Europe and emphasized the need of helping these institutions to reach their full potential. In this area of activity, both the European Commission (EC) and the European Investment Bank (EIB) decided to launch the JASMINE program (Joint Action to Support Microfinance Institutions in Europe), an initiative which started in September 2008. The object of this initiative was to help institutions which provide microcredit to improve the quality of their operations, corporate structures, and sustainability. This initiative took the form of technical assistance for these institutions. In order to financially support this initiative, in January 2009 the EIB agrees with the EIF the implementation of a microfinance pilot called RCM Micro (Risk Capital Mandate). Under such program, the European Investment Fund would provide funds to microcredit institutions. At the same time, aiming to complement the mandates RCM Micro and JASMINE, the EC launched another mandate to support the European microfinance sector, called EPPA (European Parliament Preparatory Action). This program had a budget of four million Euros, and its objective was to support microfinance institutions so they could expand their operational capacities and increase the microcredit provision. Said support would involve investing in the capital of institutions and/or granting direct loans. This program was a success, and up to now four investments have been made in European microfinance institutions. Thanks to this support, these institutions have been able to expand their operations, while increasing the provision of microcredits to unemployed people, entrepreneurs, immigrants and microenterprises

However, these initial pilot programs had a problem: their size. The total sum of these three programs (JASMINE, RCM Micro, EPPA), barely reached 20 million Euros, a limited quantity for a sector which is growing and has much greater potential. For this reason, the impact of the actions, although significant in their scope of action, was restricted to simple local actions. In fact, the main objective of these programs was to “prepare the ground” for the main initiative of the EC in the scope of microfinance; the European Progress Microfinance Facility (PROGRESS) Initiative.

In 2010, motivated by the adverse effects of the financial crisis, the EC Directorate General for Employment, Social Affairs and Inclusion, together with the EIB launched the program PROGRESS, the main objective of which is to increase the access to microcredits of microenterprises, entrepreneurs, and, in general, those unemployed people who use self-employment as an instrument to improve their employment situation. In turn, the program places a special emphasis on social inclusion and support to those groups which have a limited access to the traditional banking system. PROGRESS is the first pan European program exclusively dedicated to the microfinance sector. Apart from providing funds, this program offers the structural framework needed to take over the smaller predecessor programs (EPPA, Micro RCM, etc.), evolving towards an only program for the initiatives of the European Union aimed at supporting the sector.

The PROGRESS program, managed by the EIF, is implemented through (1) a guarantee which offers hedging against the risk of default of microcredit suppliers (entirely founded by the EC), and (2) an investment fund structured under the laws of Luxemburg, the European Progress Microfinance Facility, financed both by the EC and the EIB. This facility provides funding to microcredit suppliers of the European Union through loans, capital and/or other financial instruments. The total cost of PROGRESS amounts to 203 million Euros, divided between the guarantee and the investment fund. Said program is an example of how the cooperation between the EU and the EIB Group can reach an impact and a greater level of leverage of the Community funds, maximizing this way the use of resources which are scarce. This program is probably one of the first to offer a greater variety of financial instruments, compared to other programs of the EC. This follows the logic of being able to adapt to the diverse needs of the variety of microcredit suppliers of the EU, as well as the different social-economic realities of each Member State. Up to now, 18 contracts have been signed in 12 countries

with different microcredit providers, which demonstrates already, in its first operational year, a great constantly growing demand.

Why did the EC decide to join several programs under the “brand” PROGRESS? The main reason is based on the principle of European Added Value. That is to say that interventions which increment efficiency, act with effectiveness and reach synergy with other existing programs are considered added value. The PROGRESS program meets all the requirements. Unifying the smaller programs of the European Union which support the microfinance sector (for example EPPA, Micro RCM, etc.), it has been possible to reach the critical mass necessary to optimize the scarce resources available, minimize the cost structure, and maximize the impact of the program. With that critical mass it is possible to increment the impact of the measures of the instrument through the EU. In fact, with only a year of implementation, it is already possible to discern that measures such as PROGRESS are an effective way to address the current market fragmentation and support a segment of the market which does not yet have sufficiently sound bases to create a sustainable sector in Europe. In turn, PROGRESS has achieved to unify in an only program a series of tools which fulfill the diverse needs of microcredit suppliers of the EU. This tool will help microcredit suppliers to develop their local competences, which are key to build an efficient and coherent market. The creation of a pan-European portfolio of actives comprised of investments in the microfinance sector, achieves a diversification level which would not be possible with actions only at a national level. This represents a great advantage in a sector in which there are still a vast majority of institutions which have difficulties in reaching their sustainability. This entails certain risk for private sector investors who, apart from seeking social impact, seek certain financial sustainability. Precisely because of this, and aiming to encourage the entry of private investors in the European microfinance sector, and achieve a greater leveraging of EU resources, the PROGRESS fund is structured so that it can offer guarantees to this kind of investors.

Being able to unify the initiatives under an only pan-European vehicle has the advantage of being able to set global objectives, promote good practices in the sector (for example a handbook of good conduct), and increment the quality standard. This kind of initiatives promote a qualitative development of the market, and in the long term, it increments the sophistication of microcredit suppliers, increasing in turn the profits the final beneficiaries may obtain. A centralized program, combined with expertise and the ability

to implement innovative financial solutions, may promote the necessary visibility, integration and quality to create a sustainable microfinance sector which provides continuous support to entrepreneurs, microenterprises, the unemployed and all beneficiaries of microcredits.

What are the lessons we have learnt from the EIF after a year of implementation of the PROGRESS fund and that can be applied to Spain? After this first operational year of PROGRESS, we have seen that for the sector to be sustainable and successful in the long term there must be at least five fundamental pillars:

1. Availability and access to financial instruments which have the capacity to balance social objectives and social impact, with the financial sustainability of microcredit suppliers.
2. Non-financial technical assistance, as well as financial support for microcredit suppliers to develop their operational capacities, and so that small institutions can reach the necessary size and rate of growth to be able to operate independently, as well as those institutions which are settle can increase their impact and the scope of their operations.
3. Mentoring and financial education for the final beneficiaries and the entrepreneurs, especially in the initial stages of the development of their activities. These kind of initiatives are key to reduce the write-off ratio of microcredit suppliers and help the final beneficiaries to reach the goals for which they initially asked for a microcredit. This kind of service is more important the more the program focuses on the most disadvantaged sectors of society. We have noted that throughout the EU, these services are offered directly by intermediaries, or in cooperation with the suppliers of said services. The EC supports these initiatives with the funds of the European Social Fund.
4. Dissemination of good practices, quality standards, and data transparency, so that the investors which are interested in participating in this sector are capable of distinguishing between those institutions with a greater social impact potential and long-term sustainability, and to protect the final beneficiary of any kind of improper and abusive practices. In turn, the development of common reliable metric databases to measure the social impact is a key point to increase transparency and efficiency in the sector.

5. The development of a regulatory framework which allows the evolution and behavior of the microcredit institutions is key for the existence of an efficient and sustainable industry which supports the final beneficiary.

Up to now, we have seen that there is a tendency in the microfinance sector towards, efficiency, professionalization and sustainability of the same. This can be seen in initiatives such as the ones that are being carried out in Spain, which seek the development, by consensus of a regulatory framework for the sector. The EIF welcomes this kind of initiatives, and as we previously mentioned, the development of said regulatory framework is one of the key pillars for the correct functioning of the sector. Furthermore, the support of facilities such as PROGRESS offer the sector in Spain access to stable funding and other kinds of measures which we mentioned previously; the growth and sustainability perspectives of the Spanish microfinance sector are very promising.

5. MICROCREDITS IN FRANCE. ADIE'S EXPERIENCE

Maria Novak
Founder of ADIE

One of the most representative examples of microfinance regulation in Western Countries, more precisely in European ones, is the case of France. The French regulation, promoted by the association Adie (*Association pour le Droit a l'Initiative Economique*)⁴, has followed a long process in which it has been gradually adapting the regulations to create an environment where social inclusion has become a reality, through the development of microenterprises and microfinance.

Adie was created in 1998, as an association with no capital thanks to the joint efforts of three people. Twenty years later, the original objective of this association has not changed. Its mission and its *raison d'être* is based on three pillars: financing, coaching and contribution.

Financing people who have the project of creating a microenterprise or a business unit and which, for several reasons, do not have access to commercial banking.

Coaching of the microentrepreneurs. Coaching before, during and after the creation of the company, to ensure the running, sustainability and durability of the business.

Finally, contribution to the development and improvement of the institutional setting of microcredits and the creation of companies.

⁴ www.adie.org.

These three pillars are reinforced with the ideas Adie has always had of what the environment of the microenterprise entails. Adie believes a microenterprise to be the result of the wishes and evolution of our economy, in which deindustrialization and the apparition and increase of precarious work and unemployment have gradually taken place. These situations have encouraged the way of thinking that favors independent work to spread out. The lack of confidence in paid employment has increased even more these desires of self-employment.

However, in order to achieve this dream, the first thing needed is capital, or at least the possibility of having access to it when the conventional bank systems are not willing to grant these loans. This is when Adie comes in.

The importance Adie gives to microenterprises and self-employment is based on the current situation of France. Figures show that 93% of the businesses in this country are microenterprise, with ten or less employees, of which 984,000 are businesses which have between one and nine employees and 1,746,000 (59,7% of the total) are companies with no employees. All this is occurring in an environment in which there are more than four million unemployed people, and eight million people below the relative poverty threshold. Furthermore, Adie interprets these figures pointing out that social aid in France is based on passive disbursement to employment.

Moreover, since its beginnings, Adie has made a great effort on all the legal, bureaucratic and political aspects, putting pressure on the public powers to “change the texts” which have been barriers for the development of certain professions or obstacles for the creation of independent activities. Later on we will see step by step the changes that have taken place thanks to their hard work.

Let us see the chronological evolution and the results of Adie in figures. Between 1990 and 1994 Adie’s efforts were concentrated on identifying and searching for its potential clients. We want to remind you that Adie was created as a result of the efforts of María Nowak to implement what she knew about the Grameen Bank through Muhammad Yunus. During those first years several methodologies were analyzed to adapt them to the socio-cultural context of France and the first loans were granted with Adie’s own funds collected from various investors and donors.

Between 1995 and 2001 they started having cooperation agreements with banking institutions and developed the Adie network nationally. During this

time, thanks to the lobbying work of public institutions, they managed to change banking laws to allow associations to ask for loans to be able to grant loans themselves.

In 2006, the international year of microcredits, they obtained recognition as a Non-Profit Organization and at the same time the creation of companies was recognized legally as a way to achieve social reintegration. Meanwhile, Adie kept growing past the French frontiers and Adie International was created with agencies outside France in places such as Kosovo, Tunisia and Belgium.

But perhaps seeing figures is the best way to understand the importance of this organization as well as its commitment with its foundational social mission. Adie keeps reaching a socially excluded part of the society. Amongst the people it helps, 41% are from the bottom of the social structure, and unlike the conventional market, it helps a great number of women (41% compared to 29%) as well as young entrepreneurs, doubling the average of enterprise creation outside Adie.

Concerning the data until December 2011, Adie had granted in that year 12,261 microcredits with a total value of 52.5 million Euros. The rate of portfolio at risk was 9.21% and the write-off ratio 2.51%. Quite significant figures taking into account the difficulties of doing microfinance in Western Europe. But the figures which show all the work there is in the coaching and the commitment for the created companies to last and generate work have more value than the merely economic ones.

Amongst the almost 14,000 companies that have been created with Adie's help, an employment creation of 1.38 workers per company has taken place, which, along with the data put forward before, is more than 59.7% of the total of French companies which do not have any employees. Regarding their survival, 68% of them are still active two years later, and 59% after three years. Figures to be understood taking into account the current state of the country's economy.

As we previously mentioned, an important part of Adie's work concerns the legal aspect of microfinance. We will now state some of the Adie's achievements for the French legislation, as well as the challenges it will face in the future, and the ones it is working on to achieve right now.

In 2001 they managed to amend the existing laws granting associations the possibility of asking for loans with which to grant loans to their target group. Microfinance institutions (MFI) fell under the Ministry of Finance. Years later, in 2005, they not only achieved recognition of the creation of companies as a way to achieve social reintegration, but they achieved a reduction of social security contributions for microentrepreneurs with reduced rents as well. In other words, a new specific section of contributions to social security. There is also a change in the Employment Agency, which starts offering training courses. Furthermore, that same year, 2005, there is a reform of the law on interest rates, which eliminates the upper limit of rates for loans to individual companies.

In 2007 they finally won the battle against disproportionate burdens on business. These demands were due to the anomaly in the legislation for those people with independent economic activities and income below the minimum threshold. With the previous legislation some of the people in this situation but with an annual income of more than 1,500 Euros, might have to pay contributions to social security up to a rate of 95%. Thanks to Adie's efforts, what they call a *bouclier social* (social shield) was designed; it put a limit to social security contributions, with a maximum of 48%, ratified in 2009 in the text for specific contribution plan of auto-entrepreneurs.

In 2008 an extension of what was contemplated in law in relation to the capacity of associations to borrow money and lend money was achieved. Since then, associations and foundations, whose clients are microenterprises with at least three employees, are allowed to borrow and lend. It is also permitted to grant personal loans to those who do not have access to the traditional banking system.

Furthermore, the regimes "entrepreneur" and "reduced economic activities" were created. The inscription of this kind of activities through the internet was facilitated and they must not pay social security contributions as long as they do not have profits. More than a million entrepreneurs have registered to this day. These facilities are one of the main legislative moves forward since they encourage the formalization of businesses, creating a legal framework for those which would have more difficulties to adapt themselves to the established market.

Even if the current entrepreneur regime is not perfect, it has helped the economic development in France. The objective of creating these regulatory

authorities is to adapt to the changing reality of society. There are many people who have several jobs. They work as employees but they still need some other income to subsist. If that is what is happening, and they take part in other activities which generate income, which are far from being companies, it is the legislative body's obligation to create an authority to guarantee rights and responsibilities.

European legislation has not managed to adapt to the social changes which have taken place, and although there are certain regulations for entrepreneurial work, the same rules cannot be applied to microenterprises. Although it might seem an obvious fact, they are still fighting for social security contributions to be more fair and proportional to the profits of the economic activities. Europe is still missing the cultural and mentality change from a traditionally wage-earning society to an entrepreneur society.

Finally, one of the advances which must be highlighted is that since 2010 private individuals may microfinance institutions with a void or very close to zero interest rate. In recent years, this financial model has strongly developed, mainly thanks to the creation of internet platforms to attract funding by the general public. To be eligible for these investors the microfinance institution must have at least two years' experience.

These are the achievements until now, but **what is still to be done?**
What are the future challenges of the sector?

First of all, continue developing the infrastructures which allow starting a business easily. The main goal is to simplify the creation and management of microenterprises. Adie is working mainly on three fields. One is finance and access to finance, as well as all kinds of bureaucratic procedures when it comes to creating microenterprises. It is fundamental that modest entrepreneurs can have access to funding to constitute their own equity. The procedures to create microenterprises must also be simplified, so they stop being a barrier when it comes to undertaking. The second field is the relation between these economic agents and the State in terms of administrative burdens and specially simplifying the social contributions system and creating a positive regime for autoentrepreneurs. And lastly, to carry out changes in the regularization, which make the barriers which prevent the development of the access to independent work more flexible.

Another of the important challenges of the sector is everything involved in coaching and training. Although it seems that the great problems of undertaking are economic, one of the important innovations microcredits entail, compared to the formal banking system, is coaching. Over time, it is possible that, to some extent, perspective is lost, and that while taking care of the economic part, the focus on training and education starts gradually fading. This is still a fundamental point in Adie's mission; therefore they keep dedicating effort and lobbying work policies to give it the importance it deserves. This way it is promoting coaching for the creation of enterprises to take effect through a vocational training fund to which all companies pay contributions. This fund, which already exists, has served to provide training courses for unemployed people since 2005, but the objective pursued by Adie has not yet been reached.

They are also trying to encourage the possibility of young entrepreneurs having the necessary financial support to create a microenterprise, during the creation phase and while the preparation of the project lasts.

Adie is also striving to create a system which acknowledges personal skills. A possibility would be some kind of exam which offers guarantees. The idea would be to have some kind of certificate to support the project designed, backed by the fact that it is a competent and qualified person who is developing the project.

And finally, among the challenges for the future, apart from simplifying formalities and guaranteeing quality training, is developing aspects of the microcredit environment to make the sector a more prosperous activity. The main improvements Adie suggests are on the one side, the possibility of natural persons being able to participate in refinancing microcredits which have already been granted, and on the other, allowing the existing microfinance institutions to finance companies which more than five years' experience, so microcredits are not limited only to the creation of new companies.

All the changes they hope to achieve, and the entire journey travelled in France, are thanks to the meticulous lobbying work carried out from the legal department of Adie. In each proposal made, several departments are involved, from the Presidency and the Department of Studies to the internal legal framework itself made up of advisors and volunteers, as well as law firms which volunteer their work.

Once each case is studied, the lobbying work starts with a great dissemination campaign. It must reach clients, as well as society in general, the existing laws and the real situation. This way they can start explaining that the current laws are not adapted to reality. It is important to acknowledge that there are failings and that the environment could be improved to create a space which is more propitious for economic and social development.

Adie carries out a legal study and also analyzes the social and economic impact that the measure would have if it is passed. Then the bill or amendment to the current law is submitted, which along with the impact study is released in the media to reach the population, not just as a law but also with an economic and social justification which supports it. Once the need is spread, the proposal is presented to the appropriate ministry, waiting for the right moment, and with the proposal developed already so the administration does not have to work on it. From that moment on, all kinds of negotiations and meetings take place to manage, in the best-case scenario, to get the government to pass the bill. This is a long and hard task according to Adie's experience, and it sometimes gives rise to legal processes which are not always successful.

If instead of concentrating on a country we look at Europe, the pattern is very similar. Continent wise the problems are the same in terms of adapting the institutional framework for undertaking and microenterprises. Although in Europe there is an initiative to develop microcredits, there is no concrete initiative to develop common legislations.

In the recent years, Adie along with the European Microfinance Network (EMN) and Microfinance Centre (MFC) is trying to focus efforts on this area. We can highlight a joint conference on barriers to creation and development of microenterprises.

Another important conference, called *Colloque Inversé*⁵ promoted by Adie took place on February 8, 2012. This conference directly involved the European Commission, which was responsible for the presentation.

One of the most important aspects of this conference session was that it was possible to listen first-hand to the experiences of six microentrepreneurs,

⁵ www.adie-colloqueinverse.org

explaining the barriers that they had found when undertaking. This way, it was possible to see the reality of the situation in several countries in Europe, before going deeper into the subject in the following sessions.

During the second session they insisted on the barriers, but this time not from the point of view of microentrepreneurs. Two micro financial institutions, two banks and an academic representation from university participated in this talk.

Finally, the third session aimed to show the prospects for change, although each country will have to decide its own future, since they are competences of the State, from this platforms they try to homogenize the situation of the Member States of the European Union. So, in this session there were not only representatives of businesses and employment agencies, but also the European Commission, which closed the conference, and whose role was to facilitate good practices with the purpose of equalizing the quality of microfinance in the whole of Europe.

6. THE LAW ON MICROCREDIT IN ITALY: FROM BANKING LAW TO SPECIFIC LEGISLATION

Giampietro Pizzo
President of MicroFinanza Srl

The regulatory process of microcredit in Italy has over the last three years experienced a strong acceleration. This is due to greater public attention to the phenomenon of microcredit and to the need for the swift implementation on part of the legislative system of the EU directive on consumer credit. These coinciding pressures have led to changes of the Consolidated Banking Act (*Testo Unico Bancario* - TUB), a set of rules regulating banking activity, included in the Legislative Decree no.141 of 13 August, 2010.

For the first time in Italian banking history, the act makes explicit provisions for the possibility of entities to operate formally as microcredit institutions. Without going into too much detail, the salient points of Articles 111 and 113 of the Consolidated Banking Act (TUB) are recalled below.

Article 111.

- Formally recognized microcredit operators must adopt the legal form of limited liability companies or cooperatives, with the exception of non-profit organizations that may engage in microcredit activities if they offer microcredit loans under unprofitable conditions, or with the mere intention to cover costs procedures.
- For all operators, a minimum amount of capital will be defined in implementing regulations. It is very likely that the amount requested will oscillate between a minimum of EUR 120,000 and a maximum of EUR 600,000 (corresponding to the current capital requirements applied to Non Bank Financial Institutions).

- Authorized operators must demonstrate that its business purpose will be limited to microcredit activities including additional and instrumental activities. This excludes the possibility of microcredit being but a simple line of business within a more complex institution. However, the debate still remains open with regard to whether the word "limited" should be understood as primarily or exclusively.

The regulator has defined the existence of the following **two types of microcredit products**:

1. Microenterprise loans.

- With a ceiling of EUR 25,000.
- Without collateral, for activities aimed at micro and/or self-employment.
- Accompanied by auxiliary business support services.

2. Social microcredits.

- With a ceiling of EUR 10,000.
- Without collateral, for vulnerable people.
- Accompanied by supplementary personal/family budget.
- Support services and based on better financial conditions than those prevailing in the market.

This normative approach focuses on microcredit services for enterprises and the self employed, treating social microcredit only as secondary. It should be noted that social microcredit currently outweighs microcredit for enterprises in Italy. The implications of the legislation on the real context are difficult to foresee at present.

Article 113.

In its original form, this Article of the Consolidated Banking Act (TUB) provided the immediate establishment of a private law body for maintaining a register of operators. As such, the article acknowledged a great deal of

autonomy to the sector; almost imposing a condition of self-discipline. In the new revision of the text, presented in October 2011, the establishment of this body has been postponed until a later date and the Bank of Italy will, in the interim, be in charge of keeping record, supervision and control of microcredit operators.

It should be noted that the implementing regulations are unfortunately not yet defined; the enactment of the implementing regulations lies with the Ministry of Economy and Finance upon the proposal of the Bank of Italy. Only with the adoption of the implementing regulations can the new legislation become effective and can microcredit operators apply for inclusion in the register.

Despite the debate that accompanied the preparation of the proposal of the implementing regulations, there are still many open questions regarding the final status of the classification of the legislation; including the definition of the constraints on the use of credit, the identification of beneficiaries of funding (for example, what types of microenterprise are to be considered eligible) and the policy on interest rates that non profit organizations may apply in relation to the volume of the activities.

A more comprehensive assessment of the new regulation must await the first practical applications. For now, the general judgment is that the law constitutes a necessary, but not sufficient, condition for a properly regulated microcredit sector. On one hand, it can provide a positive challenge for the professionalization of the sector. On the other hand, the banking supervisory authorities are still looking at microcredit as an exceptional condition, and to some extent also as a privileged sector (since applied control conditions are fewer if compared to other sectors). As such, it should remain a well-defined area without the risk of potential overlapping with Non Banking Financial Institutions.

For these reasons, and with an almost general consensus among microcredit operators, the road has been taken to provide the sector with a real dedicated legislation, which not only will allow for more professional and rigorous microcredit activities, but above all, accept the challenges of growth and strong local roots.

In this spirit, the new regulation should strongly emphasize the importance of microcredit and its promotion as a tool for promoting social inclusion and

combating financial exclusion. The specificity of microfinance compared to other financial instruments lies primarily in the type of credit assessment and the provision of essential accompanying services such as financial education, training, mentoring and technical assistance to investment projects.

The legislation should be characterized by a number of specific elements, namely:

- Bureaucratic simplification, both for microcredit operators and for applicant.
- An advantageous fiscal system for operators in order to foster the transformation of informal economic activities.
- Liberalization of applied interest rates, recognizing that the adopted policy of preferential interest rates has so far penalized, rather than promoted, the industry.
- Public support for the development and consolidation of non-financial services, which are regarded as essential and can be seen as a set of positive externalities produced by microcredit operators.
- A communication and guidance policy for a public opinion that must be able to effectively guide situations of distortion produced by excesses in the supply of consumer credit and the phenomena of over-indebtedness.
- A set of tools that encourage local authorities wishing to promote and develop the provision of microcredit within its territory.
- Support for research and financial analysis of the phenomena of financial exclusion and imbalance between credit supply and credit demand.

This involves a non-going process that actively includes some parliamentary groups as well as a good number of experts and networks of operators. The hope is that the momentum of the amendment of the Consolidated Banking Act can now be translated into providing Italy with a flexible and effective legislation for the national development of microcredit as soon as possible.

7. IS THE REGULATORY FRAMEWORK IMPORTANT FOR THE DEVELOPMENT OF THE MICROFINANCE SECTOR? CASE STUDY ON THE ROMANIAN EXPERIENCE

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Microcredit is defined by the European Commission, as a loan under 25,000 € to support the development of self-employment and microenterprises. It has a double impact: an economic impact, as it allows the creation of income generating activities, and a social impact as it contributes to the social inclusion and therefore to the financial inclusion of individuals.

The term “microfinance” includes both microcredit for small businesses of microentrepreneurs, community development projects, social programs and loans to lower income individuals, especially the poor and the very poor as well as other services associated to credit, e.g. business development services, microinsurance, guarantee, etc. In Romania the business development services (non-financial services) provided to the microcredit beneficiaries or potential beneficiaries cannot be provided by the microcredit (financial services) provider.

In Eastern Europe, individuals and microcompanies with no credit history and few assets to use as collateral, rarely have access to the formal financial sector, as long as due to the size of loans sought by these borrowers, that are often too small, the administrative costs of granting and monitoring such loans outweighing the benefits for banks. In less words: it is too expensive for the banks, including the SMEs banks, to provide microcredits.

Those borrowers need to seek alternative credit sources, such as informal commercial and non-commercial lenders — often at a very high cost — unless they can access donor supported sources administrated by non-profit non-governmental organizations (NGOs), or Credit Unions.

Microfinance activities started in Romania almost 20 years ago (1992-1995), when the first international microfinance organizations launched Entrepreneurship Development and Microfinance projects in Romania. At the end of the project phase, the microfinance activities were transferred to the NGOs established, to ensure continuation and sustainability of the intervention.

After Romania's accession to the European Union, the MF sector is facing a new challenge, the increased demand for financial services from the micro and small enterprises; the estimated unmet demand for 2007 is projected at over 700 million euro.

Is Microfinance Legislation Needed?

The legal framework for the microfinance activities in Romania was initially created (2000) to allow Ministry of Labor and Ministry of Economy to channel the public funds Programs for Entrepreneurship Development and Microfinance provision, to unemployed and potential entrepreneurs from the former mining and mono-industrial towns within the industrial regions' restructuring process.

Initially, specific legal framework was considered needed to differentiate the microfinance activities from the initial microcredit and business development projects implemented by the international MFIs, and raise awareness of the policy makers on the MF sector and its impact and contribution to the country's economic development.

During the following years 2004-2005, the legal and regulatory framework was re-defined, Microcredit company law 240 was adopted by the Romanian Parliament in June 2005, with the main aim to support the diversification of the financial sources for the MFI's portfolio, protection of the clients, clear governance mechanism, risk control and transparency to lead towards the sustainability and development of the sector.

Main actors involved in the lobby effort were the representatives of the MFIs, SMEs agency, Ministry of Economy.

During the same period the pawn shops, mortgage and leasing financial services providers, Credit Unions, guarantee funds for SMEs and farmers, were drafting and promoting their own legal framework pursuing the same goals: sustainability and development.

Government Ordinance 28/2006 was transformed in 2009 in Law 93 of the Non Bank Financial Institutions (NBFI), unified under a single law as the legal and regulatory framework of all NBFIs. This law regulates the registration and minimum capital requirements, conditions for loans granting, client's protection, reporting requirements, governance and management, among others, aiming to ensure and maintain financial stability of the Romanian financial sector.

Central Bank: National Bank of Romania (NBR) is the supervisory authority of all Non Bank Financial Institutions (NBMFIs): Leasing, Mortgage, Credit Unions, Guarantee/ Counter-guarantee fund, Pawn shops, including Micro Finance Companies.

All NBFI are authorized by NBR and registered in the NBFI general registry. Based on the amount of capital, value of the portfolio and the value of total assets, the large MFIs are registered in the special registry. The supervisory regulations and reporting requirements for the large MFIs are similar to the banking sector.

Within the last years: 2008-2011 the Non Bank Financial sector is serving one third of the Romanian financial market.

The Romanian Microcredit providers are financially and operationally sustainable. The development of the sector measured in terms of geographical outreach, increased efficiency, productivity and profitability are good indicators that the development process will continue.

Because of the diversification of financial sources for MFIs portfolio: social lenders, investors, EU funds, as well as the access to technical assistance provided by the investors and EU programs, the sector evolved rapidly and became more efficient and productive in achieving its mission of providing affordable financial services to underserved entrepreneurs.

The Romanian experience proves that a clear and concise microfinance legislation would likely place the MF sector on the fast track to development, which in turn, would serve as a driving force in combating poverty, creating jobs, educating borrowers about finance and business, increasing entrepreneurship and social welfare, and developing the Micro, Small and Medium Enterprise sector.

Lessons Learned:

Few lessons can be learned from Romania's experience in the creation of an effective regulatory framework for microfinance.

First, a clear, coherent and supportive legal framework is necessary for the development of the microfinance sector. Prior to 2000, the Romanian microfinance sector was: "not regulated at all", "well regulated" for a short period in 2005, when the Microcredit Company Law was in force and since 2006 as Non Bank Financial Institution, the sector is "overregulated". It is supervised strictly by the NBR and the Ministry of Finance, based on rules that were designed for the banking sector rather than the microfinance sector through the Non Bank Financial Institution Law.

Due to the legal framework, the Romanian Microfinance sector is divided into different segments. The first is a mature one, efficient, operationally and financially self-sufficient and attractive to lenders. The second is composed of a large number of new MFIs, registered after 2006. They are still immature and need specialized technical assistance and training in order to successfully integrate into the sector, and thereby, contribute to its achievements.

It seems that the commercialization strategy pursued by most of the MFIs since 2004 paid off. However, faced with the need to be more and more profitable, the MFIs are struggling to maintain their social orientation.

The Second lesson learned is the importance of continuously lobbying stakeholders, making them aware of the sector's most important characteristic: efficient financial services with positive social and developmental impact.

Therefore, active participation in the elaboration process of the European Code of Good Conduct, European Microfinance Network (EMN) Legal and Regulatory Working Group and the organization of the 9th EMN Conference in Bucharest with the intention to be a forum of debates, an exchange of ideas and experiences on the theme "Bridging the sustainability gap", is part of the process started almost ten years ago.

Moreover, the achievement of the triple bottom line, through a continuous improvement of the quality of services provided to targeted clients, social responsibility towards the staff, clients, community and environment, is the challenge that faces the Romanian and European microfinance sector.

8. HUNGARIAN MICROFINANCE LEGISLATION

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8.1. Introduction

The purpose of this document is to provide a short summary of the legislation currently applicable to the microcrediting sector in Hungary. It also gives a brief outline of how the legislation is put into practice and how it has evolved throughout time. The document itself does not aim at completeness, i.e. it does not intend to describe the structure and practice of all the organizations defining themselves as ‘microfinance’ institutions without having a significant social impact. It rather concentrates on the determinant institutions and the practice thereof. However, the presented legislation is considered as standard with regard to all the organizations not mentioned herein.

There is no general legal framework regarding the microcrediting sector in Hungary. However, there are special rules in force which regulate the operation of institutions that deal with microcrediting. In order to interpret and understand these rules and regulations it is inevitable to learn about the history of microcrediting in Hungary. For this reason, I will also write about the evolution of the microcrediting sector in Hungary briefly.

8.2. Historical overview: the establishment of non-profit microfinance organizations

8.2.1 Political and democratic transformation in Hungary

After the political changes, the number of micro and small enterprises started to increase rapidly at the beginning of the nineties in Hungary,

mainly due to the fact that a lot of people who had been made redundant as a result of the closing down of factories were forced to set up their own enterprises. Since the change-over from the controlled plan type economic model to market economy, these enterprises had to form the backbone of the national economy and the Hungarian governments that came into power after the political changes aimed at strengthening this sector. Due to their high number and ability to provide employment, it is indeed an important national economic interest.

The development and efficient operation of the enterprises (and especially their survival) belonging to the sector, were significantly hindered by the fact that there were no real entrepreneurial traditions in the country and people did not have entrepreneurial experience or knowledge. At the same time the lack of capital in the sector posed a serious problem. The countries of the European Community (and later the European Union) provided great help to Hungary in order to tackle the problems. The first entrepreneurship promotion projects were started at this time within the framework of the PHARE program.

8.2.2. PHARE enterprise promotion program

Group 24 of the developed industrial countries made a decision for the first time in 1989 to support the process of economic and political transformation in the former socialist countries of Central and Eastern Europe. The PHARE program was started in 1990 in Poland and Hungary (this is where the PHARE abbreviation comes from: Poland-Hungary Assistance for the Reconstruction of the Economy, in other words, Aid program for the Economic Transformation of Poland and Hungary) within the scope of this support.

Following the historical changes which took place in the region, the number of countries receiving the benefits increased gradually. The purpose of the aid-program was to facilitate the change-over to market economy in the countries of the region, which among others included privatization and the full liberalization of the economy, too. This step provided funds from which the individual governments could finance the transformation managed by themselves.

Recognizing that small and medium-sized enterprises play a determinant role in furthering the economy, the government of the Hungarian Republic

worked out an entrepreneurship promotion program. As an important element of this, the government initiated the establishment of an agency aiming at supporting and motivating the enterprises. Various financial institutions and bodies representing interest joined this initiative, and the 16 founders set up the Hungarian Foundation for Enterprise Promotion (HFEP) on 27 March 1990 with a starting capital of HUF 4.24 billion (approximately EUR 14 million).

8.2.3. The setting up of the enterprise promotion network

Since the objectives of the PHARE program launched in Hungary and the objectives of HFEP were the same, the HFEP was entrusted with the handling of the aid-program of 21 million ECU reserved for the development of small and medium-sized enterprises in the 1990 budget of the PHARE program. PHARE required the setting up of a Local Enterprise Agencies's (LEA) network, where the previously mentioned target group was supported in the form of professional counseling and business services.

At the outset six pilot LEA's were set up in the form of a foundation:

- Enterprise Agency of Jász-Nagykun-Szolnok County, Szolnok.
- Enterprise Centre of Tolna County, Szekszárd.
- Enterprise Agency of Borsod-Abaúj-Zemplén Count, Miskolc.
- Enterprise Centre of Somogy County, Kaposvár.
- Fejér Enterprise Agency, Székesfehérvár.
- PRIMOM Enterprise Agency of Szabolcs-Szatmár-Bereg County, Nyíregyháza.

Then the network was expanded to the whole territory of the country.

At the beginning, HFEP selected the independent foundations established by various founders by means of tenders, and later it also created such foundations. There are twenty Local Enterprise Agencies altogether (there is one in each and every county and one in the capital).

8.2.4. Launching the microcrediting schemes in Hungary.

The concept of launching the National Microcredit Scheme was formulated at the beginning of 1992. Within the framework of the PHARE program the Committee of the European Community wanted to handle the problem developed economies also had to face, i.e. that most of the micro and small enterprises are not credit-worthy in the eye of the profit orientated credit institutions. This is such a market failure where the market mechanism does not operate suitably (the supply does not satisfy the demand being present permanently), the solving of which is in the interest of the national economy, and makes the intervention of the government justified and necessary.

Market failures: a situation when government intervention is required in order to maintain undisturbed operation. Incomplete markets are a type of market failure, because the quantity of products demanded by consumers does not equate to the quantity supplied by suppliers. Certain capital markets can also behave in this manner.

In reply to these demands, the Committee of the European Community separated 1.15 million ECU from the 21 million ECU subsidy directed to the sector of Small and Medium-sized Enterprises in the 1990 budget of the PHARE program in order to finance the program to be launched.

After this, the enterprise agencies operating in the counties and the capital started to operate the first microfinance program in Hungary — under the name of Microcredit Scheme (today National Microcredit Programme) — in 1992 under the financial interposition and professional coordination of HFEP. At the outset the sources for the program were provided by PHARE (then the Hungarian government as a co-financer) in the form of earmarked subsidy.

8.3. Legislative environment and microcrediting practice; first operating period: 1992-1998

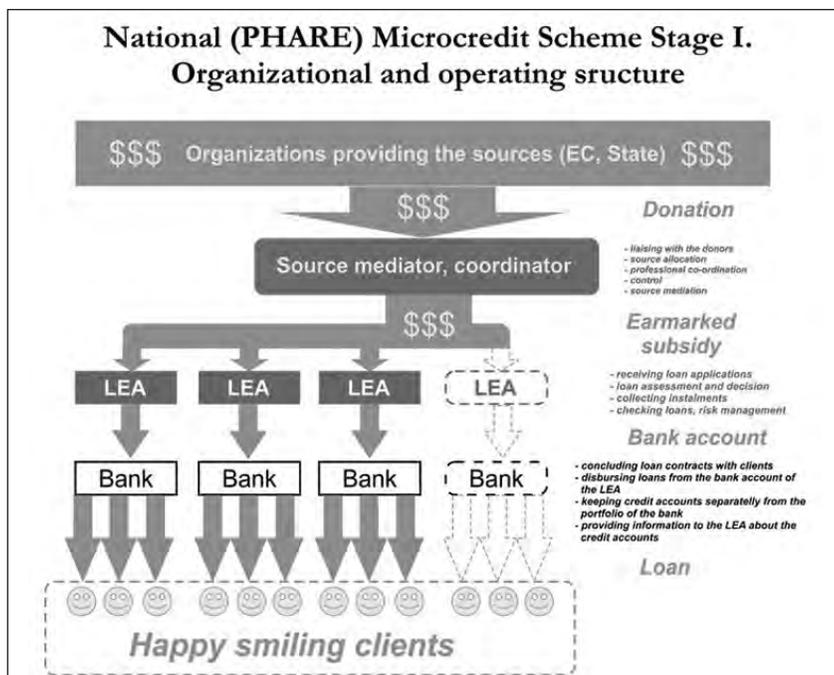
The legislative background of the microcrediting practices to be presented will be grouped according to the following aspects:

- The legal status of the concerned organizations,

- The general legislation regarding the operation of the concerned organizations (resulting from their legal status),
- Special legislation having an impact on the crediting practice of the concerned organizations,
- General legislation having an impact on the crediting practice of the concerned organizations,
- Internal regulation regarding microcrediting,
- Supervision, reporting obligations.

8.3.1. Organizational and operating structure

The following diagram shows the organizations participating in the operation of the Microcredit Scheme, their most important responsibilities, as well as their connections:



8. 3.2. Organizations involved in the operation of the program.

National program coordinator and mediator of the sources: **Hungarian Foundation for Enterprise Promotion (HFEP).**

- Legal status: non-profit foundation.
- Responsibilities:
 - Liaising with the donors.
 - Source allocation.
 - Providing technical assistance for the Local Enterprise Agencies (LEAs).
 - Professional evaluation of the program.
 - Checking program implementation.
 - Mediating the sources to the LEAs in the form of earmarked subsidies.

Local Enterprise Agencies (LEAs).

- Legal status: non-profit foundation.
- Responsibilities:
 - Receiving loan applications.
 - Assessing and approving of loan applications.
 - Checking loans, risk management.

Commercial Banks.

- Legal status: profit orientated commercial banks operating under the effect of the Act on Financial Institutions and the Activities of Financial Institutions.

When the Microcredit Programme was launched in 1992, the operation of profit orientated financial organizations was regulated by Act No. LXIX of 1991 on Financial Institutions and the Activities of Financial Institutions.

The basic function of the Act was to protect depositors and to regulate the operation of profit orientated players of the money market. This Act was repealed and replaced by Act No. CXII of 1996 on Credit Institutions and Financial Enterprises.

- Although the LEAs acting as creditors in the Microcredit Programme.
 - Did not deal with deposit taking.
 - Received the sources — public money — in the form of earmarked subsidy in order to finance programs fulfilling specific social goals.
 - Performed their activities as non-profit organizations (they did not make any profit).

Several experts believed (in my opinion quite wrongly) that commercial banks should be included in the operation of the program because, according to the provisions of the above-mentioned Act, ‘only banks may grant loans’ in Hungary. Though this conclusion could not be drawn from the context (and function) of the Act, due to the various opinions and to ensure that the program did not violate the Act, commercial banks were also included in the program.

- Responsibilities:
 - Keeping the separate program account of the Local Enterprise Agency.
 - Concluding the loan agreements with the clients on the basis of the decision of the LEA.
 - Disbursing the loan from the bank account of the LEA.
 - Collecting installments.
 - Keeping loan accounts (credit records) separately from the own loan portfolio.
 - Supplying LEAs with data with regard to the loan portfolio.

The LEAs were selected by the Hungarian Foundation for Enterprise Promotion via tenders, and the commercial banks were selected by the LEAs also by means of tenders.

LEAs paid the commercial banks a fee, which could be accounted for to the debit of the fund. The bank did not assume any kind of risk related to the lending.

8.3.3. General legislation concerning the operation of the foundations.

Act No. IV of 1959 of the Civil Code regulated the operation of foundations, whereas a Government Decree [currently Government Decree No. 224/2000 (XII.19.)] regulated the management thereof.

The main general characteristics of the foundations on the basis of the referred rules of law:

- They are non-profit organizations having independent legal personality.
- The objectives of the organization are defined by the founders in the Deed of Foundation and the set objectives may only be modified later on with limitations.
- The assets of the foundation are handled by the Board of Trustees specified by the founders in the Deed of Foundation.
- The rights of the founders are limited:
 - They may only participate in handling the assets of the foundation and the management thereof with limitations (the founders may not represent a majority in the Board of Trustees).
 - Any member of the Board of Trustees may only be removed if it can be proved that he/she hinders the operation of the foundation in view of the set objectives.
- The Deed of Foundation may only be modified with the uniform agreement of all the founders.
- The founders or donors may not claim back the donations provided for the achievement of the objectives in any manner.
- The foundations are represented by the President of the Board of Trustees.

- In order to perform operative tasks, the foundation may set up a work organization, which is managed by the Managing Director.
- The foundations are registered by the Courts, and the statutory supervision is exercised by the Public Prosecutor's Office.

In 1992 the operation of commercial banks was regulated by Act No. LXIX of 1991 on Financial Institutions and the Activities of Financial Institutions. This Act was repealed and replaced by Act No. CXII of 1996 on Credit Institutions and Financial Enterprises.

8.3.4. Special legislation relating to the microcrediting activity

When the program was launched in 1992, there was no general legal framework regarding the microcrediting activity, nor was there any special legislation in force concerning the microcrediting activity of the individual microfinance organizations.

8.3.5. General regulation

The general rules regarding the accounting and reporting obligations of the organizations participating in the operation of the microcredit program were provided by Act No. XVIII of 1991 on Accounting. This Act was repealed and replaced by Act No. C of 2000 on Accounting.

8.3.6. Internal regulation

The internal rules of procedures of the program are listed in the Manual of the PHARE Microcredit Programme. The Manual and the terms and conditions of the program were developed by a British specialist company with the cooperation of Hungarian professionals, in view of the national characteristics and legal background.

According to the regulation, the funds were operated in a decentralized manner. Each enterprise promotion foundation managed its own fund, which was handled separately from its other funds.

In order to run the program, each foundation set up its own microcredit division, which was managed by a microcredit manager having a degree in

economics or law. These microcredit managers learned how to manage the funds on courses organized by Western European specialists.

The foundations created a sub-office network, which spawned more than 150 contact points all over the country. In these regional and central offices the potential clients were not only able to submit their loan applications but they also received technical assistance. The entire assessment and portfolio management was performed by the microcredit division of the foundations. The loans were assessed by the Microcredit Committees set up at each foundation. Economic specialists, lawyers, entrepreneurs and the managers of the individual foundations participated in the work of these committees as a social undertaking. The loan assessment was always preceded by the examination of the loan application and a personal visit paid to the client. Then, on the basis of the recommendation of the microcredit division, the Microcredit Committee decided on the disbursement of the loan. The operation of the program was checked by an international audit company on behalf of the HFEP quarterly.

The bank disbursed the loans (concluded the contracts) from the microcredit fund (deposit) placed at the bank in return for a fee, collected the installments and the interests, as well as kept the records. However, the microcredit division of the foundations was responsible for monitoring the loan portfolio, conducting follow-up checks and managing legal procedures aiming at the collection of overdue debts.

The payments made by the clients — including the interests as well — had to be ploughed back into the funds. The operation was financed by calling the budget from the funds, the amount of which depended on the number of loans disbursed and the interest received from the clients.

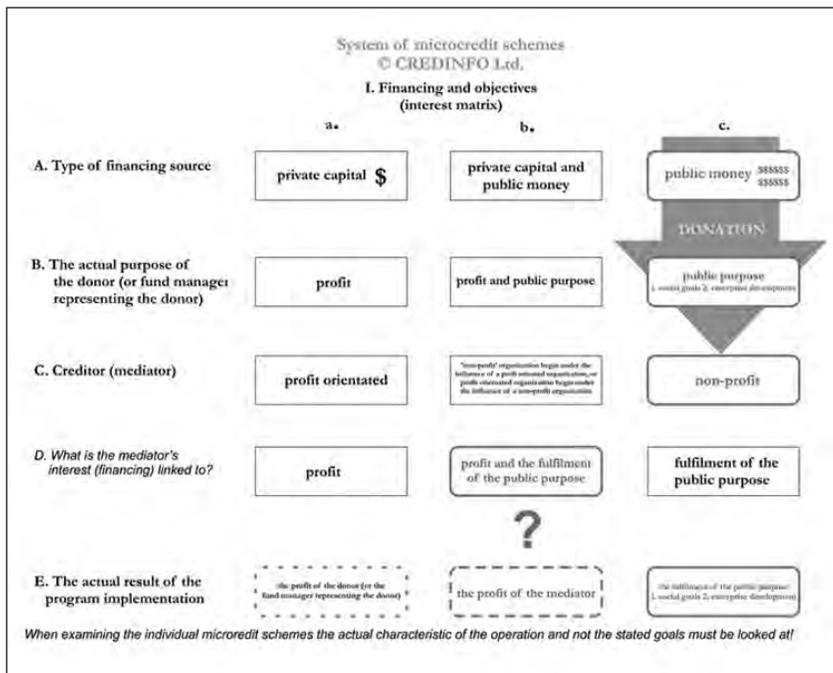
The procedures were conducted quickly and flexibly, and the foundations showed maximum tolerance towards businesses that had payment difficulties.

In the first period, the foundations were not allowed to request anything else but the asset purchased from the loan as the security of the loan so that the social goals could be achieved. The auditors of the PHARE program checked the adherence to this requirement regularly.

At the national coordinator, which was the HFEP, all the tasks related to the central coordination were performed by a manager and an administrator.

8.3.7. Interest matrix and the fulfillment of the social goals.

The interest matrix (© CREDINFO Ltd.) of the first stage of the program is shown by the following diagram:



8.3.8. Summary of the experience.

With regard to the fulfillment of the social goals this program was considered as one of the best enterprise promotion programs of the PHARE and the best and most successful program in Hungary.

In May 1998, the European Economic Committee of the UN organized the Microcrediting Best Practice Specialists Meeting together with USAID within the framework of Southeast European Cooperation Initiative (SECI), in which 12 countries, including Greece and Turkey, participated from Central and Eastern Europe. According to the survey conducted by the British Bannock Consulting, the then existing Hungarian practice was the best microcredit program in the region.

The success of the program was also due to the fact that there was continuous professional consultation taking place between the national coordinator and the professionals. National professional meetings were organized quarterly, where the participants could exchange their experience and put forward suggestions for the improvement of the program.

Although the program was a great success, there were several problems that had to be solved.

Problems relating to the operation:

- It was difficult to adjust the loan products to the financing needs of the clients, and the proposals regarding the improvement of the rules of procedure could only come into force after it had been approved in Brussels. This made the system very inflexible.
- With regard to the financing of the operating costs, the system was not sustainable for a long time. The HFEP did not have any income from the operation of the program. Even the salary of the program coordinator had to be paid from a different source. At the LEAs even the direct costs could not be financed with the help of the system. In the interest matrix the profit was indicated conditionally because by using the sources they obtained the ownership right over the fund received as donation.
- The involvement of commercial banks in the operation of the program was unjustified from a professional point of view. It only made the operation of the system more expensive and slower. Whereas the HFEP did not receive any sources from the program, and the LEAs found it really hard to finance the directly incurred costs, the commercial banks had to be given the fee requested by them and did not assume any responsibility or risk in relation to the operation of the program.

8.4. Need for the legislation and the amendment of the Act.

As described above the involvement of commercial banks in the created microcrediting system was unjustified from a professional point of view, since the non-profit foundations involved in the operation thereof

- Did not deal with deposit taking.
- Received the sources — public money — in the form of earmarked subsidy in order to finance programs fulfilling specific social goals.
- Performed their activities as non-profit organizations (they did not make any profit).

Another problem was caused by the fact that commercial banks became less and less interested in the program since they realized that it was really difficult to find potential clients for them. As a result, they terminated the relevant contracts in several counties, which made it difficult to find a bank that was willing to perform its responsibilities.

During the operation of the program it was always debated whether it was justified by the applicable Act to involve commercial banks in the program.

The solution seemed to be obvious. If it is not clear that the Act on Credit Institutions does not apply to the operation of the Microcredit Programme, this fact has to be clarified. It was suggested that the section on the organizations falling under the effect of the Act should be completed with the foundations being involved in the operation of the microcredit program.

The Act was amended in two steps, but not for professional or legal reasons, but for the ability of the individual parties to enforce their interests.

Due to the afore-mentioned financial problems the HFEP decided to centralize the funds the foundations received as earmarked subsidy, and to create a new operating structure. This led to a legal dispute regarding the ownership of the funds in 1998, which has not been closed down until today.

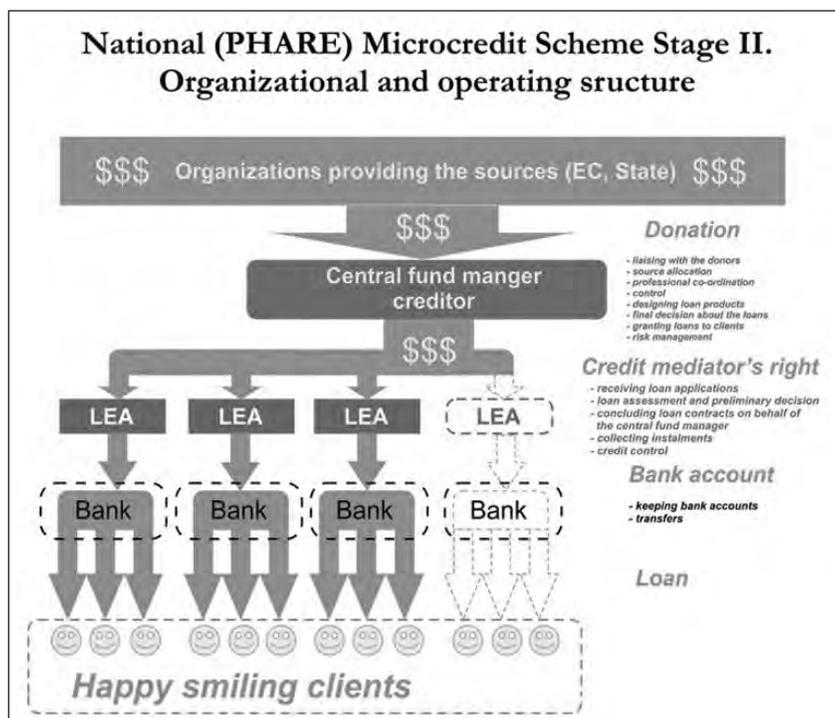
In 1998 the Hungarian Parliament amended Act No. CXII of 1996 on Credit Institutions and Financial Enterprises in such a manner that it removed the crediting activity performed from the National Microcredit Scheme of the Hungarian Foundation for Enterprise Promotion from under the effect of the Act.

The Hungarian Government amended Act No. CXII of 1996 on Credit Institutions and Financial Enterprises with Section 2 of Act No. XXXIX of 2003. On the basis of Section 2 (1) (h) of Act No. CXII of 1996. Following the coming into force of the amendment of the Act the crediting activity of the Hungarian Foundation for Enterprise Promotion and the microcrediting activity of the foundations operating in the counties and the capital do not fall under the effect of the Act.

8.5. Legal environment and microcrediting practice after the amendment of the legislation.

8.5.1. The organizational and operating structure of the National Microcredit Programme.

The organizational and operating structure of the National Microcredit Programme (the former PHARE Microcredit Programme) is shown in the diagram below:



8.5.2. Summary of the operating characteristics of the National Microcredit Programme.

National program coordinator and mediator of the sources: **Hungarian Foundation for Enterprise Promotion.**

- Responsibilities:
 - Designing loan products.
 - Granting loans from the centralized funds (National Microcredit Fund).
 - Keeping credit records.
 - Final decision prior to the disbursement of the loan.
 - Checking of the LEAs.
 - Risk management.

Local Enterprise Agencies (LEAs).

- Responsibilities:
 - Receiving loan applications.
 - Assessment and preliminary decision on the approval of loan applications.
 - Concluding loan contracts on behalf of the HFEP.
 - Collecting loans.
 - Checking loans.

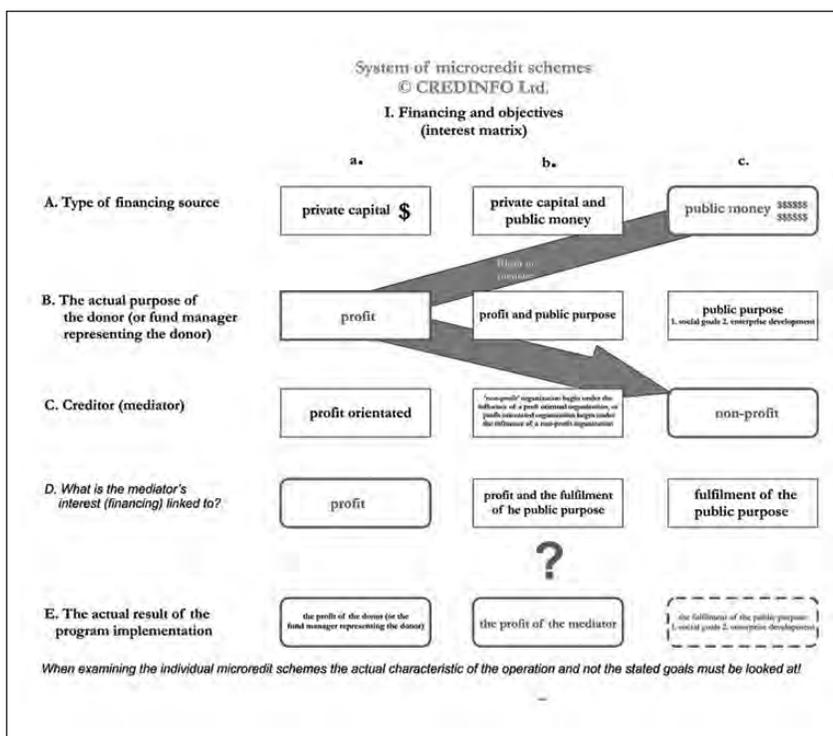
Commercial Banks.

- Responsibilities:
 - Keeping the separate program accounts of the HFEP.
 - Making bank transfers.

In this operating structure the creditor is the HFEP, the LEAs only participate as mediators in return for a fee, and the centralized fund is managed by the HFEP. The role of commercial banks is only limited to keeping the bank accounts and to perform the related transactions.

8.5.3. Interest matrix and the fulfillment of social goals, National Microcredit Scheme.

Without additional comment, the interests in the program are shown in the interest matrix (© Credinfo Ltd.) below.



8.6. Other impacts of the changes in legislation.

8.6.1. The option for alternative microcredit programs.

The legislation described above did not lead to the appearance of further microfinance organizations (this is rather a question of interest

and not legislation), but it paved the way to the introduction of alternative microcredit programs by the LEAs (Local Microcredit Programmes), which were more flexible and responded better to the needs of the businesses.

8.6.2. The internal regulation of the LEAs.

When it became clear, after the amendment of the legislation, that the microcrediting activity of the LEAs did not violate the law, an internal regulation had to be worked out, which ensured a professional framework for the performance of the lending activity independently of the HFEP and the National Microcredit Scheme.

When developing the internal regulation, it was not considered the structure and rules of the Manual of the National Microcredit Scheme, but the obligations prescribed for financial enterprises by the rules of law in force. Although there is no legal obligation regarding the creation of the lending rules of the LEAs, the developed regulations meet all the conditions set for financial enterprises operating under the effect of the Act on Credit Institutions.

This compliance made it possible for the majority of the LEAs to join easily and quickly to the Hungarian JEREMIE program, since this program required these types of regulations.

The most important areas concerned by the relevant internal regulations regarding crediting are:

- Operating manual.
- Risk assumption regulation.
- Rules of procedure.
- Valuation regulation.
- Debtor rating regulation.
- Client rating regulation.

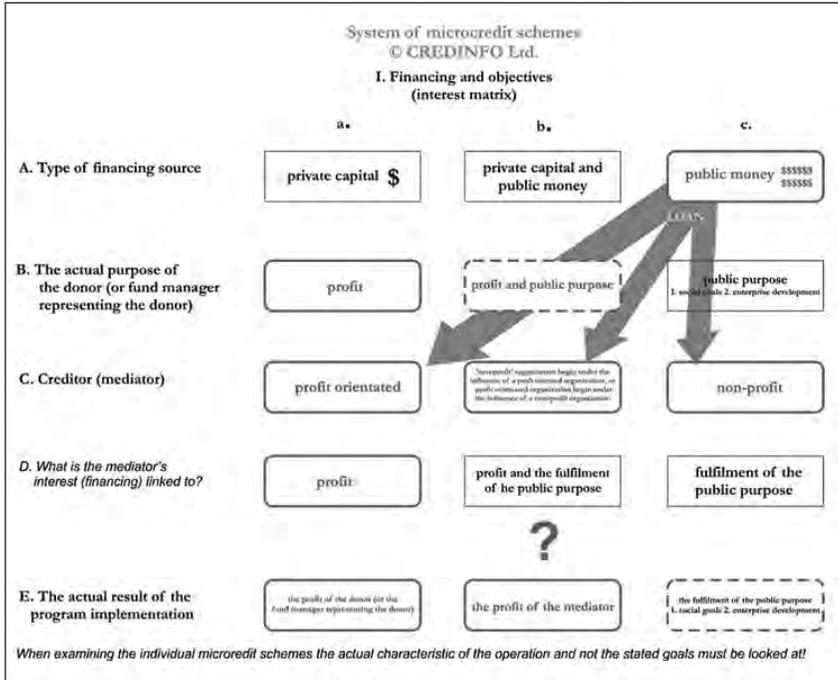
- Rules relating to the creation of provisions and expected losses.
- Management Information System.
- Document handling regulation.
- Confidentiality regulation.
- Regulation related to the conflict of interest.

8.7. The appearance of the JEREMIE Microcredit Programme and the profit orientated ‘microfinance’ organizations.

The apparent widening of the microfinance sector began when the JEREMIE Programme was launched in Hungary.

That is when the profit orientated money market players started to show real interest towards ‘microfinance’. The mediators are attracted by the low source cost (the refinancing interest rate is 0.4%) and the profit gained from the interest paid by the clients. Profit orientated financial enterprises receive the sources under the same conditions as the non profit foundations. The operation is financed from the profit. Although the range of businesses using the loans is limited (they have to be micro or small enterprises), no precise social goals have been set. As a result, the financing of the mediators does not depend on the fulfillment of such goals. According to the rules of the program, the maximum amount that may be granted by the non-profit foundations is HUF 10 million (EUR 33,900) (in Hungary this is the amount under which the commercial banks are unwilling to grant loans due to economic reasons). In case of profit orientated financial enterprises this amount is HUF 50 million (EUR 169,500), and if the loan is combined with a non refundable subsidy, this amount can reach HUF 20 million (EUR 67,800). According to the internationally accepted principles, due to the amounts that can be granted, the security requirement, and the range of clients financed, this type of financing is not considered as microfinancing.

8.7.1. Interest matrix and the fulfillment of social goals in the Hungarian JEREMIE Programme.



8.8. Regulation of the operation of the potential “microfinancing” organizations

	Regulation of the operation of potential MFI organizations		
Scope of operation	Enterprise agencies operating in the counties and the capital®	Financial undertakings	
		Foundation	Business Association
Based on the operation criteria and in accordance with the generally accepted international interpretation is it to be regarded as an MFI?	Yes.	No.	No / Possible.
Being profit orientated	Non-profit.	Non-profit.	For-profit.
Legal status	Foundation.	Foundation.	Company (mostly private limited liability company limited by shares, but it can be a union or branch office as well).
Registration authority	Court.	Hungarian Financial Supervisory Authority, court.	Hungarian Financial Supervisory Authority, Company Court.
Establishment costs	Already not possible.	By the time of establishment, the complete initial capital shall be placed on bank account, which cannot be lower than. HUF 50,000,000.	By the time of establishment, the complete initial capital shall be placed on bank account, which cannot be lower than. HUF 50,000,000.

<p>Regulation on general operation, from the legal status</p>	<p>Act IV/1959 on Civil Code</p> <p>Act CLXXXI/2011 on registration of civil organizations by court and the related procedural rules;</p> <p>Act CLXXV/2011 on demonstration right legal status of public interest, interés público, furthermore on operation and support of civil organizations;</p> <p>Act CLIV/2011 on consolidation of regional municipal councils, the takeover of such municipality institutions and some health institutions of the City Council of Budapest (concerns only determined foundations).</p>	<p>Act CXII/1996. on financial institutions and financial undertakings;</p> <p>Act IV/1959 on Civil Code;</p> <p>Act CLXXXI/2011 on registration of civil organization by court and the related procedural rules;</p> <p>Act CLXXV/2011 on demonstration right, legal status of public interest, furthermore on operation and support of civil organizations.</p>	<p>Act CXII/1996 on financial institutions and financial undertakings;</p> <p>Act IV/2006 on companies; Government Decree 250/2000 (XII. 24.) on the specifics of obligation of financial institutions and financial undertakings to elaborate annual report and book keeping.</p>
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<p>Regulation on business, audit and report obligations</p>	<p>Act C/2000 on audit;</p> <p>Government decree 350/2011. (XII. 30.) on business of civil organizations, civiles, recopilación donation gathering and some issues of public interests;</p> <p>Government decree 224/2000 (XII. 19) on specifics of some organizations to elaborate report and book-keeping in accordance with the Act on book-keeping.</p>	<p>Act/2000 on audit; 350/2011. (XII. 30.) civil organizations donation gathering and some issues of public interests;</p> <p>Government decree 224/2000 (XII. 19) on specifics of some organizations to elaborate report and book-keeping in accordance with the Act on book-keeping.</p> <p>Government decree 250/2000 (XII. 24) on the specifics financial of institutions and financial undertakings to elaborate annual report and book-keeping.</p>	<p>Act C/ 2000 on audit; Government decree 250/2000. (XII. 24) on the specifics of obligation of financial institutions and financial undertakings to elaborate annual report and book-keeping.</p>
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<p>General framework regulation on micro financing</p>	<p>There is no such.</p>	<p>Not possible.</p>	<p>No.</p>
<p>Specific regulation on micro financing</p>	<p>Based on 2. §. (1) h) of Act CXII 1996. on financial institutions and financial undertakings the scope of the act does not apply to the activity of the Hungarian Undertaking Development Foundation to provide loan from the National Micro Loan Funds; either to the micro financing activity of regional and metropolitan (Budapest) undertaking development foundations.</p>	<p>Not possible.</p>	<p>The general regulation of Act CXII/1996 on financial institutions and financial undertakings is valid, there are no restrictions.</p>
<p>Activity to be carried out based on the regulation</p>	<p>Microfinancing (Transferring loan in case of MVA from OM).</p>	<p>May undertake bail for the debt of its client. May provide with bank guarantee for the obligations of its client. May carry out banker commitment. May have broker financial service servicios for other financial institution.</p>	<p>Financial services; additional financial services, other services for example: insurance broker activity, bond renting, trade with gold, running the share book, brokering EU supports, etc.</p>

<p>General rules on internal regulation</p>	<p>Act C/2000 on audit;</p> <p>Act CLXXXI/2011 on registration of civil organizations by court and the related procedural rules;</p> <p>Act CLXXV/2011 on registration of civil organizations by court and the related procedural rules;</p> <p>Act CLXXV/2011. on demonstration right, legal status of public interest, furthermore on operation and support of civil 224/2000. (XII. 19) on specifics of some organizations to elaborate report and book-keeping in accordance with the Act on book-keeping</p>	<p>Act C/2000 on audit;</p> <p>Act CLXXXI/2011 on registration of civil organizations by court and the related procedural rules.</p> <p>Act CLXXV/2011 on demonstration right, legal status of public interest, furthermore on operation and support of civil organizations; 224/2000. (XII. 19) on specifics of some organizations to elaborate report and book-keeping in accordance with the Act on book-keeping;</p> <p>Act CXII/1996. on financial institutions and financial undertakings;</p> <p>Government Decree 250/2000. (XII. 24.) on the specifics of obligation of financial institutions and financial undertakings to elaborate annual report and book-keeping.</p>	<p>Act C/2000 on audit;</p> <p>Act CXII/1996 on financial institutions and financial undertakings;</p> <p>Act IV/2006 on companies; Government Decree 250/2000. (XII. 24.) on the specifics of obligation of financial institutions and financial undertakings to elaborate annual report and book keeping.</p>
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Major fields of the internal regulation	Audit rules; Organization and operational rules; Financing rules: (as detailed above) Rules on Data protection and data Handing; Quality insurance rules; Plans on social targets.	Audit rules Money handling rules; Client and partner qualification rules; Rules on cover assessment; Deal qualification and assessment rules; Depreciation and Reserves Rules; Rules on commitment of risks; General terms and conditions.	Audit rules; Money handling rules; Client and partner qualification rules; clientes y socios; Rules on cover assessment; Deal qualification and assessment rules; Depreciation and Reserves Rules; Rules on commitment of risks; General terms and conditions.
Supervisory Board	Statutory.	Statutory.	Statutory.
External auditor	Statutory.	Statutory.	Statutory.
Internal controller	Optional.	Statutory.	Statutory.
Determination of school qualification of managers	Based on internal regulation, statutorily determined in the financing field.	Determined based on act.	Determined based on act.
Controlling authority (exercising lawful control)	Office of Public Prosecutor.	Office of public prosecutor, hungarian financial supervisory authority.	Hungarian financial supervisory authority.

Reporting obligations towards the authorities	There is not any on general micro financing activity.	Towards hungarian financial supervisory authority, monthly.	Towards hungarian financial supervisory authority, monthly.
Reporting obligations towards donors	Daily on-line data service (<i>every transaction on the complete client stock and loan credit portfolio, JEREMIE</i>).	No.	Daily on-line data service (<i>every transaction on the complete client stock and loan credit portfolio, JEREMIE</i>).
Controls of donor organization (s)	At least 3 times a year.	No.	Maximum once a year.
Compliance with EU regulations (Code of Good Conduct)	Undertaken voluntarily (by the time the study is made, one organization complies in 99%, the others in 90%).	Not to be applied.	No.

8.9. Summary of experience

The following shall be examined concerning the regulation of microfinance in Hungary and generally:

Does the legal regulation establish a proper legal framework for spread in Hungary and strengthening the microfinance sector?

The question implies another question: Why is the spread and strengthening of microfinance important?

Without replying this question, the request for spread and strengthening of the microfinance would remain only a self-objective.

Of course the objectives shall be reviewed from the society's point of view. Taking the international practice of microfinance into consideration, we can determine the following objectives being useful from the society's point of view:

- Fight against poverty.
- Strengthening self-employment.
- Promotion of launching undertakings for the sake of self-employment and increase of work place establishment.
- Strengthening the micro undertaking sector via the durable financing of investments, for the sake of long term maintenance of their self-employment and work place establishing ability.
- Promotion of economics, in capital poor period, increases the outflow of money into the economy.

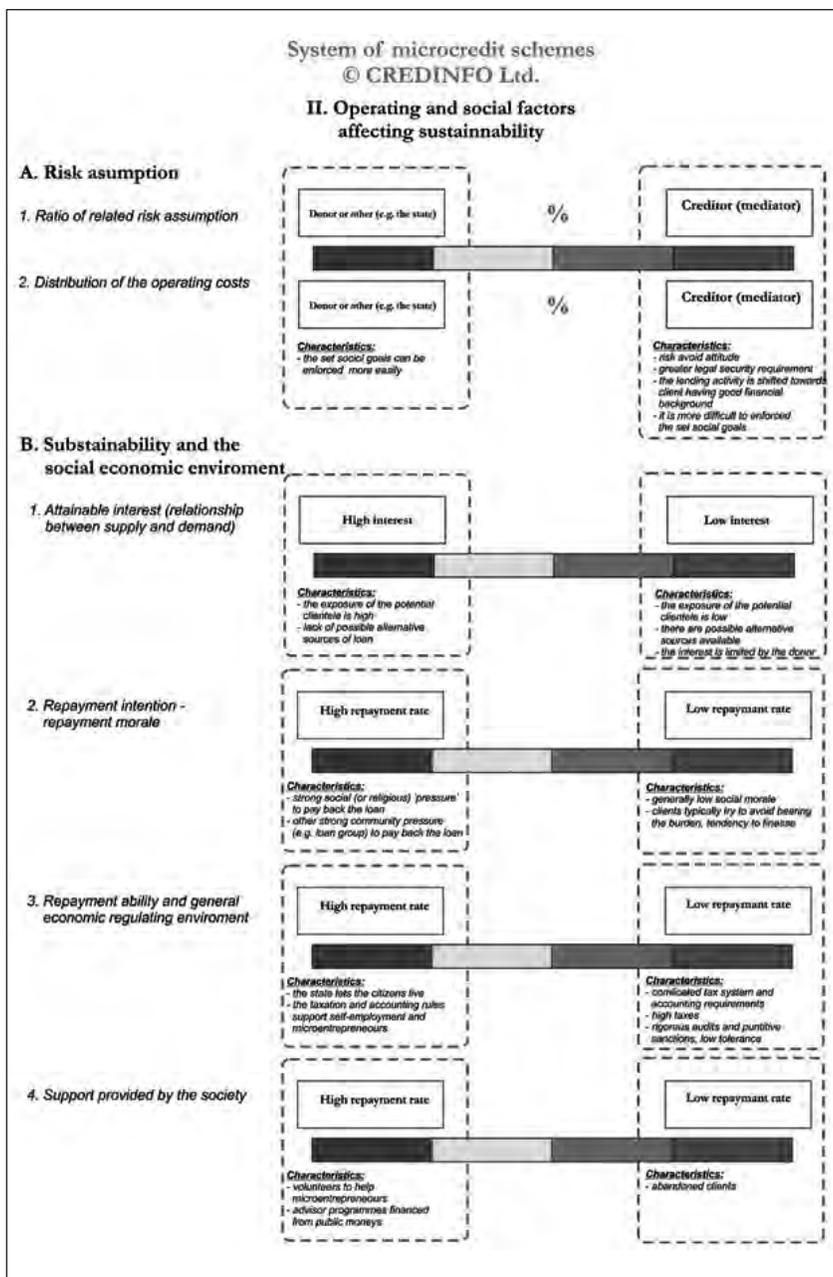
It is obvious that there is a significant difference between the first and the last item of the enumeration. This means quite serious differences between financing and methodology in respect of the microcredit programs realizing different social objectives.

Regarding the fact that there are quite significant obstacles in the spread of microfinancing from the viewpoint of financing, sustainability and interests, the issue must be examined as complex. Following the examination of the possible social targets, the initial question shall be raised such as:

Are the defects of the legal regulations or other factors the major burdens of the strengthening of the microfinancing with social objectives and the microfinancing sector in Hungary?

As the expectations regarding to the sustainability, are quite high against the current microfinancing, the fact whether this factor can be realized, is to be regarded as key factor in the spread of microfinancing accomplishing social objectives. (The constructions of microloans financed by investors expecting extra profit are not classified into this category.)

We highlight the factors impacting the sustainability the most on the below model:



Due to its lengthy nature, I would not like to introduce the analysis of the Hungarian situation based on the above factors (this was not the aim of the present study at all), but I would like to refer to the fact that the burdens of the spread of microfinancing accomplishing social objectives shall be examined in every country as a complex. A sole factor cannot be simply analyzed. Nevertheless it is important, and requires analysis, that in a given society which objectives from the ones listed above may enjoy priority, and which problem's treatment is rendered by the economic and social environment possible via the help of the micro loan program.

Finally, replying to the initial question —without detailed analysis—I am of the opinion that in the current Hungary it is not the legal and regulatory background which is the major obstacle for the spread and strengthening of the microloan for social objective.

Both, the profit orientated and nonprofit actor's operation is properly regulated in Hungary nowadays.

The obstacles in the involvement of financing, sustainability and other actors, shown in the economic and social environment, are much more obstacles in the spread of microloans accomplishing social objectives than the legal obstacles.

9. CONCLUSION

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During the 2nd National Meeting the members of the Spanish Microfinance Legislation Group had a productive debate concerning the presentations of other countries' legislation to agree on what field we wanted to approach our local legislation proposal.

After Clifford Chance's proposal regarding the suitability of the Foundation as a legal entity to shelter MFIs, an interesting debate was originated to determine if the microfinance activity should be regulated independently of its legal entity, or if we would have to circumscribe to the microcredit granted by nonprofit organizations with social purpose.

We must not confuse this debate with the well-known discussion in the microfinance world about sustainability vs. scope. Even though the entities that are working with the legislation proposal share a social purpose, we intend to develop a sector that is sustainable in the medium and long term.

At the end, the Group accepted the proposition to focus the legislation on the country's microfinance social sector. The intention was to center the proposal on those entities that share a social objective without limiting the access to other possible agents who don't share this approach, but can provide their added value to the sector's development.

Also discussed was whether the proposal would bring up a new microfinance legislation or if we wanted it to be part of the regulatory development of an existing and more comprehensive law. Although everyone preferred the idea of a specific microfinance legislation, for practical reasons the group decided to include it in a law that is related to the sector.

Therefore, the Group's work focused on a proposal that summarizes the agreements reached, allowing it to be easily incorporated in an existing law.

The proposal adopted is as follows:

- 1 Microfinance Institutions are defined as those foundations and associations, recognized as public utility, with microcredits among their ordinary activities.
2. A microcredit is defined as a loan up to 25,000 Euros, granted without collateral or guarantees, for individuals excluded from traditional funding channels in Spain, whose purpose is to launch or strengthen professional or entrepreneurial activities to improve the quality of life.
3. The interest rate, which may be higher than the market, is intended to seek the entity's sustainability by providing funds for loans and nonfinancial services to beneficiaries.
4. Microfinance institutions that grant microcredit should provide, either directly or in association with others, technical support and training to beneficiaries.
5. The essential objective of the entities that grant microcredits should be the promotion of entrepreneurship, job creation, social and financial inclusion, and poverty alleviation.
6. Allow MFIs to receive loans, donations and grants from public or private entities to develop their activities.
7. Authorize microfinance institutions so that both, the microcredit and the entities can be fully or partially supported by public or private organisms.

The Clifford Chance LLP Law Firm is responsible for managing the inclusion of this proposal in any law related to the sector. Besides, the entities comprising the Spanish Microfinance Legislation Group will support and disseminate the proposal to members of the Spanish Civil Society, so that it is open to worldwide participation.

As Coordinator of the Spanish Microfinance Legislation Group, it has been an honor to participate in a legislative proposal, that comes out of the common interest of more than 120 institutions of the Civil Society, to bring financial and social inclusion to micro entrepreneurs so they can move forward with their projects and improve their living conditions.

Dear reader, we hope we can count on your support and your participation in the development of the microfinance sector in Spain.