

A Collection of Case Studies on the Legal and Regulatory Framework for Microfinance Provision

Overview

Currently, the legal framework for microcredit provision in Europe presents significant differences among European Union member states and accession countries, ranging from dedicated legal acts for microfinance provision to specific provisions on micro lending in acts regulating the banking or NGO sector. There are a number of initiatives at the European level aimed at capturing lessons learned in national jurisdictions and extrapolating them to support the development of microcredit provision in other countries.

Such an initiative is the Legal and Regulatory Environment Working Group (LER-WG), funded by the European Union (EU) and managed by the European Microfinance Network (EMN). The general objective of the LER-WG is contributing to the creation of an enabling legal and regulatory framework for microfinance activities within the European Union, strengthening the EMN capacity to lobby at the EU institutions level, and support the transfer of knowledge and best practice among microfinance sectors in EU countries.

The LER-WG unites members from France, Germany, Hungary, Italy, Romania and Spain. Through this representation, the group offers the possibility to analyze different legal environments for microfinance:

- ➔ Romanian and French legislation contains specific rules relating to microcredit and non-banking institutions.
- ➔ Italy has passed legislation in 2010 for the creation of non-bank microfinance institutions. A new article introduced in the Italian Banking Act includes that entities are allowed to grant loans to individuals for the purpose of creating or developing a business.
- ➔ In Hungary no general legal framework exists regarding the microcredit sector. However, there are special rules in force that regulate the operation of institutions that offer microcredit facilities.
- ➔ Germany recognizes the importance of microcredit, but not wanting to undermine the monopoly of banks, has created a subsidized system based on collaboration between banks and microcredit associations.
- ➔ Spain does not have a specific microfinance law, but Fundación Nantik Lum and some social entities are developing different working groups in order to propose regulation for MFIs in Spain.

This year's activities of the LER-WG brought up some key aspects characterizing the legal and regulatory framework in Europe and the challenges of microcredit provision in Europe related to the legal environment.

Firstly, the existence of specific microfinance legislation in Eastern Europe contrasted to Western European countries determined the microfinance market continues to trend towards more commercially oriented and financially sustainable MFIs in Eastern Europe, while in Western Europe social inclusion remains the primary goal of microfinance institutions which receive public financial support to develop their activities.

Secondly, there are still a number of challenges that MFIs are facing, either due to the lack of specific microfinance legislation or inadequate provisions in existing legislation such as:

- ➔ Even in those countries where microfinance legislation exists, the lack of provisions on the social goals of MFIs has led to the creation of so-called 'microfinance institutions', but which have solely commercial goals and an approach that is often unsupportive of business creation and development, such as very tight reimbursement conditions. For example, in Romania, many MFIs created after the passing of the microfinance law were purely commercial, or as illustrated in Hungary where new profit-oriented 'MFIs' appeared as the JEREMIE Programme was launched and access to low-cost funding was widely available.
- ➔ The access to credit bureau data and similar databases remains limited for microfinance institutions. In Spain, for example, non-bank MFIs have no access to the national Risks Information Center (Central de Información de Riesgos) of the Bank of Spain. In Romania, only MFIs that are registered in the Special Registry of the National Bank of Romania (NBFIs with equity of minimum 50,000,000 lei and an outstanding portfolio of minimum 25,000,000 lei) can access Credit Bureau data and report on their clients to the Credit Bureau. Smaller MFIs have to find alternative solutions, such as cooperation with banks in order to access credit bureau information.

- ➔ In most countries, interest rate caps limit the ability of some MFIs to become operationally sustainable. For example, in Macedonia the legal framework for microfinance provision was recently amended in December 2012. The changes to the Law on Financial Companies and Law on Obligation Relations include the introduction of interest rate caps. The legislation has had a negative influence on the microfinance sector due to the low rates set by regulators, consequently jeopardizing the sustainability of MFIs and limits their capacity to provide nonfinancial services, e.g. business support services to their clients.
- ➔ In certain jurisdictions, changes to the legislative framework significantly affected microcredit provision. In Croatia, the 2008 license to operate as financial services providers was withdrawn from MFIs established in early 2000's with the support of international microfinance NGOs, e.g. DEMOS. Initiatives promoting a new legal framework, or amending the existing one, to create an enabling environment for inclusive finance and microfinance are now emerging.
- ➔ The lack of specific legislation on microfinance in certain countries keeps institutions that provide microcredits as NGOs from accessing commercial funding for on lending.

Despite the challenges mentioned above, continuous initiatives to develop an enabling environment for the provision of microcredit are emerging that will respond to the needs of micro businesses and simultaneously contribute to job creation and poverty reduction. Recently, efforts have been made to coordinate legal reforms aimed to improve the microfinance environment with lobby for the stimulation of entrepreneurship development.

Besides microfinance institutions, credit unions play an important role in providing access to finance for micro entrepreneurs in several countries of the European Union such as Ireland, the United Kingdom, Poland, Romania and Bulgaria.

Credit unions represent an important source of funding for micro businesses or the self-employed as they are able to provide low amounts of funds and in a timely manner. In Romania, for example, this model has been successful due to the following:

1. Strong association of the credit unions and competent employees in the credit unions;
2. Enabling legislative framework, including tax exemptions;
3. Start in the workplace, as associations of employees; and
4. Economic and social aspects, such as lack of access to other funding sources and trust.

However, drawbacks dictate that sources of funding for credit unions are limited to members' contributions and a credit union's own funds, as external funding sources are not allowed according to the Romanian legislation.

Still there are a number of challenges that may prevent implementation of the credit union model in other countries such as:

- ➔ Lack of adequate legislative frameworks, including governance and management;
- ➔ Lack of transparency in reporting by credit unions;
- ➔ Unclear strategic direction of credit union associations;
- ➔ Political pressure;
- ➔ Lack of trained personnel;
- ➔ No regulations on membership criteria, monitoring, and supervision; and
- ➔ Lack of access to the financial and technical assistance programs financed by the European Commission, e.g. Progress and JASMINE.

This brochure aims to present several case studies on the legal and regulatory framework in countries represented within the Legal and Regulatory Work Group.

CASE STUDIES

1. Hungary



Microfinance sector summary

No unified microcredit sector exists in Hungary. However, the legal and regulatory framework described below allows **the participation** in microcredit programmes. The microcredit activity in Hungary started in 1992 when the Phare Microcredit Programme was launched. The programme is operated by **non-profit foundations**.

For a long time, the Phare programme was providing **financing** with beneficial interests (on the level of the prevailing central bank prime rate) **for micro-entrepreneurs excluded from traditional banking services without any discrimination on gender, racial, or other basis**; no profit-oriented financial company specialised in microcredit activities operates within the country – considering the investors' and their own financial interest as their priority, and operating with high transaction rates (eventually taking advantage of the vulnerability of certain clients).

Since it is possible to rapidly start a non-deposit taking financial company with relatively low initial capital and an enabling legal framework, the absence of organizations from the microcredit activity does not come from the legal regulatory aspect but instead stems from market, economic, and interest rate concerns.

The apparent widening of the microfinance sector began when the JEREMIE programme was launched in Hungary. The programme marks the time when

profit-oriented money market players started to show real interest towards 'micro-finance'. The **financial intermediaries are attracted by the profit** gained from the difference between the low source cost (the refinancing interest rate is 0.4%) and the interest paid by the clients. Profit-oriented financial companies receive the JEREMIE funding sources under the same conditions as non-profit foundations. The operation is financed from profits. 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 intermediaries does not depend on the fulfilment of such goals. According to the rules of the programme the maximum amount that may be granted by 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 the case of profit-oriented financial enterprises, the maximum 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).

Note: According to internationally accepted principles, due to the high amounts that can be granted, the security requirement, and the range of clients financed, this type of financing is not considered as microfinance in other member states of the European Union or even in other countries across the world.

➔ Funders participating in the JEREMIE Programme

HUF Exchange rate: 283 HUF/1 EUR -- 30 September 2012

Legal status of the organisation:	Foundations	Financial enterprises	Saving cooperatives
Number of organizations	16	17/10*	29 **
Average loan size	5 819 006	11 894 369	-
Maximum loan size	10 000 000	50 000 000	50 000 000
Number of clients receiving loan in 2011	564	69	-
Number of clients receiving loan in 2012	797	283	-
Total loan disbursement in 2011	5 607 831 502	1 064 859 363	-
Total loan disbursement in 2012	10 337 609 675	3 920 380 028	-
Size of the current loan portfolio	18 398 108 035	4 103 779 132	-
Total number of clients	990	314	-
Total loan disbursement	21 807 423 608	4 418 186 499	-

* The total number of the financial enterprises participating in the programme is 17 (Source: the website of the central management – Magyar Vállalkozásfinanszírozási Pénzügyi Részvénytársaság (Venture Finance Hungary Private Limited Company)). 10 organisations are listed in the CREDINFO Microcredit Information System, out of which 6 are active. The data concern these 6 active organisations.

** Source: the website of the central management -- Magyar Vállalkozásfinanszírozási Pénzügyi Részvénytársaság (Venture Finance Hungary Private Limited Company) –, the rest of the data is not public.

Microfinance legal and regulatory framework background

There is no general legal framework regarding the microcredit sector in Hungary. However, there are special rules in force regulating the operations of institutions handling microcredit.

Political and democratic transformation in Hungary

After the political changes, the number of **micro and small enterprises** increased rapidly during the early 90's 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. After the transition from the centrally planned economic model to a market economy, entrepreneurs formed the backbone of the national economy. Subsequent Hungarian governments that came into power aimed at **strengthening this sector**. Due to their high number and ability to provide employment, it was **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 lack of entrepreneurial traditions in the country, and the people did not have entrepreneurial experience or knowledge. Simultaneously, the lack of capital in the sector posed a serious problem. The countries of the European Community (and later the European Union) provided significant help to Hungary in order to tackle these problems. The first entrepreneurship promotion projects were started at this time within the framework of the PHARE programme.

PHARE enterprise promotion programme

In 1989, the group of 24 developed industrial countries decided to support the process of economic and political transformation in the former socialist countries of Central and Eastern Europe for the first time. The PHARE programme began in 1990 in Poland and Hungary (hence the acronym PHARE: Poland-Hungary Assistance for the Reconstruction of the Economy, in other words Aid-programme for the Economic Transformation of Poland and Hungary) within the scope of this support.

Following the historical changes taking place in the region, the number of the countries receiving the benefits increased gradually. The purpose of the aid-programme was to facilitate the transition to a market economy in the countries of the region, among other goals including privatization and the full liberalization of the economy. This step provided funds from which the individual PHARE governments could finance and manage their respective transformations.

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

Setting up the enterprise promotion network

Since the objectives of the PHARE programme launched in Hungary and the objectives of HFEP overlapped, HFEP was entrusted with handling the aid-programme of 21 million ECU reserved for the development of small and medium-sized enterprises in the 1990 budget of the PHARE programme. PHARE required the setting up of a Local Enterprise Agencies (LEA) network, where the previously mentioned target group was supported in the form of professional counselling and business services. Consequently, since 1991 one primary activity of HFEP has been to establish the national network of LEAs (enterprise development foundations on county and on Budapest level®).

At the outset six pilot LEA's were set up – in the form of a foundation – (Enterprise Agency of Jász-Nagykunszolnok County /Szolnok/, Enterprise Centre of Tolna

County /Szekszárd/, Enterprise Agency of Borsod-Abaúj-Zemplén County /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.

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

Launching the microcredit schemes in Hungary

The concept of launching the National Microcredit Scheme was formulated at the beginning of 1992. Within the framework of the PHARE programme, the Committee of the European Community also wanted to handle the problem developed economies were facing, i.e. that most micro and small enterprises are not credit-worthy in the eye of the profit-oriented credit institutions. This represents a market failure where market mechanisms do not operate efficiently; solving these market constraints is in the interest of the national economy and makes the intervention by 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 a product 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 programme in order to finance the programme to be launched. As a result, the enterprise agencies operating in the counties and the capital® started to operate the first microfinance programme 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, financial sources for the programme were provided by PHARE (then the Hungarian government as a co-financer) in the form of an earmarked subsidy.

Legal regulation

When the programme was launched in 1992, no **general legal framework regarding the microcredit activity existed**, nor was any **special legislation in force concerning the microcredit activity of the individual microfinance organizations in place**.

The sources received in the form of earmarked subsidy were placed in a bank account by the foundations, from which transactions were operated by the banks (the contracts were also concluded by the banks) according to the decisions of the foundation. This operational structure was developed because according to certain interpretations of the legal regulation of that period (Act No. LXIX of 1991 on Financial Institutions and the Activities of Financial Institutions, which was repealed and replaced by Act No. CXII of 1996 on Credit Institutions and Financial Enterprises), "only banks could grant loans" in Hungary.

The involvement of commercial banks in the newly created microcredit 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 programmes fulfilling specific social goals, and
- ➔ Performed their activities as non-profit organizations (they did not make any profit).

Another problem was caused by the fact that the commercial banks became increasingly less interested in the programme as they realized finding potential clients for themselves was more difficult. As a result, commercial banks terminated the relevant contracts in several counties, making it difficult to find a bank that was willing to perform its responsibilities.

During the operation of the programme the involvement of commercial banks was always debated as to whether it was justified by the applicable act.

The solution seemed obvious. It must be made evident if the Law of LEA-s applies to operating the Microfinance Programme. The suggestion was that the Article of the Law concerning institutes and organisations not of legal force of this Law, must be extended with foundations operating the micro-finance program. In other words, these foundations should be free from the effect of this Law.

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

Due to the afore-mentioned financial problems, 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, a dispute that remains unresolved to this day.

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 Parliament 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 enactment of the amendment of the Act, **the crediting activity of the Hungarian Foundation for Enterprise Promotion and the microcredit activities of the foundations operating in the counties and the capital do not fall under the effect of the Act.**

Main characteristics of the current legal and regulatory framework for microfinance providers

External and internal regulation of the operation of the potential "microfinancing" organisations – concerning their legal form and operation:

Regulation of the operation of potential MFI organisations			
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	Not possible any more	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

Regulation of the operation of potential MFI organisations			
Scope of operation	Enterprise agencies operating in the counties and the capital®	Financial undertakings	
		Foundation	Business Association
Regulation on general operation, coming from the legal status	<p>Act IV/1959. on Civil Code;</p> <p>Act CLXXXI / 2011 on registration of civil organisations 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 organisations;</p> <p>Act CLIV/ 2011 on consolidation of regional municipal councils, the take over 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 organisations 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 organisations</p>	<p>Act CXII / 1996. on financial institutions and financial undertakings;</p> <p>Act IV / 2006 on companies;</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>
Regulation on business, audit and report obligations	<p>Act C/ 2000 on audit;</p> <p>Government decree 350/2011. (XII. 30.) on business of civil organisations, donation gathering and some issues of public interests;</p> <p>Government decree 224/2000. (XII. 19 on specifics of some organisations to elaborate report and book-keeping in accordance with the Act on book-keeping</p>	<p>Act C/ 2000 on audit;</p> <p>350/2011. (XII. 30.) on business of civil organisations, donation gathering and some issues of public interests;</p> <p>Government decree 224/2000. (XII. 19 on specifics of some organisations 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 of obligation of financial institutions and financial undertakings to elaborate annual report and book-keeping</p>	<p>Act C/ 2000 on audit;</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>

Regulation of the operation of potential MFI organisations			
Scope of operation	Enterprise agencies operating in the counties and the capital®	Financial undertakings	
		Foundation	Business Association
Regulation on the maximum rate of the chargeable interest	Act IV / 1959 on Civil Code 232. § (3); Act CXII / 1996. on financial institutions and financial undertakings, 199. § (1)-(2)	Act IV / 1959 on Civil Code 232. § (3); Act CXII / 1996. on financial institutions and financial undertakings, 199. § (1)-(2)	Act IV / 1959 on Civil Code 232. § (3); Act CXII / 1996. on financial institutions and financial undertakings, 199. § (1)-(2)
General framework regulation on micro financing	There is no such	No possible	No
Specific regulation on micro financing	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 Enterprise Development Foundation to provide loan from the National Micro Loan Funds; either to the micro financing activity of regional and metropolitan (Budapest) enterprise development foundations	No possible	The general regulation of Act CXII / 1996. on financial institutions and financial undertakings is valid, there are no restrictions.
Activity to be carried out based on the regulation	micro financing (Transferring loan in case of MVA from OM)	<ul style="list-style-type: none"> - 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 broker financial service for other financial institution. 	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.

Regulation of the operation of potential MFI organisations			
Scope of operation	Enterprise agencies operating in the counties and the capital®	Financial undertakings	
		Foundation	Business Association
General rules on internal regulation	<p>Act C/ 2000 on audit; Act CLXXXI / 2011 on registration of civil organisations by court and the related procedural rules; Act CLXXV / 2011. on demonstration right, legal status of public interest, furthermore on operation and support of civil organisations; 224/2000. (XII. 19 on specifics of some organisations to elaborate report and book-keeping in accordance with the Act on book-keeping</p>	<p>Act C/ 2000 on audit; Act CLXXXI / 2011 on registration of civil organisations by court and the related procedural rules; Act CLXXV / 2011. on demonstration right, legal status of public interest, furthermore on operation and support of civil organisations; 224/2000. (XII. 19 on specifics of some organisations to elaborate report and book-keeping in accordance with the Act on book-keeping; Act CXII / 1996. on financial institutions and financial undertakings; 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; Act CXII / 1996. on financial institutions and financial undertakings; 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>
Major fields of the internal regulation	<p>Audit rules; Organisation and operational rules; Financing rules: (as detailed above) Rules on Data protection and data Handling; Quality insurance rules; Plans on social targets</p>	<p>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</p>	<p>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</p>

Regulation of the operation of potential MFI organisations			
Scope of operation	Enterprise agencies operating in the countries and the capital®	Financial undertakings	
		Foundation	Business Association
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 (every transaction on the complete client stock and loan credit portfolio)(JEREMIE)	No	Daily on-line data service (every transaction on the complete client stock and loan credit portfolio)(JEREMIE)
Controls of donor organisation(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 organisation complies in 99%, the others in 90%)	Not to be applied	No

Impact of the legal and regulatory framework on the sector development

Microfinance sector development

The possibility of alternative microcredit programmes

The change in the act detailed above (the crediting activity of the Hungarian Foundation for Enterprise Promotion and the microcredit activity of the foundations operating in the counties and the capital do not fall under the effect of the Act) did not lead to the appearance of other microfinance institutions (as mentioned above, it is more of a question of interest, not a question of regulation). Together, beside the National Microcredit Programme (initially Phare Microcredit Programme), it cleared the way for the introduction of alternative, local microcredit programmes – adapting quicker and in a more flexible way to the financial needs of the entrepreneurs – by Local Enterprise Agencies, and it also abolished the dependence from the commercial banks of the microcredit programmes fulfilling social objectives. The shift also contributed to the stability of the network of non-profit organisations focused on social objectives – foundations operating in the counties and the capital – could remain in tact despite significant lobbying activities by certain influential organisations for the elimination of this network.

Advantages and drawbacks of the current legal and regulatory framework

The Hungarian legal regulation on credit institutions and financial enterprises provides an appropriate background for organizations (both non-profit and profit-orientated organizations) and individuals who wish to perform activities in the microcredit sector wishing to establish a financial organization (with either profit-orientated or a non-profit objective). At the same time, a network of non-profit foundations is able to professionally implement microcredit programmes (financed initially from public funds) suitable for fulfilling social objectives, without the capital compliance and the administrative reporting obligations concerning profit-orientated financial institutions.

Lessons learned

The phenomenon commonly characterised as the crisis in the microfinance sector is well-known in most of countries around the world; whereby clients in certain countries who benefited from microcredits consider the microcredits as the reason of their total financial impairment instead of considering the microcredit as a tool which improves their financial welfare. Consequently, mass suicides occurred and demonstrations against microcredit were organised in addition to organisations demanding the prohibition of the microcredit activity.

In Hungary these phenomena did not occur in mass (except for certain isolated cases, and those not in the field of enterprise funding). It is due to the **microcredit programmes** funded by the European Union's funds and **the legal regulation that allows the effective managing of these programmes by non-profit organisations.**

The harmful social phenomena mentioned above cannot be explained by the crisis of the sector. It is not possible because – as mentioned in the introduction – no unified microcredit sector exists. An important distinction should be made between the **microfinance programmes financed from public funds**, initially set for the fulfilment of the social objectives and the **programmes serving the profit interests of investors** and the financial interest of the different actors. Every microcredit programme has the objective of fulfilling social goals, but it is obvious that the real operation **in some cases only serves the financial benefit of the actors.** (The clients are obviously not claiming the prohibition of such programmes because they clearly benefit.)

This phenomenon does not occur because a crisis in the microcredit sector but rather to a phenomenon called a **market mechanism** in economics. Generally, market areas where constantly high solvent demand exists, supply will also appear. (If there is no supply, that category belongs to the market failures.) In countries with a significant poor population, vulnerable people, which, due to internal legal

regulation (or the lack of the regulation) of the country are able to pay the operational costs, losses, and the extra profit claims of investors by paying high risk premiums (although with great sacrifice). There has developed a **financial provider sector, the activity of which is listed in the category of microfinance**. The result of this spontaneous, inevitable market process is what some call the crisis of the sector.

To avoid the harmful social effect of this market process, governments could take two basic regulatory measures. On one hand, by administrative regulatory **tools they could restrict the maximum**

interest rate which can be asked by market participants (in Hungary it is restricted by the Act IV / 1959. 232. § (3) and the Act CXII / 1996. 199. § (1)-(2)), **on the other hand, governments could create supply by involving public funds with limited interests** (it is their task in case of the market failures mentioned above). In Hungary the government took both measures.

For creating this supply, the most adequate and efficient method is **the microcredit programme operated by non-profit organisations and fulfilling social objectives**. The Hungarian legal regulation has created the legal background and conditions of this efficient intervention.



Microfinance sector summary

Indicator		MFIs	Credit Unions
# of microfinance providers	NBFIs	Over 200	2.000 credit unions
	Commercial companies		
	NGOs		
Estimated # of borrowers financed annually		40,000 ¹	600,000
Estimated # of loans extended annually		N/A	650,000
Estimated annual microfinance loan portfolio		EUR 336 mil ²	EUR 450 mil
Average loan size		EUR 7000	800 euro
Maximum loan size is not limited to EUR 25,000 in the legal framework for NBFIs		EUR 25,000	7000 euro

¹ Mix Market data as of 2011 for the following MFIs: Express Finance, LAM, OMRO, Patria Credit and ProCredit Bank

² Mix Market data as of 2011 for the following MFIs: Express Finance, LAM, OMRO, Patria Credit and ProCredit Bank

Microfinance legal and regulatory framework background

The legal framework for the microfinance activities in Romania was initially created in 2000 to allow the Ministry of Labour and Ministry of Economy to channel public funds from the World Bank through microfinance institutions in order to implement the 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, a specific legal framework was considered to differentiate microfinance activities from the initial microcredit and business development projects implemented by international MFIs and raise awareness of policy makers in 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 redefined. Microcredit Company Law 240 was adopted by the Romanian Parliament in June 2005, primarily aiming to support the diversification of financial sources for MFI portfolios, provide protection for clients, establish clear governance mechanisms, and assert risk control and transparency leading 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, 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, transformed in 2009 by Law 93 of the non-bank financial institutions (NBFIs), unified under a single law the legal and regulatory framework for all NBFIs. The ordinance regulates the registration and minimum capital requirements, conditions for granting loans, client protection, governance and management, and reporting requirements etc. 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 microfinance companies.

All NBFIs are authorized by NBR and registered in the NBFIs general registry. Based on the amount of capital, value of the portfolio, and the value of total assets, larger MFIs are registered in the special registry. The supervisory regulations and reporting requirements for 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 total 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.

In terms of credit unions, the mutual credit activity appeared in Romania as early as the late 19th century, a result of the need for various social categories to have access to loans, given the banking sector's development was incipient. Around at the end of the 19th century, Spiru Haret, Minister of Education, provided special support to the movement by promoting it with the help of teachers. As a result, the number of savings and credit associations increased from 24 in 1898 to 700 by 1903. Between the two World Wars the legal framework in Romania was in line with the most advanced movements in the world. Savings, credit, and assistance associations were providing important financial services to their members such as: long term loans for investment (housing, mortgages, etc.), financial aid for illness, accidents, infirmity etc.

In 1996, because Decree no. 358/1949 was no longer available and providing the adequate provisions for the credit unions to continue their operations, the National Association of Credit Unions promoted the Law no. 122.

Main characteristics of the current legal and regulatory framework for microfinance providers

1. Laws governing the provision of microcredit:

- ➔ Law 93 of the non-bank financial institutions (NBFIs)
- ➔ Law 122/1996 regarding the activity of credit unions

2. Types of legal structures under which microfinance providers can operate:

- ➔ Non-bank financial institutions

3. Minimum capital requirements for microfinance providers:

- ➔ EUR 200,000 for non-bank financial institutions
- ➔ There are no minimum capital requirements for credit unions

4. Maximum loan amount that can be granted by microfinance providers:

- ➔ EUR 25,000 as per EU definition of microcredit is not the maximum amount of credit the NBFIs can extend, in the law 93 of NBFIs there are no provisions related to the maximum or minimum amount of the credit extended, the NBFIs' current average loan amount does not exceed EUR 10,000
- ➔ EUR 7000 for credit unions

5. Provisions on interest rate and fees perceived by microfinance providers:

- ➔ In case of microcredit extended by NBFIs from own funds or unrestricted credit lines received from various lenders and investors there are no specific provisions on interest rates
- ➔ For microcredit extended under Government Programs, e.g. Microcredits for entrepreneurs in the former Mining areas, start-up finance for unemployed entrepreneurs, etc. Limitation of the interest rate for credits extended by governmental programmes was negotiated with the partner lending institutions: SMEs, banks, and NBFIs.
- ➔ In case of credit unions, nominal average interest rates up to 15% with no other fees or charges commission

6. Provisions on other types of services that can be offered by microfinance providers (cards, insurance, business development services):

- ➔ NBFIs are not allowed to provide saving products to clients, therefore the credit portfolio can be financed from external funds: donations, investments, credit loans, and from NBFIs own funds (mainly reinvested profits).
- ➔ Credit Unions are collecting resources (social fund) from their members and each year, the CUs general assembly decides, based on the annual financial results, on the interest paid to the members' social fund. Credit unions cannot receive funding from external investors or lenders. The CUs' national association has the possibility to manage the CUs financial resources and based on the members' needs may redistribute the unused financial resources among the members.

7. Provisions on reporting by microfinance institutions:

- ➔ Non-bank financial institutions report to the National Bank of Romania the structure of their credit portfolio and any information required by the National Bank for statistics and analysis
- ➔ Non-bank financial institutions that are registered in the Special Registry (NBFIs with equity of minimum 50,000,000 lei and an outstanding portfolio of minimum 25,000,000 lei) report to the Credit Bureau
- ➔ Non-bank financial institutions report their financial statements to the Romanian National Bank; the NBFIs registered in the Special Registry have financial statements audited by National Bank accredited auditors
- ➔ Credit unions report their financial statements to the Ministry of Public Finance and statistical indicators (on assets and debt) to the Romanian National Bank

Impact of the legal and regulatory framework on the sector development

Microfinance sector development

In 2005, when the Microfinance Companies Law was passed by the Romanian parliament, the sector covered approximately 5-10% of the required financing for micro and small companies in Romania. In 2009, when the sector fell under the general regulations for non-bank financial institutions, the financing provided by microfinance institutions covered approximately 30% of the market.

After 1990, credit unions decided to become independent from trade unions and politically independent. Consequently, they associated themselves into territorial unions and into the National Association of Credit Unions (U.N.C.A.R.). Presently, the National Union fights for credit unions to deliver financial services to an increased number of self-employed and entrepreneurs both from the urban and rural areas.

Advantages and drawbacks of the current legal and regulatory framework

Advantages:

- ➔ The current legislation for microfinance in Romania provides a framework for the sector development and for an increased access to finance for the unbanked.
- ➔ The number of microfinance providers grew from 8 legal entities (NGOs, commercial companies etc.) to approximately 200.
- ➔ MFI operational sustainability is over 100%.
- ➔ Credit union activity is exempt from all taxes.

Drawbacks:

- ➔ The minimum capital requirements are relatively high and the reporting provisions keep microfinance institutions from further developing their activities and reaching the poor.
- ➔ In terms of credit unions, the sources of funding are limited to contributions and own funds of members of credit unions; external sources borrowed are not allowed in Romania.

Lessons learned

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 Micro-credit company law was in force, and from 2006, as non-bank financial institution was introduced, the sector is **"overregulated"**. It is strictly supervised 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 distinct segments. The first segment is mature, efficient, operationally and financially self-sufficient, and attractive to lenders. The second segment includes a large number of new MFIs, registered after 2006. They are still young and need specialized technical assistance and training in order to successfully integrate into the sector and contribute to its achievements.

It seems that the commercialization strategy pursued by most MFIs since 2004 has paid off. However, faced with the need to be more and more profitable, 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 collaborative process of the European Code of Good Conduct, 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 initiated nearly 10 years ago.

Moreover, the achievement of the triple bottom line, by continually improving the quality of services provided to targeted clients, maintaining **social responsibility** towards the staff, clients, community and incorporating the **environment**, is the challenge that makes the Romanian microfinance sector European.

In terms of credit unions, until the Revolution of 1989, these were subordinated to labor unions. In 1990, the credit unions began to operate independently and have established the National Association of Credit Unions as a representative body, guidance and control, which significantly improving their activities.

3. Spain



Microfinance sector summary

Indicator		
# of microfinance providers	Banks	1
	Commercial companies	
	NGOs	5
Estimated # of borrowers financed annually		
Estimated # of loans extended annually		
Estimated annual microfinance loan portfolio		N/A
Average loan size		EUR 10,000
Maximum loan size		EUR 25,000

Microfinance legal and regulatory framework background

The absence of a legal framework for microfinance activities in Spain allowed the financial sector (Banks and Saving Banks) to lead the sector and left NGOs to play a support role in the social activities. This model continued until the collapse of the saving banks in 2010-2011, but the model proved to have

many disadvantages as many programmes lacked the social approach despite the participation of NGOs. A SWOT analysis was done at the first Spanish Microfinance Meeting in September 2010, organized by the Spanish Microfinance Forum and held in Madrid.

In the SWOT analysis, the absence of a regulatory framework was identified as: disadvantage, threat, and opportunity.

In September 2010, at the initiative of the Spanish Microfinance Forum, a working group was created to work on microfinance legislation. The Spanish Legislation Working Group is composed by around one hundred organizations representing the entire sector (NGOs, Saving Banks, Universities, Consultants, Beneficiaries, etc.).

During 2011 and 2012, many general meetings took place and online work was done to agree on the main issues that microfinance legislation should govern. The main issues are:

- ➔ A non-prudential regulation but limited to micro-credit products;
- ➔ A clear definition of microcredit;
- ➔ A non-profit but sustainable sector;
- ➔ An interest rate below the financial sector and with a profit margin;
- ➔ Suggested juridical entity as Foundation; and,
- ➔ Support from the Government in form of a percentage guaranteed of each loan.

Currently, promoters of the legislation are speaking with political parties and civil societies to explain our proposal in order to introduce it to the parliament.

Main characteristics of the current legal and regulatory framework for microfinance providers

1. Laws governing the provision of microcredit, law of the bank financial institutions
2. Types of legal structures under which microfinance providers can operate: Bank financial institutions
3. Minimum capital requirements for microfinance providers
4. Maximum loan amount that can be granted by microfinance providers: EUR 25,000
5. Provisions on interest rate and fees perceived by microfinance provider: N/A
6. Provisions on other types of services that can be offered by microfinance providers (deposits, cards, insurance, business development services): N/A
7. Provisions on reporting by microfinance institutions: N/A

Impact of the legal and regulatory framework on the sector development

Microfinance sector development

After the collapse of the savings banks in 2010-2011, microcredit activity stopped almost entirely. Only MicroBank and some NGOs continued with minor activity. However, the sector is already gone. Most of the social entities that support the microcredit activities of the saving banks are closed.

Advantages and drawbacks of the current legal and regulatory framework

Advantages:

- ➔ There is no current legislation for microfinance in Spain, so in theory anyone can lend money just with the limitation of "usura" interest rate. Limited to microcredits in this case.

Drawbacks

- ➔ Absence of microfinance institutions
- ➔ Microfinance in Spain limited to microcredits
- ➔ Lack of coordination
- ➔ No sustainable programs
- ➔ Absence of a social approach

Lessons learned

A clear, coherent and supportive legal framework is necessary for the development of the microfinance sector. Prior to 2011, the microfinance was regulated by the financial sector, leaving banks and saving banks the leading role as microcredit providers. NGOs played an intermediate role as social service providers and intermediaries with the beneficiaries.

The first lesson learned is that the lack of social approach by many programs led to the most in need clients not being served.

The second lesson learned is the misconception of microcredit by most in the financial sector, perceiving microcredit more as a small credit than a poverty reduction tool.

The third lesson learned is the importance to work together as a coordinated and inclusive sector looking for synergies between all organizations to design a regulatory framework that will allow merging a microfinance sector with a social approach but maintaining sustainability as an objective.

Therefore, active participation in EMN Legal and Regulatory Working Group and the organization of the 2nd Spanish Microfinance National Meeting was important to work coordinated within the European context in order to learn from other experiences.

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