

**The development of microcredit in the European Union
- A tool for growth and social cohesion -
Executive Summary**

Definition of microcredit

Microcredit consists in making small loans to low-income earners who usually have no access to bank loans because they are insufficiently solvent and/or because the cost of managing such loans is considered too high. Microcredit loans enable the beneficiaries to create or expand micro-enterprises or other income generating activities.

Microcredit in Europe

Microcredit has developed very quickly in several Central and Eastern European countries since 1992. The sector has been expanding at an average annual rate of 67 per cent. In Western Europe, the development of microcredit is relatively recent, with the exception of the United Kingdom and France. The total number of customers is still relatively small, even though growth of the number of loans is quite rapid, ranging between 25 and 100 per cent p.a. Microcredit has developed in a variety of forms, including specialised banks, downscaling commercial banks, credit cooperatives and not-for-profit associations.

Institutional barriers to the development of microcredit

- Microfinance institutions in some countries are not allowed to borrow and on-lend.
- Interest rates are capped, making it impossible to cover the additional cost of distributing small loans.
- The new Basel Committee capital adequacy regulations are unsuitable to the microcredit sector.

Outlook

The European microcredit potential market comprises a minimum of 11 million customers. It is profitable and microcredit institutions are efficient and effective, both financially and socially. These institutions need start-up assistance, financial support for non-banking services such as coaching, and the removal of institutional barriers. The ultimate goal, of course, is to cover the cost of lending. Microcredit development is consistent with the Lisbon Strategy for growth and social cohesion. Based on a philosophy of fostering initiative and developing small enterprises, it has a considerable impact on employment.

Action to be taken at European level

- Enterprise DG and DG Markt should draw up an inventory of European legal and regulatory best practices for microcredit and micro-enterprises. This would help to define the status that should be given to European microfinance institutions. Three issues are key:
 - Microfinance institutions should be allowed to borrow and on-lend
 - Caps on interest rate should be removed so that microfinance institutions can cover their costs
 - Basel Committee capital adequacy requirements should be adapted to microfinance institutions' portfolios

- The Regional Policy DG and the EIF should launch an intensive communication drive focusing on the Joint European Resources for Micro to Medium Enterprises (JEREMIE) so that member states can take it into account when preparing the next generation of ERDF funding.

- The Employment, Social Affairs and Equal Opportunities DG should continue its business training and advice programmes for the unemployed.

- DG Ecfm and DG Markt should establish an appropriate legal framework to encourage securitisation and thereby facilitate microcredit guarantee.

- The European Parliament's commissions for Economic and Monetary Affairs and Employment and Social Affairs should be more closely involved, with a view to contributing to the above proposals.

- In sum, the European Commission should draw up **an action plan for microcredit** similar to the one that exists for venture capital.

The development of microcredit in the European Union: A tool for growth and social cohesion

Definition of microcredit

The international definition of microcredit is a small loan made to a low-income earner who usually has no access to bank loans, either because he or she is insufficiently solvent and/or because the transaction cost of such loans is considered too high. Microcredit loans enable entrepreneurs to create or expand micro-enterprises or income-generating activities. Their benefit lies in combining a social objective with a financial approach aiming at the sustainability of the Microfinance Institution (MFI). From the social point of view, microcredit is an efficient tool in the fight against poverty, enabling a recycling of existing resources. From the bank sector's viewpoint, it provides a new market in which the low value of each transaction is offset by their quantity. Microfinance is a broad concept encompassing all financial products such as savings, micro-insurance, transfers and guarantees.

Microcredit in Europe

Microcredit first took off in the developing countries, where over 100 million customers currently have access to it. After 1992 it spread very quickly to many central and eastern European countries and developed in new and future member states of the European Union (EU) such as Poland, Romania, Bulgaria and Slovakia. Different kinds of microfinance institutions coexist. Credit unions are the most numerous, accounting for 78 per cent of the microcredit portfolio, followed by banks specialised in microcredit (16 per cent), non-bank institutions (5 per cent) and downscaling commercial banks aiming for the upper end of the market (1 per cent). With average annual growth of 67 per cent, the sector is expanding rapidly, led by microfinance banks with growth of 105 per cent p.a., followed by specialised windows of commercial banks with 70 per cent. Credit unions, spawned by cooperative movements such as the Raiffeisen movement, continue to develop their business but without greatly increasing their membership. MFIs play an important role in the hardest-to-reach segments. Half of them cover their costs¹.

The development of microcredit in Western Europe is relatively recent, with the exception of the United Kingdom and France, where it was launched at the end of the 1980s. In Western Europe it did not benefit from economic transformations, such as those that occurred in Central and Eastern Europe, or the aid to countries in transition received from international donors. Instead microcredit has taken on different forms such as partnership between non-profit association and banks in France; public financial institution in Finland, or savings banks acting directly or through foundations in Spain. The total number of customers is still relatively small, even though growth of the number of loans is quite rapid, ranging between 25 and 100 per cent p.a.

¹ 2004 data from the Microfinance Centre.

Outlook

1. Demand

Demand for microcredit is sustained by three major trends:

- The growing importance of small enterprises

Contrary to popular belief, most of Europe's enterprises are very small (21 million enterprises with less than 10 employees)². The trend towards small enterprises is set to continue with the decline in industrial activity and the growth of service industries and new technologies. Many of these very small enterprises, especially those currently being created, have no access to credit.³ The European Commission has already stressed the importance of this sector for stimulating employment in Europe through the Lisbon Strategy and policies for encouraging small and medium-sized enterprises (SMEs).

- Unemployment and exclusion

The number of unemployed in the expanded 25-nation European Union is estimated at 18.5 million, or 8.6 per cent of the workforce. About 69 million people live below the poverty line. In a country such as France one third of all new jobs is directly or indirectly the result of enterprise creation, and 40 per cent of the new entrepreneurs were previously jobless. Self-employment is therefore a means to economic growth as well as social integration.

- The role of the informal sector

In most EU countries there is a large sector of small informal income generating activities⁴ that need to be integrated into the economy so that they may be allowed to grow, become official and, like other enterprises, contribute to public expenditure.

Demand for microcredit is hard to estimate since it is largely concealed and only gradually coming to light with supply. In Central and Eastern Europe the microcredit penetration rate is estimated at about 5 per cent of the potential market. The importance of this market is confirmed by the rapid growth of MFIs' activity. At

² According to the August 2001 survey by the European Network for SME Research carried out in 19 European countries, there are 20.5 million such enterprises in Europe, 93 per cent of which are micro-enterprises with 0-9 employees. If we extrapolate this percentage to the entire 25-nation EU (23 million according to the European Commission's Enterprise and Industry DG information bulletin for January-March 2006) a rough estimate of the number of micro-enterprises in the EU would be 21,390,000.

³ Only 20 per cent of companies set up in France have access to credit.

⁴ According to Friedrich Schneider, the shadow economy in OECD countries is worth an estimated 14.2 per cent-15 of GDP. It is composed of three types of activities, criminal, undeclared employment, and activities that generate revenue, which is what interests us here.

present, the European market comprises some 4 million micro-enterprises (20% of the total number of micro-enterprises) and a minimum of 7 million informal activities in the process of being registered⁵. It is very likely that the market will continue to develop as public opinion changes, institutional barriers are lifted, and microcredit gains greater visibility.

2. Supply

Because the banking sector in Western Europe is so densely developed, microcredit is unlikely to expand as it did in the southern countries, outside of partnerships with banks. Central and Eastern Europe may offer a preview of the future market characterised by a continuum of non-bank institutions, credit unions, specialised microfinance banks and commercial banks covering the various market segments. In Western Europe microcredit has only just taken off, for two main reasons: public opinion is slower to grasp economic developments, and the legal and regulatory framework is unsuitable for microcredit and micro-enterprises.

In both cases the prerequisite for microfinance to develop is profitability. That means reducing both operating costs and risk, but also increasing the volume of transactions and the range of products as well as setting interest rates at appropriate levels. Risk is well managed on the whole, but progress needs to be made in curbing operating costs through the use of new technologies and decision-making tools based on credit scoring methods.

3. Conditions for growth

The conditions for microfinance to develop are to be found in three areas: public opinion, finance and the institutional environment.

- **Information**

Information is important for promoting better public understanding of the economic revolution led by services and new technologies. Putting the Lisbon Strategy into place supposes a dynamic vision of the economy that, by its very nature, includes a portion of risk. Europeans will not accept risk until they have a clearer vision of the future and of the importance of economic initiative.

The European Commission can play an important role through its communications policy and Euro Info Centres. It would be useful to have an ongoing communication drive focusing on microcredit.

⁵ The hypothesis here is that at least one quarter of the active population below the poverty line (approximately 30 million people) carry out some kind of informal activity that they would like to legalise.

- Financing

Like all new activities, microcredit requires start-up investments, which may be both public and private. In Central and Eastern Europe microcredit was launched with international assistance funds⁶; in Spain it has largely been financed by savings banks; while in France it is supported both by public funding and banks. Greater microfinance support is required for the hardest-to-reach customer segments (the poorest populations, rural communities etc.). In any case the ultimate objective is to cover costs progressively and make profits so that microcredit attracts commercial financing.

The Joint European Resources for Micro to Medium Enterprises (JEREMIE)⁷ can play a major role by bringing a range of resources to the sector during its development phase, such as technical assistance, subsidies, lines of credit, equity, and guarantees, and also by providing leverage for private financing.

In Western Europe, where regulations are more complex, business development services (training and advice) are vital to the success of micro-enterprises. Financing comes from local authorities, the state and the European Social Fund. In countries such as France and the United Kingdom, volunteers participate in mentoring the start-ups.

- Institutional background

From an institutional perspective, credit developed historically in Europe to meet the needs of an industrial society with a narrow range of banking products and services. Today it is no longer suited to the real needs of SMEs, still less to micro-enterprises.

The main obstacles to microcredit are the caps on interest rates that prevent lenders from covering the cost of distributing small loans, as well as the monopoly of banks, which prevents non-bank institutions from getting into microfinance. These obstacles are a hangover from the last century when they were implemented to prevent usury. They are less easily justified today given the competition in the banking sector and overall low interest rates. However, cases of abuse do occur in some countries such as the United Kingdom, where the absence of regulation leads to predatory practices in consumer credit.

Finally, the Basel Committee's new regulations could slow down the development of microcredit. By making capital adequacy requirements dependent on the use of risk

⁶ World Bank, US Aid, KFW, etc.

⁷ JEREMIE is a joint initiative between DG Regio in association with the EIF for the purpose of improving access to finance for SMEs and encouraging the development of microcredit in 2007-2013, within the framework of the ERDF.

assessment models, the Basel accord encourages loans and transactions that are easy to evaluate because they are based on tried-and-tested methods. By contrast, it is detrimental to transactions that are just as safe—given their diversity—but less easy to evaluate because they require a different methodology. The diversification of risk in microcredit should be recognised as a factor that reduces capital adequacy requirements.

In view of the rapid development of microfinance, the Basel Committee and/or the European Commission should draw up a list of best practices for regulating the sector. Many countries including European states such as France and Bulgaria, have changed their legislation to make access to credit easier for a greater number of people.

The major obstacles for micro-enterprises are the over-taxation of labour (social insurance fees in particular) and red tape, which makes fixed charges comparatively more burdensome for small production units and mean that mentoring is required for new entrepreneurs. Nor is it easy for start-up micro-enterprises, usually registered as sole proprietorships, to find equity capital in addition to their loan. Lastly there is a scarcity of office and workshop space resulting in high rents.

- Development models

The models for developing microcredit in the EU are the same as in the rest of the world. Since microcredit is relatively recent here, the transformation of subsidised activities into “bankable” ones is bound to be gradual.

First, the partnership between banks and non-bank institutions means that either the MFIs bring the customers and the banks make the loans, or alternatively the banks open credit lines to microfinance institutions who thereby take on a retail role and become a point of entry into the conventional banking system. Such cooperation is mutually beneficial: banks obtain specific information on this customer segment and outsource their operating costs, while microfinance institutions learn techniques, such as customer evaluation methods and scoring, from banks.

Partnerships may also develop through shareholdings, sharing of operating costs, risk hedging or securitisation. It is hoped that the public-private partnerships encouraged by JEREMIE will enable banks to extend their services to the upper segments of clientele while non-bank organisations will aim for the lowest segment with the higher operating costs.

At this stage it is not possible to say if or when it would make sense in Western Europe to set up specialised microfinance banks like the ProCredit Banks. At present occasional plans to set up a “social bank” for the least well-off face two hurdles. They are unable to cover their costs, and they create a ghetto for the poor. Conversely,

post office banks will probably play a greater role in providing banking services for this segment of the population in Western Europe, as is the case elsewhere.

Generally speaking, the trend towards product diversification will continue. This applies not only to savings, which only banks are authorised to collect, but also to transfers, which may become more competitive, and to micro-insurance, now being studied in several countries.

Conclusion

The European microcredit market comprises a minimum of 11 million customers. It is potentially profitable as long as practitioners avoid the “humanitarian temptation” and set up sustainable institutions that are efficient and effective, both financially and socially. For microcredit to grow, MFIs need start-up assistance, financial support for non-banking services such as coaching, and the removal of institutional barriers. The ultimate goal, of course, is to cover the cost of lending. Even though this activity will be less profitable than other banking businesses for some time, the long-term economic benefits of such a policy are obvious. Moreover microcredit is consistent with the Lisbon Strategy for growth and social cohesion. It is based on a philosophy of taking initiatives and developing small enterprises, and it has a considerable impact on employment.

Actions to be taken:

***At European Commission level**

1) Enterprise DG and DG Markt should draw up an inventory of European legal and regulatory best practices for microcredit and micro-enterprises. This would help to define the status that should be given to European MFIs. Three issues are key⁸:

- MFIs should be allowed to obtain credit in order to lend
- Caps on interest rate should be removed so that MFIs can cover their costs
- Basel Committee capital adequacy requirements should be adapted to MFI portfolios

2) The Regional Policy DG and the EIF should launch an intensive communication drive focusing on JEREMIE so that member states may take it into account when preparing the next generation of ERDF funding for 2007-2013.

3) The Employment, Social Affairs and Equal Opportunities DG should continue its advisory and management training programmes on enterprise creation for the unemployed.

⁸ For example:

Country	Interest rate ceiling	Non bank MFIs unable to obtain credit in order to lend
Belgium	Yes	No
Finland	No	Yes (except for Finverra, which has special authorisation)
France	No	No (but Ministry of Finance authorisation requested)
Germany	No	Yes
Hungary	Yes	No
Netherlands	Yes	No
Poland	Yes	No
Slovakia	No	No (but central bank authorisation required)
Spain	No	Yes
United Kingdom	No	No (but licence required)

4) DG Ecfm and DG Markt should establish an appropriate legal framework to encourage securitisation and thereby facilitate microcredit guarantee.

5) Finally the European Commission should draw up an action plan for microcredit similar to the one that exists for venture capital.

****At European Parliament level***

Firm, coordinated action with the European Parliament's commissions for Economic and Monetary Affairs and Employment and Social Affairs would have a major impact on the above proposals and stimulate the development of microcredit.

****At bank level***

Banks' social responsibility is being combined with the interest for a new market in which the low value of individual transactions would be offset by their volume. The experience in the US following the Community Reinvestment Act, and in Central and Eastern Europe, offers a promising outlook.