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THE MICROCREDITING SECTOR IN HUNGARY

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TABLE OF CONTENTS

1. NATIONAL ENVIRONMENT.....	2
2. THE HISTORY OF MICROFINANCING IN HUNGARY.....	6
3. THE MAIN PARTICIPANTS OF THE MICROFINANCING SECTOR.....	7
3.1. The government sector.....	7
3.1.1. Ministry of Economy and Transport (GKM) – government body.....	7
3.1.2. Labour Centres – administrative organs.....	7
3.2. Non-Profit sector.....	8
3.2.1. Hungarian Enterprise Agency – non-profit organization.....	8
3.2.2. The Hungarian Microfinance Network ® made up of the enterprise agencies operating in the counties and the capital ® – non-profit network of non-profit organizations.....	9
3.3. Profit orientated sector.....	11
3.3.1. Savings co-operatives and credit societies – profit orientated co-operative credit institutions dealing with deposits as well.....	13
3.3.2. Mikrohitel Rt. – profit orientated financial enterprise not dealing with deposits sponsored by non-profit organizations.....	15
4. THE OPERATING MODEL OF THE INDIVIDUAL MICROFINANCING PROGRAMMES	16
4.1. The operation of the National Microcredit Programme.....	16
4.2. The operation of the Local Microcredit Programmes.....	19
5. MICROFINANCING PROGRAMMES IN HUNGARY.....	20
5.1. General conditions.....	20
5.2. Comparative table of the various credit conditions.....	21
6. FACILITATING THE INCLUSION OF OTHER FINANCIAL SOURCES.....	22
7. GOVERNMENTAL SUPPORT.....	22
8. REGULATIONS REGARDING THE HANDLING OF FINANCES AND MICROENTERPRISES.....	23
9. FINANCIAL AND FUNCTIONAL SUSTAINABILITY.....	25
10. CHALLENGES TO BE MET BY THE SECTOR.....	27

1. NATIONAL ENVIRONMENT

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 after the change-over from the controlled plan type economic model to market economy these enterprises had to form the backbone of the national economy, 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 interest from a national economy point of view**.

Number of operating enterprises according to the number of staff employed (2000–)										
Year	2000		2001		2002		2003		2004	
	number	ratio	number	ratio	number	ratio	number	ratio	number	ratio
0 person	17 665	3%	18 721	3%	22 835	3%	16 414	2%	15 970	2%
1 person	408 066	65%	424 782	66%	465 000	67%	464 150	66%	464 096	66%
2 persons	78 508	13%	80 520	12%	82 558	12%	90 205	13%	92 375	13%
3– 4 people	54 001	9%	54 113	8%	55 088	8%	58 827	8%	61 473	9%
5– 9 people	34 620	6%	35 205	5%	35 469	5%	37 504	5%	39 613	6%
10–19 people	16 407	3%	16 656	3%	16 910	2%	17 530	3%	18 170	3%
20–49 people	9 442	2%	9 501	1%	9 919	1%	10 252	1%	10 636	2%
50–249 people	5 350	1%	5 337	1%	5 006	1%	5 015	1%	5 028	1%
250 people or more	1 088	0%	1 046	0%	1 003	0%	958	0%	946	0%
Enterprises in total	625 147	100%	645 881	100%	693 788	100%	700 855	100%	708 307	100%
Micro enterprises in total	592 860	95%	613 341	95%	660 950	95%	667 100	95%	673 527	95%

Source: Central Statistical Office 2007

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 the 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 development projects were started at this time within the framework of the Phare programme.

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 programme 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-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 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-size enterprises play a determinant role in furthering the economy, the government of the Hungarian Republic worked out an entrepreneurship development programme. 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.

Since the objectives of the PHARE programme launched in Hungary and the objectives of HFEP were the same, the HFEP was entrusted with the handling of 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. The Phare required the setting up of Local Enterprise Agencies's (LEA) network, where the previously mentioned target group is supported in the form of professional counselling and business services. Thus, since 1991 the main activity of HFEP has been the creation of the national network of the Local Enterprise Agencies (**enterprise agencies operating in the counties and the capital** ®).

At the outset six pilote 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 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.

Meanwhile – mainly also owing to the above-mentioned programmes – the situation has changed greatly. A 'self-purification' process has gone through in the sector of small and medium-sized enterprises, as a result of which, considering its operation, a more stable micro and small entrepreneurial layer has emerged. At the same time the lack of capital in the sector is still a problem, which has been confirmed by several national and foreign studies as well.

The reason for this, on the one hand, lies with the fact that the emerged entrepreneurial layer does not have such enterprising past going back several generations that would have made the accumulation of capital possible. On the other hand, the profit orientated participants of the financial market have been reluctant to finance this entrepreneurial group so far.

The root cause of this is as follows:

- The **low income** owing to the generally small amount of loan requirement of the small and medium-sized entrepreneurial sector, the **low profitability** resulting from the **high costs of their advisory and after-care demand**, and the significantly **higher risk** resulting from the expected major failure ratio cannot be accepted by them.
- It is an additional risk for them that they cannot evaluate the entrepreneurial past of the majority of the enterprises. (*This, on the one hand, arises from their book-keeping habits, and the fact that according to the international experience, this entrepreneurial sector mainly supports itself from activities performed in the field of 'grey economy'. As a result of this, with regard to their book-keeping figures the enterprises showing permanent deficit are also capable of operating at an appropriate level. This, however, cannot be evaluated by the banking sector.*)
- The negative experience gained during the crisis leading to the bank consolidation of the nineties withheld the granting of credits for the sector for a long time.

After the initial difficulties regarding the operation of the market economy and two-tier bank system emerging as a result of the social changes of the nineties such competition has been created among the participants of the financial market by today that significantly affects the operation of the micro-financing sector, too.

According to the ‘flash report’ of the Hungarian Financial Supervisory Authority regarding the year of 2006, the profit orientated financial sector is characterized by *increasing competition, growing profiteering, greater assumption of risk, deteriorating loan portfolio, decelerating business growth, growing competition for the sources and the weakening asset profitability.*

The greatness of the emerged competition is also indicated by the number of the participants: 37 banks, 8 specialized credit institutions, 156 savings co-operatives, 5 credit societies, 238 financial enterprises, and 321 credit institutions providing services beyond the borders operate in Hungary. The activity of 22,598 agents of credit institutions and 8,669 agents representing financial enterprises connects to this.

As a result of the growing competition, these organizations turn to the more risky micro and small entrepreneurial crediting with their entrepreneurial credit products, which overlaps the declared target group of the ‘official’ microfinance programmes in Hungary. Apart from the fact that this can be considered favourable in view of the financing of the micro-entrepreneurial sector, knowing the operating characteristics it also carries significant risks for the financial sector in the longer run.

Bank credits of the banking sector granted to micro, small and medium-sized enterprises in the first quarter of 2007, and credits outstanding on 31 March 2007 (number and billion HUF)

Description	Microenterprises		Small enterprises		Medium-sized enterprises		Total	
	number	gross value	number	gross value	number	gross value	number	gross value
Credits lent in the reference period in total (accumulated as of 1 Jan)	31 306	266,602	17 672	233,451	9 344	285,397	58 322	785,450
Credits beyond one year in total	3 003	100,661	1 338	74,304	722	76,926	5 063	251,891
HUF credits beyond one year:	1 263	41,351	686	30,312	425	39,523	2 374	111,185
<i>Out of this:</i> investment credit	297	16,774	178	9,215	192	17,386	667	43,374
Foreign exchange credits beyond one year	1 740	59,311	652	43,991	297	37,404	2 689	140,706
Credits within one year in total	28 303	165,940	16 334	159,147	8 622	208,471	53 259	533,558
HUF credits within one year:	26 058	100,114	14 543	126,143	7 685	156,717	48 286	382,975
<i>Out of this:</i> export prefinancing credit	5	0,344	4	0,072	2	0,143	11	0,559
Foreign exchange credits within one year	2 245	65,826	1 791	33,004	937	51,754	4 973	150,584
Credits lent (at the end of the reference period)	108 001	1 005,197	29 616	961,982	12 580	1 237,194	150 197	3 204,373

Source: Hungarian Financial Supervisory Authority

It is important to note here that in Hungary - *due to the processes to be described later* - the ‘development’ of microfinancing has taken such a direction that today only **entrepreneurial loan lending** is understood by the microcrediting activity of the microfinancing institutions performing microcrediting on the basis of the authorization of the law, and the former social goals and aspects have nearly completely disappeared from the official central programmes.



Several experts are concerned about this, since the widening of the gap between the rich and the poor generates significant social tension.

(Dr Antal Szabó writes in his study called Microcredits in the World: 'In Hungary, according to some surveys, 2.7 million people live under the poverty line. 100 people freeze to death annually, and the number of homeless people exceeds 100 thousand. Approximately half a million people, out of which are 300 thousand children, do not get enough food! The number of unemployed people reached 312 thousand at the end of 2006, the unemployment rate was 7.5%, which means that there were 16 000 more unemployed people than one year earlier.' 'This raises the collective responsibility of the governing party and the parties of the opposition. This problem is distressing because the former traditional welfare system has become worn-out in the meantime, and a wider and wider segment of the society is considering their situation unstable due to the reduction of the expenditures in the budget and the tightening of the expenditures on the cost of unemployment. Also, the savings of the people has basically become eroded as a result of inflation, and there is no money for self-employment. In addition to this, the local governments have no funds to get the economic activity off the ground in the bankrupt factories, closed down mine premises and underdeveloped rural areas. This is not just a Hungarian phenomenon.' 'In the self-employing unemployed entrepreneur category preparing for new life (Note by me: to which today there is no suitable legal business form in Hungary as opposed to the United Kingdom, and for which only the individual Local Microcredit Programmes and the Labour Centres provide insufficient funds – as described later) in many cases the family savings or credits received from friends mean the only source of money to launch a new business.'

2. THE HISTORY OF MICROFINANCING IN HUNGARY

The launching of the National Microcredit Scheme – (MCS)

The concept of launching the National Microcredit Scheme was outlined at the beginning of 1992. Within the framework of the Phare programme, the Committee of the European Community wanted to lighten the concern also well-known to developed economies, i.e. that most of the micro and small enterprises are not credit-worthy for the profit orientated credit institutions, with this initiative. This is such a market failure where the market mechanism does not operate suitably - (*there is no adequate supply to the demand being present permanently*), the solving of whose is in the interest of the national economy, and makes the intervention by the government justified and necessary.

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.

After this, the **enterprise agencies operating in the counties and the capital** ® started to operate the first microfinancing construction launched as microfinancing programme in Hungary - *under the name of Microcredit Scheme (today National Microcredit Programme)* – in 1992 under the financial interposition and professional co-ordination of HFEP. At the outset the sources for the programme were provided by Phare (*then the Hungarian government as a co-financer*) in the form of earmarked subsidy subject to conditions. ***The manual as well as the terms and conditions of the programme were worked out by a British specialist company with the co-operation of Hungarian professionals in view of the domestic characteristics and legal background.***

It is important to note that the microfinancing programmes described here refer to the microfinancing of the participants, considered as entrepreneurs/enterprises from a legal point of view, of the sector in accordance with the Hungarian rules of law. The target group regarded as the potential customer base of the microcredits is not defined exactly in the EU. For example: the legal notion of ‘social enterprise’ or ‘self-employing enterprise’ known in the United Kingdom is unknown in Hungary. That is why it is practical to differentiate between ‘*social microcredit*’ and ‘*entrepreneurial microcredit*’ of entrepreneurship development purpose, the objectives of whose are very different, since they indicate two branches of microfinancing showing significant differences.

At the moment in addition to the National Microcredit Programme – *with a financing proportion varying in ratio and significance per counties* – there are **Local Microcredit Programmes** as well, which will be described in chapter 4.

3. THE MAIN PARTICIPANTS OF THE MICROFINANCING SECTOR

3.1. The government sector

3.1.1. Ministry of Economy and Transport (GKM) – government body

<http://en.gkm.gov.hu/>

In accordance with Government Regulation No. 2163/2004 (VII. 5.), the minister for the economics and transport exercises the ownership rights relating to the Microcredit Funds owned by the state, and supervises the National Microcredit Programme.

The Ministry of Economy and Transport delegates the President of the National Microcredit Committee, too. This committee is the advisory body of the HFEP advisory board. It does not have any operative authority in connection with the operation and regulation of the microcredit programmes.

3.1.2. Labour Centres – administrative organs

The (regional, county and local) Labour Centres are administrative organs belonging to the *Public Employment Service* (<http://en.afsz.hu/Engine.aspx>) working under the supervision of the Ministry of Social Affairs and Labour (<http://www.szmm.gov.hu/main.php?folderID=13318&langchanged=eng>). They deal with the registration of unemployed people and co-ordinate and perform services provided by the state for the unemployed. **They are not considered as microfinancing organizations**, at the same time they can belong to the microfinancing category due to the amount provided by them and the target system of the ‘*subsidy facilitating the transformation of unemployed people into entrepreneurs*’ in accordance with Decree No. 6/1996 (VII.16.) of the Ministry of Labour, thus they are also mentioned for the sake of completeness. These subsidies are provided by the Labour Centres from state sources.

Short description:

The subsidy facilitating the transformation of unemployed people into entrepreneurs may be provided for those persons seeking employment who:

- have been registered at the Labour Centre as a person seeking employment for at least three months, and
- provide employment for themselves as a primary agricultural producer – with an activity outside employment – within the form of individual enterprise, or as a personally co-operating member of a partnership (by setting up partnership or joining an already existing enterprise), in accordance with Section 3 (18) of Act CXVII of 1995 on Income Tax.

The forms of the subsidy facilitating the launching of the enterprise:

- a) interest free capital allocation up to HUF 3 million, which either has to be reimbursed or does not have to be reimbursed, and
- b) subsidy that does not have to be reimbursed up to the amount of the *lowest compulsory salary** provided monthly for at least six months.

In case of providing interest free capital allocation that has to be or does not have to be reimbursed, a further condition of the subsidy is:

- the existence of own sources up to at least 20% of the gross cost of the investment, and
- the reimbursement of the subsidy – in case of granting subsidy to be reimbursed – or the provision of financial security in the event the subsidy has to be reimbursed due to the violation of the obligations.

The subsidies that can be provided with regard to becoming an entrepreneur – on the basis of a tendering procedure – may be granted jointly and separately as well.

The subsidy specified in point b) may be established as of the date of becoming an entrepreneur, thus the commencing date of the payment of the subsidy is:

- a) in case of setting up an individual enterprise having a duty of registration the entrepreneur’s certificate, or if another provision of law stipulates the issuance of another document as a condition for pursuing the entrepreneurial activity, the date of acquiring the document,
- b) in case of pursuing primary producer’s activity the date of issuance of the primary producer’s certificate,
- c) in case of any other enterprises the registrations made in the company register, or the date of registering any change.

* *Salaries, emoluments (minimum wage, guaranteed minimum wage)*

<i>Between 1 January 2007 and 31 December 2007 Government Decree No. 316/2005 (XII. 25.)</i>	<i>Monthly salary HUF/month</i>	<i>Weekly wage HUF/week</i>	<i>Daily wage HUF/day</i>	<i>Hourly rate HUF/hour</i>
<i>Minimum wage Section 2 of the Government Decree</i>	65,500	15,080	3,020	377

3.2. Non-Profit sector

3.2.1. Hungarian Enterprise Agency – non-profit organization

The circumstances of the establishment of the Hungarian Enterprise Agency (HEA) were described in item 1. This organization operating in the form of an agency has been playing an important role in microfinancing in Hungary since the beginning, and has achieved significant success and results in this field.

<http://www.mva.hu/>

At the moment, due to the international contracts, it is the national co-ordinator of the National Microcredit Programme, and also manages the National Microcredit Fund specified in these contracts. In accordance with Section 2 (1) (h) of Act CXII of 1996 on Credit Institutions and Financial Enterprises the credit granting activity of the organization from the National Microcredit Fund does not fall under the effect of the Act. In compliance with this, as a specialized non-profit micro-financing organization is entitled to grant credits within the framework of the National Microcredit Programme.

The HFEP does not deal with the entities applying for the credit directly. This is done by the members of the *Hungarian Microfinance Network* ® made up of the *enterprise agencies operating in the counties and the capital* ® being in a contractual relationship with it. The whole credit assessment procedure takes place at these organizations.

The operating model of the National Microcredit Programme is described in chapter 4.

The HFEP considers the safeguarding of the National Microcredit Fund, in other words the minimizing of credit losses, as its most important role filled in the National Microcredit Programme. For this purpose several financial lawyers work on the preliminary control of loan granting and on checking the legal securities (primarily properties) required from the clients. In order to increase the efficiency of the return, the collection of problematic credits is done by a specialized collecting company.

3.2.2. *The Hungarian Microfinance Network* ® made up of the enterprise agencies operating in the counties and the capital ® – non-profit network of non-profit organizations

The **most important participants** of the Hungarian microfinancing sector are the **enterprise agencies operating in the counties and the capital** ® making up the **Hungarian Microfinance Network** ®. <http://www.hungarian-microfinance.org.hu/>

The members of the Network, the **enterprise agencies operating in the counties and the capital** ® - *the first in Hungary* – began their microfinancing activity in 1992 as a contractual partner to the Hungarian Enterprise Agency. As the entities managing the National Microcredit Programme in practice, only these organizations have microcrediting practice, experience and knowledge of more than a decade in Hungary.

In accordance with Section 2 (1) (h) of Act CXII of 1996 on Credit Institutions and Financial Enterprises only these organizations may perform independently full microcrediting activity falling outside the effect of the act.

Considering their legal form, these organizations are non-profit foundations (agencies). They are independent organizations having legal personality. The working body of the agencies is run by the managing directors. The managing directors are appointed by the advisory board elected by the founders. The advisory boards are the main supervisory boards of the agencies, which are managed by the president elected by the advisory board from its members.

The majority of the 20 independent enterprise agencies were formed with the comprehensive co-operation of the local communities and with the support of the European Community. When the microfinancing activity began in Hungary at the beginning of the nineties, the Delegates of the European Community to Hungary as well as the HFEP selected these organizations by means of tenders or in certain cases established these organizations themselves in order to handle the entrepreneurial Phare programmes in Hungary.

Due to the political, structural and personal changes described later, these organizations found it necessary to set up a mutual interest representing network in the form of a consortium – with voluntary accession – and its working body having legal personality, the National Enterprise Network Non-Profit Company. (Only the HFEP did not join the Network.) The Network under the name of Hungarian Microfinance Network ® became a member of the **European Microfinance Network** (EMN).

Owing to the co-operation and the intervention of the consortium, the members of the network have managed to achieve that their microcrediting activity does not fall under the effect of the act on credit institutions and financial enterprises, thus they are entitled independently to perform microcrediting without the participation of commercial banks adding extra cost to the process.

They have an advanced, Internet-based internal communication and credit recording system, to which an up-to-date, Internet-based provider is connected for the clients. www.mvfportal.hu

As a result of the continuous development, in addition to the credit construction of the National Microcredit Programme, there are numerous microcredit constructions on offer.



The management of the Network is made up of the presidium consisting of seven members, the members of whose are elected by the managing directors of the 20 affiliated organizations from themselves. The presidium of the Consortium elects the President of the Consortium from its members.

With regard to microfinancing, in order to perform the professional work, the Consortium has set up two bodies. These are:

- The **National Microcredit Professional Council** – a professional body that consists of the financing directors of the county and has great practical experience.
- **National Microcredit Professional Committee** – a body that has the greatest microcrediting experience and expertise in Hungary. Its members are appointed by the presidium of the Consortium from the members of the National Microcredit Professional Committee. The President of the Committee is elected by the members of the Committee from themselves.

The procedures of the **Local Microcredit Programmes** operated in accordance with the own regulation of the Network have been worked out by the specialists of the Consortium on the basis of their microfinancing experience of more than 15 years in such a manner that it can serve the needs of micro entrepreneurs with the least difficulty as quickly as possible. The majority of the specialists earned their microfinancing certificate in Western European countries. *(In the majority of the cases the Dutch Small Enterprise Network made the exchange of experience possible).*

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 Co-operation Initiative (SECI), in which 12 countries - *including Greece and Turkey* – participated from Central and East Europe. According to the survey conducted by the British Bannock Consulting, the **then existing Hungarian practice was the best microcredit programme in the region.** This means the significant recognition of the microcrediting activity of the agencies.

It must also be mentioned that one of the members of the Network, the Budapest Enterprise Public Funds, won the Innovative Urban Strategy award of the EURO CITIES organization congregating European cities with its Budapest Small Entrepreneurial Credit construction in 2001.

3.3. Profit orientated sector

The participants of the profit orientated money market operating under the effect of Act CXII of 1996 on Credit Institutions and Financial Enterprises are:

the banks,
 specialized credit institutions,
 co-operative credit institutions: savings co-operatives and credit societies
 financial enterprises.

Although these enterprises cannot be considered as microfinancing organizations, they are mentioned because due to the growing competition among them **they turn to the micro and small entrepreneurial sector more often assuming greater and greater risk with their credit products offered to enterprises**, and some of their participants represent significant lobbying power.

The great majority of banks and financial groups are in foreign ownership. The registered offices of the parent companies with the exception of one are abroad (mainly in the European Union). The strategy of the parent companies is based on the fact that the central east European region grows rapidly. It can be characterized by expanding demand and having financial – loan, deposit, investment – markets. The business of financial brokers has increased rapidly and the business of credit institutions has increased at an outstanding pace in Hungary. In addition, their profitability in proportion to their assets and capital has reached exceptional peaks. Last year, however, while the business was still growing at a relatively rapid pace, the profitability slackened, the loss of value *increased greatly, due to the deterioration of the quality of the credits. (In the whole of the EU the processes taking place last year were to the contrary of this.)*

The total portfolio of the banking sector at the end of March 2007 (in billion HUF)

Description	Free of problems	To be observed separately	Problematic*	Under average	Dubious	Bad	Falling under classification obligation in total
Items of the balance sheet in total	14,812,768	1,266,015	428,303	144,303	112,581	171,419	16,507,086
Out of this: securities of trading purpose	97,025	2,203	1,785	1,115	0,000	0,670	101,013
Securities of investment purpose	693,582	1,101	0,000	0,000	0,000	0,000	694,683
Investments by credit institutions	1,938,614	182,564	0,168	0,002	0,000	0,166	2,121,346
Entrepreneurial credits	4,902,993	751,046	207,940	66,154	56,189	85,597	5,861,979
Household credits	4,074,466	263,991	124,884	34,664	37,131	53,089	4,463,341
Investments abroad	848,956	29,669	15,151	2,786	11,448	0,917	893,776
Other assets	376,452	8,492	70,075	31,749	7,614	30,712	455,019
Out of this: financial interests	459,276	7,223	66,263	30,855	6,632	28,776	532,762
Items outside the balance sheet in total	14,900,998	429,521	54,385	28,415	13,266	12,704	15,384,904
Pending liabilities	5,326,603	427,539	53,818	28,415	13,266	12,137	5,807,960
Future liabilities	9,574,395	1,982	0,567	0,000	0,000	0,567	9,576,944
Items falling under classification obligation in total	29,713,766	1,695,536	482,688	172,718	125,847	184,123	31,891,990

* Problematic: under average, dubious and bad at the same time.

Source: Hungarian Financial Supervisory Authority

The credits, primarily currency credits, increased at an extremely rapid pace, whereas the deposits, especially deposits by the population, practically stagnated. In order to counterbalance their balance sheet, the banks relied on **foreign currency sources** to a greater extent. In the beginning, the prevalent part of these was credits, mainly credits taken out from the parent bank. However, last year the ratio of deposits taken out abroad increased significantly.

Bank credits provided by the banking sector to microenterprises (number and in billion HUF)

Description	Dec 2001 audited		Dec 2002 audited		Dec 2003 audited		Dec 2004 audited		Dec 2005 audited		Dec 2006 preview	
	number	gross value	number	gross value	number	gross value	number	gross value	number	gross value	number	gross value
Credits granted in the reference period in total (accumulated as of 1 Jan)	23 724	382,852	34 841	412,894	79 084	480,483	71 940	474,787	55 209	624,540	115 080	797,281
Credits beyond one year in total	10 351	185,065	16 947	233,967	18 268	244,055	8 176	201,063	10 036	245,995	14 282	348,269
HUF credits beyond one year:	9 982	137,450	16 540	190,650	15 436	161,820	5 141	93,200	5 055	104,764	7 436	139,495
Out of this: investment credit	1 988	31,753	3 532	45,822	2 233	38,434	1 251	27,926	1 193	22,855	1 574	50,298
Foreign currency credits beyond one year	369	47,615	407	43,317	2 832	82,235	3 035	107,863	4 981	141,231	6 846	208,775
Credits within one year in total	13 373	197,787	17 894	178,927	60 816	236,428	63 764	273,724	45 173	378,545	100 798	449,012
HUF credits within one year:	12 730	162,410	17 497	152,312	60 073	198,103	61 350	164,058	39 672	303,307	90 114	324,025
Out of this: export prefinancing credit	3	0,260	7	0,247	16	0,186	17	0,358	10	0,152	8	0,073
Foreign currency credits within one year	643	35,377	397	26,615	743	38,325	2 414	109,666	5 501	75,238	10 684	124,986
Lended credits (at the end of the reference period) in total	41 049	416,847	36 247	525,816	..	680,947	..	747,323	67 107	897,708	104 826	904,092

Source: Hungarian Financial Supervisory Authority

The banking balance sheet structure that had formed by the second half of the decade increases the risk exposure of the banks, since the high volatility of the price of the assets not only affects the quality of the credits negatively but at the same time it can deteriorate the degree of source supply as well, adding to the difficulties of the banks caused by the deterioration of the portfolio. The tension hiding in the balance sheets of the banks has to be expected in the future, too, since besides the expected slowing down of the credit expansion, there will be significant difference in the growth rate of credits and client (population) deposits.

The slowing down economic growth, the temporarily decreasing real incomes, and the slackening consumer demand naturally hold back the demand for the services of the financial organizations, especially the demand for credits. However, essentially the problem is not caused by the decreasing demand for credits, though its profitability risk is not to be overlooked, but **the further deterioration of the quality of the outstanding credits. This risk exists both in case of companies (mainly small and medium-sized enterprises) and credits lended to the population.**

The **income coverage of credits is expected to further decrease in 2007 too**, whereas in view of the GDP and the gross income the population still cannot be considered as over-indebted on an international level. **However, the proportion of the instalments can be considered high compared to the available incomes.** This situation is further aggravated by the fact that the proportion of personal savings compared to the available income and GDP fell back in the second half of last year, thus the **solvency of households further declined.**

With regard to the coverage of credits it must be noted that the uncertainty concerning the assessment of the properties, flats, commercial or industrial properties, typically serving as the collateral for the credits is quite big at the moment.

If the crediting risks are considered from the side of the credit institutions, the signs of a certain kind of change could have been observed since the middle of 2006. **In the first half of 2006 the sectoral and functional structure of the credits clearly moved towards the more risky directions: the proportion of credits lent to the population, within this the proportion of credits having low or no collateral at all increased. Within company crediting, the *proportion of credits lent to small and medium-sized enterprises, within this to microenterprises*, increased. Within the total crediting the proportion of credits denominated in currency considerably increased. It reached fifty percent towards the middle of the year.** These, in addition to the risks of the credits *lended* in HUF, include further market risks as well.

In the second half of the year, however, within company crediting the big companies moved forward again, within the credits *lended* to the population the ratio of personal credits having no coverage at all and purchase loans slightly fell back, and the **ratio of personal credits covered with mortgage increased. According to the Hungarian Financial Supervisory Authority, these mortgage loans of free disposition may have very high risks in the long run, since they realize a kind of capital consumption.**

The Hungarian Financial Supervisory Authority also established that a typical domestic manifestation of the **growing competition** is the increasing sale of credit products posing more risks than those of the earlier credits. This includes among others the **credit card loans, the mortgage loans of free disposition, credits *lended* to clients not providing all the necessary documents or having a negative credit history (being on the BAR list), cash credit without security, mortgage loans *lended* on high credit / collateral ratio.**

3.3.1. Savings co-operatives and credit societies – profit orientated co-operative credit institutions dealing with deposits as well

The savings co-operatives <http://www.takarekszovetkezetek.hu/> perform their activities in accordance with the permit issued by and under the regular control of the Hungarian Financial Supervisory Authority. **They are not considered as microfinancing organizations.** Their activity is more like the activity of the commercial banks, at the same time they do not say no to lending credits of small amounts. This, however, is done by them as a profit orientated organization in order to increase their incomes and profit.

The co-operative savings bank – unlike the financial institutions having a different form – is not only an economic organization, but the community of the members as well. The clients are often the members or owners of the savings co-operatives themselves, which has several advantages: they can participate in the activities of the co-operative, they can receive a share of the profit, in the event they are elected, they can fill in a position in the bodies, and can take advantage of the services provided for the members – usually under more favourable conditions.

Their activity has always been characterized by exercising the basic principles of co-operation: self-help, taking responsibility for ourselves; voluntary membership, **one vote per member**, and democratic self-governing.

The savings co-operatives strive to satisfy the needs of their members and business partners with their product range in every respect. In their branches in addition to the traditional savings book they offer depositing opportunities, securities and keeping current accounts for both private people and

companies. They grant among others personal, consumer, housing and entrepreneurial credits. They like dealing with credits of small amounts. They do not establish such conditions that would exclude clients that need only some ten thousand or one hundred thousand forints. In addition to the basic services, the savings co-operatives also offer housing pre-saving, insurance and leasing products. The clients can choose from five different types of bank cards at the moment.

The savings co-operatives declared as a mutual central organization that they operate:

- the National Association of Savings Co-operatives representing their interests (**OTSZ**)
- in addition to performing full commercial banking activities, the Magyar Takarékszövetkezeti Bank Rt (**Takarékbank Rt**) performing the functions of a central bank arising from the financial-economic co-operation
- and the National Savings Co-operative Institutional Representative Fund (**OTIVA**) to be established as an independent legal entity in order to ensure stability, and handle controlling and crisis management.

The National Association of Savings Co-operatives (OTSZ) is a national, professional organization of the savings co-operatives to protect their interest. It was established in 1990 in order to strengthen their market position and harmonize their national interests.

The Savings Co-operatives Integration established in 1993 created the proper organizational framework and possibility for the co-operation on group-level, harmonized development and the full-scale servicing of the rural *population, corporate customers* and *local governments*.

With the Savings Co-operatives' network of nearly 1,600 branch offices, the Savings Co-operatives are present in every second settlement of Hungary and provide financial services to more than 1 million clients. The network is served by more than 550 ATM machines (the second biggest network in the country), eBanking and Internet banking.

Since their establishment, the savings co-operatives have been the banks of the rural areas, since 90% of the branches making up the network can be found in villages or townships where **financial services** are only provided by the savings co-operatives.

Bank credits granted to microenterprises by the savings co-operatives (number, and in million HUF)

Description	Dec 2003 audited		Dec 2004 audited		Dec 2005 audited		Dec 2006 preview	
	number	gross value	number	gross value	number	gross value	number	gross value
Credits lent in the reference period in total (accumulated as of 1 January)	35 721	92,586,481	49 468	102,787,910	91 868	115,762,816	146 063	159,841,018
Credits beyond one year in total	8 690	48,562,134	8 076	55,548,966	3 622	33,827,368	4 165	47,141,799
HUF credits beyond one year:	8 679	48,476,734	8 072	55,197,462	3 554	31,420,241	4 049	42,763,391
Out of this: investment credit	2 997	21,573,260	2 473	19,812,738	1 536	14,916,572	1 668	59,762,097
Foreign currency credits beyond one year	11	85,400	4	351,504	68	2,407,127	116	4,378,408
Credits within one year in total	27 031	44,024,347	41 392	47,238,944	88 246	81,935,448	141 898	112,699,219
HUF credits within one year:	27 029	44,011,347	41 391	47,062,173	88 244	81,903,421	141 227	112,377,421
Out of this: export prefinancing credit	14	36,760	9	13,360	30	86,820	314	1,396,696
Foreign Currency credits within one year	2	13,000	1	176,771	2	32,027	671	321,798
Lended Credits (at the end of the reference period) in total	22 095	145,835,113	33 513	169,120,266

.. the structure of data supply changed as of the first quarter of 2005

Source: Hungarian Financial Supervisory Authority

3.3.2. *Mikrohitel Rt. – profit orientated financial enterprise not dealing with deposits sponsored by non-profit organizations*

This profit orientated financial enterprise having a modest effect on market economy level (*its equity in 2005: HUF 50,784,000; Credits outstanding: HUF140,318,000 – source Hungarian Financial Supervisory Authority, more information: http://www.pszaf.hu/engine.aspx?page=pszafhu_idosorok) is also present in the market offering microcredit.*

The direct owner of the enterprise is an economic organization, the owner of whose are a foundation and a private person. The subscribed capital of HUF 50 million of the joint stock company was provided by the Open Society Institute having a registered seat in New York.
<http://www.pszaf.hu/hatarozatok/2004/200409/20040916/i-2071-2004.htm>

The company offers the following credit products with the following conditions:

	<i>Credit for small enterprises</i>	<i>Credit lent to non-profit organizations</i>	<i>Collective (not corporate) credit</i>
Credit amount	HUF 500,000 – HUF 3,000,000	HUF 500,000 – HUF 3,000,000	HUF 500,000 – HUF 3,000,000
Duration	3 - 12 months	3 - 12 months	3 - 12 months
Interest rate	fixed, at present 19% per annum	fixed, at present 13% per annum	fixed, at present 19% per annum
Handling cost	2 % per annum	1 % per annum	2 % per annum

Note: According to our information that has not been confirmed the prevalent part of the credit portfolio is made up of non-profit credits.

4. THE OPERATING MODEL OF THE INDIVIDUAL MICROFINANCING PROGRAMMES

4.1. The operation of the National Microcredit Programme

THE SUCCESSFUL DECENTRALIZED PERIOD BETWEEN 1992 AND 2000

It has already been described how the programme began. During this period the construction was considered as one of the best PFARE constructions and the best and most successful programme in Hungary. As it has already been mentioned, in 1998 a British survey qualified the programme as the best practice in the region.

The operation of the programme is as follows:

The capitalization of non-profit microfinancing organizations selected on the basis of a tender and supported by the EU as well began in the countries belonging to the European Community within the framework of the Phare programme. HEA acted as a financial broker and it was also the co-ordinator in Hungary. In the first year the individual agencies separated the sources of the microcredit funds from the subsidies received for the realization of their business plan. In the following years they received the sources – expressly for filling up their **microcredit funds** – in the form of earmarked subsidy subject to conditions.

The funds were operated in a **decentralized manner**. Each enterprise agency operating in the counties performed their activities from their own funds managed separately from their other funds.

In order to run the programme, each agency set up its own **microcredit division** and appointed a **microcredit manager** to run this division. These microcredit managers obtained their entitlement to manage the funds on qualifying courses run by Western European specialists. It was compulsory to exchange experience in Western Europe, which primarily included professional visits to and consultations in the Netherlands, Germany, Belgium, the United Kingdom and Ireland.

The agencies set up their **sub-office network**, which created more than **150 contact points** all over the country. In addition to the possibility of submitting their microcredit applications, the potential clients received information and professional advice in these regional and central offices. The whole assessment and portfolio management of microcrediting was managed by the microcredit division of the agencies. It was the **Microcredit Committee** – set up at each agency – that was entitled to assess the credits. Economic specialists, lawyers, entrepreneurs and the managers of the individual agencies participated in the work of these committees as a social undertaking. The preparation of the assessment included the examination of the business plan **submitted on the application form of the credit application** and the **sight visit made to the entrepreneur**. After this, on the basis of the proposal of the division, the Microcredit Committee decided whether the credit could be granted or not.

In order to disburse and collect the credits - due to the regulations of the time - each agency entered into a contract separately with a branch of a bank selected by them by means of tendering. The bank disbursed the credits (concluded the contracts) from the local microcredit fund (deposit) placed at the bank for an extra fee, collected the repayments and interests, as well as kept the credit records. However, it was the task of the microcredit division of the agencies to supervise the credit portfolio, to conduct follow-up checks, and to manage legal procedures aiming at the collection of overdue debts.



The procedures were conducted quickly and flexibly, and the agencies showed maximum tolerance towards enterprises having insolvency problems.

In the first period the agencies were not allowed to request any other legal security in addition to the assets purchased from the credit so that the social objectives could be met. The auditors of Phare checked the adherence to this regularly.

The HFEP had the financial settlements of the programmes checked by international auditing companies quarterly.

The tasks of central co-ordination were performed by a manager and an administrator at the national co-ordinator, HFEP.

The programme was successful due to the fact that there was continuous professional consultation between the national co-ordinator and the specialists. National professional meetings were organized quarterly, where they could exchange their experience and their ideas as to how to improve the programme. The proposals regarding the modification of the manual describing the operation of the programme only came into effect upon the approval received from Brussels.

Microcredit lent during the first decentralized period of the National Microcredit Programme between 1992-2000 <i>(informative figures prior to the closing audit)</i>				
Fund available (HUF)	Granted credits (HUF)	Size of the credit fund at the end of the period (HUF)	Average rotation	Growth ratio of the nominal value
3,915,864,102	11,072,129,199	5,965,611,430	2.8	1.5

Note: The network was established continuously in several steps during this period, and the maximum credit amount that could be granted increased from HUF 300,000 to HUF 1,300,000 gradually.

The successful operation of the network came to a standstill due to the intense competition, but the supervision provided by the European Union protected the system until 1998.

CENTRALIZED PERIOD BETWEEN 2000 AND 2006

Following the 1998 elections, the intention to obtain the microcredit funds became more intense. After the changes had taken place in the management of HFEP, the centralization of the local microcredit funds began.

In order to implement the centralization, the HFEP prepared an international contract, against which the enterprise agencies protested, however, the Hungarian delegation to the EU was not informed about this. The contract, which is considered to be legally worrying by many, was signed in 2000 by the representatives of HFEP, the Hungarian government and the Hungarian delegation to the EU.

This document provided the background to the National Microcredit Fund created by the centralization.

The majority of the agencies handed over the right to manage the microcredit fund – being in their ownership as per their legal viewpoint – to the HFEP. This is when the period of centralized operation of the microcredit programme began.

We disregard the detailed description of the operation structure created by the unsuccessful and legally worrying measures, only their consequences will be described briefly.

The operation of the programme became slow and inflexible, and the workforce as well as the annual budget of the HFEP significantly increased. **The professional consultation between the specialists of the network and the HFEP ceased to exist nearly completely.**

A positive aspect, however, that the amount of the microcredit that can be lent within the framework of the programme was raised to first HUF 3 million, then soon to HUF 6 million, and the conditions of the credit construction were improved.

Granting microcredits from the National Microcredit Fund after the centralization broken down to sectors (HUF)							
Year	Industry	Agriculture	Tourism	Services	Trade	Other	Total
2 000	282,801,848	78,072,436	60,859,000	505,805,105	606,394,078	52,161,185	1,586,095,652
2 001	1,111,067,152	696,512,564	311,784,275	2,328,964,441	1,993,532,443	155,115,000	6,596,977,876
2 002	1,578,777,861	674,820,450	450,127,725	3,202,907,470	3,268,701,297	215,147,000	9,390,483,805
2 003 *	641,202,200	326,077,000	195,980,000	1,192,402,030	1,213,846,113	41,095,000	3,610,604,346
2 004 *	185,773,000	128,971,000	127,974,000	488,645,000	473,268,500	20,548,000	1,425,181,504
2 005	596,557,000	444,750,500	162,550,000	1,452,189,505	1,182,349,805	92,718,000	3,931,116,815
2 006	563,738,653	608,677,500	188,342,000	1,409,547,420	1,254,637,100	50,877,500	4,075,822,179
Total	4,959,917,714	2,957,881,450	1,497,617,000	10,580,460,971	9,992,729,336	627,661,685	30,616,282,177

Source: Hungarian Microfinance Network ©

* The drastic decline in the indicated years was due to the implementation of Government Decree No. 1065/2003 (VII.15.) on the improvement of the opportunities of micro, small and medium-sized enterprises to receive credit adopted in an amateurish manner.

It can be disputed from a professional point of view that the previously flexible collateral assessment rules – *despite the express objection of the agencies* – became stricter. **As a result of this, the programme abandoned its original purpose, and excludes a large number of the population most in need not being able to offer adequate security from taking advantage of the microcredit.**

PERIOD LASTING FROM 2002 UNTIL TODAY

Although the change of the government in 2002 prevented the complete rearrangement of the microcredit funds, the emerged most significant problems were not resolved. The lobbying activity became stronger.

It is deemed to be a positive change that as a result of the effort of several years, the act on credit institutions was amended in such a manner that the microcrediting activity of the agencies operating in the counties and the capital © does not fall under its effect. This way the participation of the banks, which was rather expensive for small enterprises, could be excluded from the processes.

In accordance with the decision of the minister for the economics, the previously centralized microcredit funds began to be decentralized again, though since the adoption of the decision in 2005, this has only taken place only in case of half of the agencies. The concluded contracts have not resolved the legal disputes regarding ownership. Presumably, they have just postponed them indefinitely.

At present, the national microcredit programme operates without a participating bank. The whole assessment procedure takes place at the agencies. After the assessment has been completed, the whole draft contract package and the value appraisal of the assets offered as collateral prepared by an official appraiser must be sent to the HEA in Budapest for preliminary control. Here, the material is checked

by financial lawyers, and indicate whether the collateral and the contracts are satisfactory or not. The borrowing agreement may only be concluded with the client after this, which is also done by the agencies again. The contracts must be recorded in a notarial document in front of a notary public so that the debts can be collected faster. In the event the conditions of lending the credit are met, the whole document package must be sent to the HFEP in Budapest again, where it is reviewed by the financial lawyers again, who decide whether the credit can be granted or not. If the granting of the credit is authorized, the HFEP transfers the credit amount to the bank account of the borrower shortly.

(This procedure is still considered as slow and bureaucratic by several specialists, impairing the efficiency of the agencies and the improvement of the enterprises requesting the credit. However, fast improvement in this field cannot be forecast.)

4.2. The operation of the Local Microcredit Programmes

Certain members of the *Hungarian Microfinance Network*® also operate Local Microcredit Programmes next to the National Microcredit Programme, where more emphasis is placed on creating a client-friendly procedure.

The first microcredit programmes began in Fejér then Szabolcs- Szatmár- Bereg counties in Hungary. The sources of the agencies received from various donors (in most of the cases the funds returned by the HFEP becoming decentralized again) constitute the sources of the funds.

The operation of the programmes is the same as the operating model of the decentralized National Microcredit Programme. The only difference is that there is no need for the participation of commercial banks. The conclusion of the borrowing agreements, the granting and collection of the credits as well as recording the credits are performed by the agencies themselves. In order to improve the quality of the services, they use the advanced Internet-based recording and service providing system developed by one of the members of the network, Fejér Enterprise Agency.

With its help credit applications can be submitted via the Internet, the outstanding credit amount can be checked by the clients, and the financial utilization of the managed credit funds can be tracked by the donors. The crediting activity is accompanied with advisory services. The clients can create a ‘microsite’, which is an Internet-based service provided free of charge, where they can present their enterprises. They can also find business partners free of charge.

<http://www.mvfportal.hu> ; <http://www.microfinance.hu>

Lended microcredits from the Local Microcredit Funds broken down to sectors (HUF)							
Year	Industry	Agriculture	Tourism	Services	Trade	Other	Total
2 000-2004	127,860,000	20,497,971	37,500,000	103,175,253	134,100,000	9,000,000	432,133,224
2 005	11,000,000	6,000,000	-	53,800,000	23,500,000	-	94,300,000
2 006	77,540,000	81,015,000	76,874,168	73,210,000	81,859,549	-	390,468,717
Until 12 August 2007	109,475,000	133,809,000	66,165,832	261,217,000	196,860,451	4,578,279	772,105,562
In total:	325,875,000	241,321,971	180,540,000	491,402,253	436,320,000	13,578,279	1,689,037,503

Source: *Hungarian Microfinance Network*®

5. MICROFINANCING PROGRAMMES IN HUNGARY (Target groups, financial terms and conditions)

5.1. General conditions

The entrepreneurs and their enterprises requesting the financial support of the **National Microcredit Programme** as well as the **Local Microcredit Programmes** performed by the **Hungarian Microfinancing Network** ® must meet the following general requirements:

CONDITIONS REGARDING ELIGIBILITY:

- the enterprise has to be registered or authorized to register in the company register, or the person has to have or be entitled to the entrepreneur's certificate, or has to have a licence entitling him to other ventures;
- the number of people employed by the enterprise may not exceed **nine**;
- the **maximum annual turnover** of the enterprise is **HUF 200 million**;
- the enterprise has to have its registered office in Hungary, and the proportionate share of the foreign owners may not exceed 25%;
- any enterprise that does not meet the eligibility criteria specified in this point cannot possess 25% or more of the capital or the right of vote of the enterprise applying for the credit;
- the enterprise settles its tax paying liabilities towards the state and the local government, and it does not have any overdue dues or social security contribution;
- the enterprise may not have overdue credit debt towards any bank;
- there are no bankruptcy, liquidation or full settlement proceedings against the company.

GENERAL OBJECTIVES:

- to provide financial services in order to handle 'incomplete markets' (capital markets operating insufficiently) that have formed as a result of market failures; in particular:
 - to provide suitable financial support, business advice and guidance for microenterprises by taking into consideration the characteristics and special needs of the sector;
 - the product should complete the services provided by the commercial banks in such a manner that it should provide financial support for enterprises the financing of whose is too risky or unremunerative for the commercial banks, or which do not have the legal securities required by the banks;
- to provide help for the target group in order to ensure the own resources necessary for obtaining domestic and European Union subsidies;
- to provide financial support for the layers of the society at a disadvantage (minorities, people having a large family, women, young people, unemployed people, etc.) as part of the battle against impoverishment by supporting them to become entrepreneurs or self-employed.

SPECIFIC OBJECTIVES:

- to facilitate and motivate the setting up of micro and small enterprises;
- to strengthen the small entrepreneurial sector, and to facilitate their improvement and expansion;
- to stimulate the developments and investments of the small entrepreneurial sector by means of the influx of capital tending to the sector;

- to expand the range of financial services provided for the small entrepreneurial sector and to improve the quality of such services;
- to facilitate micro and small enterprises to become the suppliers of big and multinational corporations;
- to facilitate and support the creation of corporate networks,
- to support economic innovation;
- to create new jobs.

5.2. Comparative table of the various credit conditions

Credit construction/ Parameters	National Microcredit (01) (for investment)	National Microcredit (02) (for current assets)	HMN (01) basic construction (for investment)	HMN (02) basic construction (combined: for investment and current assets, too)	HMN (03) basic construction (combined: for investment and current assets, too)	HMN (04) basic construction (for current assets)	HMN (05) basic construction (for current assets)	Microcredit to women entrepreneurs (VS/2006/0424 -HU) (HMN-EMN pilot project)
Purpose of the credit	For investment, and for investment and current assets up to 50% of the credit	Only for current assets	Only for investment	For investment and current assets	For investment and current assets	Only for current assets	Only for current assets	It can be used for entrepreneurial purposes freely*
Credit amount	6,350,000	6,350,000	6,350,000	6,350,000	6,350,000	6,350,000	6,350,000	5,000,000
Minimum duration	6	6	6	6	37	6	13	6
Maximum duration	96	36	96	36	96	12	36	96
Minimum grace period	1	1	1	1	1	1	1	1
Maximum grace period	6	6	9	9	9	6	6	6
Transaction interest	Variable, the prevailing bank rate (7.75%)	Variable, the prevailing bank rate (7.75%)	Variable, the prevailing bank rate +1% (8.75%)	Variable, the prevailing bank rate +1% (8.75%)	Variable, the prevailing bank rate +3% (10.75%)	Variable, the prevailing bank rate +1% (8.75%)	Variable, the prevailing bank rate +2% (9.75%)	Variable, the prevailing bank rate -1% (6.75%) (If the bank rate falls under 6%, the interest rate of the credit is 5%)
Frequency of settling the interest	Monthly, on the outstanding principal	Monthly, on the outstanding principal	Monthly, on the outstanding principal	Monthly, on the outstanding principal	Monthly, on the outstanding principal	Monthly, on the outstanding principal	Monthly, on the outstanding principal	Monthly, on the outstanding principal
Default interest on overdue principal	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%
Default interest on overdue interest	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%	Transaction interest +6%
Required own resources	20% of the credit amount	20% of the credit amount	10% of the credit amount	10% of the credit amount	10% of the credit amount	10% of the credit amount	10% of the credit amount	-
Special regulation								In case of an economic organization the company is owned by a woman in at least 50%, or the managing director of the company is a woman.

* The purpose of the credit must be indicated in the credit application. However, its use does not have to be proved with invoices and other documents. The LEC may check whether the credit has been used for the indicated purpose at a later date.

Note: in accordance with the decision of the minister for the economy and transport adopted in 2005, the transaction interest rate of microcredits has been set at the bank rate \pm 3 %. Although the decision is only a recommendation (not a provision of law), the operators of the programmes accept it.

6. FACILITATING THE INCLUSION OF OTHER FINANCIAL SOURCES

The members of the *Hungarian Microfinance Network*® have always paid a lot of attention to providing the best possible service for micro entrepreneurs customized to the needs of the clients despite the unfavourable controlling and regulating environment that can be experienced in Hungary.

For this purpose they have sought various innovative solutions for the inclusion of alternative financial sources into microfinancing. The most significant ones are as follows.

Construction	Developer	Characteristics
Budapest Small Entrepreneurial Credit	Budapest Enterprise Public Funds	Microcredit programme completed with sources provided by credit institutions. In 2001 it won the Innovative Urban Strategy award of the EUROCITIES organization congregating European cities.
Fehérvár microcredit	Fejér Enterprise Agency	Microcredit programme serving the purpose of developing local enterprises financed by the Local Government of Székesfehérvár.
IBM microcredit for restarting	Fejér Enterprise Agency	When IBM closed down its Székesfehérvár plant, it donated HUF 300 million to the local enterprise agency to set up a microcredit programme for restarting. Former IBM employees wishing to set up an enterprise or microenterprises employing such former IBM employees could apply to this credit. The programme proved that microfinancing can be applied efficiently in order to tackle certain local employment crisis.
OTP-FEA microcredit	Fejér Enterprise Agency	The first microcredit programme in Hungary fully based on sources provided by commercial banks. Due to the high interest rates it is not expected to be very popular.
Hajdú-Bihar Small Entrepreneurial Programme Credit	Budapest Enterprise Public Funds	Credit programme launched to the pattern of the Budapest Small Entrepreneurial Credit programme.
'Aranyhomok' microcredit programme	Bács-Kiskun Enterprise Agency	Microcredit programme completed with sources provided by credit institutions.

7. GOVERNMENTAL SUPPORT

So far all the Hungarian governments have emphasized their ambitions to support the sector. However, it must be noted that the Hungarian enterprise development system is characterized by fierce lobbying activity. That is why the professional work of the Ministry of Economy and Transport supervising the field faces a lot of difficulties. Since the practical measures always appear as a consequence of certain intention of action, the occurring contrasting intentions often suppress each other. For an outsider it can create the image of 'standing in one place'. In this situation it is rather difficult to speak about clear-cut governmental support.

Naturally, one can see changes or developments of professional nature, too, which shows that the microfinancing professional organizations are supported greatly. The amendment of Act CXII of 1996 on Credit Institutions and Financial Enterprises can be owed to this, which significantly improved the legal background of microcrediting, and made way for several favourable technical and financing changes.

(A counterexample of this is Government Decree No. 1065/2003 (VII.15.) on the improvement of the opportunities of micro, small and medium-sized enterprises to receive credit adopted despite the strong protest of the professional organizations, which in a paradox manner made the opportunities of micro, small and medium-sized enterprises to receive credit significantly worse. The consequences of the drastic fall in the number of clients have been shown earlier.)

8. REGULATIONS REGARDING THE HANDLING OF FINANCES AND MICROENTERPRISES

The most important relevant Hungarian rules of law and resolutions:

Law or Government Decree	Content	Note
Act XXXIV of 2004 on small and medium-sized enterprises and the support of their development	It provides the definition* of the individual entrepreneurial categories (micro, small and medium-sized enterprise), as well as the conditions of the state subsidies and programmes that can be provided for them and their harmonization. It determines the constitution of the Enterprise Development Council.	Law.
Act IV of 2006 on economic organizations	It determines the forms of the economic organizations that can be established and the legal conditions regarding their establishment.	Law.
Act CXII of 1996 on credit institutions and financial enterprises	It determines the rules and conditions of operation for the profit orientated participants of the money market.	Law. In accordance with Section 2 (1) (h) of the act, the lending of credit from the National Microcredit Fund by HEA as well as the microcrediting activity of the enterprise agencies operating in the counties and the capital ® do not fall under the effect of the act!
Government Decree No. 1167/2002 (X.10.) on the tasks relating to the implementation of the 'Esélyt a jövőnek' (Let us give future a chance) programme	A decision (among others) about the need to increase the (National) Microcredit Fund by one billion forint.	It is not a law. It has not been executed.
Government Decree No. 1065/2003 (VII.15) on the improvement of the opportunities of micro, small and medium-sized enterprises to receive credits	It reduced the upper limit of the credit that can be lent within the framework of the National Microcredit Programme to HUF 3 million from HUF 6 million, and it made the eligibility conditions stricter.	It is not a law. It has been adopted despite the protest of the microfinancing organizations. The number of people applying for the credit has decreased dramatically quite contrary to the declared objectives.

Decree No. 80/2004 (V.18.) adopted by the Ministry of Economy and Transport on the participating organizations performing partial tasks in the utilization and handling of certain allowances of the Ministry of Economy and Transport	It places the tasks relating to the handling of the Microcredit construction under the effect of the Vállalkozói Támogatásközvetítő ZRt.	Law. It has not been executed.
Government Decree No. 2163/2004 (VII.5.) for returning regional and national credit funds financed by PHARE, on the arrangement of the rights relating to the credit guarantee funds in connection with them, and the operation of the Microcredit Programme, Microcredit System implemented with the utilization of the Funds	It authorizes the minister for the economics and transport to exercise proprietary rights relating to the state-owned Microcredit Funds on behalf of the Hungarian Republic.	It is not a law. The financial closure of the funds with the EU had not taken place until the preparation of the study.
Directive No. 15/2006 (MK 94.) of the Ministry of Economy and Transport on the organizational and operational regulation of the Ministry of Economy and Transport	It places the ‘professional’ supervision of the (National) Microcredit Programme under the effect of the financing department, and the performance of the tasks of the President of the National Microcredit Committee (the advisory body of the advisory board of the HFEP).	It is not a law.
Decree No. 6/1996 (VII. 16.) of the Ministry of Social Affairs and Labour on subsidies facilitating employment, as well as subsidies that can be granted from the Labour Market Fund to handle employment crisis situations	It determines the conditions of granting the subsidies facilitating the unemployed people to become entrepreneurs.	Law. It is under execution.

* According to Section 3 (1) of Act XXXIV of 2004, an enterprise is considered to be a small or medium-sized enterprise if

a) it employs fewer than 250 people, and

b) its net annual sales revenues do not exceed a HUF amount equalling to EUR 50 million, or the total amount of its balance sheet does not exceed a HUF amount equalling to EUR 43 million.

(2) Within the SME category an enterprise is considered to be a small enterprise if

a) it employs fewer than 50 people, and

b) its net annual sales revenues or the total amount of its balance sheet do not exceed a HUF amount equalling to EUR 10 million.

(3) Within the SME category an enterprise is considered to be a **microenterprise** if

a) it employs fewer than 10 people, and

b) its net annual sales revenues or the total amount of its balance sheet do not exceed a HUF amount equalling to EUR 2 million.

(4) An enterprise in which the direct or indirect ownership stake of the state or the local government – on the basis of its capital or vote – exceeds 25% separately or collectively is not considered to be an SME.

Note:

There is no separate regulation regarding the establishment and operation of microenterprises. They also fall under the effect of the general economic and taxation laws. The effective taxation laws have not been listed.



Other regulation:

The National Microcredit Programme is (in principle) operated in accordance with the Microcredit Manual in a manner specified in the international contract.

The members of the Network operate the mutual Local Microcredit constructions of the *Hungarian Microfinance Network* ® in accordance with the rules of procedure approved by the National Microcredit Professional Committee created on the basis of the Microfinancing Regulation approved by the presidium of the network.

The single independent microfinancing organizations of the *Hungarian Microfinance Network* ® operate their microcredit constructions financed from own sources or sources received from other donors in accordance with their own internal regulation.

9. FINANCIAL AND FUNCTIONAL SUSTAINABILITY

During the past 15 years since the microfinancing programmes have been present in Hungary, the operators have gained great experience regarding the financial sustainability of the programmes.

In the first eight years of the operation of the National Microcredit Programme – *which according to the reports of the EU delegation was a success story in the life of the Phare programmes operated in Hungary* – the financial sustainability was realized on a national level. (The financial figures have been presented above.) As I have already mentioned, the programme was considered to be the best practice in the region according to an international survey.

During this period the microcredit funds handled in a decentralized manner **were handled and managed by the organizations placing out the credits**. The costs of central co-ordination were very little, because the tasks could be attended to by a manager and an administrator. However, it is important to see that the financial sustainability is in close connection with the size of the handled fund and the credit portfolio, the scale of the transaction interest rate of the credits, as well as the size of the crediting loss. The scale of the risk undertaken at the time of placing out the credits affects this latter factor significantly. It is also affected by the scale of the legal securities required as the collateral of the credits.

I find it important to highlight in this subject that we should not take the category measured with the scale of the commercial banks as a starting point when estimating the possibility of self-sustaining during the planning of the individual microfinance programmes. The European practice also shows that when programmes financed from public funds serving national economy interests are launched, financial return and sustainability are not necessarily the most important aspects. It is much more important for the national economy to facilitate the progress and improve the competitiveness of micro and small enterprises with the various measures.

The microfinance programmes are like this, for example. The necessity of state intervention and financing in case of these programmes can be deducted from the theoretical tendency of **market failures**, which starts from the fact that the normal efficient operation of the market has some prerequisites. Since in the given case these conditions can be rather strict and incomplete, they are not

satisfied completely in certain market segments. Thus, in those market segments the market will either break down or result in inefficient supply or demand differing from the optimum.

There can be market failures where for some reason the operating functions of the market do not assert themselves satisfactorily or at all.

Accordingly, those places are called market failures in the market processes when government intervention is required in order to maintain undisturbed operation.

‘Incomplete markets’, including, for example, the certain money markets as well, are considered as one type of the market failures. One of its typical types is microfinancing, where there is no suitable market supply for the continuously existing demand due to the reasons described in the previous chapters. This situation can only be resolved with adequate financing and co-ordination.

At the same time it is important to be aware of the fact that this is not only a financing issue in case of microcrediting and it cannot be narrowed down to the implementation of the profitable operation of certain funds. Those ‘benefits’ that can be expected from the programmes are much more important, however it is not easy to transform these benefits into figures.

For example, in my opinion in case of microcredits facilitating unemployed people to become entrepreneurs the yield increasing factor of the funds should not be considered to be a primary and exclusive importance. It appears as a yield for the society if the unemployed people do not queue up for the unemployment benefit (which could as well be provided in figures) for months, if they can keep themselves and probably their families, and last but not least they have a possibility to avoid the mental and psychic deterioration that is often provable in case of unemployed people, and which makes it more and more difficult for them to return to the labour market. Not to mention its consequence on health. By taking into consideration these aspects it is not so easy to determine the criteria of financial sustainability, thus, the centralization of the microcredit programme in 2000 with reference to financial sustainability considering the long-term effects on the economy was a mistake.

Naturally, the credit-like subsidies operated as a fund to be returned work with a much better efficiency compared to the one-off subsidies not to be returned, even if the fund is becoming less, since the necessary replacement of the fund is of a much smaller scale. In case of microcredit programmes – should the nominal value of the funds decrease – in my opinion this **replacement financing** has to be compared to the previously mentioned **non-financial ‘social benefit’** and considered by the political decision-makers.

I also find it important that the evaluation of this should take place by taking into consideration the local national characteristics. The development of the given economy as well as the social and cultural background are very important, which can show significant differences even within the individual countries.

(It cannot be accepted from a professional point of view, for example, that certain microcredit programmes operated in Asia or in the third world – e.g. *the ‘beggar’s programme’ or the ‘latrine programme’* – can be adapted in Hungary under a system of conditions operating with enterprise development criteria.)

10. CHALLENGES TO BE MET BY THE SECTOR

At the moment, the biggest challenge to be met by the microfinancing sector in Hungary – *since the centralization of the National Microcredit Programme in 2000* – is to **enforce the professional aspects** in the central measures **better**, and to **obtain alternative sources** in order to operate the Local Microcredit Programmes.

The centralization of the sources of the National Microcredit Programme of the Hungarian Enterprise Agency implemented in 2000 and the centralized operation of the programme are against the international practice and have led to abandoning the original purposes gradually. The created ‘National Microcredit Fund’ cannot work efficiently in its present form, and the alternative Local Microcredit Funds are not enough to counterbalance the errors of the central programmes.

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TIBOR SZEKFÜ
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DOCUMENTS USED DURING THE PREPARATION OF THIS STUDY:

1.	Dr Antal Szabó <i>Retired counsellor of the UN, the scientific director of the ERENET Network</i> ‘MICROCREDITS IN THE WORLD’, a study
2.	The flash report of the Hungarian Financial Supervisory Authority regarding 2006.