

The Microlending sector in Hungary microlending to SMEs

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1. NATIONAL ENVIRONMENT

The economy of Hungary²

Hungary has been a member of OECD since 1996, NATO since 1999, the European Union since 2004 and one of the founding members of the organization called Visegrad Co-operation. Hungary covers an area of 93,036 square kilometres with a population of 10,067,000 (as of the end of November 2006). The population density is 108 /km², the population is continuously decreasing (by 23,000 people annually) due to the high mortality rate and the low birth rate.

According to its constitution Hungary has a social market economy based on fair market competition and a basic economic security for everyone guaranteed by the state. Within the European Union Hungary is considered to be a rather poor country. The GDP has been steadily growing, in 2006 it amounted to HUF 23,752 billion (EUR 95 billion), GDP per capita: EUR 9,360. Compared to the European Union average, wages are low in Hungary, whereas costs and duties on labour are high. (The average gross monthly wage was HUF 178,000 (EUR 712) in 2006. The rate of unemployment has been slightly growing since 2001, despite the fact that the number of employees increased, it was at 7.5% in 2006.

Like industrially developed countries, Hungary has an ageing population. The activity rate of about 53-54% can be considered particularly low.³

Hungary's finances are steadily in the red, in 2006 its deficit was the largest in European Union countries. The level of national debt increased to 66 % of the GDP⁴. The convergence program designed by the Government and approved by the EU is radically decreasing the deficit in 2007 already, which brings significant restrictions and tensions.

The service sector is becoming stronger and stronger in the Hungarian economy; the economic structure can be best described as a developed industrial country. Processing, engineering and car industry dominated by multinationally owned companies have high significance. Hungary lacks natural resources, its economy requires imports, the balance of payments as well as its balance of foreign trade are both in the red.

The role of SMEs in the Hungarian Economy and resources available for SMEs

Micro-, small and medium-sized enterprises play an important role in the economic life of the country: they employ 65% of all employees, they produce half of the gross added value, and they are accounted for 36% of all export sales. The majority of them operate with a high labour force and low capital intensity; they take much higher share from employment than from sales income or income generation. In an international comparison the difference between Hungarian small and large companies is rather big.

Including the number of individuals carrying out economic activities with a separate tax number, the number of registered enterprises exceeds 1.2 million⁵; the number of active enterprises however does not reach 800,000⁶. It is favourable that the number of enterprises without employees is decreasing while the number of enterprises with several employees is continuously growing; however it is true that microenterprises with one employee are the greatest in number.

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² Figures in the study are converted to euros at an exchange rate of HUF250/EUR and are rounded

³ <http://portal.ksh.hu/pls/ksh/docs/hunxftp/idoszaki/fmf/fm20612.pdf>

⁴ [http://www2.pm.gov.hu/web/home.nsf/portalarticles/9CE71763C9C1ECB1C125727C0048022C/\\$File/Fobb%20makrogazdasagi_jel_zoszamok%20eves%20adatok.xls](http://www2.pm.gov.hu/web/home.nsf/portalarticles/9CE71763C9C1ECB1C125727C0048022C/$File/Fobb%20makrogazdasagi_jel_zoszamok%20eves%20adatok.xls)

⁵ http://portal.ksh.hu/pls/ksh/docs/hun/xstadat/xstadat_eves/tab3_02_01ic.html

⁶ http://portal.ksh.hu/pls/ksh/docs/hun/xstadat/xstadat_eves/tab3_02_02i.html

99.9% of enterprises operating in Hungary are micro-, small or medium-sized enterprises⁷. Within this, the proportion of microenterprises i.e. those employing no or 1-9 employees is high (95.1% of all active enterprises⁸), whereas the proportion of medium-sized enterprises is particularly small in an international comparison. One of the biggest problems is that the performance, capital force and assets of Hungarian microenterprises are far behind the average of the EU15 countries.

It significantly hindered the development and efficient operation (or simply the survival) of the enterprises in the sector that the population of the country did not have notable entrepreneurial traditions, experience or knowledge, nor the necessary accumulated capital.

Even today a notable under-capitalization and lack of resources of micro- and small enterprises still remain a problem. The evolved entrepreneurial group does not have an entrepreneurial past, which could have enabled capital accumulation, on the other hand profit-oriented actors of the financial market are averse from financing entrepreneurs, which has the following reasons:

Small volume loans have high expenses and significantly high risks due to higher failure rates.

A risk-raiser is the fact that the majority of these enterprises do not have a considerable entrepreneurial past.

Lending organizations have too "careful" business policy due to their bad experiences in the early '90s.

According to the analysis of the Hungarian Financial Supervisory Authority for 2006, the profit-oriented financial sector is characterized by *increasing competition, increasing hunger for profit, willingness to take greater risks, deteriorating loan portfolio, slowing business expansion, increasing competition for resources and deteriorating assets profitability*⁹.

This is indicated by the number of market actors as well: there are 37 banks, 8 specialized lending institutes, 156 savings co-operatives, 5 lending co-operatives, 238 financial enterprises as well as 321 lending institutes servicing areas over the borders, 22,598 lending institute agents and 8,669 agents representing financial enterprises.

Some experts are rather concerned by the widening gap between the rich and the poor, which generates notable social tensions¹⁰. Surveys show that to date there are 2.7 million people living under the subsistence level¹¹ in Hungary, 100 people freeze to death annually, and the number of homeless people exceeds 100,000. Up to half a million people are under-nourished, 300,000 of whom are children. The number of unemployed people was 312,000 in late 2006; the unemployment rate is 7.5 %¹². The former traditional social benefits shrank due to the decrease in government expenditures. Private savings have virtually been eroded by inflation.

All in all, there is a quite wide range of enterprises and private people with a chance of self-employment in Hungary, whose development would be necessary and possible in social and/or economic aspects but whose needs for development resources are not yet satisfied by money market actors. This range of enterprises will be the potential target group of state-supported microfinance programs for a long time.

2. THE ORIGIN OF MICROFINANCE IN HUNGARY

The National Microcredit Scheme (MCS) was launched by the European Union Commission and the Hungarian Government in the framework of the small and medium-sized enterprise promotion program of PHARE in 1991.¹³

The main aim of the PHARE SME program was to promote employment and economic restructuring through the promotion of the SME sector. On the verge of the political change in 1990 both the Hungarian Government and the European Union found it outstandingly important to increase the number and the influence of small and medium-sized enterprises as well as to establish the institution of enterprise promotion.

In order to achieve the above mentioned goals, beginning from 1991, the European Union - using PHARE resources - provided significant financial and professional help for the establishment of enterprise

⁷ http://portal.ksh.hu/pls/ksh/docs/hun/xstadat/xstadat_eves/tabl3_02_03i.html

⁸ http://portal.ksh.hu/pls/ksh/docs/hun/xstadat/xstadat_eves/tabl3_02_03i.html

⁹ http://www.pszaf.hu/engine.aspx?page=pszafhu_publicaciok

(http://www.pszaf.hu/engine.aspx?page=pszafhu_publicaciok&switch-content=pszaf_ujdonsagok_20070801_1&switch-zone=Content%20Zone%204&switch-render-mode=full)

¹⁰ study of Szabó, Antal: Mikrohitelek a világban (Microcredits in the World)

¹¹ According to the definition of the Central Statistics Office (KSH), in 2006 it was HUF 60,128 (EUR 240)

¹² http://portal.ksh.hu/pls/ksh/docs/hun/xstadat/xstadat_eves/tabl2_01_05ia.html?136;

http://portal.ksh.hu/pls/ksh/docs/hun/xstadat/xstadat_eves/tabl7_02_03ib.html

¹³ PHARE is the acronym of Poland-Hungary Assistance for the Reconstruction of the Economy.

development foundations in the counties and the capital city and their operational organizations called Local Enterprise Agencies (later to be referred to as LEAs) as well as for the training of their staff and for the launch and operation of enterprise support programs run by the foundations. The national network of enterprise promotion foundations in the counties and the capital city had covered the whole country by 1996. (In the initial experimental program LEAs were formed in 6 counties, then as a result of successful operation, LEAs were established in all the 19 counties and the capital city.)

In accordance with the EU norms, the members of the Network are: sector-neutral, operating by the principles of decentralization and regionality, built on extensive local support and co-operation. The basic activities of the LEAs, financed by PHARE, are counselling, training, properties (business incubators, industrial parks), providing microcredit as well as generating development programs.

The concept of the National Microcredit Scheme was formed in 1991, reflecting that most micro- and small enterprises were not credit-worthy for the profit-oriented lending institutes. This is considered such a market failure where the market mechanism does not work properly (an adequate supply does not form to the permanent demand), and the solution to this problem is in the interest of national economy, and this requires and justifies government intervention. To finance the start-up program, the European Commission allocated ECU 1.15 million from the ECU 21 million of the Hungarian PHARE budget designated for the SME sector in 1990.

The first microfinance construction of Hungary - and among the first in Europe - was started in 1992 by the enterprise development foundations of the counties and the capital city ® (i.e. LEAs) under the professional co-ordination and financial interposition of MVA. The resources for the scheme were provided by PHARE (and the Hungarian Government as partner in finance) in the form of targeted supports with conditions. The amount of funds available for microcredit has been continuously growing: now it amounts to about EUR 60 million.

The development of the microcredit program is the result of an integral improvement, which in certain periods of time did not lack regulatory, financial or operational shortcomings.

3. THE MAJOR ACTORS OF THE MICROFINANCE SECTOR

A summary of the organizations described in this chapter is shown in chart No.1. – See Appendix

3.1 Government actors

It is the Government's competency to develop the policy and program of SME promotion as well as to establish the necessary legal background, institution and the creation and provision of resources. Within all this, it is important to promote the access of SMEs to resources. The establishment of the legal and institutional background has been mostly realized in Hungary, it only requires to be refined, and the current programs to be properly configured and operated.

Regarding the government management of microfinance, the role of the **Ministry of Economy and Transport** (GKM) must be emphasized because the it supervises the majority of the national organizations that have direct relations to microfinance (such as MVA, MFB, MAG).¹⁴ Furthermore, it is the Minister of Economy and Transport that practises the owner's rights regarding Microcredit Funds as well as exercises government supervision of the National Microcredit Program on the basis of Government Decree No. 2163/2004. (July 5th).

3.2 Organizations with national authority and with direct relation to microfinance

3.2.1 Hungarian Enterprise Promotion Network Consortium non-profit Plc. was created by the enterprise promotion foundations of the counties and the capital city.

A study about the Network commissioned by the European Union (and done by the international consulting organization called DFC in 1999-2000), recommended a closer co-operation of the enterprise promotion foundations by establishing a consortium which would operate on market terms. The advisors claimed the operation of several LEAs to be of European standards, and they identified the main problems with shortcomings in management, regulation and network co-operation.

Having taken this recommendation, the foundations established the Hungarian Enterprise Promotion Network Consortium yet as an organization without legal entity on 28th April 2000. In December 2003 in the organization of the Consortium the foundations established the National Enterprise Promotion Consortium as

¹⁴ For more detailed introduction of these organizations, see chapter 3.2.

an NGO, which changed its name and organizational form to Hungarian Enterprise Promotion Network Consortium non-profit Plc. in 2007. This way the Network can submit applications independently for programs and tasks as well as do the formerly neglected work of network management and development jointly from a common fund.

In order to strengthen the cooperation among the members of the Consortium, a web-based closed-communication Management Information System (VIR) was set up, which have been used successfully by the members for several years now. It has also been extended with an Internet-based service system for the clients.

The consortium also registered the most important trademarks and the logo of the network as well as the product called “microcredit” through the Hungarian Patent Office. The procedures of the **Local Microcredit Programs**, which are operated by own regulations of the Network have been elaborated by internationally trained experts of the consortium based on their 15-years microlending experience.

Under the name of *Hungarian Microfinance Network* ® the network became a member of the *European Microfinance Network – /EMN/*.

Only the members of the Network are entitled to independently carry out full-range microlending activities without any restrictions of the law.¹⁵

3.2.2 The Hungarian Foundation for Enterprise Promotion – non-profit organization

Since 2001 it has been the Hungarian Foundation for Enterprise Promotion (MVA) that relayed the professional and financial support of PHARE for the creation and operation of the LEA network, thus for the development of the microcredit program as well. To this day it is still the national co-ordinator of the National Microcredit Program, and it is the caretaker of the National Microcredit Fund. It operates under supervision of the Ministry of Economy and Transport; its work is assisted by the National Microcredit Board. MVA does not deal with the applicants directly, it is done by the local enterprise agencies ® (LEAs) in the counties and the capital city that are contracted by MVA. The entire process of loan assessment is done at these organizations.

MVA currently concentrates on the preservation of the National Microcredit Fund, i.e. minimizing lending losses in the National Microcredit Program - as expected by the Ministry. In order to increase the efficiency of returns it hires specialized companies to collect problematic loans.

3.2.3 Hungarian Development Bank (MFB)

The entirely state-owned MFB, which operates on the basis of a separate law, has not been lending small amounts to microenterprises before. Its basic task was to operate the preferential loan constructions supported by the state in the direction of enterprises and local governments, which was done by refinancing commercial banks. **It started to develop the so-called Microcredit Plus Program in co-operation with the Hungarian Enterprise Promotion Network Consortium in 2005, then to operate the program with the involvement of the LEA network. The main motive of the program was the lack of resources and regulatory problems in the National Microcredit Program.**

3.2.4 Creditguarantee Ltd. (HG Zrt)

Creditguarantee Ltd., which was founded by the state and financial institutes, has a great past and experience in the field of strengthening the security of commercial loans. The guarantee of HG Zrt. became a **key factor in the Microcredit Plus program. The guarantee provided by HG Zrt.** is also associated with some PPP loan constructions developed recently by the Hungarian Enterprise Promotion Network Consortium and its members.

3.2.5 Hungarian Centre for Economic Development and Subsidy Intermediation Ltd. (MAG Zrt.)

MAG Zrt. was created by the Government through merging former subsidy intermediary organizations. MAG Zrt. became a major subsidy intermediary agency responsible for the **Economic Development Operational Program** financed under the **EU Structural Funds**.

3.2.6 Hungarian Enterprise Finance Ltd.

The company was established in 2007 in order to become the holding fund of the **JEREMIE program**¹⁶, which was initiated and is financed by the EU. One of the main aims of the JEREMIE program is

¹⁵ Article h.) in § 2. (1) of Act CXII/1996 about lending institutes and financial enterprises

¹⁶ A Jeremie program az Európai Bizottság, az Európai Beruházási Bank, az Európai Beruházási Alap közös akciója, amely segíti a mikro-, kis- és közepes vállalkozások finanszírozási forrásokhoz jutását az Európai Unió strukturális alapjaiból.

to promote microcredits of greater volume and effect. In October, 2007, the company issued the call for application for the potential microfinance organizations. The members of the Hungarian Microfinance Network are potential organizations to become microfinance intermediaries.

3.2.7 Public Employment Service (ÁFSz)

The Public Employment Service is not considered to be a microfinance institute, nevertheless the support promoting the unemployed to become entrepreneurs provided by its offices belongs to the category of microfinance due to its amount and objectives. These supports are available from state funds at 7 regional centres and 23 district offices. The Service operates under supervision of the Ministry of Social Affairs and Labour.

3.2.8 Actors on the financial market

Banks, specialized lending institutes, co-operative lending institutes and financial enterprises can not be considered as microfinance organizations however we mention them here because due to the increasing competition among them they **tend to offer their entrepreneurial loan products** more and more often **to the micro- and small enterprises** taking higher risk, and in the race for resources they more often aspire to the public funds intended for microlending.

In Hungary it is important to emphasize that the small volume loans provided to microenterprises by financial institutes can not be considered microcredits. Microcredit serves the finance of enterprises that are not bank-worthy, of those that can not be provided with loans in the classic way of commercial banks. Therefore we do not cover the construction called *Széchenyi Card* in this study in detail since that construction provides short-term loans for circulating capital to already bank-worthy enterprises and those with a great turn-over and this way it does not belong to the area of microlending. Thus the chambers or the offices of the National Association of Entrepreneurs and Employers (VOSZ), which promote the Card are not microfinance institutes either.

In Hungary the business size of financial mediators and lending institutes grew at a fast pace, their profitability reflected on assets and capital also reached unprecedented heights. In the last year however while business size continued to grow at a relatively fast pace, profitability fell back, and **the quality of the loans declined.** (In the entire EU the opposite was seen last year.)

3.2.8.1 Banks

Chart No. 2.: Loans to microenterprises granted by the bank sector (number of loans and million EUR)

	2001		2002		2003		2004		2005		2006	
	No.	Gross value	No.	Gross value	No.	Gross value	No.	Gross value	No.	Gross value	No.	Gross value
Total loans granted in the period	23 724	1 531	34 841	1 652	79 084	1 922	71 940	1 899	55 209	2 498	114 701	3 163
Total loans with duration > 1 year	10 351	740	16 947	936	18 268	976	8 176	804	10 036	984	14 005	1 384
HUF loans with duration > 1 year	9 982	550	16 540	763	15 436	647	5 141	373	5 055	419	7 424	549
Development loans out of the above	1 988	127	3 532	183	2 233	154	1 251	112	1 193	91	1 574	201
Foreign currency loans with duration > 1 year	369	190	407	173	2 832	329	3 035	431	4 981	565	6 581	834
Total loans with duration < 1 year	13 373	791	17 894	716	60 816	946	63 764	1 095	45 173	1 514	100 696	1 780
HUF loans with duration < 1 year	12 730	650	17 497	609	60 073	792	61 350	656	39 672	1 213	90 026	1 287
Export pre-finance loans out of the above	3	1	7	1	16	1	17	1	10	1	8	0
Foreign currency loans with duration < 1 year	643	142	397	106	743	153	2 414	439	5 501	301	10 670	492
Total volume of loans (end of period)	41 049	1 667	36 247	2 103		2 724		2 989	67 107	3 591	104 754	3 582

Source: Hungarian Financial Supervisory Authority (www.pszaf.hu/engine.aspx?page=pszafhu-idosorok)

The table above shows that the sum of bank loans provided to microenterprises continued to increase dynamically after the halt in 2004. It must be noted however that the dynamic increase can be particularly witnessed in the category of loans within the year, and it is a significantly smaller increase in the category of loans reaching over the end of year.

Concerning the development of microenterprises it is almost worrying that despite the strong increase in 2006 the total number of loans reaching over the end of year is still much lower than it was in 2002 and 2003, and it is considered to be infinitesimal compared to the number of microenterprises (even if we take into account that a significant part of microenterprises consists of self-employed entrepreneurs out of necessity, who do not want development or expansion).

3.2.8.2 Savings co-operatives

Savings co-operatives¹⁷ are not considered as microfinance institutes either, their activities rather match those of commercial banks; however they are less unwilling to lend small amounts.

Their lending activities range from personal and consumer loans to housing and entrepreneurial loans among other things. Through their network of over 1600 branch offices the savings co-operatives are present in every other settlement in Hungary, they provide financial services to more than 1 million clients. 90% of the branch offices are found in villages and hamlets where financial services are provided almost exclusively by savings co-operatives.

In the lending activities of savings co-operatives - similarly to banks - the total volume of short-term loans to microenterprises increased significantly, at the same time the number of loans with duration of over 1 year decreased unfortunately.

It is important to mention that the National Federation of Savings Co-operatives (OTSZ) and the Hungarian Enterprise Promotion Network Consortium signed a co-operation agreement in 2007 in order to strengthen the 15-year collaboration of the microlending of LEAs and the lending activities of the savings co-operatives.

3.2.9 Other non-profit organizations

The professional and financial development of microenterprises is also promoted by a number of non-profit organizations that can not be considered to be microfinance institutes either, despite the fact that they often have remarkable resources, activities or achievements. Some of the most important ones are:

Agricultural Credit Guarantee Foundation

National Employment Foundation (OFA)

Life Career Foundation

3.3. Microfinance institutions operating on local level

3.3.1 The local enterprise agencies in the counties and the capital city ® that make up the Hungarian Microfinance Network ® are the most important actors of the Hungarian microfinance sector.¹⁸

The members of the Network, the **local enterprise agencies in the counties and the capital city ®** - *for the first time in Hungary and among the first in Europe* - started their microfinance activities with professional and financial support from the PHARE SME program in 1992. As practical executors of the National Microcredit Program in Hungary these organizations have the exclusive knowledge, practice and experience of nearly fifteen years in microlending.

The foundations are independent organizations with legal entities. It is important to mention that the foundations were selected by way of call for tender in order to implement the PHARE SME program. The business plans prepared by the LEAs were approved and also financed by the EU Delegation and quarterly audited by international advisory or auditing firms.

After total establishment of the network, the 19 centres in the counties and the one in the capital operated a total of 150 sub-branches or offices. Thus we can talk about a nationwide network which is able to deliver business development services to a singularly wide range of enterprises at a high standard and cost-efficiently.

In 1996 EU experts and politicians claimed the Hungarian microcredit program to be a success story not only in terms of the Hungarian program but in terms of all the Eastern-Central European PHARE programs.

¹⁷ <http://www.takarekszovetkezetek.hu/>

¹⁸ <http://www.hungarian-microfinance.org.hu/>

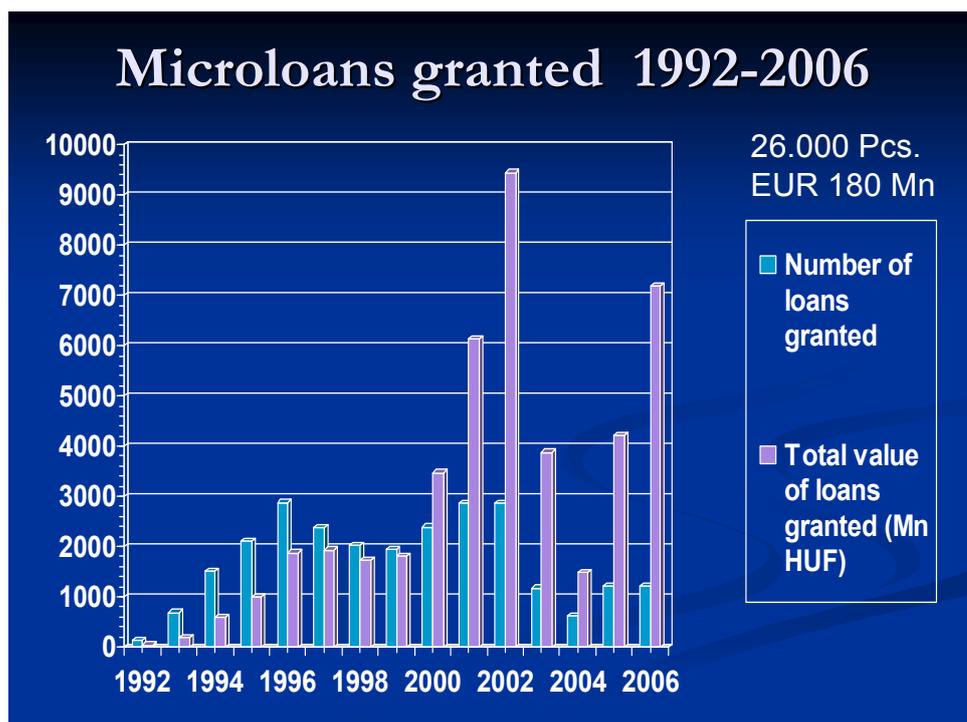
In May 1998 in the framework of South-Eastern European Co-operation Initiative (SECI) and together with USAID, the UNO-EEC organized an Expert Meeting for the Best Practice of Microlending, with the participation of 12 Central-Eastern European countries - *including Greece and Turkey*. According to the British Bannock Consulting firm, **the Hungarian practice of the time was the best microlending program in the region!**¹⁹

In 1998 the PHARE support of the enterprise promotion foundations in the counties and the capital city however started a continuous decrease then stopped altogether saying that its role would be taken over by the finance of the Hungarian Government and the incomes of the sustainable programs to a growing extent. Unfortunately this did not take place; probably due to network management shortcomings. When the program-leading PHARE experts left, the professional standards of national co-ordination declined, and the staff of central management became over-politicized. From 1999, it became a tendency that Network programs were taken away from the LEA network.

Despite all this (and to the surprise of many), the LEA network did not weaken notably and none of them ceased to exist. The network itself managed to remain operational. In achieving this, the following factors must have played an important part: knowledge, which became marketable, activities that became self-sustainable due to incomes from services, the microcredit totals of LEAs and probably their co-operation established with the creation of the consortium in 2000.

From the beginning the **LEA Network** made over **26,000 loan contracts** and provided over **HUF 45 billion (ca. EUR 180 million)** worth Microcredit and Microcredit Plus for the microenterprises while permanent lack of resources and shortcomings in central regulations hindered their operation.

Diagram No.1.: Microloans granted by the LEA Network in Hungary between 1992-2006



Source: from presentation of István Kovács

The explanation for the cycles seen in the chart is the following: As long as the local Funds were provided with PHARE resources (between 1992 and 1996); the number of granted loans increased. After that the number of loans decreased; new loans could only be granted from the already repaid amounts. In 1999 and 2000, when new funding arrived, the total amount granted grew again; especially as the upper limit of a single loan was increased to HUF 3 million (EUR 12,000) and later to HUF 6 million (EUR 24,000).

Owing to the operational shortcomings of the centralized fund, the National Microcredit Fund (OMA) became empty in August 2002, and the program halted. The inflexible operation and the lowering of the grantable amount from HUF 6 million (EUR 24,000) back to HUF 3 million (EUR 12,000) resulted in the near

¹⁹ Alan Doran, Matthew Gamser and Jacob Levitsky: Background paper on financial policies and programmes for strengthening SMEs, through micro-credit, credit guarantee schemes and other intermediaries.

failure of the program; the enterprises were unable to apply for the loans. Consequently, by 2004, ungranted amounts of HUF billions (several millions EUR) were accumulated in the Fund. As the terms became more favourable for the enterprises, the program re-ignited; so the reserves of the Fund were exhausted again by 2006.

3.3.2 Other non-profit microfinance institutes

Apart from the LEAs operating the microcredit program, which was developed in the framework of the PHARE program, there are some more non-profit organizations (e.g. Life Career Foundation) that also carry out microfinance activities but their individual role and success in enterprise promotion are dwarfed by the lending work of the LEAs in terms of the number of financed enterprises and volume of loans.

3.3.3 Microcredit Ltd

Due to its name and character, **Microcredit Ltd.** is worth mentioning here. It is a profit-oriented financial enterprise supported by non-profit organizations but it does not collect deposits. (*in 2005 its own capital was: HUF 50,784,000 (EUR 203,000); its granted loans totalled at HUF 140,318,000 (EUR 561,000).*)²⁰

4. THE OPERATIONAL MODELS OF THE INDIVIDUAL MICROFINANCE PROGRAMS

Due to their importance and performance, in this chapter we will give a more detailed description of the models of microcredit constructions originating from way back in 1991-1992 run by the enterprise promotion foundations in the counties and the capital city (i.e. LEAs), which are named also in laws.

4.1 The model of the basic construction operating between 1992 and 2000

The local enterprise agencies in the counties and the capital city received the sources to the microcredit funds as targeted grants with conditions from the EU PHARE program. The funds operated in a **decentralized** way, each county enterprise promotion foundation managed its own fund, which was separated from its other resources. The terms and operational regulations of the program were written by international experts with the involvement of Hungarian experts (like the staff of LEAs among others). In order to operate the program each foundation created its own **microcredit division**, and appointed a **microcredit manager** to run it. The microcredit managers obtained the expertise to handle the funds at qualifying courses and in international exchange programs.

The entire process of loan assessment and portfolio handling in microlending was done by the microcredit divisions of the foundations. The approval of loan applications was made by **Microcredit Boards** created by each foundation. In the work of these boards economists, lawyers, bank experts, entrepreneurs and foundation staff took part in the form of social contribution. Preparation of the approval process meant the examination of the business plan presented on the **application form** and also a **site visit** in each case. Then on the basis of the preparation work done by the microcredit division the Microcredit Board decided on the approval of the loan application.

In accordance with the legal regulations of the time each foundation contracted a **financial institute - mostly a savings co-operative** - chosen in a call for tender to grant and collect the loans. The financial institute granted the loans for a fee from the local microcredit funds deposited at that institute making loan contracts with the clients, then collected repayments and interests as well as making records of the loans. **It was the duty of the microcredit division of the foundation to supervise the credit portfolio, do follow-up check-ups and manage legal procedures of occasional dead loans.**

The procedures were characterized by fast and flexible operation, the foundations exercised maximum tolerance towards enterprises with financial difficulties. In the first period the foundations were not allowed to ask for more collateral than the assets purchased from the loaned amount so that the social aims could be achieved. The financial accounts of the programs were quarterly checked by international auditing firms. Central co-ordination tasks were done by a manager and a clerk.

From the beginning, related counselling and training activities were important elements of the microcredit program. These were also entirely financed from PHARE funds in this period, in a way scheduled and detailed in the annual business plans of the LEAs. There was continuous professional consultation between the national co-ordinator and the practical experts (national professional meetings, exchange events). Suggestions for modifying the manual, which described program operation, could be implemented only after having been approved in Brussels, which was usually a long process but it meant a professional control.

²⁰ – resource: Hungarian Financial Supervisory Authority information: http://www.pszaf.hu/engine.aspx?page=pszafhu_idosorok).

4.2 The centralized model introduced in 2000

The success of the decentralized program and the build-up of the local funds surprised and raised the interest of many in both positive and negative sense. Between 1998 and 2000 a number of revisions, assessments and concepts were made about the program's present and future. In 2000, a - both professionally and legally debated - contract was signed, creating the National Microcredit Fund (OMA) by centralizing the formerly decentralized funds.

The centralized operation of the microcredit program had been producing several hindering effects. The processes became sluggish, less flexible and the central apparatus significantly expanded thus making program operation more expensive. **The professional consultation between the practical experts and the centre management has not been sufficiently developed to compensate the above mentioned deficits.**

Still it was a favourable move to raise the amount of microcredit that could be granted in the program first to HUF 3 million (EUR 12,000) then soon to HUF 6 million (EUR 24,000) as urged by the LEAs previously, and to significantly improve the terms of the credit construction.

It was however a major mistake – according to the regional microfinance organizations - to "harden" the previously flexible collateral assessment regulations. **This significantly parted the program from its original aim, and even today excludes the neediest group of the population that does not have the necessary collateral to apply for microcredit.**

4.3 Constructions currently operated by the Hungarian Microfinance Network

In December 2005, after several years of professional debate, the economic minister, who was supervising the program, approved of most of the initiatives of the Hungarian Enterprise Promotion Network Consortium regarding the re-establishment of the Local Microcredit Funds and the rationalization of the National Microcredit Program. Thus in 2006-2007 the Local Microcredit Funds were re-established.

The Hungarian Enterprise Promotion Network Consortium developed the system of the multi-stage microcredit constructions, which are built on each other and are still operated by the members of the network (i.e. the LEAs).

The general aims of the programs run by *the Hungarian Microfinance Network* ® are:

provide financial support and business consultation

to micro enterprises that are not credit-worthy for commercial banks but viable for development

complementing the services of commercial banks

to the groups of society with disadvantages (i.e. minorities, large families, women, the young, the unemployed etc.), as part of the fight against poverty, promoting the process of becoming an entrepreneur or self-employed, making them bank-worthy.

The basis of all these constructions is the successful decentralized model run before 2000. All the constructions are offered by the LEAs in an integrated service package, the elements of which are the counselling and training programs run by the LEAs.

4.3.1. Local Microcredit Program from the resources of the re-established Local Microcredit Funds

The model of this program is almost identical to the one run before 2000 with the exception that today there is no need to involve a participating bank due to the legal authorization. The LEAs make the microcredit contracts in their own names, and they may transfer the sums approved by the microcredit boards directly from their bank accounts to the enterprises.

Keeping records of the loans is also done by the foundations themselves with help of an Internet-based record-keeping and service-providing system, which has been developed by one of the members of the network: Fejér Enterprise Agency. This enables the clients to send their applications and get data of their debts through the Internet, and enables the donors to track the financial usage of the handled loan funds. Lending is supplemented with a consultation service.

Local Special Programs from the resources of other donors

Knowing the success of the Local Microcredit Program, in some cases outside donors (such as IBM) provided resources to an LEA for the purpose of microlending in the interest of helping redundant employees to become entrepreneurs.

4.3.2. National Microcredit Program from the resources of the National Microcredit Fund

In the construction that became more rational and flexible from 2006, it is still the LEAs that receive the microcredit applications, assess the business plans, make site visits (and also do related counselling). The decisions are made by the Microcredit Boards of the LEAs but they must also be approved by MVA. In the central model the contracts today are not made by the local branch offices of the central bank but by the LEAs on behalf of MVA. Money transfers are also done by authorized staff of the LEAs but only after approval by MVA and from the bank account of MVA. The problems that arose from the centralized operation still exist partly.

4.3.3. Microcredit Plus Program from the resources of the Hungarian Development Bank (MFB)

The Microcredit Plus program was developed jointly by experts of the Hungarian Enterprise Promotion Network Consortium and the Hungarian Development Bank. The **target group** of the Microcredit Plus Program is a slightly more prepared, viable group of microenterprises. In this program as well it is the LEAs (or companies owned by them) receive microcredit applications, make assessments and site visits (and do related counselling). The decisions are made by the MFB with the help of forms completed electronically by the LEAs. The approved contracts get signed by the staff of the LEAs (or the companies owned by them) authorized to do so by MFB. The sums are transferred to the enterprises by MFB on the basis of the withdrawal advice made by the LEAs. The original documents need not be sent to MFB.

4.3.4. Small Enterprise Loan constructions with the involvement of the resources of the Local Microcredit Funds and financial institutes (PPP-like constructions)

There are several constructions in the network that are operated by the LEAs together with banks or mostly savings co-operatives using the resources of local funds. It is worth mentioning that in 2001 a member of the Network called Budapest Enterprise Promotion Public Foundation was awarded the Innovative City Strategies Award of EURO CITIES, an organization of European Cities, for the Budapest Small Enterprise Loan construction.

In these constructions the savings co-operative and the microcredit board of the LEA make a simultaneous decision about the finance of a microenterprise. The contract is also made simultaneously by signing one or two parallel contracts.

4.3.5. Microfactoring constructions (draft)

The Consortium already suggested years before, that a microfactoring program should be added to the microfinance constructions. The Ministry of Economy and Transport announced the Lanchid Factoring Program in 2003; in which it granted support to microenterprises. The program was later suspended and then again restarted; now it does not include interest rate support for SMEs taking factoring services. The Consortium suggests continuing the program in a more efficient way; so that factoring companies provided with cheap funding would be able offer low-cost factoring services, extended with consulting and educational services of the LEAs as well.

5. MICROFINANCE TARGET GROUPS

General terms: The entrepreneurs and their enterprises that apply for the financial support of either the **National Microcredit Program** or the **Local Microcredit Program**, which are operated by the *Hungarian Microfinance Network*®, must meet the following general requirements:

- The applicant must be either an enterprise having already been listed in the company registry or an entrepreneur with an entrepreneurial licence or one who is entitled for one.
- The number of employees of the enterprise must not exceed **nine**.
- The annual turnover of the enterprise can be a maximum of **HUF 200 million (EUR 800,000)**.
- The enterprise must fulfill its tax-paying duty towards the state and the municipality, it must not owe any duties or social security contribution or have an overdue debt to another bank;
- The firm must not be bankrupt or being liquidated.

The Hungarian microcredit regulations and practice do not differentiate between „*social microcredit*” and “*entrepreneurial microcredit*” with the latter one more targeted at enterprise development, nevertheless the

wide range of programs run by the Hungarian Microfinance Network are able to serve both aims with regionally different emphasis.

Previously the microcredit constructions did not show preferences and did not prohibit the investment in certain sectors or target groups (except for some marginal prohibited activities). In periods of resource shortages the LEAs tended to give preference to manufacturing enterprises rather than services or trade.

The share of industries in the loans actually granted from the National Microcredit Fund is shown in the following chart.

Chart No. 3.: Microloans granted from National Microcredit Fund between 2000-2006

Granted Microcredit loans from the National Microcredit Funds after centralization broken into sectors (million EUR)							
Year	Industry	Agriculture	Tourism	Services	Commerce	Other	Total
2 000-2006 altogether	19,840	11,832	5,990	42,322	39,971	2,511	122,465
Share	16.2%	9.7%	4.9%	34.6%	32.6%	2.1%	

Source: Hungarian Microfinance Network ®

After the re-establishment of the Local Microcredit Funds, the Hungarian Enterprise Promotion Network Consortium and some of the LEAs developed several loan constructions serving the needs of specific target groups, like the construction serving the finance of female entrepreneurs, which was designed based on a program initiated by the European Microfinance Network.

6. FINANCIAL TERMS AND CONDITIONS

Due to their outstanding significance, this chapter will mostly detail the terms and conditions of the microcredit programs operated by the *Hungarian Microfinance Network* ® with the help of the chart No.4. – *See Appendix*

Notes to chart:

- The chart does not contain all details of regulation.
- The individual loan constructions are built on each other and enable the finance of both weaker and stronger enterprises.
- It is also possible to combine the individual loan constructions.
- the interest rate of microcredits is set to be within a range of the central bank's base interest rate $\pm 3\%$ by the decision of the minister of economy and transport made in 2005.

7. THE PROMOTION OF INVOLVING OTHER FINANCIAL MEANS

The members of the *Hungarian Microfinance Network* ® have always aimed that they provide the microenterprises with the best possible service customized to the clients' needs.

In order to realize that, they have continuously been searching for various innovative ways to involve alternative financial resources in microfinance. Several constructions that blend preferentially conditioned and supported microlending with bank loan constructions in a PPP form have been worked out. In addition to the 2 constructions shown in the previous (Number 2) table, the following became registered schemes of the Network:

- Budapest Small Enterprise Loan designed by Enterprise Promotion Public Foundation in Budapest (awarded with EURO CITIES Award)
 - IBM Restarting Microcredit developed by the Regional Enterprise Promotion Foundation in Szekesfehervar
 - “Aranyhomok” Microcredit Program designed by Enterprise Promotion Foundation in Bacs-Kiskun County
- These successful programs provide a good base to involve resources from further financial institutions or other donors (like large companies carrying out major downsizing).

Hopefully, the resources from EU Structural Funds' JEREMIE program will soon be available for the microcredit program of the Network.

8. GOVERNMENT SUPPORT

There have been many debates on the government's policy related to microfinance support in the last decade. Sometimes there are some very innovative moves independent of the governments; however several operative decisions hint that the professional apparatus of the Ministry of Economy and Transport (GKM), which is responsible for enterprise promotion, did not always lay proportional weight on the microcredit program. Many times one gets the feeling that they fail to sufficiently appreciate the indirect ways of supporting enterprises and the significance of mediating and service providing institution. The importance of the microcredit program was realized by the Ministry only after the EU had launched the JEREMIE program.

It is still necessary to emphasize for many even today that microcredit does not mean commercial bank loans given to microenterprises.

In their rhetoric all governments so far have emphasized the support of the SME sector and the improvement of finance terms; however it has not entirely been realized in practice or not at the required extent. Here are some innovative and positive decisions in microfinance:

- Act XXXIX/2003 on the modification of Act CXII/1996 on lending institutes and financial enterprises. On the basis of Article (1) h. in §2 of the act, microlending activities of the enterprise promotion foundations in the counties and the capital city ® are exempt from the action of this law that is the foundations can provide microcredit with much favourable conditions than market actors.
- The economic minister's decision in 2005, which enabled the re-establishment of the Local Microcredit Funds and the rationalization of the National Microcredit Program.
- Act LXXVI/2007 about the modification of Act XX/2001 on the Hungarian Development Bank (MFB). §1 of the law enables MFB to take part in the finance of loans needed for the microlending activities of the enterprise promotion foundations, too.

9. REGULATION: FINANCIAL HANDLING, REGULATING MICROENTERPRISES

The most important Hungarian regulations:

- Act XXXIX/2003 on the modification of Act CXII/1996 about lending institutes and financial enterprises: It defines operational rules and conditions for profit-oriented actors of the financial market. On the basis of Article (1) h. in §2 of the act lending from the National Microcredit Fund of MVA and the microlending activities of the enterprise promotion foundations in the county and the capital city ® are exempt from the action of this law.
- Government Decree No. 2163/2004. (July 5th) to settle the operation of the Microcredit Program, Microcredit System realized by utilizing the rights and Funds relating the revolving regional and national credit funds financed by PHARE, and their connecting credit guarantee funds: It authorizes the minister of economy and transport to practise the owner's rights relating the state-owned Microcredit Funds on behalf of the Hungarian Republic. Financial settlement of the funds with the EU has not been accomplished before the preparation of this study.
- Act LXXVI/2007 about the modification of Act XX/2001 on the Hungarian Development Bank: §1 of the law enables MFB to take part in the finance of loans needed for the microlending activities of the Hungarian Enterprise Promotion Foundation and the enterprise promotion foundations in the counties and the capital city on the basis of a government decree.

Other regulations:

The National Microcredit Program is operated on the basis of the "Microcredit Manual" as approved by the Ministry of Economy and Transport.

The common Local Microcredit constructions of the *Hungarian Microfinance Network* ® are operated by the members of the Network in a procedure approved by the National Microcredit Professional Committee and developed on the basis of the Microfinance Regulation approved by the presidency of the Network.

10. FINANCIAL AND OPERATIONAL SUSTAINABILITY

During the past 15 years of the Hungarian operation of microfinance programs a great deal of positive experience was accumulated in the field of the financial and operational sustainability of the programs. The Microcredit Program, which was launched by the PHARE Program and modified several times, has been running effectively to this day however with alternating success. In the first eight years of operation, in the

entirely decentralized period, financial sustainability was achieved nationwide, and the nominal value of the received funds increased by 50%.

Chart No. 5.: Some details of National Microcredit Program 1992-2000

Total sums of Microcredit loans in the first decentralized period of the National Microcredit Program 1992-2000. (Orientating data before closing audit.)				
Provided Funds (EUR)	Granted loans (EUR)	Volume of credit funds at the end of period (EUR)	Average turn	Increase of nominal value
15 663 456	44 288 517	23 862 446	2.8	1.5

Note: The network was established in several stages gradually in this period, the maximum loan amount was raised gradually from HUF 300,000 to HUF 1,300,000. (from EUR 1,200 to 5,200)

In that period the formed and decentralized microcredit funds were **directly handled and managed by the organizations that granted the loans**. The costs of central co-ordination were negligible because the tasks could be done by one manager and one clerk. It is important to see however that financial sustainability is in strong relation with the magnitude of the handled fund, portfolio, the transaction interest of the loans and the losses on loans. This last factor is largely affected by the magnitude of risks taken upon granting the loans as well as the magnitude of the legal collateral required for loan security.

Since the centralization of the program in 2000, program incomes now had to cover the expenses of 3 participants (i.e. LEA, MVA, participating Bank), and the share of received commissions was not at all in proportion with the work done. The costs of central apparatus increased significantly.

In 2002 experts from the Hungarian Microfinance Network set out the conditions for sustaining the nominal value of the NMF. Some of its elements were accepted by the Ministry of Economy and Transport in 2005 (eliminating the bank actor and slightly reducing the central role of MVA).

Some professional arguments regarding financial sustainability

In our opinion in the case of starting a program financed by public funds and serving the interests of national economy (like microloan) it is not particularly necessary to consider financial returns and sustainability to be of primary or exclusive importance.

The necessity of government intervention and finance in these programs can be deducted from the theoretical trend of market failures. For reasons known, money market actors can not or do not want to provide the resources needed by a wide range of existing or potential microenterprises; therefore government intervention is needed in order to improve this group of enterprises. We believe that substantive support of the microcredit program (covering losses, refilling the funds from time to time) is a much more effective solution than the alternative of providing non-repayable grants and benefits to the needy.

We believe that in the case of microcredits promoting the unemployed to become entrepreneurs, the increase of fund proceeds should not be considered as a primary or exclusive objective. In view of society an out-turn of the program is that the participating unemployed no longer queue for unemployment benefit for months (this can even be translated into sums), they support themselves and perhaps their families, and last but not least they get a chance to avoid the mental and psychic disintegration. When you put these aspects on the scales, it is not so unambiguous to determine the criteria of financial sustainability, which ought to be done with the consideration of national characteristics. It is very important to contemplate the economy's level of development as well as the social and cultural background, which may show a remarkable variety even within the given country.

11. THE CHALLENGES FACED BY THE SECTOR

The greatest challenges that the Hungarian microfinance sector faces are:

- enforcing the professional arguments more effectively in the central measures, further rationalization of the national Microcredit Program,
- creating constructions more suitable for the target group of social and entrepreneurial microlending,
- creating a more effective national co-ordination, training, monitoring and marketing,
- accessing alternative resources for the operation of the Local Microcredit Programs,
- raising the efficiency and professional standards of the individual microfinance institutes onto a unified, homogeneous level

- developing the JEREMIE Microcredit Program as professionally as possible: instead of allowing market aspects and the idea of „let a 100 flowers flourish” to prevail above all, the program should promote the strengthening of the enterprise promotion institution and its strong bond to counselling programs.

Dr. Antal Szabó, Dr Péter Szirmai, Ákos Almási and Dr. Gyula Szegedi offered their help and their studies to making this report.

Chart No.1.: The major actors of the Hungarian microfinance sector

1. Government level	The Government of the Republic of Hungary							
	Organizations with national authority and with direct relation to microfinance					Organizations with national authority and with indirect relation to microfinance		
2. National level	2.1.MVHK (Hungarian Enterprise Promotion Network Consortium); former OVK Kht. (National Enterprise Promotion Consortium Public Utility Company)	2.2.MVA (Hungarian Foundation for Enterprise Promotion)	2.3.MFB (Hungarian Development Bank)	2.4. Credit-guarantee Ltd.	2.5. - MAG Zrt. (Hungarian Centre for Economy Development, Subsidy intermediation Ltd.) Hungarian Enterprise Finance Ltd.	Other state organizations Public Employment Service	Other actors financial market: - banks - savings co-operatives	Other non-profit organizations: -Life Career Foundation - Agricultural Enterprise loan Guarantee Foundation
3. Local implementation level	foundations for enterprise promotion in 19 counties and the capital city (LEAs)				Potential providers of JEREMIE Microcredit: LEAs		- branch offices of banks - branch offices of savings co-operatives - bank agents - Mikrohitel Rt.	

Source: made by István Kovács

Chart No. 4.: Conditions of microcredit programs

Description	National Microcredit for development/circulating capital	HMA constructions				Microcredit Plus	PPP constructions run jointly with financial institutes	
		For development	Combined	For circulating capital	Microcredit for female entrepreneurs		Small Enterprise loan	Golden Sand for development/circulating capital
Maximum of loan amount (in million HUF)	6.350	6.350	6.350	6.350	5	Loan aim "A": 15; Loan aim "B": 5	15	39 192
Maximum loan period	96/36	96	36/96	12/36	96	Loan aim "A": 120 Loan aim "B": 84	60	36/48
Maximum moratorium (months)	6	9	9	6	6	24	6	6
Interest rate	Varying, central bank base rate (7.75%)	Varying, central bank base rate + 1% (8.75%)	Varying, central bank base rate + 3% (10.75%)	Varying, central bank base rate + 1% (8.75%)+2% (9.75%)	Varying, central bank base rate - 1% (6.75%)	Varying, central bank base rate (7.75%)	Base interest rate: 10.75%	Central bank base rate / 3 months BUBOR +3%
Credit guarantee	Not available	Not available	Not available	Not available		Max. 80% of loan amount with interests	Max. 80% of loan amount with interests	-
Credit guarantee fee	-	-	-	-		Fee to be paid by MFB	Annual 1% of the guaranteed amount (to be paid in one payment)	-
Minimum own funds	20% of loan amount applied for	10% of loan amount	10% of loan amount	10% of loan amount	-	15% of total net value of development	20% of loan amount applied for	20%/0%
Client centre	LEA	LEA	LEA	LEA		LEA	LEA	LEA
Provided by	MVA	LEA	LEA	LEA		MFB Rt.	LEA and financial institute	LEA/savings co-op
Manual, network software	Available, can be expanded	Available	Available	Available		Available	Available/can be expanded	Available
Program development experience	16 years	5 years	5 years	5 years		2 years	6 years	1 year
Service experience	15 years	2 years	2 years	2 years		1,5 year	6 years	0,5 year

made by István Kovács

