Lengyel, I. (ed) 2003:Knowledge Transfer, Small and Medium-Sized Enterprises, and Regional Development in Hungary. JATEPress, Szeged: 96-110

7 Microfinance in Hungary: Opportunities and Impediments

László Kállay

7.1 Introduction

Micro-credits have a history of 11 years in Hungary and their practice developed at a time when a large number of very small enterprises were formed with little experience and even less equity. The experts both planning and implementing the programmes launched micro credits with little practical experience.

The issue of micro-financing has been included in the SME development strategy of every Government. The question is what changes would best serve the achievement of the original goals of micro-credits, better utilisation of funds available for this purpose (accumulated and new funds) and, finally, more effective enterprise promotion. This article attempts to raise the basic issues involved in micro-financing, without finding answers to which it would be almost impossible to plan the future changes.

For the purpose of development, growth, or often for the purpose of simple operation one of the important issues is whether they can have access to, and if so, under what conditions, to external funding. In the life of viable enterprises it is a typical situation that the enterprise is unable to finance its business opportunities with its own funds. In developed market economies the main rule is that a financial inter-mediary system, the money market, takes care of channelling the savings to the players in the economy who need loans and can use the funds most effectively.

At the same time, it happens in all countries of the world that part of the enterprises cannot have access to external funds. For both the business and financial sectors the ratio of businesses, not financed by banks, is a very important indicator. In developed market economies this ratio can be as low as 10%, while in the majority of developing countries, including transition economies, it exceeds even 90%.

The special (partly small enterprise oriented) credit schemes play an important role where, due to some reasons, the money market does not perform this inter-mediary role or if this role is incomplete. Such cases might involve discrimination by the banks against some minority or women entrepreneurs without good reasons by, e.g., classifying them as a high risk group despite the actual experience. One of

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the typical cases for a disadvantageous position is the lack of chance of small enterprises to have access to external financing.

In many countries the white patches left out by the money markets also involve re-allocation of funds if there are some areas and groups from which banks collect funds but are unwilling to make loans to (which is often justified for their considerations). This practice makes the problem of unequal economic chances even more severe.[1]

In Hungary nearly 90% of the enterprises have not taken a bank loan yet, which number if practically identical with those who do not even have a chance to obtain a loan from the money market. Although some enterprises do not even wish to use loans or external funding, the number of those for whom micro-credits could really contribute to the development of the business is relatively large. Therefore there is a definite need for a micro-credit scheme in Hungary. But what kind of a scheme is needed?

7.2 Potential answers to the problem

The issue is how to promote financing for those who are „financially underserved”?[2] The potential answers differ from each other in many aspects, since micro-financing schemes operate in many countries from the United States, which is one of the most developed countries of the world with a very sophisticated money market, to Pakistan, which is a country with very low income.

The development of the principles and „architecture” of the programmes is a disputed issue and during the recent times the choice between the various approaches has come up in more and more studies and for a in Hungary too (KHF 1998, Csaba, Bara et al 1998, Csaba, Laczkó et al 1998, Laky 1994, Lengyel 2000, OECD 1996, Vajda and Czakó 1998).

In my views the main issue if whether in micro-financing stress is put on giving cheap fund or increasing profitability. Part of the technical literature describes the two programmes with attributes of „subsidised” and „sustainable”. The selection between the two types of programmes also determines almost all further features and, finally, also the impact of the programmes. The philosophy behind the placement of cheap funds is that since money markets do not serve part of the enterprise sector, lending should take place applying a logic, which is in contrast

[1] In the USA the Community Reinvestment Act is trying to find an answer to this problem to a certain extent (Buttari 1995). This Act in fact invites and encourages banks to make loans to the same community from which they also collect funds. The evaluation of the Act is controversial (mainly bankers reject the influence on their placement practices), but many people think that this Act helps a lot to improve the situation of many communities and also brings new customers to some of the banks.

[2] In the USA this group is described as „financially underserved”.

with the laws of the money market. The sustainable programmes also rely on the same principle, but reach a contrary conclusion as they try to extend the money markets to the white patches too. The basic elements of the two types of programmes differ from each other.

(a) Interest rate policy

One of the important differences between the two approaches is the interest rate policy. The subsidised schemes use very low (sometimes negative in real terms) interest based on the assumption that only this can mean real support to the enterprises. Another frequently expressed argument in addition to the low interest rates is that the enterprises to be supported are in a difficult situation, with low profitability, and therefore they are unable to pay high interest rates.

The approach adopted by the sustainable programmes is that excess income generation should be supported in the enterprises and therefore, if the placement of funds is successful, the payment of high interest rates does not cause a problem. In fact, it guarantees that the executors of the programme actually promote the economy.

The use of relatively high interest rates follows from the view that the borrower must pay for the higher risks and higher operating expenses of the loan, which is also a core rule in bank loans. Therefore the sustainable programmes involve the extension of money markets to areas where it did not operate before or operated only to retain the principles of the money market.

One of the most important differences between the two programmes is also related to the interest rate. The subsidised programmes require on-going financing even if the real interest rate is not negative, since the operating expenses are not covered by the interest margin. The sustainable programmes do not require on-going financing, since the interest income covers the operating expenses and losses (if the programme management is adequate).

It is also important to mention that the real interest rates applied in the developed and developing countries are higher than the money market rates, with both low and high inflation, which indicates that this issue is not primarily subject to the level of development or macro-economic conditions of the country.

(b) Opportunities to attract additional funding

The chances of subsidised micro-financing programmes to attract additional funding are very bad, because they can only be financed as donations and on the whole (considering also the operating expenses) their assets are declining in real terms. In the case of subsidised programmes „donor dependence” always develops since the method of their operation and existence depends almost exclusively on the decisions of the organisation providing the funds. One of the consequences of that is that for the organisation managing the loans the donor becomes the really important customer, and primarily his requirements must be put into focus and not those of the borrowing businesses.

The sustainable programmes have much better chances to attract additional funds, since they can increase the invested funds. It is also an important factor that, in the case of programmes of larger volumes even the interest of traditional credit market players may be aroused since these programmes can take larger loans and can extend their funding with bank loans and perhaps subordinated loan capital, which in the end improves the financing position of small enterprises.

(c) Loan conditions

The different type programmes determine the rules of lending differently. If the programme distributes cheap funds, it is necessary to determine the terms and conditions of the loans in an administrative manner since in such cases the market conform instruments of allocation do not work. Therefore the organisation providing the funds is forced to centrally regulate those who are eligible for the programme, the conditions of disbursement of the loans and often even the organisation performing the programme. In the case of the sustainable programmes it is enough to determine the guiding principles and some major parameters, the majority of decisions is adopted by the implementing organisations. For example, there is no point in restricting the purpose of use (purchase of assets or current assets), the exact interest rate, the age of the enterprise, its assets, number of employees since the right selection is assured through automatic processes. It could also be left to the executing organisations to take into account the local features in their own lending policy.

The interest rate plays a crucial role in the fact finding the right target groups, because enterprises which have access to loans from the banks will not apply for micro-credit at a higher interest rate. It is also obvious that even without any administrative regulations it is a basic interest of both creditors and borrowers to make sure that a business promotion effect is achieved. This is the basic task in business promotion, since a failure necessarily involves financial losses for both of them.

(d) Lending methods, staged loans

Although they comply with the principles of prudent lending, the sustainable micro-credit schemes cannot follow the banking practices in all aspects, because their objective is to disburse loans to companies, financing of which is not profitable even for banks operating well. The expenses may be kept low and collateral may be provided using the following non-traditional instruments.

The loan amount disbursed for the first time is usually very low (in the USA USD 500, in developing countries perhaps a few dozens of dollars only) and, following the first successful repayment, the available loan amount increases in several steps (usually five to seven). The entrepreneur can only receive the maximum loan amount at the end of the process. This method involves several advantages. In lending and using external funds an entrepreneur can learn about capital investment, business calculations, payment discipline and all conditions required for the successful use of loans with a relatively small amount and with low risks. The creditor organisation also begins to teach and test its customer with low risks since it turns out in every stage how well the funds are used.

Banking practices put a lot of stress on the evaluation of the history of a business because creditworthiness is partly based on history. It is one of the reasons why very small enterprises hardly have a chance to have access to loans. *Cash-flow based lending* considers the future abilities of the enterprise and the estimated revenues are considered as the collateral of the loan. It also gives a solution to the problem of collateral, since in general micro-businesses do not have collateral that would be acceptable for banks. However, if a loan is disbursed on the basis of their future revenues, the problem can be solved.

Group lending is a kind of guarantee substitute. In the loan groups a rule is applied whereby none of the members of the group may receive the next stage of the loan if any of the members fails to pay. The other function of the group is that its members discuss with each other their business problems and they form a real community, which also increases responsibility. This kind of relationship is recorded only in contracts under private law. It has no legal background or involves undertaking of payment liabilities.

According to the technical literature one of the clearest and most important differences between the two types of loans is in the impact on the economy. The subsidised loans almost always „miss" the target group and their stimulation on the economy is very weak. It hardly ever happens that a large volume project can be implemented since the available funds are restricted.[3] A significant number of enterprises can only be pushed to the path of growth through successful and sustainable programmes.

The choice between the two types is not defined clearly by the development, size of the country, the rate of inflation or the size of the potential target group. International experience indicates that the sustainable micro-financing scheme can be used in developed and developing, large and small countries even if it aims at a

[3] Germany is a strong exception. The western part of the country finances the east German small enterprises with cheap loans and also uses a lot of other instruments (Welter 1997). At the same time, the impacts of the programme are considered very weak (Csaba, Laczkó et al 1998.

relatively small number of businesses. The use of a high real interest rate is not subject to the rate of inflation, or the equity position of the companies before lending.

7.3 Where does the Hungarian micro-credit scheme belong?

The micro-credit scheme in Hungary[4], run by HFEP (Hungarian Foundation for Enterprise Promotion) and its network and financed by the PHARE and the Government[5], clearly falls into the category of subsidised micro-credits. In certain periods the interest rate was the average of other preferential interest rates or, at other times, the prime rate of the National Bank of Hungary, but interest rates has always been below the interest rate on loans to enterprises. Consequently, the micro-credit scheme provided cheap funds to the businesses.

Although during the majority of the scheme, the real interest rate was not negative, the scheme had to be financed continuously and the invested capital did not increase. By the middle of 1998 the disbursed funds exceeded HUF 5.7 billion at the current HUF rates while the actual size of the fund remained below HUF 4.4 billion. (The applied calculation method estimated the value of disbursed funds from below, while the actual size of the fund is estimates from above.) Since part of the funds are in the accounts of the Local Enterprise Agencies (LEAs), in the middle of 1998 HUF 3.4 billion was placed to businesses, which also contained part of the non-performing loan portfolio, therefore part of this total figure has most probably been lost. A more realistic assumption for the same figure would be HUF 3.1 billion. The calculations may also be interpreted assuming that in the middle of 1998 only 54% of the total funds contributed to the micro-credit scheme were „working” in the Hungarian small business sector. It is also important to mention that the funds used were provided to the LEAs free of charges, i.e. no interest was charged on the scheme and that nearly one third of the interest income was banking interest i.e., originated from funds kept on the account (not lent at the time). It should definitely be noted that the loss of capital and the relatively low return on the funds does not reflect the activities and efforts of HFEP and LEAs, but was primarily the result of the structure of the scheme.

As a consequence of the above, donor dependence has remained. The most striking indication of this fact is that the delay in the annual necessary financing slows down the scheme and sometimes even leads to a halt in the programme. It is

[4] The Hungarian-American Enterprise Fund also had a micro-credit scheme, but it was stopped after a few years and the scheme lent to much fewer businesses than the scheme run by.

[5] There were also examples for funding from other sources. E.g. the Budapest Chamber of Commerce and Industry and Budapest Municipality also contributed some funds to micro-credits, but for the entire scheme these were not of major importance and some funds did not prove to be long-term funds.

also clear that part of the funds contributed year by year was used to replace the lost capital, so not the whole amount could be used for loans to enterprises. It is also clear that the micro-credit scheme was unable to attract funds from the money markets.

The real interest rate on micro-credits calculated at the time of disbursement has also changed significantly. During the period to date the fluctuation was close to nine percent, it was over 5% and below –4%. During the last three years, because of falling inflation, the real interest rate exceeded the starting figure by several percentage points, calculated for the entire term of the loan. At the same time, there is no sign that the increase of real interest would have reduced the volume of loans available for placement. For such aspects it is possible that micro-credits have always remained within its potential framework.

7.4 What are the chances for a sustainable micro-credit scheme in Hungary?

Many people argue that in Hungary the conditions do not exist for a sustainable micro-credit scheme. This issue should be reviewed briefly to see what the most important conditions are.

The number one issue is that there is *demand for loans* of small amounts with relatively high interest rates. For the purpose of money markets, the chances of a sustainable micro-credit scheme are the better the more enterprises are not financed by the money market. In this respect the chances are good in Hungary, because approximately 90% of the businesses fall into the category that they practically have no chance of having access to bank loans. A significant portion of these business (40-45%) plan some development, which means that altogether there are approximately 270,000-300,000 businesses in Hungary which, at first sight, could form the target group of a micro-financing scheme aimed at generating some excess income. Naturally, it does not mean that, based on the underwriting criteria, so many businesses would be eligible for loans, but it is a fair statement that there would be enough companies to choose from.

Although there are no exact statistical data, it still may be argued that there are segments in the formal and informal credit market which already finance development projects with high interest rates among micro-enterprises. For example, it is well known practice that if someone cannot obtain a loan from the increasing choice of banks he will take a personal loan worth even several millions of Hungarian Forints and will finance his enterprise from that. It is also well known that some enterprises often take loans from the informal credit market for a very short term, with very high interest rates.[6] It is clear that these examples indicate problems in the credit market and also show that under certain circumstances the businesses are also willing to sue relatively expensive funds, if they expect to be able to pay them back too.

Another requirement for a sustainable programme is to have the required *human resources*: those running the scheme must possess adequate technical and professional knowledge, management skills and should be able to select the businesses which are capable of growing and can apply sound lending techniques. Since this a special area, it is difficult to state anything definite before it is tested. However, the LEA officers and micro-credit committees have gained some experience during the last nearly six years even if they have done so during the implementation of a different scheme, working with a different logic. Similarly, a large number of experts gained experience in other enterprise promotion agencies, commercial bank and savings co-operative networks and therefore it may be assumed that the human resources, required for a sustainable micro-credit scheme, exist and they could be found.

Micro-credits also have an *infrastructure*. There is a nation-wide network used by the enterprise promotion organisations, executing banks and savings co-operatives which are already involved in such activities and now they are already close to businesses.

In the micro-credit contracts several aspects may also be observed which indicate that the conditions for developing a sustainable scheme exist. These include e.g., that the collateral on the loans and the equity required from businesses often exceed the minimum amount required in the loan agreements and that those implementing the programme and the entrepreneurs have always been able to react fast to the changes in conditions and requirements (practically immediately). The development of micro-credits will accelerate a lot if the size of funds and ownership of funds, accumulated in the programme, can be identified and determined in the near future, as this would make the current situation clearer too and it is an absolute basic requirement to use the funds of the programme as capital in the future.

There are several *regulatory problems* to be solved too. The Hungarian money market is over-regulated in a sense that it restricts, or sets very strict requirements for, not only collection of deposits but also lending even if lending does not use funds raised from deposits.[7] This is why the practice whereby non-profit organisations directly lend to micro-enterprises cannot be used in Hungary. One of the possible solutions is the liberalisation of money market regulations in these aspects but it is not sure that this would be a success and, on the other hand, it would

[6] On the basis of the review of the impacts of micro-credit, such cases are described in Vajda and Czakó (1998).

[7] In many countries non-profit organisations are also allowed to extend loans, but they may not collect deposits. Such organisations can only use their equity for such purposes.

also take a long time. However, the liberalisation and deregulation opportunities should be duly considered and the issue should remain on the agenda.[8]

Another possible solution would be to involve the banks and savings co-operatives to manage the lending (this is the practice in the current micro-credit scheme too). Naturally, banks would not apply their own lending policies in this case but would follow the principles of the scheme. Experience from many countries shows, that such co-operation may be formed successfully between banks and non-profit organisations, even in the case of sustainable micro-credit schemes.

Experience also shows that the *interests* of the executing agencies play a very important role in deciding the conditions according to which the enterprise promotion schemes operate. In the current situation there is a fair chance that the HFEP and LEAs should support (not dramatic, but major) changes in the conditions for micro-credit. The main reason for that is that the financing conditions of the LEA network will change if they need to cover more and more of their operating expenses with funds outside the national budget. A sustainable financing scheme could form the most important element among the activities of an at least partly self-sustaining enterprise promotion agency and the other services could be provided in connection to that scheme.

In my views the 2003 is ideal, for almost all aspects, to change micro-credits in order to develop the backbone of a more effective enterprise promotion activity. The changes in the micro-credit scheme are on the agenda, development of small enterprises is a prime political aspect and many years of experience has been collected by the implementing organisations. The ownership title of the existing funds has been decided on, and inflation is low.

In the new micro-credit scheme small enterprises would not be financed with cheap funds, but the scheme would concentrate on promoting the generation of excess income. The funds of the programme would be considered and treated as equity by the implementing organisations, with their own responsibility and at their own risks. The new funds originating from the budget also reach the implementing organisations in the form or equity or loan. The development of a lending policy would be less restricted, in other words the executing organisations would be able to decide on the policy applied by them in many cases (naturally complying with the requirements of the funding organisations in the meantime). Further funds could be attracted partly from money markets and the principle could be applied that more effective organisations gain more funds and therefore can place out more too. The primary purpose of the consultation and training programmes would be to reduce the risks of loans and promote successful lending. Micro-financing would be a kind of financial incubation, which would also mean that a significant part of the financed enterprises would become creditworthy for banks (which is rarely the case) and this

[8] There are several proposals for the deregulation for the money market for the purpose of promoting the financing of micro-enterprises (Bannock 1998).

way the gap in the credit market, which is the essence of the problem, could also be reduced.

7.5 How to reform micro lending?

In the course of the transition process several hundreds of micro businesses have been established, and currently there are 800 thousand micro and small firms operating in Hungary. They became an important part of the Hungarian economy being the only sector where there has been net job creation since 1990. About 90% of this sector is financially underserved; they do not have access to either credit or equity finance.

The politically inspired attempts to issue loans to SMEs in the early nineties failed. The commercial banks at that time did not have the adequate risk management capacity nor clear understanding of the new market segment of micro and small enterprises. After the initial failures they withdrew from this market.

After a long lull, commercial banks start to turn their attention towards smaller firms, and this time by applying newly developed risk management methods, start to down-scale their loan sizes. This resulted in an increasing credit volume to SMEs. However downscaling did not reach low enough to serve the needs of the businesses needing micro (less than HUF 3-5 million) loans (Table 7.1). Hundreds of thousand of micro businesses in Hungary still remain financially underserved or completely excluded from the financial services market.

Table 7.1 Outstanding loans at the end of the year (billion Hungarian forint and %)

	1999	**2000**	**2001**	**2000/ 1999**	**2001/ 2000**	**2001/ 1999**
Micro	112.7	210.7	416.8	187.0	197.8	369.9
Small	110.6	264.9	300.5	239.5	113.4	271.7
Medium	237.7	428.5	563.3	180.3	131.5	237.0
Total	461.0	904.1	1 280.7	196.1	141.7	277.8

Source: Supervising Authority of Financial Institutions in Hungary

The currently operating micro credit program financed by the EU PHARE program and the Hungarian government failed to reach the critical mass providing only 17 thousand loans in 11 years, having an outstanding loan portfolio of HUF 9 billion ($35 million). Interest rates are subsidized; the operational costs and losses coming from bad loans are continuously covered by the donors. After the latest modifications of loan conditions, the loan sizes tend to be above what traditionally is considered a micro loan to be able to meet the needs of micro-enterprises in Hungary.

The attempts of independent NGOs to run micro credit programs resulted in limited success. This is because they have to follow the same procedures as regulated financial institutions, thus their costs are too high and the requirements too stringent to operate profitably on the low end market segment which requires operational flexibility and simplicity of procedures.

Direct and indirect evidence shows that there are hundreds of thousands of financially underserved micro businesses in Hungary expressing interest in accessing credit and other financial services. It is estimated that the potential market for micro credit is 15-20 times larger than the current volume of outstanding micro loans. Due to the lack of appropriate services for the micro-entrepreneurs, the borrowers turn to substitute loan products like high interest rate personal loans, mortgage loans, and even informal loans. Even though these products may not be the right vehicles to finance micro and small businesses, such substitutes reach a large scale of operation indicating that there is a need for flexible lending practices specifically tailored to the needs of the sector.

The newly developed risk management methods can also provide solution to the problem of lack of sufficient collateral which is very frequent among micro businesses in Hungary. Applying moral guarantee, personal contacts with the borrowers and the technique of step-up gradually increasing loans are good examples of innovative risk management methods successfully used by several new type micro credit programs worldwide to help to build up the credit history of micro firms. These methods supported by the relatively developed financial infrastructure in Hungary could be used for the benefit of micro-lending.

7.6 Major impediments for microfinance development in Hungary

The major reason why commercial banks' downsizing efforts do not reach the micro credit segment is that their (relative) transaction costs are too high since they have to meet complicated reporting, recording, and risk evaluation requirements, as well, as personnel and organizational criteria. Savings cooperatives also serve clients who need small loans, but their risk management capacity is limited, and the quality of their loan portfolio is not particularly good, again most likely due to application of credit review procedures that do not apply to micro-enterprises. (Savings cooperatives were given temporary exemption from some elements of the regulation on credit institutions like minimum capital requirement, but with expiration of this exemption they will soon lose this flexibility.)

At the beginning of the transition period it was important to filter potential players of the financial market, but under the current circumstances there is no rational objective reason to maintain such rigorous regulation which limits lending activity to regulated financial institutions and leads to the overall credit contraction in the economy. It is clear that the supply side of the financial markets is over-regulated, and this limits the supply of lower end financial services. Maintaining the sanity of the financial system is an important point, but the regulation has to match and in fact catch up with the current market reality.

Introducing the carefully defined lending opportunity for organizations (including financial companies and NGOs) from their own capital, borrowed or donated funds, would create micro finance institutions that could serve this almost untouched potential markets. Lack of such regulatory options to provide credit limits the credit delivery to the lower end market, and leaves the regulated commercial banks in quasi monopolistic situation.

Officials in the Ministry of Finance expressed opinions in informal interviews that they are open to consider the necessary modifications to accommodate microfinance operations. Currently only the “official”, government sponsored micro credit program is exempted from the general regulation on financial institutions.

A more liberal approach to financial markets regulation is in line with the policy of the European Commission, which recommends and encourages easing this aspect of the financial regulation in the member countries.

Another good reason of reforming micro finance is that Hungary must develop competitive structures that can absorb the EU funds after joining the Union. Micro credit institutions which can become parts of the financial markets are more efficient vehicles of both SME and local economic development than organizations that passively distribute subsidies.

The Hungarian governments, up to now, have preferred supporting subsidized micro credit which distorts the markets and creates unfair competition for the financial institutions. One reason for this is (we have to be frank here) poor understanding of the problem; accepting the old dogma: micro firms can be assisted by cheap services. This approach ignores the counter effectiveness of cheap loans and looks only at the few subsidized businesses as “evidence” of success. This policy attempts to substitute the missing market with a subsidized program instead of facilitating the proper development of microfinance market segment. This, consequently, does not lead to the necessary systemic changes in the financial sector long run.

7.7 Policy options to improve the state of microfinance in Hungary

The elements of a new policy that can facilitate the development of the micro credit market could be as follows:

(a) Amending the regulation on financial institutions (Act CXII, 1996 on Credit Institutions and Financial Companies) is necessary to allow the lending of regulated non-banking organizations (micro credit institutions) from their own capital and

donated funds without taking deposits. Micro credit institutions should be registered, and should meet only minimal requirements in terms of the scope of services for the clientele (micro enterprises) and professional qualification to ensure proper management of the institution. Their reporting obligations should be kept to a minimum and there should be no mandatory credit procedures that such institutions were required to follow. Introducing the notion of micro credit institution as a new non-banking entity would replace the monopoly of the "official" micro credit program run by the HFEP.

The new regulation would create the opportunity for existing and new organizations to qualify themselves as micro credit institutions and build up their market with reasonably low transaction costs. The activity of micro credit institutions would not disturb the activity of commercial banks, but it would aim at developing a complementary lower end market.

(b) Reorganizing the existing micro credit program aiming at financial sustainability in 3-4 years, opening its funds to other competitive micro credit institutions is needed. The current government sponsored largest micro credit program is completely donor dependent (it is not an asset it's a liability for the government). However it has accumulated substantial funds (in the excess of HUF 13 billion). These assets should be mobilized to fund the non-banking micro finance programs including reformed existing government sponsored program and the new ones initiated by independent organizations.

This concept is supported by the best NGOs currently involved in micro lending in Hungary. The best performing LEAs and independent organizations like the Autonomy Foundation, BB Foundation, and the 'Életpálya' Foundation are interested in operating in a new institutional environment in which the actual performance of their organizations is the major success criterion.

It is also important to amend the regulations in order to create an equal footing for the commercial banks and savings cooperatives to be involved in microfinance. Mandatory elements of risk assessment required by the Supervisory Authority of Financial Institutions are too stringent for micro credit operations. For example, commercial banks have to give at least 50% weight to objective criteria in their risk assessment system, while they would like to pay more attention to subjective issues.

A major benefit of the reformed regulation for commercial banks and savings cooperatives would be that they could build up new relations with micro finance institutions. For example they could outsource their lending activity, or buy micro loan portfolios creating a secondary market of the lower end financial products.

In summary there appear to be two major strategies for improving the microfinance sector in Hungary:

- In the *short run*: Changing the regulation to accommodate the non-banking microfinance institutions and reforming the government sponsored micro credit program.

- In the *longer term*: Facilitating the development of competitive, financially sustainable micro credit institutions alongside with the regular commercial banking institutions, which will explore and serve a new market segment.

The major elements of restructuring the government program should aim at abandoning direct subsidized credit that distorts the market towards developing a system of performance-based support for a broad number of institutions. These could involve abandoning heavy subsidies and replace them with orientation towards financial sustainability, adjusting loan conditions, and others to improve operational efficiency.

Enterprise promotion experts often mention it as a commonplace that if you wish to help someone who is starving *do not give him fish but teach him to fish*. In the context of financial schemes, in my views, there is a clear analogy with subsidised and sustainable loans. Subsidised loans are cheap loans and, irrespective of whether they finance development or not, they always provide easy finance and do not force the business into stressing financial return significantly. In other words, they create dependence and they hardly promote the establishment of a long-term stable and sustainable business. In sustainable programmes both the enterprises and the implementors of programmes get into a situation that their basic interests include to learn how to have a successful business and make loans, i.e. they learn to fish.

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