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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on the application of Directive 2006/48/EC to microcredit

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1. INTRODUCTION

Microcredit is generally recognised – by Member States, financial institutions, national supervisory authorities and more widely – as an effective financing channel for job creation and social inclusion, which can attenuate the adverse effects of the current financial crisis while contributing to entrepreneurship and economic growth in the EU. That is why the development of microcredit has been high on the European Commission agenda for the last few years.

In November 2007, the European Commission published its communication "A European initiative for the development of microcredit in support of growth and employment" in order to promote a more favourable environment for microcredit provision. In the past few months, the European Commission has been directly engaged with both the microcredit sector and national public authorities to identify obstacles microcredit providers face in deploying their services throughout the EU and to consider how these might be overcome and whether there is a need for regulatory action at national or EU level. The review and discussion stage led by the European Commission has included a conference organized jointly with the European Economic and Social Committee on 2 December 2011.

The willingness to develop microcredit in the EU was also shared by the EU co-legislators during the negotiation process of the Directive 2009/111/EC[1]. They requested the European Commission to review the application of the Directive 2006/48/EC[2] to microcredit. As laid down in Article 156 of the latter, the European Commission has been asked to report the results of this review to the European Parliament and the Council together with any appropriate proposals.

The next section aims at clarifying what is meant by microcredit with a special focus on the microlenders, to begin with a clear appreciation of the participants to this lending activity and the issues at stake. The third section gives an overview of the prudential supervision of microlenders across the EU and identifies the effects of the prudential requirements on microcredit activities resulting from the application of the Directive 2006/48/EC. The last part concludes whether or not the EU banking prudential requirements need to be amended.

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1 Directive 2009/111/EC of 16 September 2009 amending Directive 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements and crisis management.

2 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions

2. THE MICROCREDIT LANDSCAPE IN THE EUROPEAN UNION

2.1. Microcredit is a concept with various definitions

There is no single definition of microcredit. The term 'microcredit' is generally used to refer to small loans provided to people excluded from the traditional financial system or lacking access to banks, with a view to helping them create or develop businesses. However, the definition of microcredit varies widely amongst Member States and stakeholders depending on the social environment, economic situation, and policy goals.

The demand for microcredit is sustained by a wide spectrum of borrowers. Microcredit may be only available to 'micro-entrepreneurs', self-employed people seeking to finance small businesses. It may also focus only on other groups such as socially excluded people trying to cope with emergencies, fund education, or even acquire basic household assets.

Microcredits are generally very small, short term and unsecured, with usually more frequent repayments and higher interest rates than conventional bank loans. However, beyond this general description, microcredits are granted under widely varying loan terms and conditions. For instance, the loan repayment term is generally less than six months, but may extend to ten years. As regards interest rates, an important factor determining their level is the existence of usury laws. Where usury laws are in place, lenders are not allowed to charge above a stated maximum interest rate. In Member States which do not have such restrictions, the interest rates may be higher than where there are usury laws. In amounts, microcredit generally refers to loans not exceeding EUR 25,000[3]. However, a lot of European stakeholders define microcredit as loans with either much smaller or much higher amounts.

The activities carried out by micro lenders may go beyond lending and include other financial services, such as savings products, current accounts, payment services, transfer services, insurance, leasing, and so forth. This wide range of financial services should however be referred to as 'microfinance' and used in a wider sense than the term 'microcredit'.

The lack of a consistent and generally used definition of microcredit is an obstacle to collecting information and data about this activity, which makes it difficult to track the evolution of microcredit in the EU. Sound facts and figures on the volume of microcredit and related services, particularly for the EU as a whole, are difficult to find. Loans with similar characteristics may be classified alternatively as microcredit or conventional loans, depending on the context. They can be reported as consumer loans, retail loans, corporate loans or loans to small and medium-sized enterprises (SMEs).

[3] The European Commission refers to this amount in the EU microcredit programmes.

2.2. The wide spectrum of definitions is reflected in the variety of microcredit suppliers

2.2.1. Overview of the types of institutions supplying microcredits within the EU

The varying definitions are reflected in the variety of legal forms used by microcredit suppliers. Providers of microcredit fall under different categories: commercial and savings banks, cooperatives, microfinance institutions, non-banking financial institutions, credit unions, foundations and other types of non-profit organisation such as non-governmental organisations and associations. The microcredit sector within the EU is also diverse with respect to sizes and business models. In addition to classifying lenders by institutional types, microlenders can be broken down into further groups:

– institutions which are required to obtain a licence to carry out banking activities, versus those required to be registered with some banking supervisory authority without being required to obtain a licence or those required to be only registered as a legal entity;

– those which have a not-for-profit status versus those with a profit-making purpose;

– private institutions versus public ones;

– lenders which have microlending as their core business versus those for which microlending constitutes a relatively small proportion of their business portfolio.

Lenders can also be differentiated according to the categories of their borrowers: non-bank institutions often grant the microcredits provided to poor households whereas microcredits to micro-enterprises and small businesses are mainly provided by banks. The microlenders also differ in terms of what products and services they are lawfully allowed to offer; whether they are subject to prudential supervision; and how administrative and business operations are funded.

This diversity is related to the regulatory environment in each country (see section 3). Some Member States in the European Union have a banking monopoly, which means that lending activities are restricted to only banking entities. Conversely, in other Member States, non-banking institutions are allowed to grant microcredits. There are also some exceptions with certain jurisdictions allowing specific non-banking institutions to grant microcredit despite the banking monopoly. It is worth nothing that EU banking legislation only prohibits non-banking microlenders from taking deposits.

2.2.2. Banking institutions play a key role in the EU even though microcredit is often only a side activity

The banking system is an important institutional supplier of microcredit in the EU through savings, co-operative and commercial banks. These can be broken down into four main groups depending on their business models:

- banks having regular microcredit activities with specialised lending departments;
- banks granting microcredits through separate foundations;
- banks going into partnership with public financial institutions which define the credit policy and assume the full risk of the loans (under certain conditions) while the banks remain responsible for the credit decision;
- banks having indirect involvement in microcredit through wholesale loans, credit and liquidity facilities to financial institutions specialised in microcredit.

While being only a side activity for most of these banking institutions, microcredit is often considered as an opportunity to participate in the development of businesses and clients which might be profitable in the future. Cross selling (where the provision of loan gives banks opportunity to sell other services to the borrowers) may then help to make the funding of microcredit more profitable. Banks can also be motivated by the potential benefits of collaborating with public bodies through public-private partnerships.

2.2.3. Non-banking institutions that primarily grant microcredits are another important supplier

In most Member States, non-banking institutions carry out the bulk of microcredit provision. The existing non-banking institutional models range from non-governmental organisations, non-profit associations, charities, trusts and foundations to credit unions and religious institutions. In accordance with EU banking legislation, apart from a few exceptions, non-banking institutions are not allowed to receive deposits from the public, which are restricted to licensed and supervised banking institutions. These non-banking institutions grant microcredits to socially or financially excluded groups as a primary activity.

Over time, some of these non-bank microcredit organisations evolve into for-profit companies such as regulated banking institutions. This institutional transformation is often driven by a need for more capital and a desire to offer a wider range of services such as deposit taking.

In some Member States, partnerships between non-profit organisations and banking or public institutions are established. The former perform an informal selection of the applicants to receive funding and offer them assistance after credits have been granted while the latter provide for the funding of the credits.

2.2.4. The public sector is one of the most influential actors on the microcredit market

Despite the difficulty of measuring the size of the microcredit sector, one of the most influential actors within the EU is the public sector that provides banking and non-banking institutions with support aiming at bridging gaps or failures in the microcredit market. This support is provided at national, regional, and European levels by a wide range of public actors from state-owned banks to the EU structural funds and other public guarantee, loan or equity schemes.

EU policy gives high priority to microcredits enabling institutions to receive funding from various European sources such as the European Social Fund, the European Regional Development Fund, the European Investment Fund, the Joint European Resources for Micro to Medium Enterprises (JEREMIE programme financed by the Structural Funds), the Competitiveness and Innovation Programme (CIP) and the European Progress Microfinance Facility (Progress Microfinance). The objective of these EU programmes is to encourage financial institutions to grant microcredits. Other EU programmes also help microcredit providers to improve governance, mitigate risks, and partially offset the high administrative costs inherent in microcredit through guarantees and technical support, such as the Joint Action to Support Micro-Finance Institutions in Europe (JASMINE) which focuses mainly on the capacity building of non-bank microcredit providers.

At national and regional levels, a number of measures are taken to promote microcredit funding and partially share the risk with microlenders through guarantee schemes. Public programmes giving direct financial support to micro-lenders and borrowers are also implemented. Where state-owned banks exist, they tend to be the main funding providers for microcredit activities.

3. PRUDENTIAL SUPERVISION OF MICROCREDIT ACTIVITIES WITHIN THE EU RESULTING FROM THE APPLICATION OF DIRECTIVE 2006/48/EC

3.1. A large portion of microcredit providers are exempted from the application of prudential requirements laid down in the Directive 2006/48/EC

The variety of institutional forms used by microlenders is reflected in the diverse landscape of regulatory frameworks applied to these microcredit providers across the EU. Broadly speaking, only microlenders operating under European banking law have to fulfil the requirements of the Directive 2006/48/EC. The trigger to fall under European banking law is to receive deposits or other repayable funds from the public and, at the same time, grant credits for its own account in accordance with the definition of a credit institution as laid down in Article 4 (1) of Directive 2006/48/EC. That means that non-deposit taking microlenders are not required to obtain a banking licence and meet the Directive 2006/48/EC prudential requirements unless the Member States apply a stricter approach by allowing only licensed banking institutions to grant microcredits.

Moreover, whereas the prudential legislation concerning banking institutions is harmonised to a certain extent by Directive 2006/48/EC, the regulatory approach to microcredit provided by non-banking institutions differs widely from country to country. In most Member States, there are no specific rules related to these non-banking microlenders that fall in the scope of generally applicable corporate laws, while specific regulatory frameworks for the provision of microcredit can be laid down in the national legislation, as, for example, is the case in Italy.

These findings have two implications:

– institutions with similar activities are not subject to the same regulatory requirements across the EU; and

– Directive 2006/48/EC might not be as penalising for microcredit as might have been expected, given its limited scope of application.

3.2. Several factors tend to mitigate the impact of the prudential requirements laid down in Directive 2006/48/EC on microcredit activities although there may be some burdensome effects

3.2.1. The Directive 2006/48/EC does not take account of the specific nature of microcredit

The specific nature of microcredit is not taken into account in EU banking legislation. The provision of microcredit is considered as a common lending activity and falls in the scope of the applicable rules on financing and providing loans. This is true with regard to Directive 2006/48/EC that does not make any reference to specific prudential rules related to microcredit. That means that there is neither a waiver allowing banks to exempt their microcredit activity from the prudential requirements nor specific rules mitigating the prudential requirements compared with those applied to other banking activities.

3.2.2. Access to public guarantee schemes enables microcredit providers to significantly reduce the level of own funds required to cover the credit risk they are exposed to

Microcredits may carry high credit risk – that is the risk that the borrower defaults before repaying the principal and scheduled interest according to the loan contract – due to possible over-indebtedness of microborrowers and lack of guarantees traditionally required by banks. This credit risk may be underestimated due to information asymmetry.

The Directive 2006/48/EC requires banking microlenders to hold a minimum amount of own funds to cover this credit risk in order for them to remain solvent in the event of default of the borrowers. Under this Directive, the banking institutions can calculate the minimum capital using different methods of varying degrees of sophistication, namely the standardised approach and internal ratings based approach. Under the standardised approach, which is the simplest and most common approach implemented by small-sized banking institutions, the minimum level of own funds is determined with regard to the riskiness of the microcredits. This riskiness is measured in terms of risk weights (i.e. the riskier the loan for the bank, the higher the risk weight). Under the standardised approach, microcredits are given a weighting of 75%[4] from the moment that there is low correlation between microcredits[5].

Banks are required to hold tier 1 capital of at least 4% of the risk-weighted amount of microcredits and total capital of at least 8%. That means that the minimum total capital comes to EUR 600 if the microloan value is EUR 10,000 (or 6% of the loan value, after the 75% weighting). Nevertheless, in the majority of Member States, local, regional, or national public authorities have implemented credit guarantee schemes which assume some of the risk borne by microlenders. These guarantee schemes generally fix a maximum amount that can be secured, expressed as an

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[4] Actually, all exposures to small and medium enterprises, including microcredits, carry the same risk weight irrespective of the size, nature (credit or liquidity facility, personal loan, etc.) and risk profile of the counterparty.

[5] A microcredit portfolio should have less risk than the weighted average risk of its constituent microcredits if there is a significant number of loans and the credit risk of these loans does not get worse and better simultaneously.

absolute amount and/or as a percentage of the borrowed amount (generally from 60% to 80% of the loan). Both standardised and internal ratings based approaches allow banking institutions to assign the risk weight of the guarantor to the protected portion (while the risk weight of the microborrower remains to be assigned to the unprotected portion). As such public guarantees often carry a 0% or 20% risk weight, the minimum level of own funds the banking microcredit providers are required to hold to cover the credit risk generated by microloans can be sharply mitigated. Existing capital requirements do not seem therefore to penalise microcredit activity since the level of own funds can be much lower than 6% of the loan amount.

An overall increase in capital requirements and reinforcement of capital quality are provided for by the upcoming prudential rules currently under negotiation, 'CRD IV/CRR', that will replace the Directive 2006/48/EC from 2013. These new rules that transpose the Basel III framework into the European banking legislation aim at strengthening the EU banking sector and financial stability. However, SMEs have expressed concerns over the impact of these new rules[6] on lending conditions, given the limited availability of funding sources alternative to the banking channel. That is why a provision is introduced in the CRDIV/CRR proposal (Article 485 of CRR) requiring the European Commission to review the capital requirements for exposures to SMEs after three years from the entry into force of CRD IV/CRR. In the meantime, in July 2011, the European Commission mandated the European Banking Authority (EBA) to analyse the appropriateness of the existing risk weights applicable to SMEs lending[7] and assess the impact of (i) a possible reduction in these risk weights and (ii) a possible increase from EUR 1 million to 5 million in the threshold below which exposures to SMEs benefit from these risk weights.

In its report finalised in October 2012, the EBA warns against any permanent modification of the risk weights or threshold in absence of adequate evidence that justifies a departure from the Basel agreement. However, the EBA suggests alternative measures to ease lending conditions for SMEs such as (i) the introduction of a temporary exemption of the capital conservation, (ii) the alleviation of capital requirements during periods of economic difficulty or (iii) the introduction of a temporary supporting discount applied to capital requirements without modifying the risk weights. Without pre-empting the negotiation process on the CRDIV/CRR proposal, any of the suggested measures would also benefit microcredit providers as a microcredit is treated in a comparable manner as a loan to an SME.

3.2.3. *Most microcredit can be exempted from the large exposure limit designed to limit concentration risk*

Given the small size of microcredits, in theory, there is no loan the value of which would exceed 25% of the regulatory own funds of the banking microcredit providers (the concentration risk limit). However, where the microloans are guaranteed by the same counterparty, such as a state government or local authority, the portion of the loans that are guaranteed could be treated as having been incurred to the guarantor rather than to the microborrowers, which may lead to a breach of the 25% limit. However, the exposure to the public guarantor can be exempted from the application of the large exposure limit.

[6] In particular, the introduction of the so-called capital conservation buffer (2.5% of risk-weighted assets in addition to the current 8% requirement) which would be phased in between 2016 and 2019.

[7] The risk weights are left unchanged in the CRD IV/CRR proposal.

3.2.4. The Directive requirements in terms of risk management help the banking microlenders to mitigate their risks

Directive 2006/48/EC requires that banking microlenders have in place a comprehensive risk management process to identify, evaluate, monitor and control all their risks. Such requirements help the microlenders to strengthen their internal control frameworks and develop effective risk management skills and strategies, which can in turn reinforce their credibility and profitability while improving the financial stability of the microcredit sector. The development of efficient internal control frameworks also enables banking microlenders to be less exposed to credit risks, money laundering and employee fraud.

3.2.5. Directive 2006/48/EC requires banking microcredit providers to comply with prudential rules to mitigate liquidity risk

On the asset side, banking microlenders may lack a cushion of unencumbered, high-quality liquid assets to enable them to face a liquidity stress, given that microcredits are often illiquid and transformed with difficulty into liquid instruments (through covered bonds issuance or securitisation). On the liability side, deposit-taking institutions may face the risk of deposit run off especially where they have no access to stable sources of liquidity from other banking, public or international institutions.

Directive 2006/48/EC requires that banking institutions, including microlenders, have sound liquidity management strategies, policies and processes to identify, measure, monitor and control liquidity risk on a day-to-day basis, and contingency plans for handling liquidity problems.

3.2.6. Directive 2006/48/EC may involve high administrative burdens which may reduce the attractiveness of microcredit as a banking business while strengthening financial investor confidence in microcredit providers

The application of prudential requirements laid down in Directive 2006/48/EC might be disproportionately expensive for both the supervisory authorities and banking microlenders especially if the latter do not pose serious risks to the overall banking and payment system. When measured as a percentage of total assets, the smaller banking microlenders are, the higher the costs resulting from the application of prudential requirements can be. This may lower the profitability of microlending and reduce its attractiveness as a banking business. However, some prudential requirements, especially those related to prudential reporting, the risk assessment process and capital adequacy can be commensurate with the smaller size and complexity of these institutions, which helps to alleviate the administrative burden.

Even though microcredit institutions have no significant systemic impact in terms of financial stability, the failure of any one of them might affect the credibility of the other banking microcredit providers. As such, the reduced likelihood of failure of applicable firms due to the Directive should be welcomed. In addition, the banking prudential requirements can enhance financial investor confidence in microcredit providers as a safe destination for investor funds. Such confidence can help microcredit institutions to attract more long-term funding enabling them to reach a more significant scale and provide their customers with a wider range of services.

4. CONCLUSIONS

The European Commission recognises the need to promote the provision of microcredit and the development of microcredit providers. It should be recalled that the European Commission is very active in this area notably with the JEREMIE and JASMINE initiatives and the European Progress Microfinance Facility launched in 2010 to increase the availability of microcredit for alleviating unemployment of young people and helping to set up or develop their business.

In this context, neither the European Commission, nor a number of national public authorities consider that the prudential requirements as laid down in Directive 2006/48/EC impede the development of microcredit activities. As noted earlier in this report, these prudential rules would not seem to be as penalising for microcredit in the EU as might have been expected, precluding the need for tailoring them to the particular features of microcredit activities. Moreover, microcredit brings together a wide range of actors which are not subject to similar laws or rules and is dealt with in a diversity of ways across Member States depending on the policy framework and the legislation in place. Given this heterogeneous situation combined with the lack of a consistent and commonly used definition of microcredit, any action to modify the prudential and regulatory framework would require prior careful consideration to ensure that microcredit activities are effectively promoted.

It might also be argued that no prudential reform needs to be undertaken if the development of microcredit is considered to be driven to a large extent by non-prudential factors. That does not mean that prudential regulation has no impact on the development of such activities, but that prudential factors do not play a critical role in the development of microcredit, making any prudential reforms not necessary. A number of areas outside of the prudential sphere could instead be the focus of reforms. For instance, a way to foster the supply of microcredits may be to create a more favourable general environment for institutions specialised in microcredit by facilitating their access to financial resources. This development might be promoted through a wider provision of loan guarantees, encouraging closer cooperation between banks and non-banks or more financial transparency.

Under this approach, the development of codes of conduct of voluntary application like, for instance, those which have been issued by the microcredit industry itself in recent years, or more recently by the European Commission,[8] can help to provide a higher degree of recognition and credibility to those microcredit providers adhering to them. Review of the consumer protection environment for microcredit, which is outside the remit of Directive 2006/48/EC, and any appropriate improvements, may also have positive effects on microcredit activities.

Finally, greater attention given to the institutional framework for self-employment and microenterprises could also increase their chance of success and make microcredit more profitable. Measures to simplify legal and administrative regimes or to smooth the transition between unemployment or social welfare dependence and self-employment could be fostered as well.

[8] In October 2011, the European Commission issued a comprehensive European Code of Good Conduct for Microcredit Provision developed jointly with individual microcredit providers, banks and their respective national and European trade bodies, regulators, academics, and rating agencies.