



MICROCREDIT AS A
TOOL OF ETHICAL
FINANCING FOR
SUSTAINABLE
DEVELOPMENT

OCCASIONAL PAPERS: 10

MICROCREDIT AS A
TOOL OF ETHICAL
FINANCING FOR
SUSTAINABLE
DEVELOPMENT

EDITED BY
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FOREWORD

This publication presents edited versions of the interventions made by the writers at a seminar organised by the European Federation of Ethical and Alternative Banks (FEBEA) on the occasion of its Annual General Meeting held in Malta in April 2010. The theme of the seminar was *Microcredit as a Tool of Ethical Financing for Sustainable Development*.

The views expressed are the authors'. APS Bank is publishing these proceedings in order to widen the discussion on such an important subject. Microcredit is presently the theme under scrutiny in terms of the evolving market forms that it is assuming in various countries and in terms of the supervisory connotations that it conveys at a time of stress throughout the global financial markets.

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April 2011

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MICROFINANCE, ECONOMIC GROWTH
AND SUSTAINABLE DEVELOPMENT
IN A GLOBAL ECONOMY
Theory and Practice

Concepts are introduced, understood, interpreted and applied in particular social and temporal contexts. It pays all those interested in tracing the validity and usefulness for everyday life of such concepts to verify from time to time the true significance of the terms in use especially as their meaning for those who use them in conversation and printed form may reflect various nuances over time. This means that users of specific terms may believe they are in agreement when in fact they will be referring to different positions. Or they may think that they are not in consonance with one another when, in fact, they will not be referring to the same idea; they are misled by the terminology which may sound ‘familiar’ but which in fact will not be exactly so.

This generic statement holds for all areas of human behaviour, whether considered scientific or not. It is therefore even more relevant to the areas of discussion related to the terms introduced in the title to this write-up, namely, microfinance, economic growth, equitable and sustainable development, and global economy. Terms that cross-over, time and again, into finance, economics, politics, international law and jurisdiction, national and/

or federal legislation, and, not least, equity and morals. No matter how 'simple' or 'straightforward' terms may appear to be, and so seemingly subject to 'only' one common interpretation, such ideas and their applications may truly be covering a much wider array/shades of interpretations than may be expected.

It was with such a scenario in mind, that the theme chosen for discussion at the annual general conference of FEBEA (European Federation of Ethical and Alternative Banks) held in Malta in April 2010 addressed the role of microfinance and microcredit as financial tools – therefore means – to achieve a social and economic end: the empowerment of people who would otherwise find it hard to progress in life and the encouragement of desirable economic objectives inspired by sustainable development, regional and global solidarity, and ethical behaviour. Experience demonstrates, time and time again, that such objectives have to be constantly kept under observation and that mankind has to strive hard, one generation after another, to continue aspiring for their attainment.

This introduction first presents a series of remarks regarding the use of models in analyses that focus on the role of microfinance and credit as these have been evolving in the past few decades and, in turn, highlights the main themes addressed by the respective authors in this publication.

1. The Issues: Constant market evolution, finance and economic growth over time, income inequalities, and governance

The aim has originally been to 'fill a gap': provide finance and 'managerial knowhow' to segments of the population,

generally women, who live in geographical areas that urgently need the injection of financial resources to achieve a multiple of objectives, namely, escape poverty, create wealth through encouraging enterprise, boost consumption, saving and employment, thereby securing an enhanced future for many who otherwise would have been left without one. It identified a new niche market that, over time, became replicated in other regions and for other sub-groups in the population with the promise of boosting human dignity through work, enhanced living standards, and prospect for a brighter future for many.

But as happens always, success gives rise to two forces: a shortage of resources as demand for them expands quickly – a shortage that induces new ‘players’ with readily available means to meet the rapid rate of expansion; and a dilution of the quality of the players in the market, where transactors with other objectives besides the original ones will enter. In short, the ‘market’ for microfinance will reach beyond the original confines both in terms of supply and in terms of demand, both those who provide resources at various prices (interest rates) and those who want to use such resources (borrowers). Indeed, the initial target of providing funds for investment *and* knowhow to run small business will be extended to cover slowly funds for what may be considered more ‘consumption’ than social capital accretion. In part, this evolution arises from considerations related to the need to diversify product and sector risk for the fund providers. And, in time, the frenzy to borrow spreads throughout communities following more direct and ‘aggressive’ marketing of funds but not necessarily of the managerial support that induces the effective application of such funds.

This combination of changes in personal and social perceptions on borrowing and debt and a more

accommodating supply of resources in a region where these were traditionally in short supply tend to lead to over-borrowing, higher charges and, eventually, defaults. At that stage, the political and regulatory powers realise that these markets are 'under-supervised', if they are properly regulated at all, and move to tighten up the act. A new scenario will emerge as a result, and the various 'markets' will have to adapt accordingly : some players will exit, new ones may be encouraged to join and a second round of activity, now under a set of rules specifically tailored for the particular economic area, gets going.

This situation is typical of all markets' behaviour over time. There is nothing peculiar to the various markets for 'microfinance'. Markets are constantly on the move. They are brought into being by people who adapt them according to their needs as new players enter and/or insiders exit. This means that there is a continuum of services that vary in terms of volumes, charges, timeliness and location. Such 'markets' are not only defined by the number and size of players who participate in them, but also by the particular legislation – or its absence – that specifies the 'environment' and condition, at least in part, the behaviour and style of all who participate in these transactions. Such markets may compete within very restrictive domains or find rival commodities in other finance-related set ups, which pertain to what may be traditionally considered a different institutional configuration with its historically-defined ways of operation.

Technology facilitates the emergence of such rival markets in the provision of access to financial services to the 'poor' or to other particularly disadvantaged sub-groups in a population. Thus, for example, traditional microfinance institutions are facing challenges from the

tandem of formal banking sectors and mobile phone companies. Such competition may be successful in particular geographical areas with the setting up of institutions specifically geared towards the mass market (similar, in another context, to low-cost airlines), ones that emphasise differentiation and a stubborn focus on service delivery. Besides scale effects may render these bottom-of-the-pyramid markets potentially attractive for banks in some countries. Witness the profitable operations run by banks in South Africa in working with the government to support the payment of government grants into specifically designed bank accounts. Or the experiments carried out by banks in harnessing traditional informal financial systems as distribution mechanisms; loan repayments from this under-serviced client base approaching the 100% mark. The spectrum of service providers keep changing over time simultaneously with a multitude of other transformations in the rest of the economy in a region, nationally and also globally.

It is important to assess the role of microfinance enterprises within such a wide context for a specific policy-oriented reason: to assess its contribution to income generation, employment growth and enhancement of personal and social welfare. Microfinance is a means to an end: its ultimate beneficiaries must not solely gain in the short run through the provision of financial resources and managerial knowhow but, as a result, bring into being a resilient productive set-up that can sustain itself through region-wide expansion of the demand for goods and services. The initial boost to particular individuals acts as a catalyst for future sustained demand, and, therefore supply. But for this to occur other factors have to be in place in order to render such a process truly effective. Otherwise, the positive contribution that the microfinance

injection may make to aggregate economic demand in a region may be countered by other factors that induce a restriction of activity, with the net effect of the two sets of operations being very low if not outright negative.

The line of reasoning is similar to that undertaken when evaluating the effectiveness of fiscal intervention, through changes in tax regimes, public sector expenditure, and government borrowing on the profile of aggregate economic activity over time. The net contribution of such programmes will depend on various factors that condition the behaviour of domestic households and firms, international demand for the goods and services produced in an area, and the net flow of capital to support capital renovation and accretion. To state that a particular activity did not succeed in sustaining economic growth may stretch the judgement a bit too far unless the conclusion has been set after enough time been given to allow systems to adapt adequately to the innovations introduced.

Or, it could well be that claims for the envisaged positive contribution by specific initiatives taken may be 'exaggerated/overblown' with the result that whatever outcomes they produce will be considered as inadequate if not outright poor showing. This seems to be the case with the end-results emerging in Jobra, the Bagladeshi village where Muhammad Yunus founded the Grameen Bank in the 1970's. Jobra remains trapped in poverty, has begun to experience rising individual indebtedness and Grameen Bank is defending itself from the accusation that it had become 'a person-oriented organisation, not a rules or system-based organisation' (*Financial Times*, April 27, 2011: p.4). And, in nearby India, despite India's strong economic growth, with annual rates in the 8% region in recent years, the country's ability to transform the lives of many of its 1.2 billion people is uncertain. Like in other

countries, the poor are faced with rising food prices and worries about food and energy security.

Similar observations can be extended to the net impact of fair trade on economic growth and a more equitable income/wealth distribution. Objective analysis suggests that fair trade is neither the interventionist force in free trade that some made it out to be nor the successful vehicle to eradicate wealth and income distribution inequalities. Indeed, it is none of these two. Research points at two important observations (Vide: Mohan, 2010).

First, the beneficiaries of fair trade activity are not necessarily the persons or households pertaining to the lowest deciles in a country's/region's income distribution configuration or living in the 'poorest' countries. Rather, they are those in the income brackets that fall in a higher income distribution region. In country terms, trade penetration is greater in middle-income than in low-income. This observation makes sense on reflection: marketing costs represent an important component of product distribution. Only those producers who can command enough resources to research, package and market 'standardised' products succeed to break into markets and in time improve on their market share.

Second, fair trade does not distort international free trade flows. Claims that it is market distortive appear to have been exaggerated. Although its volume has increased rapidly, yet at its current levels it is unlikely to distort markets. It may also be claimed that the model may not be appropriate for all producers. Besides, it is unable to address structural problems within trading systems. In short, fair trade can best be described as a niche market designed to benefit some producers and, on these terms, it is generally successful. It does achieve its selected, limited, objective. This is a positive achievement.

And, again, one speaks of 'diminishing income inequalities' among persons/households, regions, or countries. But once more one has to be careful when devising measuring tools to assess movements in the income configurations of peoples over time and across regions or political boundaries. Income inequalities may be described in 'absolute' or 'relative' terms. (Strictly speaking all measurements are truly relative with relation to time). All statistical coefficients are bound to be time and technique bound, and therefore, in a sense, somewhat restrictive from policy perspectives. However, such considerations did not inhibit researchers to continue striving to bring together aspects of these income considerations, and even propose ways of combining them (Niemietz, 2011). Of course, some analysts remain sceptical of the true significance for policy implementation, especially if one were to stick to the purely pragmatic and emphasise the effectiveness of measures undertaken to reach desired objectives. And one has to be very considerate about the sources of statistics that are used to identify and 'explain' income differences over time among different sub-groups in a population (Vide, e.g., Díaz-Giménez, Glover and Ríos-Rull, 2011) Causal relationships are hard to establish in a generalised way from statistical data bases; they are always subject to analysts' interpretations and, therefore, could be time and region bound.

Given this 'grey area' of policy in a financial/economic sector that emerged to achieve valid, praiseworthy objectives in terms of human development, it was expected to draw the attention of financial regulators as the volume of activities financed through a mixture of non-bank and banking institutions increased. Microcredit is at the core of many microfinance business models, and has a number

of distinctive features. Product design, client profile and underwriting methodology give microcredit a unique risk profile. Effective credit risk management therefore demands different tools from those used in conventional retail lending.

The optimal way in which a 'market' regulates itself in terms of risks and governance is a moot issue. Some analysts argue for auto-regulation, through the formation of specific boards made up of members who devise a code of conduct for practitioners and follow the behaviour of the members that are issued with warrants to exercise their profession. Such boards regulate the every-day practice of accountants, medical personnel, and lawyers in various countries. In addition, there could be 'national/state' or, in some countries, even federal/union supervisory bodies that track and report on the way in which business transactions are carried out and on the evaluation of the various risks involved in such dealings.

The Bank for International Settlements (BIS) explored, through its Basel Committee on Banking Supervision, the manner in which the core principles for effective banking supervision can be applied to Microfinance. (BIS, 2010). The need for clarifying the role supervisors have to perform can be appreciated from the penetration that microfinance had in various countries. The document points out the following facts.

"In many countries, microfinance – the provision of financial services in limited amounts to low-income persons and small, informal businesses – is increasingly being offered by formal financial institutions. Although banks dominate deposit taking in most countries, non-banks (eg microfinance institutions, financial cooperatives) that take deposits may be significant providers as well. According to conservative estimates, non-bank deposit

takers (including cooperatives) hold some 5% of deposit accounts in the developing world. Further, while these institutions typically take deposits in small increments, the proportion of citizens they serve may be significant in some jurisdictions. In Rwanda, deposit takers other than banks hold 10% of the amount of deposits but serve nearly 40% of depositors. Similarly, the number of loans from regulated non-banks may surpass those granted by banks in some markets. For example, recent figures from Bangladesh show microcredit providers hold nearly 7 million loans compared to 4.4 million in banks, while Zambian microcredit providers have three times as many borrowers as commercial banks.

Non-banks that mobilise deposits should be subject to regulation and supervision commensurate to the type, complexity and size of their transactions. In addition to protecting depositor funds, official oversight may enhance access to financial services by increasing public confidence in microfinance providers, improving their operational standards and setting a level playing field for both banks and non-banks. However, compliance with prudential rules in particular can be costly for both supervised institutions and supervisors relatively to the risks posed by this line of business. Thus, microfinance oversight must weigh the risks posed by non-banks that mobilise deposits and the supervisory efforts that are necessary to monitor and control those risks, as well as the role of this line of business in fostering financial inclusion. This calls for a coherent regulatory and supervisory approach, tailored to the unique characteristics of microfinance vis-à-vis conventional retail banking." (BIS, 2010: 9)

Within this emerging scenario, the Basel Committee proposed the following four key considerations with regard to supervision of microenterprises (BIS, 2010:2):

- i) allocate supervisory resources efficiently, especially where depository microfinance does not represent a large portion of the financial system but comprises a large number of small institutions;
- ii) develop specialised knowledge within the supervisory team to effectively evaluate the risks of microfinance activities, particularly microlending;
- iii) recognise proven control and managerial practices that may differ from traditional banking but may suit the microfinance business both in small and large institutions; and
- iv) achieve clarity in the regulations with regard to permitted microfinance activities to different institutional types, while retaining flexibility to deal with individual cases.

All the time, the aim is to enable the performance of a vital empowering sector that can facilitate the transfer of financial resources that are often in short supply on the understanding that these are being utilised in the best interest of the two parties concerned (savers and borrowers/investors) and, in turn, in the interest of the community as a whole. In this way, economic diversification and growth are encouraged and induced, so that personal and social incomes rise faster than they would have otherwise done.

In summary, the provision of financial services in limited amounts to low-income persons and small, informal businesses – microfinance – may have been the ‘missing link’ in a financial range of services on offer in many countries. However, no matter how valid and praiseworthy objectives may be, one has to be on guard that resources available in a community for supporting future economic growth are transferred in

time to where they can encourage future production and service provision. To ensure the smooth performance of the respective sub-markets for such resource transfers, regular evaluations have to be undertaken to monitor the products developed and exchanged, the transmission instruments and repayment facilities. The effectiveness of the monitoring boards or authorities has to be addressed; the long-term sustainability of resource transfers to those sectors that may be neglected for whatever reason by the financial institutions in place could be conditioned by existing rules, their interpretation and their day-to-day implementation. Governance, product development and effectiveness over time must be assessed holistically to ensure that desirable objectives are attained.

These ideas are explored further in the contributions in this collection of writings. The main thrusts of the respective articles are summarised below.

2. The subjects under discussion

The presentations focus on two distinct areas of analysis. The five articles in part one address issues, markets and regulation. These are followed by three articles in part two that put forward the everyday experience from three programmes already in place; they reflect matters that have to be resolved in particular situations where concepts and models may be useful up to a point, beyond which it is an institution's command of resources – financial and human – that becomes critical for the success of an operation.

Karol Sachs launches the debate by addressing the key issues that arise from the need that many felt has to be addressed in Europe in order to enable the transfer of

resources via a network of financial and non-financial organisations so as to generate employment and wealth. This need instigated the formation of FEBEA, which saw this federation spreading gradually across the member countries of the European Union and which, at present, is preparing to face two challenges. The first one is the creation of a financing and mutual assistance mechanism among FEBEA members to enable them to overcome temporary difficulties and be independent and invulnerable regarding the changes that would appear inevitably in their national banking systems. The second is the creation of new ethical financial institutions to support social cohesion and sustainable development in the European Union, especially if Basel III regulations were to accentuate the exclusion of the social sector and the SMEs and SMIs sector from the mainstream banking system. Developing structures that can deliver results and devising financial tools that can meet specific market needs is an ongoing exercise that FEBEA members should follow with determination.

André Laude tackles these subjects directly by exploring the subject of whether microfinance has developed as an 'industry' and whether it has reached the status of a fully-fledged asset class, worthy of portfolio allocation by institutional investors. He suggests that while the homogeneity of microfinance brings it closer to the definition of an asset class, especially as a result of the financial crisis of the past few years, yet it critically falters when it comes to liquidity; markets are not likely to develop further until there is a critical mass of exposure among a large number of investors. There must emerge an established community of willing buyers being matched with willing sellers and being supported by recognised trading platforms. For this to

happen, there has to be further mainstream rating agency involvement in rating micro finance institutions (MFIs) and collateralised debt obligations; continued involvement of international financial institutions such as the IFC; gradual participation of leading and well-managed banks in the sector; and securitisation returns as a legitimate financing liquefying technique, provided transparency and traceable underlying assets are the norm.

Per-Erik Eriksson, Helmut Kraemer-Eis and Alessio Conforti analyse the European market for microfinance in the context of the European small and medium sized enterprise (SMEs) landscape. Their assessment suggests the co-existence of several microfinance business models that cover shades of both finance and non-financial support services like training and counselling. These activities aim to induce the emergence of income-generating activities. They therefore have to pay close attention to the needs and entrepreneurial characteristics of potential clients, of productive users. These can be individuals, start-up companies or ones already operating; there is a variety of resource-seekers. Equally varied is the number of providers who themselves are developing. Hence, we are witnessing evolving specific markets (or sub-markets) for finance and organisation-related support services that require attention of both users and providers. Simple, generic assertions regarding demand or supply cannot be taken to reflect the variegated, multifaceted realities that make up the microfinance network. Flexibility and adaptation are, consequently, a prime characteristic that can see this specific sector develop in Europe in the years ahead.

Michael Bonello examines the relationship between credit for small business and economic restructuring and growth in the context of the Maltese economy. This

economy has registered a degree of resilience in the face of the global upheavals of the past four years, a fact that suggests that SMEs respond to both their external economic environment and, also, to those measures on credit support that enable them to see through difficult periods for trade and business transactions. Surveys demonstrate that small enterprises in Malta did not consider access to finance a main concern. But this could be because the demand for bank loans in recent years was comparatively subdued. This demand is well below the EU's average of 22%; it was 10% for Malta. Various explanations can be tempted: a mix of internal and external finance, postponement of investment plans, and, to a lesser extent, the level of the cost of capital. Finance, by itself, does not seem to have been a limiting factor. Indeed, it is proposed that the creation of a more congenial environment, with an emphasis on innovation, research and development and marketing, may be critical for economic restructuring and income sustainability in the SMEs sector in the years ahead.

Karol Gabarretta highlights the general approach of the Malta Financial Services Authority (MFSA) to microcredit and microfinance. The MFSA is the regulator for financial services in Malta and therefore the presentation clarifies the relationship between the law, as is and as interpreted, to microcredit institutions in the Maltese Islands. *Prima facie*, it seems that the area of microfinance may not be so well recognised nor utilised to a significant extent in Malta; hence the absence of 'pure' microfinance institutions on the Islands. But this could be because of the way in which local legislation regulates the banking licence. Indeed, the MFSA did register one institution that 'voluntarily subscribes with relevant associations that seem to be committed to the undertaking of so-

called payday lending in a safe and responsible manner, with an appropriate level of consumer protection'. This meant the inclusion of principles within the licence which aim to address the potential for vulnerable customers becoming over-indebted: e.g. maximum 'payday' loan amount indexed to borrower's income; a 'cooling off' period; no rollover of borrowers' loans; no advances to finance a borrower's unpaid interest and fees; once total indebtedness is paid in full on or after the due date, there has to be a one day 'cooling off period' before a new loan is contemplated and acceded to.

Part Two, examining particular experiences from several countries, starts off by the contribution of Gaetano Giunta and Domenico Marino. These writers analyse the role of those 'enterprises/initiatives' that have a priority in attaining wide social goals in the context of the hypothesis that 'greater income and wealth inequality is a stimulus for economic growth'. Using cluster analyses, they draw on the strong similarities that emerge from patterns of economic and social characteristics in the entire Mediterranean basin, throughout Italy, and in a specific South Italian region. They put a case for 'social cohesion' as a means of breaking a seemingly rigid pattern that has emerged over time, which tends to render income and wealth inequalities almost a 'prerequisite' for economic growth. In turn, they illustrate how such a 'socially cohesive model' may be implemented drawing on the experience of the Community Foundation of Messina in Sicily. It is possible to integrate several goals – economic, demographic, cultural, and environmental – within the confines of well-designed projects from which many may benefit both in the medium and in the long term. Such projects lead to a series of achievements. These are personal and social empowerment, active participation

in an economy by individuals and companies, vibrant educational systems that stimulate the search for talent in various areas, and 'responsible consumption'.

Fabio Salviato illustrates the transition from 'a dream to realisation' with examples from the experience of the Banca Popolare Etica set up in March 1999 in Italy and the efforts that went into the project of setting up a similar initiative in Palestine. This latter case, still a 'dream', would have brought together several participants from various countries in the Middle East and the European Union. The project in Italy materialised and is evolving steadily; the project in Palestine is still on the drawing board awaiting calmer times in the region and capital resources before it can proceed to the implementation stage. But Salviato emphasises the need to 'dream' as a source of inspiration prodding enterprise and solutions: using monetary resources efficiently one can create a better future for a larger number of people, a future where peace and well-being can support each other in the interest of many.

Lars Hektoen narrates the experience of Cultura Bank, a Norwegian savings bank established in 1997 to offer an 'alternative' to conventional banks in that country. Cultura seeks to focus on the sound development of the real economy, meaning that it does not focus solely on pure financial activities as the end-all of its existence. Hektoen draws on Cultura's familiarity with the Competition and Innovation Programme (CIP) managed by the European Investment Fund on behalf of the European Commission. He highlights a basic fact that percolates most of such activities: financial instruments are useful to fill certain gaps in raising resources, lending them, and following up processes for sustaining micro-credit activities. But there are basic administrative overheads and running

costs that have to be borne by the micro-credit institution. Therefore, the micro-credit institution must generate surpluses in other activities in order to continue to attract resources and be in a position to support/subsidise selected initiatives.

3. Conclusion

The papers present the challenges that lie ahead if 'dreams' of desirable objectives are to become realisable and yield the expected results. There are wide gaps in wealth and income creation the world over, whether measured on a global, national, regional or locality basis. The search for human empowerment and equity has to be tempered with the drive to encourage enterprise without losing sight of social cohesion through the spirit of solidarity. But this quest implies the search for the suitable institutional set up that can bring together solidarity, subsidiarity, sustainable income growth as reflected in demographic evolution, flexible economic systems, and sound governance throughout the respective units that constitute a community (families; productive units; public sector institutions, international organisations).

The main ideas that are put forward to stimulate discussion refer to the continuous need to study societies as they evolve. We have to be constantly aware of the uncertainty that at all times encompass future economic and social activities, and of the necessity to critically address from time to time the underlying models that guide human behaviour, the tools used in reaching our goals, and the people who implement them. We have to avoid blaming tools when the problems lie with the people who use them.

The contributors to this publication are practitioners in their field. Therefore they focus on the pragmatic day-to-day operations in the context of going for long-term objectives. They are not blinded by the fact that the objectives are desirable in themselves. Rather, they point out the limitations of the models and tools at hand and, as a consequence, soberly discuss possible ways to proceed ahead in the face of various uncertainties and prerequisites for success.

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PART ONE
ISSUES, MARKETS
AND REGULATION

ETHICAL FINANCE AND FEBEA Results to date and way ahead

A hundred years ago, a group of Maltese led by a Jesuit priest set up a savings institution to encourage Maltese workers' families to save. It also provided small loans. Similar groups in Bilbao, Spain, and Trentino, Italy, invented what we call today 'micro credit'. The world needed almost a century to recognise this innovation and gave the Nobel Peace Prize to Muhammad Yunus and Grameen Bank in 2006. This was one of the reasons why we chose the subject "Micro-credits as a tool of ethical finance for sustainable development".

The two other reasons were:

- the project "Active Europe", aiming at encouraging the financing of social inclusion by job and activities creation; and
- the way we can define what ethical and alternative banks are, showing concretely how we act daily.

Every year FEBEA organises its annual general meeting in one of the countries where the members are located. This year, FEBEA is really proud to organise its general assembly on the occasion of the 100th anniversary of APS

Bank, which is one of the more active members of the Federation.

FEBEA was created among several saving and credit co-operatives, namely, the Caisse Solidaire du Nord Pas de Calais (France), Credal and Hefboom (Belgium), an investment company in Poland called TISE, and two banks : Banca Etica (Italy), set up in 1999, and Crédit Coopératif, a French co-operative bank involved since 1983 in the support of solidarity-based finance and co-founding member and shareholder of the Bank for Social and Economic Initiatives, the BISE Bank, a Polish bank set up with the Polish Ministry of Labour in 1990.

Two other members joined shortly after: La Nef (France), a saving and credit co-operative associated with Crédit Coopératif, and the Bank für Sozialwirtschaft - BFS (Germany), a bank specialized in the social and healthcare sector in Germany. Those two entities were considered as founding members.

The need for such a network

Above all, creating common tools was one of the reasons for establishing FEBEA. And FEBEA did come out with concrete solutions to common problems. These include the mutual guarantee fund named *Solidarity Guarantee*, run by Crédit Coopératif, which covers the loans granted by the FEBEA members, in France, Italy, Belgium, Germany and Poland ; the investment co-operative company, *SEFEA*, the European Ethical and Alternative Financing Company, run by Banca Etica in Italy, which operates in Italy, France, Belgium, Slovakia, Poland and Norway; *Solidarity Choice*, a mutual investment fund run by Ecofi Investissement (Crédit Coopératif's asset management

subsidiary), which can invest up to 5% of its assets in FEBEA members securities (Bank Für Sozialwirtschaft (DE), Etimos Italie (IT) and La Nef (FR) were beneficiaries of this financial instrument) and finally *CoopEst*, an investment company registered in Brussels that aims to finance microfinance institutions, co-operative banks and mutual insurance companies in the new European Union's member states.

FEBEA members joined their forces to strengthen the equity of Banca Etica (Italy), Credal (Belgium), Cultura Bank (Norway), Integra (Slovakia), Merkur Bank (Denmark) and TISE (Poland) when needed, proceeding by a direct participation or through SEFEA. All these interventions reached a total amount of around twenty million euros. FEBEA members also share a certain number of co-financing projects for around 30 million euros.

Three projects are presently in preparation:

- The more advanced is *FEFISOL* – the European fund for solidarity-based financing, which is the result of four years of discussions and co-operation within the FEBEA commission called « Financing the South and Fair Trade »;
- The *Active Europe* project gathers more than 10 FEBEA members who are studying the feasibility of a European Fund for Ethical Microfinance, which could be run by SEFEA ;
- And a *Climate Fund* is being elaborated, an investment fund dedicated to projects contributing to fighting both poverty and climate change in least-developed countries in Asia and in Africa. Such fund will enable the scaling up of social projects using carbon finance and therefore wide-spread efficient technologies in the field of energy efficiency in favour of the poor.

FEBEA, chaired between 2001 and 2007 by Jean-Paul Vigier, founder and Chairman of the Board of SIDI (International Company for Development and Investment, based in France), was created on the basis of the founding project that forecast the creation of a refinancing bank beside Crédit Coopératif for all the ethical finance initiatives existing in the European Union. This founding idea was code-named ‘the European Alternative Bank’.

Who are our members? Successive waves of other financial institutions joined the first circle of founders. Nowadays FEBEA counts on 24 members, among which 9 are also members of the International Association of Investors of Social Economy (INAISE) and 6 form part of the European Microfinance Network (EMN). Thirteen are co-operatives; seven are limited liability companies, while there are 2 foundations, one Charity and one Spanish saving bank.

This short summary highlights one important factor: FEBEA is a concrete, pragmatic yet heterogeneous institution in terms of the form and the localisation of its members.

But at the dawn of the tenth anniversary of FEBEA, a lot more needs to be done. Even though, we are happy to state, that many steps have already been made.

Indeed, the name of our federation includes the word “alternative”. But what does it mean? The inclusion of this term is attributed to the Alternative Bank Switzerland (ABS) that became a member in 2003. When it was created, 20 years ago, Switzerland was being shaken by the scandal of the bank accounts despoliation of the victims of World War II, in particular the Shoah ones. The founders of ABS created an “alternative” to the Swiss banking system that relies on the secret of ‘banking’. They founded a bank

where the names of the borrowers are known and where every customer who wants to make a deposit signs an attestation to confirm that he or she complied with the tax office obligations.

In several other fields, the banks of FEBEA created alternatives to the mainstream banking system. One can mention Banca Etica that finances social co-operatives in Italy which manage the lands and other items seized from the Mafia; La NEF, Merkur Bank, Cultura Bank et Ekobanken, are pioneers in the financing of sustainable development initiatives; Charity Bank (United Kingdom) and Tise which are the sole institutions on their market to finance not-for-profit organisations; Colonia Caixa Pollença which supports the local economy in the Balearic Islands, like FEMU Qui in Corsica.

But we still have not invented a real “alternative” model in terms of credits and loans, in other words, a model that can lend money to those who do not dispose of guarantees, that can fix the interest rate depending on the payment facilities of the customer, that can provide capital to those promising projects that do not have the available resources to start up.

We can mention very interesting experiences and step forwards, but these are still being tested. For instance:

1. The sharing of the saving returns. Launched by the GLS Bank (Germany), the idea was developed by the Crédit Coopératif (FR) for its financial investments in 1983. Nowadays, it is the basis of all FEBEA members’ activity, with a few rare exceptions.
2. Etica Sgr, the asset management company of Banca Etica (IT), shows how to affect 1 Euro for each 1,000 euros invested to guarantee the programme for micro credits managed by Banca Etica.

3. Other examples can be highlighted like the mutual guarantee fund *Solidarity Guarantee*, which covers a mix of several sectors and countries and which is run by Crédit Coopératif, the joint guarantee circles which consist in a group of persons who stand security for one borrower, the reduction of the interest rate in relation to the environmental impacts of the project financed. But all those experiences need to be first reinforced and then “commercialised”.

Our ambition for the coming years?

We think of devising a new way of financing the creation of economic activity in Europe, with a double objective: job creation and the promotion of sustainable development. Both these conditions are necessary to ensure social cohesion and economic sustainability, which are the cornerstones of the unification and the further development of the European Union.

In order to dispose of the means to achieve such ambition, there are two challenges that our federation is willing to meet for the coming years:

1. There is a need to create financing and mutual assistance mechanisms among members, which should enable them to overcome the temporary difficulties and, above all, be independent and invulnerable regarding the changes that would appear inevitably in their national banking systems.
2. Our second challenge is to contribute to the creation of new ethical financial institutions, because ethical finance is indispensable to promote the citizens’

initiatives contributing to the social cohesion and sustainable development in the European Union. Moreover, the Basel III regulation is going to accentuate the exclusion of the social sector and the SMEs and SMIs sector from the mainstream banking system.

In order to take up the first challenge, it is essential to find what brings us together and develop common tools. For example SEFEA should become a more pronounced investment tool of the European ethical finance in order to provide around 30 to 40 million euros of equity indispensable to reinforce the existing members and develop the new ones over the next two years.

In several new countries of the European Union, the number of credit unions, which are saving and credit institutions, is increasing. This co-operative system, which is close to its customers, can be welcomed by the European family of the social and ethical finance.

Banca Etica, La Nef and Fiare worked on a common project to create the European Ethical Bank for three years. Such initiative has never been tried before among the ethical banks in Europe. They are trying to reinvent the initial project that was at the origin of FEBEA. The road is very hard but full of promises.

The programme for the coming years seems to be quite ambitious; some of you may even consider it as unrealistic. But, as Adam Mickiewicz, a great Polish poet born in Lithuania at the end of the 18th century, said in "Ode to the Youth" (1820):

"Assess your strength by your projects and not your projects by your strength."

And FEBEA, in 2011, will only be 10 years-old. FEBEA will have the strength of youth to meet the true challenge

of the ethical finance: invent and spread wide the new forms of financing and banking services.

Finally I want to thank again APS Bank for their welcome. Their joining FEBEA and their active participation have always showed their commitment to exercise an ethical and alternative finance, placing people and general interest before profit. But still APS generates very reasonable rates of return. Its model is all that FEBEA aims to promote and support.

This General Assembly is therefore expected to be extremely rich and constructive. I want to believe that the eruption of the Icelandic volcano Eyjafjöll wasn't organised on purpose to add spices to our meeting and make it even more memorable!!

MICROFINANCE An Emerging Asset Class?

Introduction

It might be paradoxical to be discussing microfinance as an asset class, just as the clamor from India is reaching deep into the public at large and is echoing with socially responsible investors. Yesterday's certainties like the apparent delinking of microfinance with the performance of the economy at large, or the health of the financial sector, no longer hold true. Tales of over-indebted borrowers defaulting in throngs have been rocking the boat from Morocco to Nicaragua, let alone India.

Without delving into polemics, this article aims to explore whether microfinance has developed as an "industry" and whether it has reached the status of a fully fledged asset class, worthy of portfolio allocation by institutional investors.

Microfinance worldwide is growing of age. It has long gone beyond the reprieve of the *do-gooders*, piloted by foundations, or offspring of NGOs. A large scale institutional transformation of microfinance institutions (MFIs) has taken place in countries with appropriate regulatory frameworks, warranting the emergence of

large scale players. The importance of enlightened regulation is critical, not only to foster the growth of responsible lending institutions, but also to help shield MFIs from political risk. Hence, the legal status and governance structure of an MFI are key to help bridge the access to finance gap for the poor. How successful a microfinance institution can be once it gains national significance in any country will depend largely on the quality of its staff and its systems, internal audit, risk underwriting and monitoring procedures, internal controls, access to funding, and so on. Granted. But, first and foremost, without the proper governance and ownership of demanding shareholders/investors, an MFI cannot become a long term financial player that can withstand both the demands of its target public in a socially responsible manner, while adhering to financial soundness in a fast evolving environment. The demise of Morocco's Zakoura Foundation which precipitated the crisis of the sector in that country (because it is a systemic player) stems precisely from failures in governance where the Board of non-owners was incapable of fending off the errors of its historical founder. Charismatic leaders may be visionaries at the inception of a social concept. Often, once an activity becomes mature, those leaders fail to see the wind turn and appoint competent staff to run the business in a competitive industry segment. Only a Board emanating from investors who have "skin in the game", preferably screened by the regulator for their ethics and financial fluency can fulfill the governance role needed for the next decade and beyond.

Furthermore, we also need shareholders who are deep pocketed, and who can provide the resources in the form of additional capital, should a crisis occur. That is precisely why microfinance needs to be commercial, be it a socially-

oriented business. We would argue that mission drifts or rapid irrelevance actually becomes the fate of those MFIs which do not transform into commercial outfits.

Microfinance and the financial crisis

For many years, microfinance was described as “de-linked” from economic cycles, and immune from the cycles affecting financial markets. As the theory goes, poor people showed a remarkable resilience to economic downturns, rapidly shifting inventories and productive activities to staples and basic commodities that would continue selling amidst stringent times. Loan compliance would stay stubbornly high, even through hard times, when regular commercial banks would face spiraling non-performing loans (NPLs). If this equation held true for most of the last decade, this idyllic picture started to burst at the seams in late 2008. The depth of the financial crisis indeed meant a general liquidity tightening that squeezed out many MFIs that were most exposed to the markets for funding. Adding to that, the rapid spread of news in overheating microfinance markets (e.g. Morocco, Bosnia, Nicaragua), aggravated then the perception that MFIs were no longer a haven of cycle-resistant financial activities.

There are many lessons to be learnt from the recent financial crisis. The most important one is that as microfinance is more commercial and integrated in the mainstream financial sector, it becomes inherently more cyclical, hence exposed to crises. Global figures would put the industry at a size of around US\$30 billion, reaching 130 million clients worldwide. Prior to 2008, crises were confined to specific countries, as opposed

to being a regional or sub-regional phenomenon. According to a survey of 400 MFIs carried out by the Consultative Group to Assist the Poor (CGAP, 2009), about 60% of respondents indicated that their clients are experiencing payment difficulties, expressed as a greater incidence of arrears (69% of respondents). This phenomenon showed up with greater incidence in the Europe and Central Asia regions, followed by Latin America. The second lesson from the crisis is that the rise of the portfolio at risk (PAR, broadly defined as past due loans after 30 days plus restructurings) took place with a significant time lag after the banking crisis started to gripe financial markets. The PAR did indeed rise to previously unseen territories: the common rule of thumb of “less than five per cent” dramatically rose to the ten percent range, or way beyond, especially in those markets affected by systemic shocks.

The third most important lesson of the crisis is that its magnitude was aggravated for those MFIs with a funding concentration from commercial banks. In 2009, CGAP reports that as the financial crisis unfolded, deposits worldwide fell in most economies (in 77% of markets), with the ratio of deposits to GDP falling 12% points (from 72% to 60%) (CGAP, 2010). The sharp drop in refinancing resources has meant that MFIs could no longer tap commercial funding for growth, either through loans, securitizations, or syndicated facilities. This also impacted Tier II and III MFIs, especially in urban areas, and in those markets where there are peaks of over-indebtedness.

There is, however, a silver lining to this troublesome picture: in general, those deposit taking supervised MFIs have been less affected by the credit crunch. There are of course exceptions to this general trend, with well-publicized failures, or near failures of deposit-taking

institutions such as in Cameroon, Benin and Montenegro. The ECA region in general got the worst hit, with about two-thirds reporting declines in assets, and over one fifth of MFIs worldwide having to downsize their staff to trim costs. This has marked a clear reversal of the expansionary trend in staff levels and portfolio over the years before, with customary loan growth rates in the 30-40% p.a. range, and also led to MFI borrowing costs becoming dearer.

Moving Ahead

In spite of localized breakage linked to a combination of factors described above, the most important moral of the crisis is that well-regulated deposit taking institutions were definitely more shielded and could somewhat stave off the global credit crunch. In addition, good old country risk and political interference risk have managed to retain the front page of investment criteria for all: from multilaterals, socially responsible, to institutional investors. But it is very positive that breakage did occur: investors now are keenly aware that they need to conduct in-depth due diligence; they also need to focus on multi-dimensional risk analysis, including region/country/market and institution-specific risks. In an industry that is still extremely fragmented and in need of consolidation, not to back portfolio allocation by systematic, in-depth risk profiling would be suicidal.

In sum, fundamentals and investment prospects remain strong, although some markets overheated through excessive competition not supported by adequate regulation and supervision, and in some instances, weak governance and lack of adequate financial infrastructure.

Our argument is that the very fact that there has been a downturn, and that cycles are emerging gives investing in microfinance at least a rock bottom scenario and highlights the need for both risk and sensitivity analyses. Where a specific MFI is located on the cycle must be part of risk underwriting to decipher institution, versus sector-specific risks. And this cycle has specific attributes that we refer to as: inception, or delinking of microfinance to the financial sector and the economy at large; euphoria, or unbridled growth (both investor-borne, and borrower-borne); slowdown and excessive competition leading to over-indebtedness; downturn and crisis. So far, because of the difficulties in targeting remote and rural areas and the relatively underdeveloped agri-based lending technology, this cycle is mostly applicable to urban areas, as rural markets remain far behind in the race for greater financial inclusion.

But looking into the future, we argue that industry fundamentals still show interesting investment opportunities, especially as there are opportunities for consolidation along with the arduous task of far-reaching adjustments in the operational and risk management model of many MFIs. Beyond consolidation, there is a need for a deposit-led approach for building stable financial systems targeting the underserved populations. What goes with that is of course regulatory competence and the strength of specialised supervision (preferably from an independent central bank to minimise the risk of political interference), as well as a strong financial infrastructure in the form of credit bureaus. There should be no size limitation as to the type of credit data reported to credit bureaus, and there should be no exception as to deposit protection insurance and the degree of supervision scrutiny to protect small depositors. Failures to this

premise would otherwise stain microfinance beyond remission for both institutional and socially responsible investors, let alone the public at large.

Microfinance as an Asset Class

Microfinance has yet to become an established asset class for institutional investors. At best, we can describe it as an *emerging asset class*. We define an asset class as a distinct investment proposition that is suitable for inclusion in large institutional portfolios. In order to be suitable for a global investment allocation, the asset class must fulfill a certain number of requirements:

- It must be recognisable as a distinct kind of asset;
- It is relied upon to perform consistently in similar circumstances;
- The asset must be liquid so that managers can trade, warehouse and alter allocations;
- The asset must be backed by significant industry research, ratings, listings and significant volumes to be worthy of a portfolio allocation;
- A track record to ascertain asset behaviour over time must be readily accessible on all of these dimensions.

Where do we stand?

The crisis has paradoxically helped shape the industry closer towards the category of an asset class, especially because sensitivity analyses are helping industry watchdogs establish both a high and a rock bottom financial performance in stress scenarios. The evolution of those listed securities through favorable and challenging trends provides some backbone to industry analysis.

But, this is the exception that confirms the rule: there are very few listed microfinance securities, in spite of the big bang steered by the likes of SKS and Compartamos. In addition, few debt instruments are also traceable and listed. In conclusion, microfinance is an asset class under development, but *we are not there yet* to call it a fully fledged asset class.

The homogeneity of microfinance brings it closer to the definition of an asset class, especially as a result of the crisis, but it critically falters when it comes to liquidity: markets are not likely to develop further, say like traditional commercial banking, until there is a critical mass of exposure among a large number of investors. In this latter hypothesis, we would have to establish a community of willing buyers being matched with willing sellers, and being supported by recognised trading platforms.

I believe that this is a roadmap worthwhile chartering. There are several markers that can help design the path forward:

- Further mainstream rating agency involvement is needed in rating MFIs and collateralised debt obligations, although many are taking the lead and a rapprochement is already taking place between specialized and mainstream raters;
- Securitisations must return as a legitimate financing liquefying technique (see below: case studies), provided transparency and traceable underlying assets are the norm;
- The gradual involvement of leading and well managed banks in the sector will accelerate its recognition (players such as JP Morgan, BNP Paribas and Standard Chartered are proactive in this respect);
- The continued involvement of International Financial Institutions (IFIs) such as IFC and KfW through credit

enhancement and their ability to invest in market downturns (e.g., the Microfinance Enhancement Facility – MEF, launched in early 2009 to address the liquidity problems faced by MFIs).

Challenges & Catalytic Factors

There are many challenges in the path forward. We have mentioned India, and the damage that Andhra Pradesh is doing to the perception of the asset class. But to refrain discussing political risk, there are many objective and tangible challenges ahead. Challenges, which hopefully will not become roadblocks, are the following:

- There is generally less transparency and data available for MFIs than larger financial institutions, in spite of the pioneering work of the MIX, and CGAP’s tracking of microfinance investment vehicles (MIVs);
- MIVs tend to be less diversified than collateralised debt obligations (CDOs) and have longer maturities;
- The exposure concentration of MIVs is too great as has been seen for those investment vehicles over-exposed to countries such as Nicaragua;
- The risk perception of MIVs remains comparatively high, thereby stemming the appetite of investors and prompting the need for subordination (junior investment tranches) by donors and IFIs.
- CDOs have hardly returned to normalcy.

There is no reason for undue gloom. Even if the Reserve Bank of India (RBI) remains on the sidelines as the crisis is unfolding, rumour has it that the Indian central bank wishes to open the tap of securitisation as a way to relieve the liquidity pressure on the embattled sector.

If, for example, securitised MFI paper could become listed in India, that would represent a tremendous boost for what is still today the largest microfinance pool of assets. But that might remain wishful thinking. Barring political and regulatory futurology, there are nonetheless many existing positive elements in the road towards the asset class. The consistent role of the commercial banks mentioned above, throughout the crisis, and the counter-cyclical approach of IFIs have established a baseline of consistency. Hence, these are catalytic factors that are helping microfinance evolve from being a sector towards developing as an industry (hence towards an asset class):


- The work pioneered by CGAP (Brigit Helms, Elizabeth Littlefield, Alexia Latortue, Xavier Reille, to name but a few) has established a remarkable lexicon of best practices on a worldwide scale, in sync with CGAP as the industry benchmark setter, as it developed the meso dimension for microfinance (i.e., key aspects of the financial infrastructure and regulatory framework). Best practices as documented by CGAP provide the foundation for industry analyses and comparisons that outshine any such work with respect to SME lending;
- Rating agencies are increasingly more cognizant of the sector which is a must for institutional investors. Their work complements the niche of specialised raters which can further develop as social and environmental rating entities (notion of triple bottom line);
- There are a number of pioneering public debt offerings by prime microfinance players that have helped establish a track record and contributed to prerequisite roadmarks (e.g., ProCredit, BRAC, Compartamos, MiBanco...);

- IFIs like International Finance Corporation (IFC) are likely to keep as their core strategy to deepen the sector and provide value added through credit enhancement, local currency facilities and mezzanine finance. Their consistent role as AAA rated investors fulfils an advocacy mission and brings to bear a global knowledge and expertise;
- Many well-known universities have developed specialised business and finance programmes dedicated to microfinance, building upon the body of knowledge and research.

Case Studies

I would like to mention two emblematic pointers that are tangible proof that microfinance is developing towards becoming an asset class.

The first one is a now much-forgotten landmark bond issue launched by Compartamos in 2004, and winner of the Latin Finance Deal of the Year Award. Before Compartamos became a bank and a listed financial institution, the then much lesser known limited purpose MFI was facing considerable funding constraints hampering its growth. It was not allowed to take deposits, neither was its corporate rating sufficient to reach institutional investors, beyond limited scale private placements. IFC then came into play and provided credit enhancement to Compartamos' shelf bond issue in the form of a rolling guarantee, as per the following structure:



Bond size	MXN500 million (US\$44 mil equiv.) in 2-3 tranches	Security	unsecured, pari-passu with the bondholders
Maturity	5 years - 3 year grace, monthly amortization	Rating Upgrade	mxA+ on its own / enhanced mxAA by S&P and Fitch
IFC Guarantee	34% of the outstanding principal, covers debt service	Target Investors	pension funds, mutual funds, insurance companies
Currency	disbursement in MXN becomes a USD loan to IFC	Arranger	Banamex/Citibank

The main benefits of the structure were manifold for Compartamos and for bondholders:

- The IFC guarantee meant a lower probability of default and better recovery prospects, should a default have occurred;
- The guarantee would kick in prior to a payment – liquidity event- occurring;
- The guarantee-backed paper achieved a AA rating (vs. Compartamos, then “A” rated), hence enticing investors to enter the sector and study microfinance which was still perceived as an “exotic” activity. The Mexican Comisión Nacional Bancaria y de Valores was much more supportive of an enhancement to AA (instead of AAA), so as to engage the fiduciary responsibility of investors, and elicit an in-depth analysis of the underlying activity of the issuer;

- For Compartamos, especially for the second tranche, which was three times oversubscribed, it meant recognition and reach to established institutional investors as a legitimate financial player. It also meant longer maturities than henceforth for this type of paper and access to a larger and more stable funding base. Useless to say that the demonstration effect of the rolling guarantee was powerful: Compartamos' subsequent bond issues no longer needed credit enhancement.

Our second case study is much more recent since it dates back to January 2010; it also has had offspring, including one very recent transaction in the midst of the Indian crisis in December 2010. I wish to highlight the case of IFMR Trust, a Chennai-based, Tamil Nadu wholesale player. IFMR Trust truly innovated in the field of financial engineering since it is the initiator of the first ever Multiple Originator Securitisation (MOSEC) of underlying micro-borrower loans. Also remarkable is the fact that IFMR was able to package underlying loans from four small to mid-sized MFIs, which typically have limited access to the capital markets and which may lack substantial amounts of capital to generate enough unencumbered portfolio assets for a true sale securitization. The issuers were Asirvad Microfinance Pvt Ltd, Shayata Microfinance Pvt Ltd, Satin Creditcare Network Ltd and Sonata Finance Pvt Ltd. The issue itself is very small in Western terms: only about US\$6.5 million equivalent, hardly an amount that would have mobilized mainstream investment banks! Yet, it was successfully structured on the basis of the financial soundness of the issuers and the quality of their microloan portfolios. Here are the details of this landmark transaction:



Size	Rs.308 million (US\$6.5 mil. equiv.) in 2 tranches	Maturity	11 months
Senior P1+ rated tranche	Rs.237 million (US\$5 mil. equiv.) Subscribed by the treasury department of a bank	Average loan size	Between Rs.4,200- 15,000 (US\$88-316)
Unrated subordinated tranche	Rs. 71 million (US\$1.5 mil. equiv.) Subscribed by IFMR Capital	Credit enhancement	Rs.41 million cash collateral to meet shortfalls in pool securitized by Originators
Number of contracts	42,079		

The main benefits of the first ever MOSEC in microfinance are multiple:

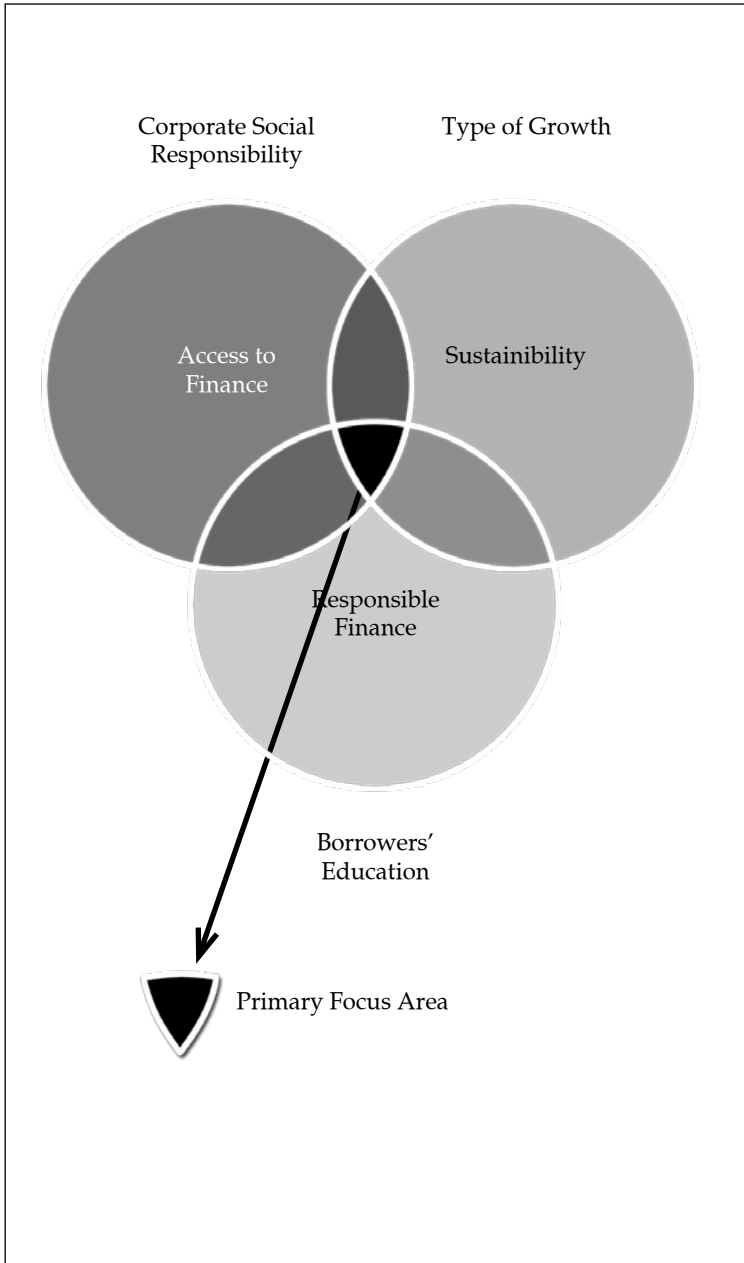
- Investors benefit from diversification via an asset backed by 42,000 micro-loans originated by a geographically diverse set of MFIs, and still today, low correlation to other asset classes;
- For Indian capital markets, it resulted in the diversification of investment paper, encouraging institutional investors to tap into a new sector, while expanding the range of P1+ (short term) investment instruments, and introduce microfinance as an eligible asset class;
- For originators, it diversifies their sources of funding and reduces funding costs as a result of the credit enhancement structure.

Social Safeguards – how can microfinance help the productive poor?

Because microfinance is so much in the news and the subject of vivid discussions, I wish to conclude this overview on the evolution of microfinance as an *emerging, or proto-asset class* with our thinking on why and how access to financial services can alleviate poverty. First, we should refrain from the one size fits all type of approach: microfinance is not a miracle drug; neither can it have overnight results. Financial inclusion, alongside access to energy, access to healthcare and education are all necessary, but not sufficient ingredients in isolation to ensure upward social mobility.

In the debate on mission drift, and the polemics on “profiting on the back of the poor”, we have stated here that highly professional, well managed financial institutions backed by strong governance from a qualified board can best mobilise resources to grow and begin to chip at the enormous gap in access to finance for the poor. Those professional MFIs, in turn need enlightened regulators and specialised supervision on the back of developed financial infrastructure to grow responsibly.

The fundamental question is not which model of microfinance is best fitted to alleviate poverty. Instead, I wish to uphold the principles of Responsible Finance which should remain at the core of an MFI’s mission, and should result in tangible strategic steps. The best MFIs, therefore, to remain sustainable and grow responsibly should avoid peddling debt in terms of market share. They should maintain a core focus on the intersection of the three key variables in the graph on the following page.



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MICROFINANCE IN EUROPE

Executive Summary¹

Microcredit in the EU means loans smaller than EUR 25,000. It is tailored to micro enterprises, employing fewer than 10 people (91% of all European businesses), and unemployed or inactive people who want to go into self-employment but do not have access to traditional banking services. 99% of start-ups in Europe are micro or small enterprises and one third of these are launched by people who are unemployed.²

The efficient support of the European microfinance sector is an important way of further developing this young market segment; it is also an immediate reaction to attenuate the effects resulting from the current crisis. The findings of this analysis show that there is a potential market gap; especially important in this context is the expected positive effect on employment for both job creation and job sustainability.

In this paper we first explain in detail the meaning of microcredit.³ As the beneficiaries of microlending are often micro enterprises (or they create micro enterprises), we explain in the second section the European SME

landscape with a special focus on micro enterprises. In a third part we focus on Microfinance Institutions (MFIs) before we analyse in the fourth part aspects of social inclusion, job creation, and market gaps.

The main findings of this paper can be summarised as follows:

- Financial exclusion in Western Europe is often concentrated among the people suffering from poverty and social marginalisation. But also in Eastern Europe the exclusion from traditional banking services constitutes a major obstacle to the launch of new business activities.
- While research in the field of microfinance in Europe is still in its infancy, there is clear evidence that microfinance is an effective financing channel for job creation and social inclusion.
- The objective of microfinance is the creation or expansion of income-generating activities. Evidence collected from studies, surveys conducted by microfinance market participants, and from EIF's own experience in the field indicates that there is still a significant un-served market demand in Europe.
- SMEs constitute the majority of all companies, irrespective of national boundaries. The majority of these companies are micro enterprises; in the EU-27, 91% of the companies have less than 10 employees. The ability of a financial system to reach such small entities is crucial for the achievement of general socio-economic improvement.
- In the EU member countries, micro enterprises are often present in the following sectors: construction, real estate, and hospitality, as well as in wholesaling and retailing.
- The European microfinance market presents a dichotomy between the Western Europe and

Central Eastern Europe in terms of characteristics of intermediaries, target beneficiaries, loan size etc. In general, there is no common microfinance business model in Europe.

- The average size of microloans in the EU is increasing. In 2007, the average microloan size across the EU sample was around EUR 11k, compared to EUR 7,7k in 2005. Lenders which focus on SME support and job creation tend to lend larger sums whilst those focusing on social and financial inclusion tend to make smaller microloans. Ratings of MFIs are gaining importance in the microfinance arena, but currently with a focus on development countries. The efficient support of this sector is not only an instrument to further develop this important market segment, but also an immediate reaction to attenuate effects resulting from the crisis.
- Often, there is a transformation process for MFIs: they start as NGOs and finance their business via donations and/or public money. Over time they “grow” toward formal financial institutions and regulated entities.
- In order to address a wide range of funding needs of microfinance intermediaries, and to reach out to the lower end of the microborrower segment, public actors appear critical to ensure the necessary initial subsidy element to catalyse start-up.
- There are wide spectra of final beneficiaries and intermediaries and the target groups of support measures need to be sufficiently broad in order not to unnecessarily confine the products and to provide efficient support. Moreover, the support measures themselves need to be flexible enough to fulfill the markets’ needs.
- Not only the financial support of the sector and the final beneficiaries is crucial: non-financial support measures,

- i.e. mentoring, training and counselling are important for the microfinance sector in Europe as well.
- Main challenge for MFIs in the EU is to develop and maintain a flexible and sustainable funding model for microfinance operations that allows them to realise their individual approach.

Framework

In December 2007, with the EC Communication “A European initiative for the development of microcredit in support of growth and employment” the EC has acknowledged that Europe lacks the necessary intermediaries, capital and environment to unlock the potential of microcredit in the EU.⁴ As the microfinance sector is not fully integrated into mainstream banking this emerging market has weathered the global financial storm remarkably well. However, in 2009 the market turmoil and credit crunch hit this sector as well. However, the situation is different from country to country and from actor to actor and it is difficult to identify common EU trends. Broadly speaking, the crisis has affected microfinance mainly by:

- a) difficulties in accessing external sources of funding: many financial institutions are currently facing major problems and refocusing on their core business and less riskier market segment (liquidity tightening, rising costs of borrowing);⁵
- b) an expected increase in losses and defaults (higher defaults, higher indebtedness of customers, possibly exposure to foreign currency risk);
- c) an increased demand driven by “riskier bank customers” which are not served by banks anymore;
- d) deposit taking Microfinance Institutions (MFIs) report that client cash needs have gone up, causing savings to be withdrawn and sometimes straining repayments.⁶

As a consequence, the efficient support of this sector is not only an instrument to further develop this important

market segment, but also an immediate reaction to attenuate effects resulting from crisis. This statement is further reinforced by the evidence collected for the twelve countries analysed in the annexes.

However, not only the financial support of the sector/final beneficiaries is crucial – non-financial support measures, i.e. mentoring, training and counselling are important for the microfinance sector in Europe as well. Based on a survey by the European Microfinance Network (EMN) it can be assumed that approximately 2/3 of the microfinance clients are benefiting from assistance in helping them develop their activity.⁷

What is microcredit?

Microcredit is the extension of very small loans (below EUR 25,000) to entrepreneurs (typically micro enterprises, see next section), to social economy enterprises, to employees who wish to become self employed, to people working in the informal economy and to the unemployed and others living in poverty who are not considered bankable and therefore who are lacking access to traditional sources of capital.

Financial exclusion in Western Europe is often concentrated among the people suffering from poverty and social marginalisation. But also in Eastern Europe the exclusion from traditional banking services constitutes a major obstacle to the launch of new business activities.

The average microloan in Europe is – of course – small, but increasing. In 2007, the average microloan size across an EU sample was around EUR 11,000, compared to EUR 7,700 in 2005. There are wide variations from country to country and from region to region; for comparison: as of

end of 2008 the average (outstanding) loan size in EFSE⁸ for example was EUR 4,506.⁹

As policy tool, microcredit is considered to be cost effective: It is estimated that the average cost of support for microcredit schemes in Europe is less than EUR 5,000 per job created; hence it is typically cheaper than other labour market measures.¹⁰

The objective of microfinance is the creation or expansion of income-generating activities or micro enterprises and usually the principal need for the borrowers is working capital. The loans act as catalyst to improve the productive capacity. Hence, it is important that the borrowers are using the loans productively – if they do not, it just increases their indebtedness. This distinction between productive microcredit and undifferentiated lending needs to be kept in mind while increasing the volumes of microfinance support. Moreover, microfinance should refer to those “active poor” who prove to be technically skillful and entrepreneurial to be able to autonomously run an economic activity and to generate an appropriate cash flow (repayment of debt/savings/investment).¹¹

It might be argued that the market share of micro enterprises that do not obtain the necessary microfinancing, would be taken over by bigger companies so that the economy overall is in the same state. However, this line of argument disregards aspects like increased competition (due to the market entry of new players), employment effects, and the potential for higher reaction rates of smaller entities (and hence increased potential for growth of the economy).¹²

Sometimes, microfinance is referred to as being a tool to improve innovation and sustained economic growth. However, in this area, the potential is rather limited. Microfinance is able to increase employment and wealth,

but typically the microborrowers use their credits to create enterprises that do what others are doing as well – often in areas where there are limited economies of scale (the so called “replicative firms”). Only if these firms transform themselves later-on into innovative enterprises (new products, new services, use of innovative and productivity enhancing inputs, new modes of organisation etc.) they contribute to sustained economic growth.¹³ However, also without being innovative, the replicative firm (and with it the microlending as source of financing) can contribute to the social-economic improvement.

As the beneficiaries of microlending are often micro enterprises (or they create micro enterprises) in the following section we are going to have a brief look at the SME landscape in Europe.

The SME landscape in Europe

The European Commission defines the different enterprise categories based on the criteria headcount, turnover, and/or balance sheet total:

Figure 1: SME definition

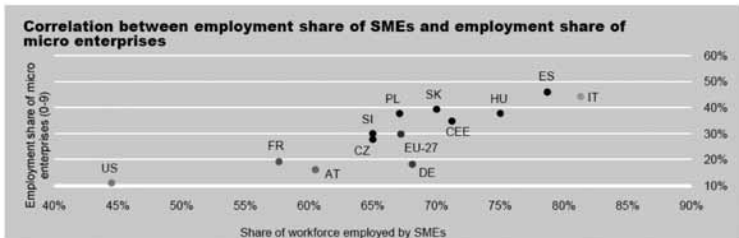
Enterprise category	Headcount	Turnover or	Balance sheet total
Medium sized	< 250	≤ € 50m	≤ € 43m
Small	< 50	≤ € 10m	≤ € 10m
Micro	< 10	≤ € 2m	≤ € 2m

Source: European Commission¹⁴

SMEs constitute the majority of all companies, irrespective of national boundaries and in most of the countries SMEs make the largest contribution to employment and value creation. In the EU-27, there are almost 20m SMEs (more than 99% of all companies),

providing more than 65m jobs. The majority of the companies are micro enterprises. In the EU-27, 91% of the companies have less than 10 employees. In the Mediterranean area the average headcount is below 5; this reflects the high proportion of family-run micro enterprises in this region (see for illustration also figures 2, 3 and 4 below).

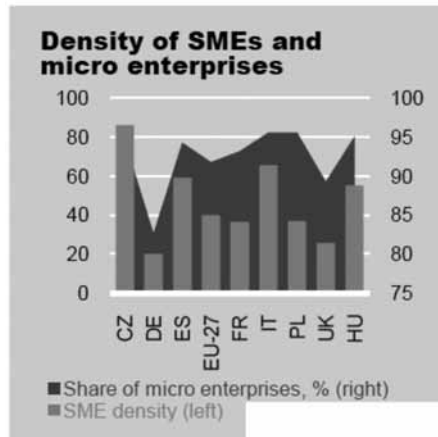
Figure 2: Correlation between employment shares of SMEs and micro enterprises



Source: Hohmann, Katharina (2009)

These figures are as well confirmed by density statistics (SMEs per 1,000 inhabitants):¹⁵

Figure 3: Density of SMEs and micro enterprises

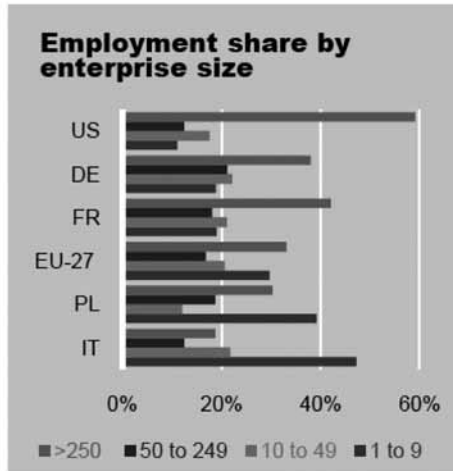


Source: Hohmann, Katharina (2009)

Typically, in European countries SMEs employ at least 50% of all people at work (in the US: around 42%). In Southern European countries, the employment contribution of SMEs is particularly high (e.g. Italy, Greece, Portugal, Spain) with 70 to 80% (for comparison: Germany 61%). In Central and Eastern Europe (CEE) the SME contribution is as well high (in the area of 70%).¹⁶

In the EU member countries, micro enterprises are very often to be found in the sectors of construction, real estate, and hospitality, as well as in wholesaling and retailing. In these sectors, more than one third of the enterprises have less than 10 employees and at least two thirds of the companies have less than 50 employees. One reason for this is that in the service sector there are often only limited possibilities for economies of scale and synergies and hence less than 50 can often represent an optimal size.¹⁷

Figure 4: Employment share by enterprise size



Source: Hohmann, Katharina (2009)

SMEs, and micro enterprises, are often called the “job-engine” of an economy and in fact the job creation/job growth rate in smaller companies is higher than in bigger companies. Micro and small enterprises represent 99% of the 2 million start-up enterprises that are created every year. One third of these enterprises are launched by unemployed.¹⁸ But to give the full picture: research from several countries shows also that this goes hand in hand with higher job loss rates in smaller enterprises compared to bigger companies.¹⁹ Statistics reveal that the survival of an enterprise is most difficult in the first year of operations and that the survival rate increases with the availability of microfinance.²⁰

EMN carried out its third survey on the activity of MFIs in 21 European countries (EU and Norway) covering 2006-2007 to detail the value and volume of credits granted, actors and target population, conditions and forms of funding.

In the Eastern EU countries (Hungary, Bulgaria, Slovakia, Romania and Poland), the majority of actors have been lending since the 1990s. The sector is therefore more mature than in the Western EU, but in some cases there has been a negative trend of loans disbursed between 2006 and 2007. As exemplified in the following tables (see figures 5 and 6), Eastern countries disbursed in 2007 a total of 15,793 loans equivalent to EUR 94m. Conversely, in the Western EU countries, the sector remains fairly young and still in an expansion process with microlenders active only since 2000. In the Western countries, the total number of loans disbursed in 2007 came to 26,957 loans equivalent to EUR 300m with nationally based lenders in France, Germany, Spain and Finland disbursed the greatest number of loans. In total, in 2007, the number of loans disbursed in the EU was 42,750 equivalent to EUR 394m. Eastern countries represented 37% of total loans and 24% of total value, whereas Western countries represented 63% of total loans and 76% of total value. On the whole, the number of active clients in the EU was 121,677 as of the end of 2007.²¹

Figure 5: Evolution of microloans in European Countries

	2005	2006	2007	Growth Rate 2007-2006
Number of loans	27,000	35,553	42,750	14%
In mEUR	210	295	394	32%

Source: Jayo, Barbara; Rico, Silvia; Lacalle, Maricruz (2008)

Figure 6: Microloans in Europe (2007)

2007		East EU	West EU	Number of Clients
Number of loans	42,750	15,817.5 (37%)	26,932.5 (63%)	121,677
In mEUR	394	96.56 (24% of total value)	299.44 (76% of total value)	

Source: Jayo, Barbara; Rico, Silvia; Lacalle, Maricruz (2008)

Microfinance Institutions as main actors

A Microfinance Institution - or MFI - is an organisation that provides microfinance services. In Developing Countries, during the 1970s and 1980s, the micro enterprise movement led to the emergence of nongovernmental organizations (NGOs) that provided small loans for the poor. In the 1990s, a number of these institutions transformed themselves into formal financial institutions in order to access and on-lend client savings, thus enhancing their outreach. Formal providers are sometimes defined as those that are subject not only to general laws but also to specific banking regulation and supervision (development banks, savings and postal banks, commercial banks, and non-bank financial intermediaries). Formal providers may also be any registered legal organisations offering any kind of financial services. Semiformal providers are registered entities subject to general and commercial laws but are not usually under bank regulation and supervision (financial NGOs, credit unions and cooperatives). Informal providers are non-registered groups such as rotating savings and credit associations and self-help groups.²²

We showed already that the microfinance sector in Europe is still young. Moreover, most of the actors are very small, it appears that most organizations do not grant more than 100 credits per year; nearly 70% of microfinance lenders employ fewer than 5 people in their microfinance programme. Overall in Europe there is no common microfinance business model and there are different types of microfinance actors, most of which are NGOs outside the formal banking system:²³

- NGOs: 28%
- Foundations: 26%
- Public institutions: 17%
- The rest (28%) is composed of banks, savings banks and other credit institutions (figures based on EMN survey).

The credit organisations can be divided into 2 groups:

- Those whose primary activity is granting microcredits (35% of all participants);
- Those for which microfinance is only a side activity (for 46% of participants it represents less than 25 % of their activity, and for 61% less than 50%).²⁴

Regionally the market participants can be distinguished:

According to market surveys prepared on behalf of EIF²⁵ and according to the market information gathering conducted by EIF, at EU level, MFIs are at different stages of their life cycles and need consequentially differentiated financial support for their business and growth. MFIs in the EU are broadly characterised by:

- in EU-15 (with a few exceptions) small size, very low or inexistence profitability, microfinance institutions heavily rely on subsidies to cover costs, very limited access to external sources of funding, social lending activity mainly targeting disadvantaged

- groups (immigrants, unemployed, etc), operational procedures are often not standardised, very high need for seed/developing funding for MFIs;
- in CEE by larger average size of the institutions, higher profitability, lending activity more focussed towards micro-entrepreneurs, difficult access to stable external sources of funding.

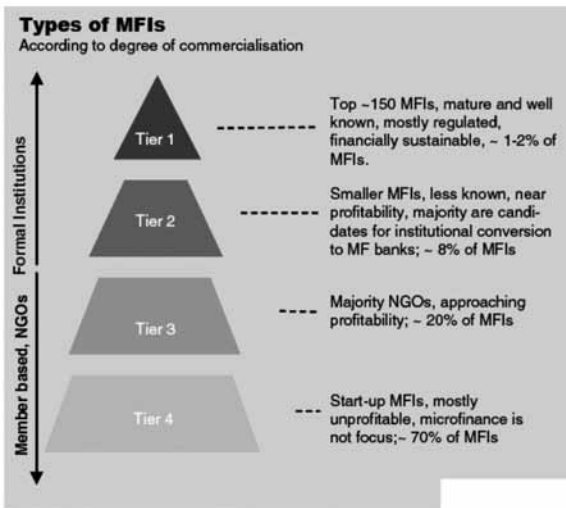
In CEE there are some IFIs (EBRD, IFC, etc.) and funds providers (i.e. ProCredit, Opportunity, BlueOrchard) active in the microcredit segment, whereas in EU-15 no IFI is providing funding to MFIs. EIF appears as the only EU wide actor in this sector.

Looking at the microfinance business models in Western Europe specifically, we can distinguish 4 main types:²⁶

1. NGOs, Microfinance driven approach: institutions with a microfinance driven approach; often they provide business support, too. Typical examples are: ADIE (France), ANDC (Portugal), Aspire (Northern Ireland, UK), or Street UK (UK).
2. NGOs with a target driven approach: NGOs, who served specific target groups (e.g. unemployed, recipients of welfare benefits, migrants) started to offer financial services, examples are the Microloan Fund of the City of Hamburg (Germany)²⁷ or Weetu (UK).
3. Support measures and programmes initiated in existing institutions and development banks. Examples are Finnvera (Finland), BDPME-Oseo (France), ICO (Spain), or in Germany the Raiffeisen and public banks.
4. Specialised units (or parts) of banks: this is still a relatively young development, examples are various caixas in Spain (e.g. Microbank/La Caixa).

The 3 largest MFIs in Europe are currently Adie (France), Finnvera (Finland), and Fundusz Mikro (Poland). Adie was created by volunteers and works in partnerships with banks; Finnvera was set up at the initiative of the Finnish state, and Fundusz Mikro has received exceptional funding from USAID as start up aid. Often, there is a transformation process for MFIs: they start as NGOs and finance their business via donations and/or public money. Over time they “grow” toward formal financial institutions and regulated entities.²⁸ MFIs (in general) can be classified in 4 categories:

Figure 7: Types of MFIs



Source: Dieckmann, Raimar (2007)

In Western European countries (i.e. Spain, Germany, UK, and Italy), microfinance has a strong focus on social inclusion and it pays limited attention to its

profitability, whereas in Eastern Europe there is a larger presence of commercial intermediaries. With regard to the commercialisation, we can distinguish between 4 business models:

- One alternative is the above mentioned upgrading of semi-formal MFIs (e.g. NGOs) to supervised formal financial institutions.
- A second alternative is the so-called downscaling: existing banks or financial institutions enter into the microfinance business (e.g. direct lending to final beneficiaries).
- A third option is "Linkage Banking", banks cooperate with MFIs (e.g. loans to MFIs by Citibank).
- A fourth alternative is the so called "Greenfield": formal financial institutions specialised in microfinance business (build up from scratch).²⁹

Compared to commercial banks, MFIs have typically the following features:³⁰

- Strong social development impact; "double return" profile (Social Return Investment (SRI) & attractive risk/return relationship);
- Granting uncollateralised loans;
- Labour-intensive delivery system and a closer relationship between lender and borrower compared to traditional banking;
- Higher cost/income ratio due to a large amount of small loans on short maturity;
- Interest rates are higher due to the nature of microlending;
- Returns are relatively stable over the economic cycle;
- Lower correlation of earnings to mainstream capital markets;
- Step lending techniques: larger follow-up loans are provided if the initial loan is successfully repaid;

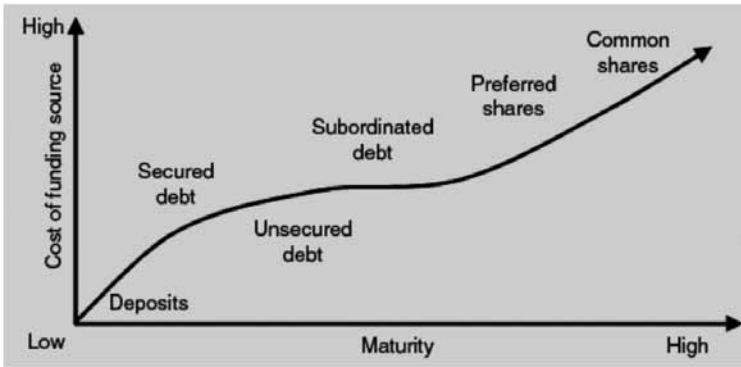
- Services often combined with mentoring/coaching/advisory/training;
- Credit assessment methods less standardised and not automated.

According to the market studies prepared by EMN on behalf of EIF, the main challenge for MFIs in the EU is to develop and maintain a flexible and sustainable funding model for microfinance operations that allows them to realise their individual approach towards providing microcredit (target groups, objectives) as well as to enlarge their portfolio and develop their institutional capacity. In this regard it is crucial to differentiate between different types of finance for specific MFIs need (see figures 8, 9 and 10).

The optimal funding depends mainly on the development stage of the MFI and the area of operation; they define the internal and external factors that determine the funding needs. Internal factors are e.g. the growth of the loan portfolio and the mobilisation of savings; external factors are mainly defined by the regulatory framework, but also the availability of donations or commercial lending are important. Moreover, the costs and maturity of the various funding sources play a major role.

In line with the Pecking Order Theory (Myers/Majluf) the MFIs have to prioritise the various sources of financing. Typically, the issuance of equity is costly and often structurally limited considering the NGO nature of most MFIs (except grant equity or donations). Equity is followed by unsecured and subordinated debt while deposits are considered to be relatively cheap. But also the maturity plays an important role of the choice of the funding source: typically equity serves as long term funding source, while deposits are of a shorter term nature (see figure 8).³¹

Figure 8: MFI funding – costs versus maturity



Source: Dieckmann, Raimar (2007)

The continuum of funding needs for MFIs in the EU can be structured as follows:

Figure 9: Funding needs of MFIs

Funding need	Description	Typical sources of funding
Start-up costs/ Institutional development	Any costs connected to the creation or substantial expansion of a MFI.	Donations and public subsidies.
Equity	Any sustainable MFI needs equity capital. Due to the special nature of its operations the equity ratio should go well beyond the one set for credit institutions in the minimum capital requirements (Basle II).	Donations and public subsidies, retained earnings, Venture philanthropy.
Refinancing loan capital	Many MFIs start their lending out of own equity. To reach scale it is necessary to find other resources to refinance the loan capital.	Capital market through partner banks, revolving loan funds set up using European structural funds (ERDF/ESF). Re-capitalisation with public funds.
Operational costs of lending operations	1. Transaction costs connected to the provision of microloans 2. Risk costs arising from defaulted loans.	Income from interest and subsidies, in some cases risk costs are at least partly covered through guarantee structures (e.g. CIP).

Operational costs of non-financial services provided	Additional non-financial services provided to microenterprises (by specialised service providers).	Donations and public subsidies, partly using existing schemes co-financing Business Development Services revenues from users of services.
Income subsidies for microfinance clients	<p>Some of the microfinance clients need additional income subsidies in the start-up phase of their business.</p> <p>In some countries schemes have been successfully established to encourage people, who receive social welfare payments, to become self-employed. People retain a certain percentage of their fare payments for some time after becoming self-employed.</p>	Public funds.

Source: Evers & Jung in European Microfinance Network (2008/2009)

In the interviews related to the above mentioned studies, the institutions reported patchworks of funding lines for microfinance operations, with most of the funding available only of periodical nature without reliable long-term commitment from donors or alternative funding sources to replace such relationships. This is detrimental to the development of the whole sector because it does not allow MFIs to engage themselves in long-term strategies to build up capacity for efficient and sustainable lending operations and to offer additional services for their clients.

In general start-ups and transforming MFIs are mostly impact-oriented and have limited risk tolerance, they are poorly interested in risk alleviation tools and more in need of grants, technical assistance, equity and long term loans. Conversely, transforming and mature MFIs have sophisticated risk management considerations and are high in demand of risk alleviation solutions. As illustrated in the following figure, different MFI beneficiaries rely on different types of investments to respond to specific risk considerations.

Figure 10: Financing needs of MFIs in various stages

Beneficiaries	Investments	Funders	Risk Considerations
Start-up MFI	Grants & Donations	Donor institutions	No risk considerations
Small MFI	Soft loans & grant equity	Social investors	Leveraging risk
Transforming MFI	Private placements (equity and debt)	Double bottom line investors	Limiting risk
Large Mature MFI	Market securities (stock & obligations)	Market investors	Managing risk

Source: Symbiotics

Ratings of MFIs are gaining importance in the microfinance arena, but currently still rather with a focus

on development countries. Objective of the rating is to make the risk profiles of MFIs comparable across countries and market segments. Due to the nature of the business, the rating methodologies need to be different compared to the typical rating approaches. There are several rating agencies, covering MFIs (e.g. MicroRate, Microfinanza, Planet Rating), for the traditional rating agencies (Fitch, Moody's, Standard & Poor's) microfinance is currently only a side aspect. Typical rating criteria are (examples only):³²

- Management, ownership, and governance;
- Strategy;
- Operational risk and enterprise risk (management);
- Accounting and financial reporting;
- Credit and market risk (management);
- Funding, liquidity and profitability;
- Information systems.
-

A "Rating Initiative" (with a focus on developing countries), started in September 2008. The initiative is designed to increase transparency in the microfinance sector (i.e. via co-funding of ratings and rating market studies). It was launched by ADA in collaboration with the Government of Luxembourg, and is supported by the Microfinance Initiative Liechtenstein, the Swiss Agency for Development and Cooperation, Oxfam Novib, responsAbility and Blue Orchard.³³

Different models in different markets

In most parts of the world, microfinance offers people excluded from formal financial services the opportunity to obtain microloans in order to generate income and engage in productive activities, often by expanding their small businesses.

Introduced in CEE after the fall of the Berlin Wall, microcredit today is represented by a dynamic sector. In the CEE microfinance began as an economic development tool in turbulent times with the development of the entrepreneurial sector, privatisation and market entry of foreign banks.

Later-on, in a more benign economic environment, small companies became less risky and in addition to the involvement of MFIs and NGOs in the provision of microfinance in Eastern Europe, commercial banks started to be increasingly interested in downscaling in order to provide microloans. Within 5 or 6 years of the collapse of the Wall, microfinance institutions in Central and Eastern Europe and in the New Independent States had attracted more than 1.7m borrowers and 2.3m depositors, with an average client growth rate of 30% per year.³⁴

In Western Europe, however, the sector's growth has been more limited, despite increasing interest in its potential. Although microfinance has some deep roots through institutions such as the Raiffeisen and Savings Banks in Germany, lending charities in England, and the co-operative model of the "Casse rurali" in Italy, it remains a fairly recent phenomenon in this region. Microfinance is mainly perceived in Western Europe as a tool for economic growth and social cohesion. Many small businesses and families lack access to financial services in spite of the existence of a dense and competent banking network. Financial exclusion is mainly concentrated among those suffering from poverty and social marginalisation.

As noted, the vast majority of the EU lenders are not-for-profit organisations in the form of NGOs, foundations or government bodies. The best financially performing organizations are however located in Eastern EU countries, namely in Romania and Bulgaria, characterised by their for

profit legal structure. Major actors disbursing microloans in the EU are: credit unions, state banks, ethical banks, savings banks and nonbank financial institutions.³⁵ The absence of profit driven market players in Western Europe (and their at least partial presence in Eastern Europe) is mainly driven by the underlying risks of the activity. Apart from economic conditions several other factors can affect the risk/return relationship of microcredit – examples are i.e. the negative impact of functioning social security systems on the default behaviour of microborrowers;³⁶ another aspect is the possibility to properly price microcredits (in some countries there are interest rate caps (ceilings)). Moreover, we mentioned the need for non-financial support (e.g. to assist borrowers in navigating the complicated business registration and tax regimes prevailing) – these services can reduce the default rates on the one hand, but on the other hand they are expensive and increase the costs of loan processing.

Currently - to our knowledge - in Western Europe not a single microlender has achieved financial sustainability and market experts doubt whether this sustainability is possible in Western Europe (subsidies of some sort are required indefinitely). Moreover, how the performance and behaviour of the profit driven microfinance actors in Eastern Europe is going to be following the financial crisis remains to be seen.

Social inclusion and job creation

As indicated in the figure 11 below, in 2007, 44% of microloan clients were women, 2% of clients were from ethnic minorities, 12% were immigrants, 12% were youth and less than 1% of microloan clients were disabled

people. These figures are based on Jayo, Rico, and Lacalle 2008. The highest rates for women can be found in Spain (nearly 70%), Bulgaria, Portugal, the United Kingdom and Romania (more than 50% for each). When comparing the number of female beneficiaries of microloans to the proportion in the population, it is evident the extent to which they are currently underrepresented. On the contrary, women represent 85.2% of total clients in microlending programmes. Immigrants also represent nearly 50% of microcredit clients in Spain and 25% in France. On average, they represent 12%, since they are less represented in other European countries, especially in Eastern Europe. Generally speaking, only 12% of microcredit beneficiaries are between 18 and 25 years old. But they represent a significantly higher proportion in Hungary (70% of clients) and Spain (30%).

Figure 11: Microcredit beneficiaries in the EU (2007)

Beneficiaries (2007)	
Woman	44%
Ethnical minorities	2%
Immigrants	12%
Young	12%
Disabled	1%

Source: Jayo, Barbara; Rico, Silvia; Lacalle, Maricruz (2008)

The relevance of other “at risk groups” such as immigrants and youth as microcredit clients is significant in some countries. For example, in Spain and France, immigrants are represented well over their proportion in the population whereas in Hungary and Spain young people are represented well over their proportion of the young entrepreneurs’ population.

The support offered for the setting up of a small enterprise is a major priority for the surveyed credit institutions, since it contributes to limiting social exclusion and unemployment. Consequently, credit is more readily granted to people starting a business than to already existing enterprises.³⁷ According to ADIE, the needs for financing at start-up are minimal in most cases: close to 60% of genuine start-ups in France are financed with less than EUR 8,000; 22% of these do not need more than EUR 2,000.³⁸ With regard to the link between microfinance and job creation, EFSE has initiated a study based on a survey among 277 urban micro and small enterprises (MSEs) in Romania, Serbia, and Montenegro (January 2005 to December 2007). One of the results was that 88% of the interviewed MSEs had either increased or sustained paid full-time positions since taking loans in 2005.

Figure 12: Results from the EFSE survey

Job category	No. of MSEs	No. of jobs	Ave. res
Jobs created	126	1,005	8.0
Jobs sustained	118	655	5.6
Jobs lost	33	-189	-5.7
Jobs created + sustained	244	1,660	6.8
Net jobs created (created – lost)	159	816	5.1
Net jobs (created + sustained – lost)	277	1,471	5.3

Source: EFSE (2008a and 2008b)

35% of the MSEs reported the creation of 1 to 9 new jobs, almost 10% of the MSEs have created more than 10 new jobs. Almost 43% of the surveyed companies have sustained the number of jobs. 12% reported lost jobs. Two thirds of the interviewees rated the loan as important or very important to the creation of new jobs in their company. 18% of the MSEs even concluded that their business would have closed had they not had access to the loans.³⁹

The microfinance industry in Europe is still young but has proven that microfinance is a tool for social inclusion and job creation. Experience shows that microlending is a business that needs to be subsidized in its initial stages. This is all the more true for Western European countries that are characterised by a more highly developed banking system.⁴⁰ However, various surveys and EIF's market experience show a gap between demand and supply in the microfinance arena.

Market gap

In a perfect market situation, there would not be a market gap with regard to microcredit, and supply and demand should meet. However, there is asymmetric information and for the lender it is often difficult to get the relevant information about the borrower – it can be reduced to the simple conclusion: the smaller the borrowing enterprise, the more difficult (and the more expensive) is the collection (and analysis) of credit-relevant information for the lender.⁴¹ E.g. there is typically no Balance Sheet and P&L information and no possibility to apply standardised (or even automated) rating methodologies. This results in high handling expenses (typically prohibitively high for banks) and high uncertainty/risk. This is linked with limited ability for the borrower to provide collateral.

The analysis of the potential market gap for microfinance in Europe is not trivial and depends very much on the data availability and on the analysed potential target group (e.g. SMEs only, micro enterprises only, only start-ups etc.). To our knowledge, there is no consistent analysis based on empirical data, however, there are various estimations.

According to the European Commission, there is a potential demand for the following:

- EU-15 of more than 550,000 microloans, totalling EUR 5.6bn;
- EU-12 of more than 155,000 microloans, totalling almost EUR 0.6bn;
- EU-27 of more than 700,000 microloans, totalling EUR 6.1bn.⁴²

These figures are based on the analysis of the population aged between 15 and 64, the share of people

at risk of poverty, the share of potential entrepreneurs, and assumptions about average microloan sizes. The already mentioned individual country studies refer to the supply and demand situation in the various countries. As a country specific example, in France, for the bankable segment ADIE⁴³ estimates the potential annual demand for microfinance at 113,000 start-up loans and 98,000 loans for financing during the first 3 years following establishment.

For the not-bankable segment, the figures are in the range of 48,000 loans (min) to 98,000 loans (max.) at start-up, and 42,000 loans following establishment.

This demand meets a significant smaller supply of 111,000 loans in the bankable sector (70,000 and 41,000) and only 10,000 loans in the not-bankable segment (8,500 and 1,500) and results to a significant market gap:⁴⁴

Figure 13: Gap analysis for microlending by ADIE

		Supply	Demand	Gap
Bankable Segment	At start-up	70,000	113,000	43,000
	Following start-up	41,000	98,000	57,000
	Total	111,000	211,000	100,000
Not-bankable Segment	At start-up	8,500	48k to 98k	39.5k to 89.5k
	Following start-up	1,500	42,000	40,500
	Total	10,000	90k to 140k	80k to 130k

Source: European Microfinance Network (2008/2009)

Also for Germany, KfW concludes in the analysis of the national market that microfinance is – although it is not a

mass market - of high relevance for start-ups and existing micro enterprises.⁴⁵

EIF has developed its know-how in the field of microfinance over years by managing specific mandates (MAP, CIP, JEREMIE, EIB-RCM Microcredit Pilot Facility/JASMINE, EPPA, etc) or by setting up operations on its own resources. EIF currently covers various segments of the European microfinance market, providing funding (equity and loans) and guarantees to a broad range of intermediaries from non bank financial institutions close to sustainability to well established microfinance banks. Under the EIB-RCM Microcredit Pilot Facility, in particular, EIF is facing significant demand from European microcredit providers, especially from greenfield initiatives, targeting both social financing (micro-entrepreneurs benefiting from social aid, ethnic minorities, women living in deprived areas...etc.) and more entrepreneurial microborrowers. This segment of the European microfinance market is particularly relevant in the old member states of the EU, where microcredit providers do not always operate on a (financially) sustainable basis. In such cases, the first objective of the microcredit provider is to promote job creation, self entrepreneurship and release pressure on public expenses related to unemployment.

The above supports the evidence that there is a potential market gap in terms of funding of microcredit providers in the EU. Addressing this gap would therefore allow microcredit providers to become sustainable and could enable them to respond to the growing demand from microborrowers.

The establishment in 2010 of a European microfinance facility for employment and social inclusion, called the European Progress Microfinance Facility, will open up

new opportunities for EIF in the microfinance space. This Facility, sponsored by DG Employment and the European Investment Bank, will go far beyond the pilot nature of transactions EIF has looked at so far and operate on the one hand through guarantee instruments managed by EIF, and on the other hand through a large Progress funding vehicle for which EIF would source the deal flow over a 6-year investment period.

The activity of the Progress funding vehicle would transform into a mix of investments on the assets side ranging from equity investments directly in greenfield MFIs (small portion of total available funds) to senior loan facilities for more mature bank and non-bank financial institutions (large portion of total available funds). It is also envisaged that part of the latter facilities could be structured with partial risk participation in the underlying micro loan portfolios, particularly for intermediaries of good credit standing like co-operative banks and smaller savings banks.

A broad definition of microfinance would be applied across a wide spectrum of financial intermediaries (including micro equity providers and funding vehicles pooling small scale operations on a national or regional level) to maximise outreach to micro entrepreneurs. The social dimension of the Facility is expected to follow naturally since the vulnerable groups identified by DG Employment (e.g. immigrants or minority groups) tend to make up an important element of the global population of micro borrowers. However, the social dimension will not be translated into limit requirements like minimum percentage of total portfolio or the like.

Final remarks

In this paper we have analysed the European market for microfinance. Starting with basic definitions we then moved to the European SME landscape and the micro enterprises' economic contribution before exploring the regional differences in microfinance markets and markets' needs.

There are wide spectra of final beneficiaries and intermediaries and there is no common microfinance business model in Europe. In addition to financial support, also non financial measures, like mentoring, training, counselling, etc. are important element of microfinance.

The objective of microfinance is the creation or expansion of income-generating activities. Microfinance providers need to focus on the potential clients that are particularly interested in the microcredit products – the productive users. These (potential) clients can be individuals, start-up companies, or existing companies. On the other hand, as shown above, also the “group” of microfinance providers is not homogenous – there are various business models and the providers are in different stages of the transformation process.

Consequently, the target groups of support measures need to be sufficiently broad in order not to unnecessarily confine the products and to provide efficient support. Moreover, the support measures themselves need to be flexible enough to fulfill the markets' needs.

Notes

- 1 Per-Erik Eriksson is Head of the Microfinance Investment Team at the EIF. Helmut Kraemer-Eis is Head of Research & Market Analysis at the European Investment Fund (EIF). Alessio Conforti is mandate manager and researcher at the EIF. Any views expressed reflect the current views of the author(s), which do not necessarily correspond to the opinions of the European Investment Fund or the European Investment Bank Group. This document is a shortened and slightly adjusted version of Kraemer-Eis, H.; Conforti, A. (2009).
- 2 See: European Commission (2009), p. 4.
- 3 Please note that we address here only the microlending area and not aspects of e.g. microinsurance. We use the terms microcredit and microlending synonymously.
- 4 European Commission (2007) 708 final; see:
http://eur-lex.europa.eu/LexUriServ/site/en/com/2007/com2007_0708en01.pdf.
- 5 See e.g.: Fitch Ratings Ltd. (2009). However, in some countries there is now additional state support available.
- 6 See e.g.: CGAP (2009).
- 7 See: http://www.european-microfinance.org/characteristic_en.php.
- 8 European Fund for South East Europe. EFSE, established in 2005, provides long-term funding to financial institutions in Southeast Europe, helping micro and small enterprises to grow and improving the quality of life for private households. EFSE is one of the largest microfinance funds worldwide and the first Public-Private Partnership of its kind. For more information see: www.efse.lu.
- 9 See: Presentation at EFSE Annual Meeting, May 2009, Novi Sad, Serbia.
- 10 See: European Commission (2007), p. 12.
- 11 See: Vigano, Laura; Bonomo, Luciano; Vitali, Paolo (2004).
- 12 See e.g.: Kritikos, Alexander; Kneiding, Christoph; Germelmann, Claas Christian (2009).
- 13 See: Baumol, William J.; Litan, Robert E.; Schramm, Carl J. (2007), p. 182.
- 14 See e.g.: http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm.
- 15 See: Hohmann, Katharina (2009), p. 6.
- 16 See: Hohmann, Katharina (2009), p. 5.
- 17 See: Hohmann, Katharina (2009), p. 10.
- 18 See: Jayo, Barbara; Rico, Silvia; Lacalle, Maricruz (2008); see also:

- http://www.european-microfinance.org/characteristic_en.php.
- 19 See: Hohmann, Katharina (2009).
- 20 See e.g.: European Commission (2003).
- 21 See: Jayo, Barbara; Rico, Silvia; Lacalle, Maricruz (2008); see also: http://www.european-microfinance.org/characteristic_en.php.
- 22 See: <http://www.cgap.org/p/site/c/template.rc/1.26.1308/>.
- 23 See: Jayo, Barbara; Rico, Silvia; Lacalle, Maricruz (2008); see also: http://www.european-microfinance.org/characteristic_en.php.
- 24 See: http://www.european-microfinance.org/characteristic_en.php.
- 25 In the context of Jeremie/Jasmine, EIF has initiated Microfinance market studies. The latest studies on behalf of EIF cover 8 countries, in Western Europe as well as in CEE: Spain, Italy, UK, Germany, Czech Republic, Slovakia, Romania, Bulgaria; earlier studies cover France, The Netherlands, Poland, and Hungary.
- 26 See: Evers, Jan; Lahn, Stefanie; Jung, Martin (2007), p. 15ff.
- 27 For information: in Germany there are around 30 MFIs outside the formal banking system; see e.g.: Kritikos, Alexander; Kneiding, Christoph; Germelmann, Claas Christian (2009).
- 28 See: Dieckmann, Raimar (2007), p. 7.
- 29 See: Evers, Jan; Lahn, Stefanie; Jung, Martin (2007), p. 15.
- 30 Based on: Dieckmann, Raimar (2007), p. 15 and McDowell, Malcolm (2006).
- 31 See: Dieckmann, Raimar (2007), p. 8.
- 32 Based on: Dieckmann, Raimar (2007), p. 16.
- 33 See e.g.: <http://www.microfinance.lu/231.html?&L=1>.
- 34 See: http://www.european-microfinance.org/european-microfinance_en.php.
- 35 See: Jayo, Barbara; Rico, Silvia; Lacalle, Maricruz (2008); see also: http://www.european-microfinance.org/characteristic_en.php.
- 36 We stress that we are not saying that the existence of a functioning social security system is negative but that the absence of such a system increases the pressure on a borrower to repay the microcredit.
- 37 See: Jayo, Barbara; Rico, Silvia; Lacalle, Maricruz (2008); see also: http://www.european-microfinance.org/characteristic_en.php.
- 38 See e.g.: ADIE (2009); e.g. <http://www.european-microfinance.org/data/file/adie-fiche-anglais.pdf>.
- 39 See: EFSE (2008a).
- 40 See e.g.: Kritikos, Alexander; Kneiding Christoph (2007).
- 41 We do not want to go here into the details of the economics of information (keywords: asymmetric information, credit rationing, signalling, screening, Akerlof's market for lemons, Stiglitz/Weiss model etc.) but refer to the related standard textbooks and

- articles. German speaking readers can also get a summary in: Kraemer-Eis (1998), p. 22ff.
- 42 See: European Commission (2007), p. 18f.
- 43 ADIE (Association pour le Droit à l'Initiative Economique) provides micro financing and mentoring to enable financially excluded unemployed people to access finance for setting up and/or developing their own business. It is a French nonprofit organisation created in 1989 with today 110 branches, 300 employees, and 22k active clients. A major part of the operating income of ADIE consists of subsidies from the French State, local and regional governments as well as the European Union to cover administrative costs, especially mentoring.
- 44 See: ADIE (2009); see e.g. <http://www.european-microfinance.org/data/file/adie-fiche-anglais.pdf>.
- 45 See: KfW (2008).

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FINANCING THE SMALL BUSINESS SECTOR Constraints and Opportunities

The holding of a seminar on credit for small businesses is both appropriate and timely given the important role played by these enterprises in modern, free-market economies and the contribution they are likely to make in the recovery phase as economies emerge from recession. It is perhaps not widely known that of the almost 20 million enterprises active within the European Union (EU) in 2005, 99.8% were small and medium-sized enterprises (SMEs), defined as businesses that employ fewer than 250 persons.¹ In turn, more than nine-tenths of these were micro enterprises, with a workforce of fewer than 10. In 2005 SMEs accounted for 58% of the value added generated in the EU and 67% of all employment, compared to 55% in the US.²

Small businesses are a major source of dynamism in the Maltese economy too. SMEs constitute the overwhelming majority of businesses, accounting for over 99% of the total and two-thirds of total employment. The vast majority are micro enterprises. These small operations act as customers of, and suppliers to, larger companies and are an essential source of entrepreneurship and innovation. It is thus no exaggeration to say that small

businesses form the backbone of European economies, including Malta's.

A better understanding by policymakers of this sector and of the constraints it faces, which are often different from those encountered by larger firms, is therefore crucial for the purpose of further expanding the economy's growth potential. In the current environment characterised by a reduced availability of credit and tighter lending standards, the financing needs of small businesses deserve particular attention. In this regard it is important to recall that SMEs in general, and micro enterprises in particular, are more dependent on the banking sector than larger firms, which have the expertise and the resources to tap the capital market. This is very much the case in the euro area: between 2004 and 2008, banks accounted for roughly 70% of the total external financing requirements compared to just 20% in the US.

This critical role of bank credit partly explains the unprecedented liquidity-providing operations undertaken by the European Central Bank since August 2007 designed to sustain the flow of credit to the real economy during the crisis, and the repeated calls by the Governing Council for banks to reinforce their balance sheets so as to be better able to fulfil their responsibility in this regard.

The economic environment in the near term

The world economy is finally emerging from the most severe recession in recent history. Global output declined by 0.8% in 2009, while trade volumes shrank by more than 12%.³ Economic activity in both the euro area and the United Kingdom, Malta's largest trading partners,

declined by 4.1% and 4.9%, respectively. This contraction had inevitable consequences for labour markets, with unemployment increasing to levels not seen in decades. The combination of lower tax revenues and higher outlays arising from the operation of automatic stabilizers and fiscal stimulus programmes took their toll on public finances, with deficits in a number of countries rising close to, or even exceeding, double digit levels.

The growth rate of these economies over the coming years will be constrained by the inevitable fiscal consolidation required to bring deficit and debt ratios back to sustainable levels.

These recessionary headwinds inevitably took their toll on Malta's open economy. The impact, however, proved less severe than might have been expected. The economy came out of the recession in the fourth quarter of 2009, after contracting for three consecutive quarters. On a seasonally adjusted basis, the peak-to-trough drop in GDP was around 3.0%, compared to 4.7% in the euro area.

The relative resilience of the Maltese economy is attributable to four factors. First, membership of the euro area has enhanced its capacity to withstand external shocks. Second, the impact of the financial crisis was mitigated by the strength of the domestic banking system, underscored by the absence of toxic assets in bank balance sheets, prudent lending policies and a funding structure based primarily on retail deposits. The third factor was the strategy of temporary government assistance targeted to those non-financial corporations (NFCs) that were in difficulty, mostly in the manufacturing and tourism sectors, along with the implementation of some infrastructure projects. Besides limiting the number of potential job losses, this approach

proved to be more appropriate in the domestic context than an across-the-board increase in spending whose impact would have been severely weakened through import leakages. The fourth factor was the continuing diversification of the economy towards high value-added services, which have proved less vulnerable to the downturn. Small businesses have featured prominently in this process. Indeed, most of the enterprises in the emerging sectors of the economy, such as those in pharmaceuticals, remote gaming, ICT and business and financial advisory services are SMEs.

Going forward, the prospects are for only slow growth in Malta's external demand. While IMF projections suggest that global activity and trade volumes will expand by around 4% and 6% this year, respectively, the recovery in the euro area promises to be less robust and more gradual than in other advanced economies, and is expected to be conditioned, *inter alia*, by the ongoing process of balance sheet adjustment in both the private and the public sectors. Economic activity is therefore expected to remain sluggish and uneven in 2010, with GDP expanding by less than 1.0% in both the euro area and the United Kingdom.⁴

Mirroring these expected trends abroad, the Central Bank of Malta's projections point to a modest GDP growth rate of around 1.0% in 2010. Net exports are likely to contribute negatively to growth, so that the main growth impulse is expected to come from domestic demand, driven by higher investment outlays on infrastructure projects and, to a lesser extent, by a moderate expansion in private consumption. Labour market conditions are unlikely to improve this year, with the unemployment rate remaining above 7%. This subdued growth outlook, together with the expectation that inflation will remain

more elevated than in the euro area, will exert downward pressure on disposable income.

Overall, therefore, the economic environment facing small businesses in the foreseeable future, both domestically and in our main trading partners, will be less favourable than that which prevailed before the onset of the financial crisis in 2007.

Small businesses access to finance

Since SMEs and micro enterprises are typically more dependent on bank financing than larger firms, the ongoing deleveraging of bank balance sheets in many EU countries represents a potential threat. The prospect of a prolonged period of restricted access to both working and investment capital at a time of subdued demand could result in the closure of many enterprises.

In the euro area, credit growth has indeed slowed progressively during the past year. The latest figures, for February, suggest that loans to the private sector contracted by 0.4% from a year earlier. The annual growth rate of loans to all NFCs - large, medium and small - fell from a peak of almost 15% in April 2008 to -2.5% in February.

With regard to credit flows to SMEs, a recently published ECB survey, which however does not include the five smallest countries in the euro area, including Malta, shows that SMEs were generally less successful than large companies in obtaining bank loans in 2009, even if the majority received part or all of what they had applied for. In the second half of 2009, 75% of all SMEs reported successful approaches, slightly less than in the first half of the year. The main reasons given by the banks

were the general economic and the firm-specific outlook, together with a reduced willingness to extend credit.

It would appear, therefore, that both demand and supply factors explain recent credit developments in the euro area. This conclusion is corroborated by the evidence from the Bank Lending Survey, which points to factors associated with the weak macroeconomic conditions, such as a lower demand for credit due to less fixed investment, combined with supply side factors such as the tightening of credit standards.

The restricted flow of credit in the euro area does not, however, appear to have been replicated in Malta, whose banking sector emerged from the financial turmoil with high capital and liquidity ratios. Domestic credit to the private sector continued to expand at steady, though slower, rates in 2009. The annual rate of increase in bank loans to the private sector declined from around 10% in 2008 to 8.3% last year, and the latest figures for February suggest that total credit is still expanding by over 6%. Lending to NFCs, meanwhile, is growing at an annual rate of 3.9%.

With regard to the recent experience of domestic small enterprises, our estimates suggest that bank lending to them expanded by around 6.6% per annum between 2005 and 2009. This impression of a sustained credit flow is confirmed by a joint survey carried out by the European Commission (EC) and the ECB during 2009.⁵ The results for Malta are based on a sample of 100 enterprises, of which 94% were categorized as micro enterprises in the services sector with an average annual turnover of less than €2 million in 2008.

One of the most significant results was that small enterprises in Malta did not consider access to finance a main concern. Only 8% of respondents cited it as their

most pressing problem, compared to 16% in the EU. In addition, only 12% thought that the willingness of banks to provide a loan had deteriorated, while the number of those replying that banks were actually more willing to extend credit was among the highest in the EU.

At the same time, however, the demand for bank loans by domestic small enterprises last year was weak. Only 10% of respondents applied for bank loans compared to 22% in the EU. The indication of a subdued demand for loans is confirmed by information derived from the Bank Lending Survey and from other intelligence collected by the Central Bank of Malta.

One possible explanation could be the fact that small businesses in Malta rely on a mix of internal and external finance to a greater extent than their European counterparts. Another is the reported postponement of investment plans in the light of the slowdown in both domestic and external demand.

Albeit to a lesser extent, supply side factors also seem to have been present. For example, according to the joint EC/ECB survey more than half of the small businesses in Malta considered the interest rate as the most limiting factor for obtaining a bank loan, a higher proportion than in any other country surveyed. And about one fifth reported that they had actually refused the loan offered because they considered the interest rate as too high.

Again, this was by far a higher percentage than anywhere else in the EU, where on average only around 6% cited high costs as a reason for turning down a loan. In the same vein, the proportion of Maltese businesses replying that interest rates charged on loans had decreased was among the lowest.

These results support the information obtained from an analysis of bank interest rates. In general, while domestic

banks have reduced interest rates charged on loans to households by more than the average in the euro area following the cumulative cut of 325 basis points in official rates by the ECB since 2008, the opposite is true for loans to NFCs. This suggests that domestic NFCs, most of which are small enterprises, are finding it more expensive to obtain or service a loan than their counterparts in the euro area. This apparent relative rigidity of domestic interest rates charged to NFCs merits further analysis as it could harm the recovery process, particularly if businesses continue to postpone their investment plans.

Other constraints faced by small enterprises in Malta

The same survey also provides an insight into the broader range of concerns faced by domestic micro and small enterprises. These include the limited purchasing power of customers, obstacles faced in trying to expand market share and competitive pressures. In addition, a disproportionately high percentage of these businesses reported higher costs in 2009.

In this regard, the automatic adjustment of wages to inflation through the COLA mechanism, irrespective of the level of productivity, is one of the factors that has been contributing adversely to the cost structure of these enterprises, and consequently to their competitive position. Here I must reiterate that a currency union member country like Malta, whose only sustainable source of long-term growth are its exports, cannot afford to allow nominal wages to grow faster than productivity, which is what has happened during the past decade.

The competitive position of these enterprises is also constrained by their ability to introduce more efficient

production processes. The proportion of enterprises that did not undertake some form of restructuring last year was one of the highest in Europe. This is probably one reason why Malta has lagged behind its European peers in pursuing the targets set by the Lisbon Innovation Scoreboard, in particular in the areas of entrepreneurship and human resources.⁶

Another frequently mentioned cost factor are administrative burdens. This is an endemic problem in Malta, confirmed by a recent survey in which a reduction in such burdens featured as the priority recommendation by executives of foreign-owned companies operating in Malta as a means of enhancing the attractiveness of the island to foreign investors.⁷

Finally, with regard to the constraint represented by the small size of the domestic market, Maltese entrepreneurs have no option other than to attempt to break into foreign markets. This is not an easy task. During the past decade, Malta has registered one of the slowest average annual export growth rates in volume terms in the EU. Survey information from micro and small enterprises reveals that the most frequently cited obstacles to exporting relate to taxation issues in foreign markets, inadequate market intelligence and insufficient capital.⁸

Recent initiatives and the way forward

This suggests the need for a comprehensive strategy to help these small enterprises exploit the opportunities offered by the EU Single Market, building on the existing public and private initiatives. The Budget for 2010, for example, included measures aimed specifically at easing some of the constraints I have just referred to.

Chief among these is a 40% tax credit scheme, which is directed at micro enterprises that invest in productive processes or create more jobs.

Meanwhile Malta Enterprise is playing an active role in assisting small businesses to tap EU regional funds. It has been recently reported that applications for grants from the European Regional Development Fund (ERDF), from which €20 million for industry and €10 million for investment in renewable energy are available, have led to the selection of almost 400 projects with a proposed outlay of €25 million. An additional €7 million, announced in the Budget for 2010, is also being made available. Maltese entrepreneurs have submitted more than 600 proposals for funding under the third call of the ERDF scheme, with the total value of assistance requested expected to exceed €40 million.

At the same time, an agreement between the Government and the European Investment Fund will provide another €10 million by the end of this year from a specialized EU fund aimed at small enterprises that would otherwise find it difficult to raise up to €25,000 to improve their operations. These initiatives should also help to increase awareness about EU funding schemes.

Malta Enterprise is also involved in the management of the Kordin Business Incubation Centre. Between 2003 and 2008, this facility produced over 50 start-ups, with a success rate of 86%. Some of the most successful ventures have gone on to employ more than 100 workers. Within the next few months small enterprises will also benefit from more than 300 industrial spaces that will be made available in three locations, while other parks for micro enterprises in both Malta and Gozo are in the pipeline. Such initiatives facilitate networking among SMEs and

can lead to the development of business clusters and consequent positive spillover effects.

Initiatives to assist small businesses have also been taken by the private sector. For instance, a major domestic bank has recently teamed up with a leading international software house in a programme designed to increase the success rate of ICT start-up companies. A number of banks have established dedicated funds or have tailored business packages that are specifically designed to meet the demands of small enterprises. In contrast, however, the concept of investing private money in small enterprises has yet to gain currency in Malta, and the commitment of government funds for the establishment of the first official venture capital fund has so far not been followed up by private investors.

Conclusion

Small businesses have undoubtedly contributed to the resilience shown by the Maltese economy during the recession. Indeed, the majority of emerging niche industries in both the manufacturing and the services sector belong to this category. Going forward, they could also play an important role in sustaining the recovery. This calls for the creation of a more congenial environment, which not only allows entrepreneurship to flourish but also focuses on the ingredients that will become increasingly important in the post-crisis economic environment. These include a greater emphasis on innovation, research and development and marketing, drawing on EU and public and private financial assistance schemes. Without such a proactive orientation, small businesses cannot hope to overcome the limitations inherent in a small domestic market.

Notes

- 1 Eurostat *Statistics in Focus* 31/2008.
- 2 Financial Times “*The cogs are clogged*”, 16 February 2010.
- 3 IMF *Update of World Economic Outlook*, January 2010.
- 4 European Commission Interim Forecasts, February 2010
- 5 Flash Euro Barometer No. 271.
- 6 European Innovation Scoreboard 2009. Link available at: <http://www.proinno-europe.eu/sites/default/files/page/10/03/1981-DG%20ENTR-Report%20EIS.pdf>
- 7 Ernst & Young’s 2009 *Malta Attractiveness Survey*.
- 8 Flash Euro Barometer No. 196 – Observatory of European SMEs.

MALTESE LEGISLATOR'S VIEWS ON MICROCREDIT AND MICROFINANCE INSTITUTIONS

It is my pleasure and honour to be here with you today. For this I would like to thank FEBEA (Federation Europeenne de Finances et Banques Ethiques et Alternatives – European Federation of Ethical and Alternative Banks and Financiers) and APS Bank Ltd for providing me with the opportunity to address this session. The views expressed are my own and they should not be interpreted as the official position of the Malta Financial Services Authority (MFSA).

Before proceeding to highlight the MFSA's general approach to microcredit and microfinance I wish to start by an overview of the role of the MFSA within the local financial system always in particular with reference to the banking and non-banking financial institutions' sector.

The MFSA is a public authority set up by an Act of Parliament, the Malta Financial Services Authority Act Cap. 330 (the Act), as amended in 1994 and 2002, which establishes the MFSA as the regulator for financial services in Malta

Accordingly, as a public statutory body, the MFSA derives its status and powers directly from legislation. The MFSA is the successor to the MFSC – the Malta Financial

Services Centre - which, between the period 1994 and 2001, was responsible for the regulation and supervision of insurance business firms, investment services firms and funds. Since 2002 the MFSA has assumed the role of single regulator for the local financial services sector which today includes credit and financial institutions (taking over in 2002 the Central Bank of Malta's oversight role in this area), securities and investment services companies, recognized investment exchanges, insurance companies, pension schemes and trustees.

The Act determines that the main organs of the MFSA are the Board of Governors, the Executive Co-Ordination Committee, the Supervisory Council, the Board of Management and Resources and the Legal Office and, naturally, their respective functions.

From the operational point of view the MFSA comprises several specialised units which together provide a structure for the licensing and supervision of persons engaged in different financial services activities. The MFSA is responsible for ensuring high standards of conduct and management in the financial services industry and is vigilant in identifying any practices which adversely affect the economic interests of operators and consumers in the areas of financial activity that it supervises. Under the Act, besides the duty to regulate, monitor and supervise financial services in Malta, the MFSA keeps under review business practices relating to the supply of financial services and disseminates information about matters relating to the exercise of its functions to the public. Furthermore, the MFSA has the power to investigate possible contravention of the law or of licence conditions by operators. In pursuit of its functions, the MFSA co-operates and collaborates with other financial regulatory bodies both locally and overseas.

With the entry of Malta in the EU in 2004 this process of co-operation has deepened both in scope and coverage and is spearheaded by the MFSA's full participation in the current but soon to be reformed, Level 3 Committee regulatory infrastructure, such as the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Supervisors (CEIOPS)¹.

On January 1, 2010 a new architecture for financial regulation within the MFSA came into being. This changed the manner in which the regulatory functions are carried out within the Supervisory Council. The stated primary objective of the reform was to deliver supervisory effectiveness and to secure greater integration in the exercise of the MFSA's regulatory functions. This greater harmonisation is expected to lead to a higher level of consistency in functions such as licensing and risk-based supervision and improve co-operation and information-sharing across the Authority.

The new model for the Supervisory Council represents an integrated approach to regulation and supervision as provided for through a single Authorisation Unit, specialist Supervision Units for Banking, Insurance and Occupational Pensions and Securities and Markets, and a Regulatory Development Unit. The Authorisation Unit is thus responsible for licensing of all financial services entities. The Unit receives and processes all applications for authorisation to conduct regulated financial services business in Malta. The remit of the Regulatory Development Unit will be to co-ordinate the development of cross-sector policy initiatives and to enable the MFSA to address market and regulatory developments as they arise. The Supervisory Units will continue to

develop further in the future to have a more focused and co-ordinated, risk-based approach to supervision with retained specialisations. In my particular case, the oversight of the Unit of which as Director I am responsible, now termed the Banking Supervision Unit, has remained unchanged i.e. the responsibility for the supervision of credit and financial institutions. It is expected that the legislative amendments to the MFSA Act reflecting the changes in the regulatory and supervisory structures highlighted above will be passed by Parliament later on this year.²

In stating the main functions of the Authority, the Act also highlights the role of the Authority as the promoter of the general interests and legitimate expectations of consumers of financial services. Thus the MFSA has the power to investigate any complaint made by consumers of financial services. To this effect the Act provides for the set-up of the Office of the Consumer Complaints Manager who investigates complaints from private consumers arising out of any financial services transaction. The Consumer Complaints Manager is directly responsible to the Board of Governors but, where appropriate, cases may be referred (for consideration) to the Supervisory Council. The Unit is also responsible for consumer awareness and education. The MFSA must also promote fair competition practices and consumer choice within the financial services industry.

At this juncture it is perhaps pertinent to provide some information on the local financial system and as indicated earlier on, I will focus primarily of the banking and so-called (in local legalisation) financial institutions' sector.

Currently there are 25 credit institutions licensed by the MFSA under the Banking Act to conduct the business of banking in or from Malta. Of these there are two branches

of institutions established in non-EEA countries and the rest are either 'stand-alone' institutions established in Malta or mainly subsidiaries of EU institutions. Also 13 financial institutions providing a number of activities similar to those undertaken by banks but which do not comprise the funding of such activities through the taking of deposits from the public are also present and in value terms, such institutions would appear to operate predominantly outside the local market. Further details on this particular type of entity will be provided later on. One may be further interested to peruse the list on the MFSA's website <http://www.mfsa.com.mt/> under *Credit Institutions/Financial Institutions - Licence Holders*³.

The total assets of the aggregate banking sector⁴ in Malta reached €40.8 billion as of 31 December 2009. Although the overall sector total decreased slightly by 2.7 per cent over the previous year, in actual fact the assets of the domestic banking sector⁵ increased during 2009 by 0.7 per cent over the previous year. To put things within the proper perspective, the latter sector's assets as of 31 December 2009, amounted to €14.6 billion or 35.9 per cent of the total assets of the aggregate banking sector. As of December 2009, there were a total of 133 bank offices and branches throughout Malta while the number of ATMs totalled 170. As demographically Malta also happens to be the most densely populated country in the EU and one of the most densely populated countries in the world, with about 1,265 inhabitants per square kilometre, it can be seen that coverage of *inter alia* banking services is extremely broad.

I will now pass on to discussing briefly several aspects of the MFSA's approach to microcredit and microfinance. At the risk of repeating what the previous esteemed speakers may have stated as to what should be understood by the

terms 'microfinance' and 'microcredit', since such terms are not defined in our local primary or secondary legislation, I will within this context be referring to the definition of the terms as used in the Microfinance Consensus Guidelines issued by the CGAP - the Consultative Group to Assist the Poor⁶. Accordingly, 'microfinance' means *the provision of banking services to lower-income people, especially the poor and the very poor. Definitions of these groups vary from country to country.*" At the same time the Guidelines state that the term 'microfinance' "*is often used in a much narrower sense, referring principally to microcredit for tiny informal businesses of microentrepreneurs, delivered using methods developed since 1980 mainly by socially-oriented non-governmental organizations*".

Thus in this respect it would seem that since *prima facie* little or no use locally is made of either the term or its wider practical implications, these concepts as utilised within the context of their application in generating economic welfare in developing countries may neither be so well recognised locally nor utilised to a significant extent.

This may perhaps be partly due to the fact that while 'traditionally' bank finance locally seems to have been tailored and channelled more towards relatively large corporate facilities, lending to the personal and retail sector seems to have taken off around 12 years ago and appears to never have looked back. Moreover, banks have over the period in question enhanced greatly their credit availability and products in general and unsecured lending for retail purposes may not have remained the anathema that it seems to have been only a few years ago.

Accordingly, probably because of the characteristics of our rather small and limited retail market, locally there does not as yet seem to be the exit of 'larger'

traditional credit institutions i.e. banks, from the small-denomination, short-term credit market as seems to have happened in other much larger jurisdictions over the same period. While this change may have been largely motivated to the high cost structures observed elsewhere in the processing of such products, in Malta this is just another characteristic of doing banking business here.

Another factor which in my opinion could also explain the dearth of microfinance institutions in Malta is the presence of a very well developed and long established local private retail and trading sector. Competitive conditions within this sector may locally have set the pace for individual businesses to develop incentives for consumers through *inter alia* so-called hire-purchase schemes which are quite a common way for paying for those fairly major items of expenditure such as cars, furniture, white goods and electronic equipment. Besides other schemes which may not necessarily fall within the legal remit of hire-purchase schemes provide interest-free loans to the consumer for the purchase of the product usually white goods and electronic equipment. In this respect it is interesting to note that persons drawing and issuing trade bills in the normal course of business under hire purchase agreements, or under sales on credit where trade bills are drawn in respect of the price due, are exempt from the licensing requirements of the Financial Institutions Act Cap. 376 (henceforth FIA) – but more about this later.

So to recap at this stage, a number of factors inherent within the local economy would seem to provide pointers for the lack within our island of a formal **operational** set-up whose primary rationale would be the provision of microcredit within our jurisdiction.

Hence, promoters of stand-alone institutions focusing purely on microcredit and microfinance may have

recognised that the Maltese market economy may not *per se* be particularly suited to being a fertile breeding place for developing this niche.

Having said this it is perhaps relevant at this stage to ask a question: Could the local legal infrastructure in any way possibly impact on the undertaking of business ventures in relation to microcredit or microfinance? Put in another way, what are the provisions of the local law which could potentially cover the provision of such services from and in Malta and what if any would be the MFSA's ethical considerations which ensure that such business operations would be based on *inter alia* the principle of financial solidarity?

Unless the proposed operation is that of a bank – where bank in Maltese legislation is defined in the Banking Act Cap. 371 as “*any person carrying on the business of banking*” while the latter activity means “*the business of a person who ... accepts deposits of money from the public withdrawable or repayable on demand or after a fixed period or after notice or who borrows or raises money from the public (including the borrowing or raising of money by the issue of debentures or debenture stock or other instruments creating or acknowledging indebtedness), in either case for the purpose of employing such money in whole or in part by lending to others or otherwise investing for the account and at the risk of the person accepting such money*” – any potential microcredit or microfinance operation contemplated as being set up locally would most probably be required to be licensed in terms of the financial legislation mentioned earlier on i.e. the FIA.

Thus, since any microcredit operation would naturally carry out an activity – lending – as listed in the Schedule [of the FIA] “*regularly or habitually for the account and at the risk of the person carrying out that activity*” which in terms of the FIA is a licensable activity, the MFSA would

then look at the particular proposed operation using the discretion provided to it in the legislation and specifically on the basis of *inter alia* a detailed and objective business plan. At this juncture it is perhaps worth repeating that while no microcredit or microfinance operation has been licensed to date, the MFSA has some years back licensed an operation which provides very short-term loans⁷ to individuals mainly for tiding over expenses incurred during the period since their last pay day⁸.

But why am I mentioning this institution here anyway? It is to indicate a point already made above; that the MFSA does not only licence an operation on the merits of the fulfilment of the minimum and statutory criteria for authorisation in terms of the applicable laws but also gives due merit to the type of activity contemplated and especially, how it would impact on the end-user. In this case this is an operation which brings with it the baggage of criticism be it as it may have been justified in some other similar (mostly unlicensed) cases. It is recognised, not least by the CGAP itself, that the administrative costs of providing small amounts lead microfinance institutions to provide their services using charges which are considerably higher in percentage terms than normal bank rates.

However, such views were certainly not lost on the MFSA. Quite the opposite I would say, since they were taken into account by the Authority during the authorisation process to minimise as much as possible negative perceptions on the type of activity conducted from Malta by this entity and to require by way of licence conditions the application of certain ethical standards in this area by this business operation.

Accordingly, what I propose for the last part of my speech is to highlight those aspects which the MFSA took into consideration in the licensing of the said institution.

Thus for the MFSA it is a plus point that an institution voluntarily subscribes with relevant associations that seem to be committed to the undertaking of so-called payday lending in a safe and responsible manner, with an appropriate level of consumer protection. To that end, members of such organisations state that they abide by mandated industry best practices to ensure responsible conduct among lenders, protect borrowers' rights, and to encourage self-governance of this type of industry.

We now come to the practical aspects adopted by the MFSA to align the institution in question with two principles advocated by the CGAP in its Microfinance Consensus Guidelines. These are the protection of borrowers against abusive lending and collection practices, together with the provision to such borrowers with what is termed as "truth in lending" practices — accurate, comparable, and transparent information about the cost of loans⁹. In this respect the MFSA deemed fit to include a number of principles within the licence which aim to address the potential for vulnerable customers becoming over-indebted:

- 'cooling off' period – borrower may rescind the contract by the end of the next day and no fees would be charged of no drawdown effected;
- maximum 'payday' loan amount indexed to the borrower's income;
- no 'rollover' of borrowers' loans by the institution by funding from the take up of 'payday' loans originating from other 'payday' lending organisations, either within an institution's group of companies, if indeed the case, or from other sources, also prohibited;
- no advances by an institution to finance a borrower's unpaid interest and fees until the latter's outstanding loan has been paid back and permitted;

- once total indebtedness is paid in full on or after the due date, a one day ‘cooling off’ period shall be applied by the institution before it grants another loan to the same borrower.

Other issues which would be addressed relate to the prevention of unacceptable loan-collection techniques. Thus, the MFSA ensures that an institution collects its repayments in a professional and lawful manner and follows best practices within applicable jurisdictions and in compliance with best practice guidelines stipulated by any relevant trade associations. Also an institution must have in place policies and procedures which address applicable consumer protection legislation and comply at all times with any national, federal, state and provincial, truth-in-lending’ and for debt collection practices of the jurisdiction in which the borrower is employed.

The second principle advocated by the CGAP would also be adopted by the MFSA as a condition in the licence whereby *“the institution shall indicate clearly in any contracts, advertising and promotional material ... viewed by potential borrowers, prior to the actual application for ‘payday’ loans, all applicable charges, fees, relevant terms and conditions and upon submission of the application by the borrower, the appropriate effective annual percentage rate (APR).”* Moreover, the MFSA further bound the institution not to *“advertise the ‘payday’ loan service in any false, misleading or deceptive manner and all contracts shall contain details of all fees and charges.”*

Thus even though the MFSA recognised that the requirement for the institution to express its pricing as an effective interest rate would and does result in quite a hefty (to say the least) APR, it still deemed that full transparency is a requisite in this area. Ultimately the decision as to whether to avail oneself of a loan or not is

purely that of the consumer on the basis of his financial condition, income and also on his ability to access other forms of less costly financing – which however may not always be possible. The CGAP itself states that “[m]icroborrowers show again and again that they are happy to have access to loans even at high rates¹⁰.”

Besides the specific *de facto* utilisation by the MFSA within its licensing process of the CGAP principles mentioned previously and which I have highlighted just a few minutes ago, given the legal status of a microfinance or microcredit institution as a financial institution within the applicable local legislation – the FIA – the MFSA would and has required the full gamut of requisite prudential regulatory and supervisory requirements commensurate with the said status, notwithstanding that financial institutions are not funded by deposits from the public. In this Malta may be somewhat unique as it appears that in several European jurisdictions, the activity of providing credit (unless undertaken by a bank) does not seem to be regulated on the same level as that undertaken locally.

In conclusion I wish to reiterate that to date the MFSA has only had relatively very limited indirect experience on the regulation and supervision of ‘traditional’ microcredit and microfinance institutions particularly those envisaged to be set up to assist less advantaged persons obtain access to basic financial services to run their own microenterprises. However, I have tried to show that local legislation and the MFSA are open to the possibility of such microcredit and microfinance operations being set up in Malta even as a springboard from where operations can be directed where needed to persons in other jurisdictions. What I can state with certainty is that the MFSA will, in the processing of any potential licence application, utilise its customary flexible

yet firm approach, be guided by best-practice initiatives in this area and would continue to place consumer protection as a central premise within the undertaking of the institution's business. I believe that there is no obstacle to the setup of microcredit and microfinance institutions locally and in fact our fairly long experience of licensing financial institutions in terms of the FIA (at least since 1994) provides us with the right background had the MFSA to be faced with an application to set up an operation of this nature.

Notes

- 1 As from 1 January 2011 the three EU financial services committees mentioned above for micro-prudential supervision and with advisory powers only, were replaced by new Authorities which took over all of the functions of those committees. The new EU supervisory framework thus consists of a network of national financial supervisors working in tandem with the 'new' European Supervisory Authorities, created by the transformation of existing Committees for the banking, securities and insurance and occupational pensions sectors - the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) respectively.
- 2 The relative amendments to the MFSA Act Cap. 330 were implemented through Act No. XIX of 2010 of the 26th November 2010.
- 3 Previous version of the current (March 2011) website. To access the latter: click *Licensed companies – Licence holders - 1) Select type of licence: - 2) Choose type of licensed activity: - Credit Institutions.* <http://www.mfsa.com.mt/pages/licenceholders.aspx>
- 4 Aggregate banking sector comprises **all** banks licensed to operate in and from Malta in terms of the Banking Act Cap. 371.
- 5 Domestic banking sector comprises those banks which operate mainly with local residents and within the local economy e.g. BOV, Lombard, HSBC, APS, Banif.

- 6 CGAP is an independent policy and research centre dedicated to advancing financial access for the world's poor. It is supported by over 30 development agencies and private foundations who share a common mission to alleviate poverty. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions and offers advisory services to governments, microfinance providers, donors, and investors.
- 7 Usually known as "payday loans" with typical main features which comprise, low to very low principal of around \$250 – 1000 and short-term duration of around 2-4 weeks.
- 8 For a more comprehensive treatise on the pros and cons of payday lending see *inter alia*:
Payday Holiday: How Households Fare after Payday Credit Bans; Donald P. Morgan and Michael R. Strain; *Federal Reserve Bank of New York Staff Reports*, no. 309; November, 2007; revised February 2008:
An Analysis of Consumers' Use of Payday Loans; Gregory Elliehausen; *The George Washington University – School of Business; Financial Services Research Program Monograph* No. 41; January 2009:
The Case against New Restriction on Payday Lending; Todd J. Zywicki; *Mercatus Center – George Mason University; Working Paper* No. 09-28; July 2009.
- 9 CGAP Microfinance Consensus - Guidelines Guiding Principles on Regulation and Supervision of Microfinance, June 2003, p.8.
- 10 Ibid.

Sources

MFSA *Annual Report 2009*; MFSA web-site; CGAP *Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance* June, 2003 Robert Peck Christen, Timothy R. Lyman, Richard Rosenberg.

PART TWO
CASE STUDIES:
Lessons from
past initiatives

MEDITERRANEAN CONTRADICTIONS Economic authoritarianism, inequalities, and the happiness of the people

1. Introduction

In an irreducibly plural context characterised by very strong socio-economic inequalities between the north-western areas and those of the southern, south-eastern, and eastern Mediterranean, the prospect of free trade raises some concern. Linking together, in fact, so strongly unequal and uneven socio-economic systems could lead to predatory dynamics on the part of the richest and more cohesive countries at the expense of the weaker ones (for a theoretical review, see Aghion P., E. Caroli, C. Garcia-Penalosa 1999). It was not by chance that paragraphs 47 and 48 of the final declaration of the Second Session of the Euro-Mediterranean Parliamentary Forum (Brussels, February 2001) mention, and greatly stress, the problem of the social impact of the economic transition. The demographic, economic, social imbalances of the powers on the shores of the *Mare Nostrum* are, however, so high that the soft approach to economic integration (such as that Euro-centric model, so far drawn in Euro-Mediterranean conferences) has not been able to generate global and mutual benefit from the processes of integration for the free trade area.

This paper will develop quantitative analyses to try to model the relationships among equality, social cohesion, and growth. The results, presented in a popular form in this publication, confirm the theses of the theories of welfare; indeed they present both a microscopic foundation and theoretical legitimisation, revealing operational routes that make it possible to think of and act for a Mediterranean area that is the most equitable and sustainable both environmentally and socially.

Our studies refute, in fact, the relationship derived from the classical Solow growth model based on the idea that greater inequality is a stimulus for growth. In the second section cluster analyses will be developed to visualize, in a succinct form, the spatial distribution of welfare and quality of life, by zooming progressively down from the entire Mediterranean basin to the areas of a city. In the third part we will study the distribution of wealth at mesoscopic and macroscopic levels; it will seek the universal laws of distribution within the capitalist market systems and to discuss simple interpretative models aimed at revealing the dominant pathological behaviours. The encounter with the fragilities, with the failures of traditional economies, and with the strong inequalities produced as well as the encounter with poverty, with the desires and needs of the people to be happy becomes the path of the falsification of the classic economic and social paradigms and leads to a re-thinking, re-founding, and experimenting with new irreducibly complex forms that are able to hold together several different meanings and forms of knowledge. The fourth section will present the results of a microscopic and highly formalized study (G. Giunta, D. Marino, 2009) of econo-physics based on an analytical resolution of an interactive network system.¹ This research has tried to draw predictive

conclusions about complex systems that simulate open local socio-economic areas. Starting from these studies, always in the fourth section, we will attempt to re-define economic assumptions on a multi-disciplinary level. Part five will put forward a policy for human development consistent with the new interpretative paradigms. Our interest is to understand what cultural, social, and economic strategies support possible transitions of phases within the system of Euro-Mediterranean regions with their highly uneven distribution of opportunities, wealth, and welfare re-distribution models to more equitable models which are more able to meet the need for happiness of the Mediterranean people, the communitarian aspect of their life, the need to develop peaceful dynamics of hybridisation and mutual interdependence. Part six then recounts the experience of the Community Foundation of Messina, which can be regarded as a case study of what has been previously stated.

2. The cluster analyses

The greatest concerns expressed in the introduction, regarding the processes of exploitation that could intensify as a result of the creation of a free trade area not adequately supported by policies of cohesion, redistribution, and sustainability has led us to abandon idealized or demagogic visions, and examine areas that may be limited in some specific way and which can elicit the irreducible complexities of the real context in a gradual journey from the macroscopic to local communities.

The first territorial atoms of the analysis are the nations bordering the Mediterranean Sea, then moving down the scale to analyse a particular country (Italy) through the

statistics of the provinces. The next step will be to analyse a cluster Province (Messina) through the local units, to finally observe the distribution patterns of a local entity (the city of Messina) through the analysis of its suburban areas. All atoms were territorially chosen to respond quite effectively to the two criteria outlined above and which can supply sufficient data and statistics.

The initial breakdown of the territories, at all levels of observation, was followed by a new regrouping based on intelligible and scientifically valid statistical tools: the cluster analysis that allows us to study the characteristics of statistical units aggregated into groups that have within them a minimum variance² and a maximum 'variance' with respect to the other groups that make up all the available data.

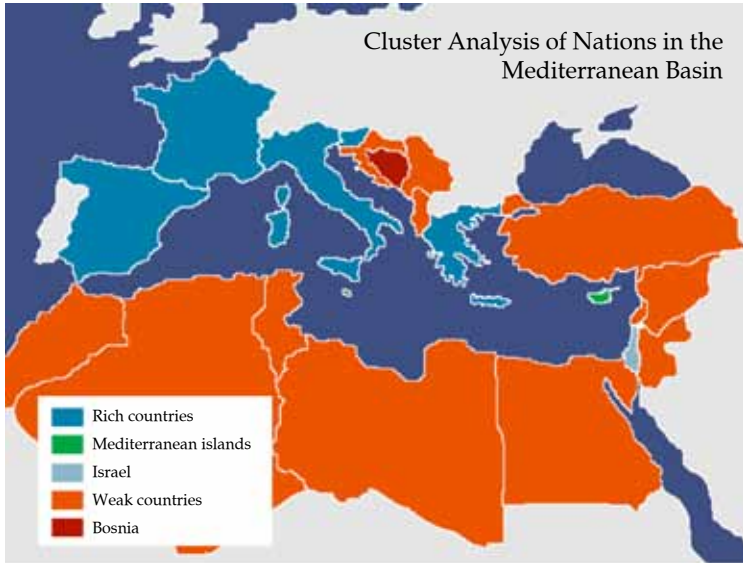
2.1 The Mediterranean

The indicators considered as coordinates identifying the socio-economic and cultural rights of nations bordering on the Mare Nostrum are the following:

- Population;
- Annual growth rate;
- Fertility Rate;
- Infant mortality;
- Life expectancy;
- Percentage of physicians per inhabitant;
- Higher education;
- Internet access;
- Annual growth rate;
- GDP per capita;
- Unemployment rate.

The results of the cluster are shown in Figure 1.

Figure 1



The following table summarizes the values of the indicators used for the development of multivariate analysis for the countries belonging to the first cluster.

Table 1: Value indicators of the cluster of weak countries

	Demographic				Socio-Cultural				Economic			
	Pop. ('000)	Annual Growth% (1995-2000)	Fertility Rate (1995-2000)	Infant Mortality Rate % (1995-2000)	Life Exp.	Human Develop Index	Doc.s % Inhab.	Univ. Stud. %	Internet Access %	Annual Growth % (1990-2000)	GDP per capite	Unemp. %
Algeria	30.841	1,8	3,25	50	68,9	0,697	1	14,8	1,93	1,7	5,31	28,4
Libya	5.408	2,1	3,8	27,8	70	0,773	1,28	19,8	3,58	2,2	8,58	30
Morocco	30.43	1,9	3,4	52,2	66,6	0,602	0,46	9,3	13,15	2,2	3,55	19,5
Tunisia	9.562	1,1	2,31	30,3	69,5	0,722	0,7	17,3	41,24	4,7	6,36	14,9
Jordan	5.041	2,9	4,69	26,6	69,7	0,717	1,66	19,5	40,91	4,8	3,97	14,7
Lebanon	3.556	2	2,29	20	72,6	0,755	2,1	38,2	85,8	7,2	4,31	19
Syria	16.61	2,6	4	26,9	70,5	0,691	1,3	6,1	3,61	5	3,56	20
Albania	3.145	-0,3	2,6	28,3	72,8	0,733	1,29	10,9	2,52	1	3,51	15
Croatia	4.655	0,1	1,68	10,1	73,3	0,809	2,29	29	55,89	2,8	8,09	23,1
Serbia	10.538	0	1,77	14,8	72,2	0,79	2,02	24,2	56,18	-7	2,29	27,9
Turkey	67.632	1,6	2,7	45,7	69	0,742	1,2	14	37,72	3,6	6,97	14,9
Cluster Ave.	17.038	1,44	2,95	30,25	70,46	0,73	1,39	18,46	31,14	2,56	5,14	20,67

Source: State of the World, 2003 – ed. Hoepfli; Calendario Atlante De Agostini, 2004. *Processing Ecos-Med*

The first cluster includes the Maghreb countries, those in the Nile Valley, and those of the Balkan peninsula which experienced war (apart from Bosnia). These are complex and problematic nations, some of them characterized by high internal stresses and/or involvement in recent conflicts. All have high values of annual population growth (except Albania), fertility rate, and infant mortality. The values of all socio-cultural indicators are, however, very low. They have high rates of unemployment although the GDP per capita is very low, but they have high annual economic growth (1990–2000), apart from Serbia (-7%), which, however, grew by 6.2% in 2001.

The second cluster is Bosnia which, although characterised by coordinates similar to those of weak countries, is characterized by a frightening unemployment rate of 40% and a very low GDP per capita. The following is the full table of values of the indicators relating to Bosnia:

Table 2: Value of relevant indicators for Bosnia

	Demography				Socio-Cultural				Economic			
	Pop. ('000)	Annual Growth% (1995-2000)	Fertility Rate (1995-2000)	Infant Mortality Rate ‰ (1995-2000)	Life Exp.	Human Develop Index	Doc.s ‰ Inhab.	Univ. Stud. ‰	Internet Access ‰	Annual Growth ‰ (1990-2000)	GDP per capite	Unemp. ‰
Bosnia	4.067	3	1,35	15	73,3	0,777	1,43	15,8	11,07	2,8	1.634	40

Source: State of the World, 2003 – ed. Hoeffli; Calendario Atlante De Agostini, 2004. *Processing Ecos-Med*

Table 3: Value indicators of the cluster of rich countries

	Demography				Socio-Cultural				Economic			
	Pop. ('000)	Annual Growth% (1995-2000)	Fertility Rate (1995-2000)	Infant Mortality Rate ‰ (1995-2000)	Life Exp.	Human Develop Index	Doc.s ‰ Inhab.	Univ. Stud. ‰	Internet Access ‰	Annual Growth ‰ (1990-2000)	GDP per capite	Unemp. ‰
France	58.453	0,4	1,73	5,5	78,1	0,928	3	50,8	263,77	1,8	24.223	8,9
Italy	57.503	0,1	1,2	5,6	78,2	0,913	5,9	47,3	275,78	1,6	23.626	9,1
Spain	39.921	0,1	1,16	5,7	78,1	0,913	3,1	55,7	182,75	2,6	19.472	12,9
Slovenia	1.985	0	1,24	6,1	75	0,879	2,28	53,3	300,75	4,2	17.367	11,8
Greece	10.623	0,3	1,3	6,6	78	0,885	4,1	49,9	132,13	2,3	16.501	10,3
Cluster Ave. 3	33.897	0,18	1,33	5,90	77,48	0,90	3,68	51,40	231,04	2,50	20.238	10,60

Source: State of the World, 2003 – ed. Hoeffli; Calendario Atlante De Agostini, 2004. *Processing Ecos-Med*

The third cluster comprises the rich part of the Mediterranean basin. Performance characterized by high socio-economic, but by a demographic *sadness*:

The cluster of rich countries is characterized by a GDP per capita which on average (€20,238) is four times greater than that of the weak countries and 12 times that of Bosnia. The average unemployment (10.6%) in rich countries is on average half that of the weak countries and four times that of Bosnia. Similar levels of inequality are also reflected in the socio-economic indicators. From the demographic point of view, however, rich countries confirm themselves as *sad*: their annual growth rate (1995–2000) is of 0.18% against the 1.44% of the weak countries while they have a fertility rate (1995–2000) of 1.33, compared to 2.95 in the weak countries.

The Mediterranean islands form the fourth cluster. As shown in Table 4, they may be considered as small rich countries in the heart of the Mediterranean.

Table 4: Value indicators of the cluster of Mediterranean islands

	Demography				Socio-Cultural				Economic			
	Pop. ('000)	Annual Growth% (1995-2000)	Fertility Rate (1995-2000)	Infant Mortality Rate ‰ (1995-2000)	Life Exp.	Human Develop Index	Doc.s ‰ Inhab.	Univ. Stud. ‰	Internet Access ‰	Annual Growth ‰ (1990-2000)	GDP per capite	Unemp. ‰
Cyprus	790	1,1	1,98	8,1	77,8	0,883	2,55	19,4	221,57	4,2	20.824	3,8
Malta	392	0,6	1,91	7,7	77,6	0,875	2,61	20,1	252,55	4,9	17.273	7,4
Media Ave. 5	591	0,85	1,95	7,90	77,70	0,88	2,58	19,75	237,06	4,55	19.049	5,60

Source: State of the World, 2003 – ed. Hoepfj; Calendario Atlante De Agostini, 2004. *Processing Ecos-Med*

Table 5: Value of the cluster indicators of Israel

	Demography				Socio-Cultural				Economic			
	Pop. ('000)	Annual Growth% (1995-2000)	Fertility Rate (1995-2000)	Infant Mortality Rate ‰ (1995-2000)	Life Exp.	Human Develop Index	Doc.s ‰ Inhab.	Univ. Stud. ‰	Internet Access ‰	Annual Growth ‰ (1990-2000)	GDP per capite	Unemp. ‰
Isreale	6.172	2,4	2,93	6,3	78,3	0,896	3,85	48,6	230,49	5,2	20.131	2,3

Source: State of the World, 2003 – ed. Hoepfj; Calendario Atlante De Agostini, 2004. *Processing Ecos-Med*

Finally, there is Israel which, in the heart of weak countries, in a framework of strong territorial conflict, is able to have a socio-economic performance typical of rich and predator countries but, unlike the latter, it also has a lively population growth typical of the countries of the southern Mediterranean. Table 5 summarizes the values of the indicators.

The cluster analyses shown so far quantify, away from any rhetoric, the wide disparities in the area. Besides the extraordinary diversity of cultures and languages there exist, then, observed on this scale, two socio-economic Mediterraneans: one rich, predatory, or else potentially predatory, but sad in terms of demography and the other with weak economies, heavily indebted and dependent, but fast growing and fecund in terms of population. We are not looking at an integrated Mediterranean, distant from the critical threshold of proximity in developing mutual economic and social relations, capable of drawing global benefits from integration. We are in front of a Mediterranean experiencing a demographic imbalance also destined to alter both the geographic distribution of the population as well as the structure of its age groups (G. Signorino – 2002).

2.2 *Italy*

Going down the scale and observing one of the rich countries, we find that the complexity observed for the whole Mediterranean area is once again encountered with an autosimilar geometry. For this analysis were chosen, such as territorial atoms, the provinces and the indicators as listed in the following legend:

Regularity index: an indicator of regularity of the local economy (the maximum value is 100, indicating highly regular territories)



The results of the cluster analysis are shown in **Figure 2**

Source: State of the World, 2003 – ed. Hoepli; Calendario Atlante De Agostani, 2004. *Processing Ecos-Med*

There are, if one looks at this scale, essentially two Italies. Table 6 shows the average values of indicators for each cluster:

Table 6: Average values of the indicators of the four clusters (North, South, Trieste, and Rome)

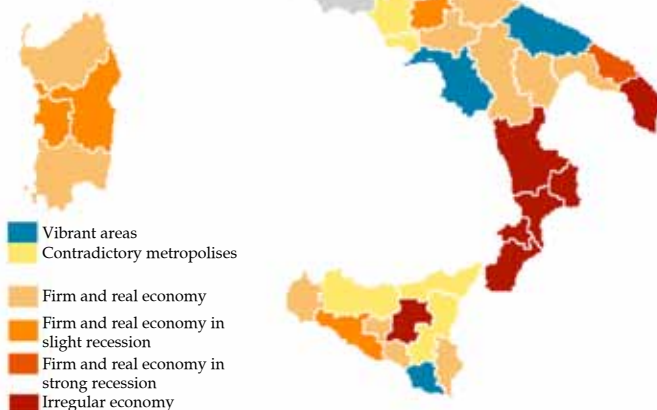
Cluster	demog1 (variations)	crim1 (ave. murders)	crim2 (minor crimes)	econ1 (protests)	Income pro cap	Unemployment	New Busnis. %	New Busnis	Ind. Regulat.
North	1,08	2,1	1625	4,1	18943	4,1	0,9	-0,3	91
Trieste	-7,5	3,6	4658	6,4	24147	5,22	-0,80	0,45	85
Rome	-1,6	4,28	2124,7	15,9	20569	7,85	5,23	0,88	79
South	-0,7	6,9	1382	8,9	11549	17,5	1,6	-0,1	79

Beside the two cases, irrelevant for the purposes of this paper, a picture emerges that is formally similar to the Mediterranean area as a whole in terms of spatial equities, but not obviously of course in terms of mean absolute values. A rich north, a magnet for people, characterised by full employment and a high index of regularity is mirrored by a south on average poorer, more conflictual, demographically sad, and with a high rate of unemployment.

2.3 Southern Italy

Always using the Provinces as territorial bases and as indicators as suggested in Section 2.2, we will now develop an analysis of southern Italy as a territorial in-depth study of what has been so far propounded. The decomposition so far made provides evidence of the presence of different and conflicting trends in the southern regions. There are, in fact, five different clusters:

Cluster Analysis of the Provinces of Southern Italy



Cluster 1: Contradictory metropolises areas and vibrant areas

The following table summarizes the values of the indicators used for the development of multivariate analysis relating to the provinces belonging to the first cluster.

Table 7

	Demo	Crim1	Crim 2	Econ1	Econ2	Econ3	Econ4	Econ5	I. Reg.
Caserta	4,5	10,52	1275,80	15,49	9'051	24,90	2,85	0,42	78
Naples	1,4	10,99	1532,81	24,15	11'161	26,24	2,53	0,26	75
Salerno	0,7	4,71	1168,72	15,47	11'241	17,20	1,73	-0,23	78
Bari	1,9	6,99	1364,95	8,82	13'158	14,15	1,22	-0,07	81
Palermo	0,9	5,45	939,43	13,59	11'049	25,54	1,89	-0,66	69
Messina	2,4	7,68	1463,06	10,96	13'027	25,20	2,31	-0,47	75
Catania	1,8	12,51	1297,34	14,51	10'871	22,94	2,66	-0,35	75
Ragusa	1,9	6,47	1008,44	9,74	12'700	13,51	3,01	0,20	81

This first cluster, consisting of areas either territorially and/or historically advantaged, and which have overall indicators of demographic vitality (+1.94% average growth from 1991 to 2001) and business dynamism (+2.27% start of new companies in 2003), has two subgroups of clearly identifiable areas. On the one hand there are the great southern cities: metropolises full of contradictions which are demographic and economic magnets, but simultaneously characterised by high unemployment (average 21.21), a high index of economic irregularity (average 73), and a highly uneven distribution of wealth distribution (see focus on cluster 1, carried out on the metropolitan area of Messina and posted on the website of the Commission of Undeclared Work – the Office of the Prime Minister, 2001). On the other hand, there are areas (Ragusa, Salerno, and Bari) with significant social and economic vitality, comparable to some provinces in the centre-north (highlighted in green in Table 7) and that are characterised, in a distinctive way, by low unemployment and a high regularity of the economy.

Cluster 2: A strong and true economy

Clusters 2, 3, and 4 will be commented together after showing the tables that identify the provinces making up the clusters and the values of the indicators characterizing them. The legend that makes the column headings easy to read is the same as appended to the first table.

Table 8

	Demo	Crim1	Crim 2	Econ1	Econ2	Econ3	Econ4	Econ5	I. Reg.
Avellino	-2,2	4,53	1266,86	12,29	10'483	16,70	0,89	-0,49	79
Isernia	-2,3	0,84	1430,10	9,42	12'085	14,02	1,04	0,16	83
Foggia	-0,8	8,89	1249,92	6,75	9'862	16,93	0,68	0,07	78
Taranto	-1,7	6,66	1448,83	7,74	12'433	19,73	0,60	0,06	77
Potenza	-2,0	5,01	1464,50	5,70	11'379	17,32	-1,04	0,09	76
Matera	-2,3	5,02	1573,33	5,15	11'674	15,92	0,52	-0,41	79
Trapani	-0,4	6,28	881,22	8,38	9'851	16,25	-0,32	-0,31	79
Caltanissetta	-1,5	11,31	1833,99	6,99	9'037	23,24	1,04	0,09	74
Siracusa	-1,5	9,68	1214,97	9,14	11'158	18,93	2,24	0,02	84
Sassari	-0,3	4,92	1701,38	6,38	12'410	16,50	2,62	0,25	84
Cagliari	-0,4	3,91	1817,39	5,64	12'538	22,75	2,71	0,03	84

*Cluster 3: A stalled and real economy in slight recession***Table 9**

	Demo	Crim1	Crim 2	Econ1	Econ2	Econ3	Econ4	Econ5	I. Reg.
Benevento	-2	3,13	1293,84	10,67	10'592	14,07	-0,14	-0,98	82
Campobasso	-3,4	2,61	1737,60	4,86	13'310	15,48	-0,45	-1,23	79
Agrigento	-5,9	9,82	695,85	6,31	8'587	20,03	0,76	-0,76	73
Nuoro	-3	16,05	1591,38	2,62	9'956	16,79	3,70	-1,48	81
Oristano	-2,5	5,29	1459,22	2,61	10'673	19,41	0,94	-0,79	85

*Cluster 4: A stalled and real economy in strong recession***Table 10**

	Demo	Crim1	Crim 2	Econ1	Econ2	Econ3	Econ4	Econ5	I. Reg.
Brindisi	-2,2	8,77	1557,83	6,43	9'986	14,59	-0,52	-2,67	76

The territories in cluster 2, 3, and 4 are all sad areas characterised by a gradual demographic decline (-2.02% from 1991 to 2001), but by a truthful economic and labour market situation (more regular local economy 79.6; better

employment). The three clusters (2, 3, 4) actually make one large group highly representative of the environment of Southern Italy which in recent times is fragmenting:

Cluster 2 – Stalled from the point of view of new enterprises

Cluster 3 – In slight recession in early 2004 from the point of view of new enterprises

Cluster 4 – In strong recession in early 2004 from the point of view of new enterprises

The processes of modernisation which have never been effectively tapped have led to the overlapping of different socio-economic models, and often dichotomous, in which the dynamics of growth (defined as the average improvement of living conditions), was not always accompanied by an actual development: of self-sustaining capacity of the local environment through a web of widespread entrepreneurship, a new *modus operandi* of the public administration. To use a *classical* terminology, such areas tend to favour income rather than innovation and production.

One should note that the values of unemployment, relatively low compared to the South, seem to be true, given the low levels of irregularity in the local economies.

The job market is adversely affected by a decline in the number of enterprises in business, with three levels of intensity ranging from economies in 'stagnation' to those which are experiencing a period of real decline (Brindisi is a case in point).

An army of unutilized workers with little or medium skills in a structurally weak economic environment constitute a very infertile ground regarding the development and growth of social entrepreneurship initiatives, unless they are strongly supported by a public

intervention based on the provision, more or less direct, of the resources.

Cluster 5: Irregular Economy

Table 11 shows the territorial elements that make up local cluster 5.

Table 11

	Demo	Crim1	Crim 2	Econ1	Econ2	Econ3	Econ4	Econ5	I. Reg.
Lecce	-2,0	3,96	1135,50	7,66	9'442	20,04	0,25	1,17	79
Cosenza	-2,3	5,54	1296,28	7,83	10'369	23,08	2,80	0,60	75
Crotone	-4,0	17,24	1566,87	8,82	8'793	22,30	1,13	1,27	68
Catanzaro	-3,4	12,28	1857,45	8,96	10'036	24,46	2,17	0,91	76
Vibo Valentia	-5,0	17,38	1616,13	9,72	9'355	20,20	2,62	0,41	76
Reggio Calabria	-2,2	22,77	1715,09	9,86	9'607	25,91	3,28	0,75	72
Enna	-4,8	9,50	903,71	4,55	10'082	28,09	0,80	1,34	81

These are very sad territories characterized by a sharp population decline (-3.37% from 1991 to 2001), but with a strong increase in new firms, in a context of high irregularity (average 75.3).

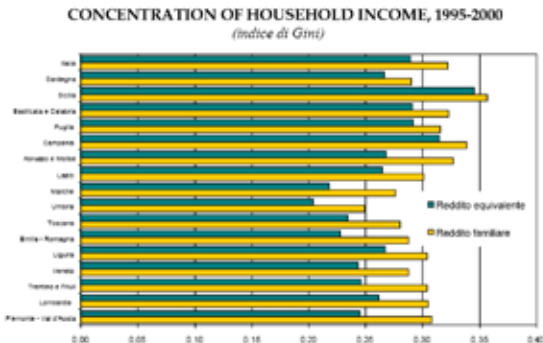
The latter group includes those territories which have very weak structural conditions of their local economies. Remote areas, with probably inadequate, infrastructure with high rates of irregularities that cause distortions in the functioning of the market and also disrupt the indicator relating to rates of unemployment.

The business structure is characterised by small size and by mature or labour-intensive products.

Recent studies by Cannari and D'Alessio (2003) confirm that the average family income, as well as the average household wealth, are, in the regions concerned,

the lowest in Italy. Obviously, the same may be said in relation to consumption per capita, GDP per capita, and disposable income (that is, net of taxes and transfers) for families. The most interesting results of the analysis by Cannari and D'Alessio (2003) concern, however, the distribution of income and wealth, as measured by the Gini coefficient. This indicator, in fact, measures the 'concentration' of a distribution: the higher its value, the greater the concentration of distribution in a few individuals in the series. The index takes the value of 1 when all the value is concentrated in a single observation (all income or all the wealth, were acquired or held by a single entity in the series); on the contrary, the index equals 0 if there was a perfect equidistribution of the series: that is, when each recipient receives the same amount of wealth or the same income. Figures 4 and 5 clearly show that the poorest regions, less socially cohesive and with a greater control of organised crime, show greater levels of concentration (of both the income of wealth). This seems to be the result as we discuss in later sections of a general nature.

Figures 4 and 5:
Concentration of income and household wealth





Analysing the meso-area of southern Italy there emerge, similar to what occurs in the *Weak Countries* of the Mediterranean, an irreducible complexity of behaviours and a spatially very unfair distribution of wealth and a quality of life: small-rich areas, sometimes mere points, within weak contexts, problematic, and often economically and socially dependent.

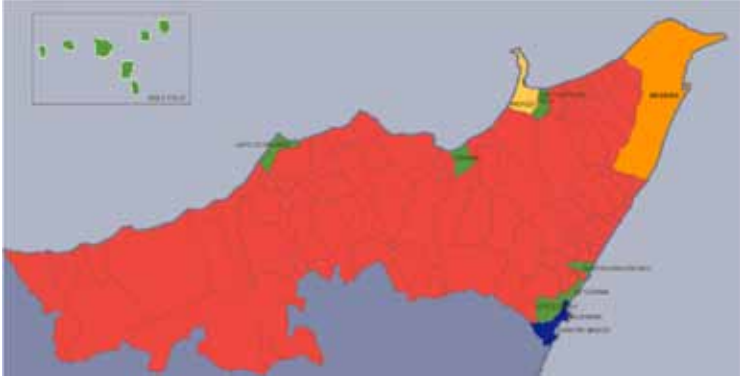
2.4 The Province and the City of Messina

Going down the scale, we have tried to analyse the provinces by using their respective municipalities as elementary particles. For this more microscopic analysis, we have chosen a standardised basket of indicators (ANCI data) which can represent:

- demographic context;
- the economic and productive systems;
- wealth;
- the transfer of funds to municipalities;
- the world of health and social services and of education.

Here is the result of the analysis plotted for the Province of Messina:

Figure 6:
Cluster analysis of the Province of Messina



- In the province of Messina we can distinguish:
- Cluster 1 (red area): The territorial background characterised by weak and fragmented economies;
 - Cluster 2 (blue area): The rich area, a point, strongly touristic
 - Cluster 3 (green area): Average tourist area
 - Cluster 4 (yellow area): Area at risk of de-industrialization
 - Cluster 5 (orange area): The metropolitan area with its many contradictions.

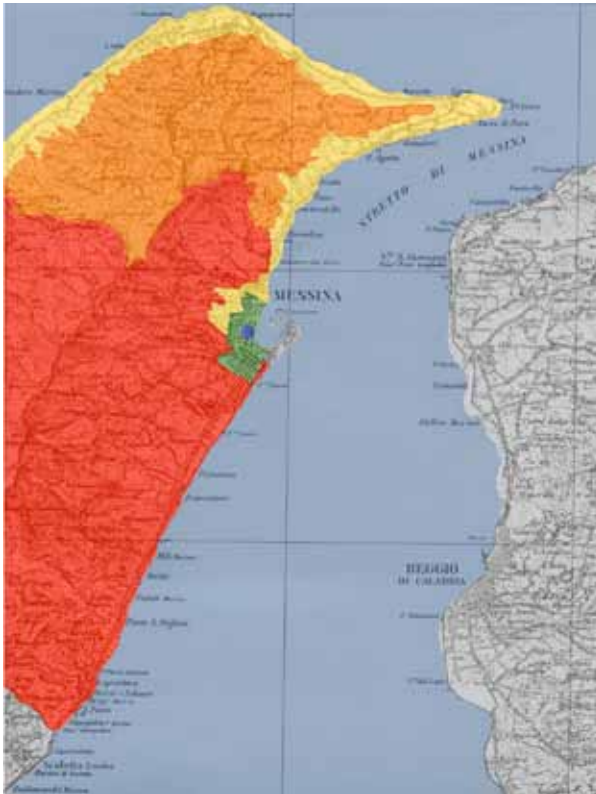
The thesis of autosimilarity is confirmed yet again if we proceed to a final zoom on the municipality of Messina. In this case we have used the elementary units as ‘particles’ of territory centred on a number of school buildings. The indicators used for the multivariate analysis are:

- wealth per capita;
- school dropout;
- accessibility to services (measured with a time of urban transport);
- juvenile crime;

- housing deprivation (measured by a logical variable on the presence of shacks in the area).

Since the clustering is ultimately a classification technique, it has allowed us to identify land homogeneous areas in the city of Messina. The following diagram shows synthetically the result of our work.

Figure 7:
Cluster analysis of the City of Messina



The *red area* is characterized by the lowest income per capita, high values of educational drop-outs, and structural housing problems. From these areas of town come most of the children who have come into contact with the judicial system: the southern suburbs 49.1%, with the following internal distribution: S. Lucia Sopra Contesse (10.2%), Bordonaro (9.5%), Aldisio-Gazzi (5.9%), Contesse-Minissale (3.9%), CEP (3.4%), the northern suburbs (22'9%), the area with the largest number of cases is Giostra-Villa Lina (8.8%); downtown (19%); the most common places of origin are the villages of Camaro-Bordonaro and Mare Grosso; suburban villages 9%, even here they mostly come from the southern hinterland of the city. The *blue and green* regions are the very central ones, the riches in services and where wealth is mostly concentrated. The *orange and yellow areas* are characterized by indicators of acceptable social and urban decay, the relational fabric of the villages is still sufficiently connected and there is a clear sense of territorial identity, the coastal areas in the north have a higher per capita income than the surrounding hilly areas but, for both territories, there is a low accessibility to services and public transport to and from the city centre, where many functions are still concentrated.

The analysis so far developed seems to indicate that, invariably with respect to the geographical scale on which we observe the phenomena, there is a strong correlation in the global economy – open – among poor social cohesion, processes of impoverishment of territories, and structures of attractors of wealth which are non-democratic and which lead to profoundly unequal pay, knowledge and opportunities. Certainly, the deep-rooted presence of organised crime and/or the presence of state organisations that distort equal opportunities (these

latter being structural conditions in many areas of the Mediterranean region under consideration in this paper) with their forms of territorial control and their ability to distort the market, amplifying fragmentation and social control, thus amplifying, in a related manner, a polarized geometry of wealth and opportunity.

The strong self-similarity of the southern Mediterranean with the south of its rich areas seems to us a matter of great interest on which to base mutual forms of joint development and practices of 'globally' emancipatory cooperation.

3. Distribution of wealth and the failure of capitalism

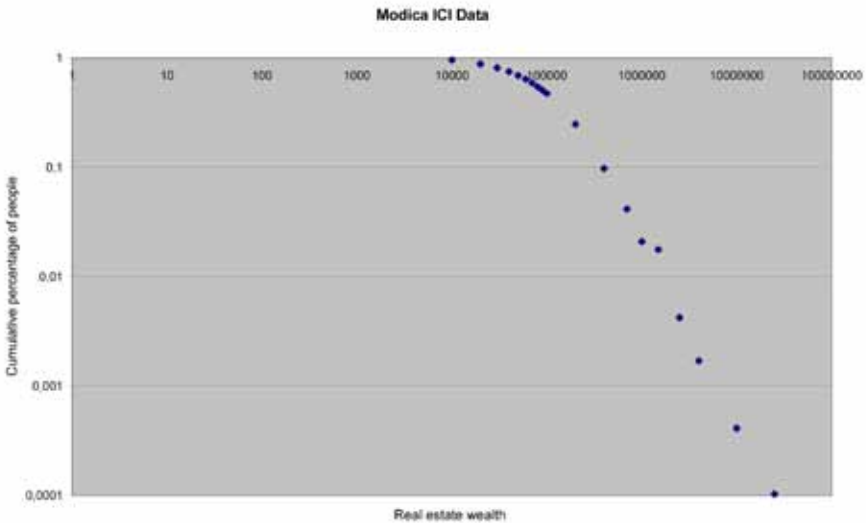
Certainly to the self-similar geometry described in the previous section there must correspond strong correlations and connections. In this section and the next we will try to build models of interpretation that help us to discern possible trends towards a more equitable and more sustainable Mediterranean world.

In fact, recent work (A. Dragulescu and VM Yakovenko – 2001; T. Wilhelm, P. Hänggi – 2003, F. Clementi, M. Gallegati, 2005, 2005, F. Clementi, T. Di Matteo, and M. Gallegati, 2006) seem to indicate that the Pareto law about the distribution of wealth has empirical evidence at a national and supranational level, apart from distorting phenomena of distribution in its tail as regards low incomes. Preliminary results obtained by us show that the observed behaviour on a macroscopic scale are self-similar to the distribution of wealth within local communities. Pareto's distribution distorted on low incomes seems to be a universal law.

The following is a typical curve we have drawn on real data of a local community.

Figure 8:

*Distribution of wealth in a local community (city of Modica)
– indicator: ICI data from the city*



The x axis shows the real-estate wealth, while the y axis shows the cumulative percentage of people who own more than the value x. The distorting effect at the top of the chart does not alter our reasoning at all; indeed a reading of the model will amplify the findings, the linearity of the distribution in the logarithmic graph in accordance with Pareto's law.

Recent research (Malesci G. *et al.* – preliminary results) makes it possible to develop a simple model of what Pareto observed empirically and expected theoretically. In fact, the linear part of the distribution is obtained with a sequential model of the distribution of the resources. Suppose we have a finite amount of resources A and we begin a sequence of hoarding according to this dynamic map: the first economic agent will seize

an amount of resources at random (by extracting a random number) between 0 and A (between nothing and everything); the second agent can grab a random amount of resources that goes from 0 to what remains after the part seized by the first agent, and so on. The distribution of wealth that comes out through this process will consist of a distribution of wealth that respects the Pareto Law and the empirical evidence in the linear range in logarithmic scale.

This highly simplified model reveals the hard effect, dominant in the law of distribution of resources, and which, we think, denounces the substantial ineffectiveness of economic exchanges and the national and local welfare systems to produce a structural and significant redistribution of wealth and income.

The capitalist market economy proper, as has been the case so far, from welfare systems and redistributive policies, cannot answer to the need for equity, universal minimum income, non-violent communication, and happiness among the Mediterranean people.

4. New models and basic paradigms

Since 1955, empirical studies by Kuznets have gainsaid the classical approaches to the Solow-style economy, namely that inequality is an incentive for growth. Comparing empirical data, in fact, it was found that the countries that have experienced major growth in recent years were those which had higher levels of equality. Further tests on empirical evidence (Alesina Rodrick, 1994; Persson, Tabellini, 1994; Perotti, 1996) have confirmed Kuznets' findings, definitely casting doubt on the results of the theoretical neoclassical models.

Recent theories of econophysics (G. Giunta and D. Marino, 2009, 2010) suggest that, in a way that does not depend on the geographical scale at which the phenomena are observed, there is a strong correlation, in the context of open global economy between poor social cohesion, the processes of impoverishment of the territories, and the structure of attractors on these territories of non-democratic wealth and therefore of profoundly unequal pay, knowledge, and opportunities. Certainly, the deep-rooted presence of organised crime and/or the presence of state organisations that distort equal opportunities (such conditions being structural in many areas of the Mediterranean), with their forms of territorial control and their ability to distort the market, increasing fragmentation and social control, and so amplifying a polarised geometry of wealth and opportunity.

We think that the strong self-similarity between the southern Mediterranean and the south of its rich areas is a matter of great interest on which to base mutual forms of common development and of practices of 'global' emancipatory cooperation.

The studies cited above, based on the Ising lattice systems, have made predictive considerations on systems that simulate complex open socio-economic areas.

The predictive model based on microscopic interactions between economic agents predicts several phases on a microscopic scale:

- a strongly depleted system;
- a very unfair system;
- the creation of economic and social platforms of cooperative behaviour;
- an equitable system.

The study of the conditions (of the parameters of the model) that determine the phase transitions,

reinterpreted, provide important economic policy suggestions concerning the problem of inequality in wealth distribution:

The degree of openness of an economy increases its ability to attract resources. However, there is a kind of poverty trap, i.e. a poverty level below which the further opening of the economic system becomes counterproductive, if not counterbalanced by strong local political cohesion;

A wealth equitably distributed with large clusters of co-operation will yield benefits not only social but also economic, because, under these conditions, if the system is open it will attract resources;

In systems that start from poverty and strong inequality and in areas where, as in the southern Mediterranean, liberal practices have merged with ancient practices of patronage and employers must work systematically to enhance the local socio-economic platforms to connect them to international networks, even outside the local system and promote such behaviour through policies of openness.

Ultimately the model indicates that the transition between the first two phases towards the second two would be possible through the implementation of local policies strongly aimed at rewarding cohesion and cooperative behaviour and policies of internationalisation and partnership, interdependent with the first, which aim to produce flows of economic resources and knowledge that will directly improve socio-economic clusters, generating long networks, which organise themselves in the territories.

Empirical studies and new models of econo-physics therefore falsify Solow-type approaches, which are based on assumptions of perfect rationality. According

to these postulates, people choose on criteria of the maximisation of profit or, in a more generalised way, on utility (the latter point will be discussed below). In the more restrictive classical hypotheses, therefore, given the same information, every person and every economic agent will make the same choice. This is certainly not true in different contexts of the Mediterranean. For example, in areas with predominantly Muslim culture there is a strong correlation between the theological-moral dimension and the law, be it social, political, or economic. The precepts of the Sharia, 'the royal road to attain salvation,' do not have a value limited to the area of the intimate relationship between man and God, but they are also the principles of good conduct in all areas of public life of the community of believers, the *umma*. An analysis of Islamic finance and economy cannot ignore a knowledge of the religious content of Islam, its history and its sources. Here we can mention, for example, some economic-religious principles:

Riba = prohibition of charging interest

Gharar = prohibition of uncertainty

Maysir =prohibition of speculation⁵

Haram (forbidden) vs. *Halal* (allowed)⁶

Zakat = the Islamic tax.

While, on one hand, Islam recognises freedom in business and negotiation, on the other hand it indicates the poles within which such freedom can be exercised:

=> Sanctity of contracts => Common law.

But still, many of the choices of Gulf States, focusing more on fundamental principles, rather than on real cost-benefit analysis, do not appear as absolutely schematised postulates of economic rationality.

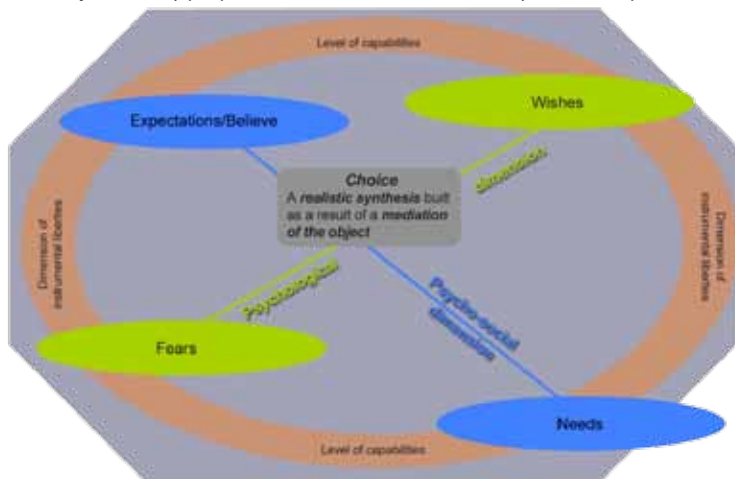
People living in conditions of high deprivation (e.g. victims of usury or those who have lived for generations in refugee camps) make economic and social choices characterised by strong economic irrationality.

In the West, to give a very different example, ethical economics represent an evolved and positive form of self-limitation in one's choices. The bonds of social and environmental responsibility strongly distort the idea of an economic rationale based on the principle of maximisation of profits.

From what has been said so far, it seems clear that the basis on which to base economic paradigms closer to the empirical evidence is far more complex than the hypothesis of perfect rationality. The schematic diagram below shows the logical sequence from which to draw important preliminary indications on which to base holistic policies of human development that are able to promote equality and cohesion, on the one hand, and expansion of individual liberties, on the other.

Figure 9:

The dynamics of people's choices that are the basis of economic processes



People choose and act on the basis of the construction of a mediation of the object. The area of choice is certainly influenced by a psycho-social dimension (needs, beliefs – what can realistically be implemented) and a psychological dimension that is built around that dynamic and highly personal imbalance that fluctuates between the desires and the fears of every individual. The weight, however, which each person attributes to fears and desires, expectations and needs is highly dependent on his condition. Personal psychological components cannot be taken into serious consideration in the economic and social micro-based paradigms (D. Kahneman – 2007).

The weight that each person gives to needs and fears with respect to the real expectation to get out of poverty, dependency, deprivation, or otherwise with respect to the real possibility of making the concrete expectations satisfy his own desires depends on the urban and human landscape where he lives; it depends, therefore, on the aesthetics of his vital territory and on the reading each person makes of the network of relationships of his closest neighbours and its key stakeholders (institutional and otherwise) with which it interacts, on the physical and relative microclimate in which he lives. The choices are based on the balance of context, not individual but, more correctly, on collective Aoki-style dynamics. If people perceive urban or extra-urban contexts, in short their life contexts, mostly as *hawks* (to quote the language of game theory), their choices will be determined more by fears; if, on the other hand, the contexts are perceived as *doves*, that is cohesive, there will give way more easily to mechanisms of sharing, cooperation, and the projection of desires. Certainly the architecture and aesthetics of the spaces, the dominant anthropo-cultural and religious paradigms of a society or local communities will strongly

influence the perception of individuals. All this reveals a strong correlation between ethics and aesthetics and clarifies how the policies to combat poverty, addictions, and deprivations or, more generally, political liberation are necessarily complex and must involve structural measures aimed at the system and meant to promote social cohesion and fruitful urban and extra-urban and socio-economic contexts; they facilitate, with respect to personalised development projects, the growth of increased personal freedoms.

Besides this horizontal level of the building of social cohesion, there is a vertical level (time) which provides quality items because man, in his complexity and not in the false caricature of the classic economic paradigms, lies at the centre of the processes of physical and social-economic transformation transformation of areas: endogenous approaches cannot but establish their roots in the social capabilities of local communities, but contextually they but evolve within the dynamics of innovation that come from the regions' ability to retain and attract creative talent and to valorize scientific and technological innovation. The correlation with the future and its generations will require that the transformation processes are driven by holistic criteria of environmental, social, and cultural responsibility.

It is clear that at this point we are still thinking, albeit in a generalised form, in the context of economic utilitarianism with environmental constraints. If we are to micro-base new socio-economic paradigms only from a search for utility, or even personal happiness, we must be aware that these models may be compatible (in terms of Pareto's observations on economic equilibrium⁷) with situations of great socio-economic inequality, even with substantial exploitative situations. These equilibriums

(of poverty traps) become possible precisely because people deprived of freedom tend to remain trapped by their need to survive and may therefore not have the courage to ask for (to imagine concrete) changes and/or act on them. Lacking ambition, their expectations are reduced to the few things considered possible (A. Sen, 1994; M. Nussbaum, 1999). Disillusionment will make the desire of what seems possible go away and slow down positive behaviour meant to make them get out of poverty, dependence, deprivation. Policies to combat poverty, addiction, and deprivations in areas as diverse as the different Mediterranean countries are complex and must necessarily involve structural measures aimed at the system and at promoting social cohesion and socio-economic development projects with respect to personalized projects which expand personal freedoms (as we shall see below). They must create the conditions for people to have a real chance to judge what kind of life they would want to live.

The information base of economic models based on absolute rationality or even utilitarianism is clearly inadequate. The convergence of real expectations towards the sphere of personal and collective desires is linked to the ability of people and this is the human horizon needed to guide the development of individuals, companies, and even economies.

If one of our purposes is, therefore, to understand the real possibilities that each person has to pursue and achieve one's goals, we must take into account not only his main assets, but also the personal and relationships traits that govern the processes of conversion of primary goods in the ability to promote one's own purposes (in this context, for example, an elderly or disabled person or one in poor health may be at a disadvantage with a

more consistent package of primary goods than a young and physically healthy person. There are many elements that influence the relationship between income, wealth, and freedom. The personalisation of politics seems an absolutely necessary strategic option. In this regard we can recall that Amartya Sen defines “functioning” as that which a person could desire, that to which a person gives value (being fed, being cared for, from the need to attend to participate to socialisation) and “capabilities” as the set of alternative combinations of functionings that one is able to achieve. “Capacitances” are therefore a kind of substantial freedom, freedom to implement more alternative lifestyles (A. Sen – 2000).

If we carry what has been said so far to the language of micro-foundation there is no doubt that the capabilities in some areas of operations can push choice and real expectations towards one’s wishes and towards the dynamics of change even in hostile environments, even with respect to strong socio-economic inequalities. A. Sen has mathematically shown that Paretian efficiency and liberty cannot be met simultaneously and that freedom must be accompanied by a functional socio-economic paradigm for human development and even regarding what has just been said about economic development.

In keeping with the most advanced research in economics and disability (M. Nussbaun, 2007; G. Borgnolo, R. de Camillis *et al.*, 2009) and with the most advanced trials in local welfare (also conducted by the network promoter of the Fondazione Comunità di Messina), one can see that the areas of operations more closely related to economic development are (G. Giunta, 2010):

- Overcoming deprivation owing to absence and/or inadequacy of income/employment and the precariousness of habitation;

- Knowledge;
- Participation and Democracy.

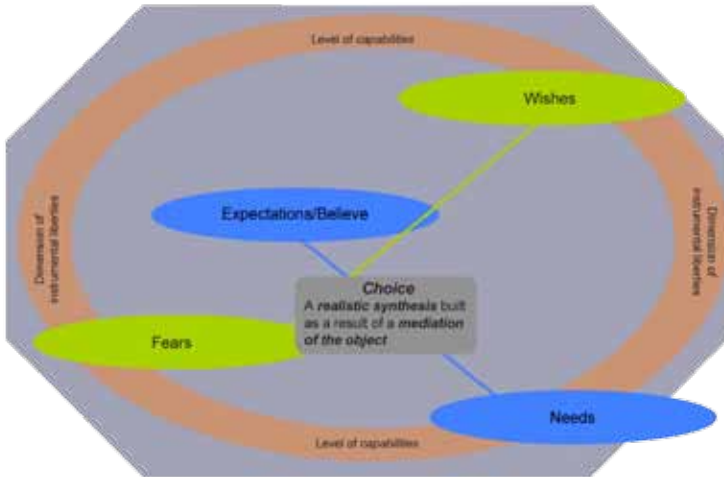
Social cohesion, therefore, and operations selected and explained above are the junctions around which to present correct policies for a new balance and human development.

5. Policies

On the conceptual strategic level, plans aimed at combating poverty and deprivations should promote, in an interdependent way, personalised projects aimed at inclusion and socio-economic systems for environmental and social responsibility which are able to generate confidence and which are based on the recognition of neighbourhood and family networks. It is obvious that such models of community welfare must be supported by inter-regional cooperation policies which have a distinctive feature of seeking a new balance. It is quite obvious that some areas of the southern and eastern Mediterranean have plunged below the poverty trap and that, if brought into contact with areas with far from acceptable levels of proximity, they are, in the absence of policies of cooperation, destined for progressive impoverishment.

Figure 10:

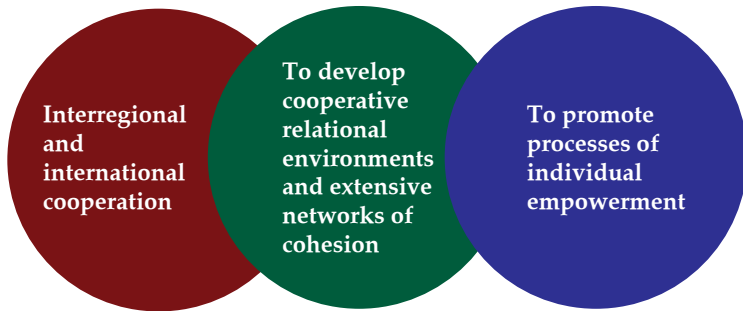
The prevailing social condition in the territories below the poverty trap



In countries which depart from conditions of poverty, deprivation, and strong inequalities and in regions where liberal practices have merged with ancient manor and patronage practices one must operate systemically to enhance local clusters of quality and to facilitate their connection to national and international networks and these behaviours and to promote policies of openness through these actions.

Figure 11

Logical and strategic diagram of the policies that combat poverty



Processes of redistribution of resources and wealth must be fostered in interregional and international cooperation so that they operate in such a way as to bridge the differences in development between the regions.

The lines of action for policies of new equilibriums are:

- Fiscal systems and Tax and redistribution incentives on different territorial levels;
- Processes favouring innovation, technology transfer, and the attraction of creative talent;
- Creation of networks of exchange and promotion of programmes of cooperation for development that see as protagonists networks of social economy and solidarity which are really not party either to the state or the market and are therefore able to propose social and economic alternative with respect to the politico-economic system of ownership and patronage;
- Removal of protectionist barriers.

Promoting socio-economic systems on the functional level means:

- Structuring holistic processes of social responsibility on the territories, such as dynamic and participatory methodologies of evaluation and which support the reprogramming of the policies and practices of institutional actors, as well as the practices of organisations and enterprises, because these (political praxis and practice), without simplifying them in the singular, gradually converge with the desires and principles (the set of values) of the citizens, communities, and local companies;
- Promoting economies of a social nature and based on solidarity in clusters and networks of clusters (business ethics assume a strategic role);
- Promoting actions for urban regeneration for a wider social and educational understanding
- Promoting processes of social infrastructure networks that can set up on the territories networks of research and social and cohesive economy which are foreign to and free from the dynamics of patronage that trap many areas of the south and are able to develop and transfer innovation into local and interdependent welfare systems in the local economies.

Against this background, therefore, change cannot arise but from systemic actions. In an ultra-modern perspective, it is necessary to create autonomous forms of social infrastructure designed to promote models of community welfare integrated into the experiences of an ethically oriented 'cluster' economy and 'cluster' networks, that are built according to criteria of environmental and social responsibility that contrast the criminal economy.

In this context, talking of development means understanding the overall capacity of a local system to sense and govern change, which incorporates innovations

and makes them compatible with the existing expertise and projects the local economies and social solidarity in a national and international dimension. So, if the traditional theories of regional development tended to emphasise the conflict between regional equity and national efficiency, the endogenous development approach focuses on the opportunities for development of local entrepreneurship and on systems which access technological and organizational innovations in a framework of the overall promotion of competitive advantages typical of each regional reality. Using a language more fitting the third system, the idea is to see the development of networks of solidarity within the territory as the pivot.

The attempt to turn a simple spatial specialisation or, worse, fragments not at all interconnected of companies and social actors into something more complex structures in systemic and/or networks of supply chains can definitely be a valid guideline for policy.

Introducing, therefore, the concept of a socio-economic territorial system as a unit of analysis, we believe that steps can be taken towards an increased capacity of interpretation if a synthesis is sought between the production system, technological knowledge embedded at local level, and local institutions. The socio-economic territorial system, that is, consists of the interconnection between the production system, availability of knowledge, including technological knowledge, and social capabilities.

While the system of production has mainly a material connotation, technological knowledge and social capabilities are mostly of an intangible nature.

The knowledge made available by R & D (codified knowledge) and learning opportunities offered by the state of knowledge in socio-economic territorial systems

(context codes) constitute technological knowledge. Social capabilities, however, are based on the actual availability of technical and cultural skills which are diffused locally and in the efficiency and effectiveness of measures taken by the institutions in the territory. The former are significantly correlated to the level and quality of education, training, and professional experience; the latter are closely linked to the experience of organising and managing progressively more complex production systems.

Reasoning from a socio-economic territorial system perspective, one can also optimise complex functions such as research, transfer of technological innovation, management, marketing and representation, and therefore it becomes easier to build connections with 'distant' markets. This latter fact is decisive in a territory that appears, as we have discussed, lacking a state and a market.

Consistent with the model built and quantitatively tested, customised projects aimed at strengthening personal empowerment may follow such lines of action:

- independent living;
- income from work;
- lifelong learning;
- democratic accessibility and participation;
- affectivity and socialization.

6. The Community Foundation of Messina – Developed social district

The strategic idea to experiment with the above policies has been to create in an area, Messina, which has been in a poverty trap for over 10–15 years, a Community

Foundation, as a third party in relation to the dynamics of the market and also to any form of economic dependency by the people, that can create an infrastructure of an Advanced Social District on the territory.

The advanced social district was created to promote organic and functional connections between the welfare system, the educational system, the cultural system, a social and united economy, production systems, scientific and technological innovation, and the social capabilities of the territories. All this seems very consistent with the scenario of the Lisbon Strategy where culture and cohesion have been suggested as factors that have led to the chain of value, the channels through which to affirm excellence and demonstrate a widespread social orientation towards innovation, creativity.

Ultimately the Foundation is directed to:

- i) **To promote the processes of empowerment of citizens and of local communities.** The regaining, in fact, of the fundamental rights to privacy and autonomy of living, affection, knowledge, and creativity-income-work is a prerequisite to free the desire otherwise overwhelmed by need, by disease, by material dependence, and by prejudices. The anticipation of a possible new future happiness or at least of a growing well-being is the human horizon needed to guide decisions and behaviour to orient the development of individuals, companies, and even economies;
- ii) **To promote social cohesion through the testing of mature forms of social dialogue and participation** as well as through the development of long networks, which also have economic value, starting from its recognition of neighbouring/

related networks who still constitute the dominant anthropological web of the weakest areas of the city;

- iii) **To promote a social and united economy, that is both male and female, where those excluded from the development find full citizenship** and that is a solid and recognised alternative to the grey forms of compliant, illegal, and criminal economies.
- iv) **To promote the opening of local systems for the exchange of resources, knowledge, and opportunities.**

6.1 The Founders

The partnership that has set up the Fondazione di Comunità is certainly one of the keystones of this programme of social infrastructure. In fact, there are involved the major social, educational, institutional, and scientific networks research of the area as well as important social actors and national and international networks.

The local actors involved are Ecos-Med, a centre of research/action for the promotion of social economy in the Mediterranean and the network of three socio-economic clusters, endorsed by Ecos-Med during the last decade.

The first cluster is the Horcynus Orca Foundation. This is a grouping of 18 institutional actors dealing with scientific research, the third system, and the ethically oriented market. These include: the University of Messina, the University of Reggio Calabria, the Thalassographic Institute IAMC-CNR, the Centre for Studies and Research Ecos-Med itself, IDS&UNITELM Informatica – a leading Italian ITC firm – , the Mediterranean publisher

GEM-Mesogea. The Foundation is the instrument of internationalisation and creative attraction of the District. Today it is:

- i) An International group for the studying of the Sciences and Marine and Environment Technologies under the aegis of UNIDO/UN (which is currently testing a prototype for carrying out research for electric micro-generation from sea currents);
- ii) A coalition of Mediterranean cultures which, through the International School of Film of Civil Commitment, the Horcynus Festival, the *punteggiature* of Contemporary Art of the Mediterranean, the laboratories of aesthetics and of the social and unified economy is, in fact, a small civil Euro-Mediterranean parliament of intellectuals for social economy, art, culture, environment, and gender equality;
- iii) A grouping aiming at divulging science, cultural tourism, and education. At Capo Peloro – in the monumental complex on the edge of the homonymous nature reserve – and the Straits of Messina on the offshore platform, ENERMAR, the world's first prototype for the production of energy from marine currents, there is the 'heart' of the Park, the home of creative spaces, of scientific popularisation, multimedia, animation for reading, of the library, of theatrical experiments, of multidisciplinary interactive approaches, spaces for contemporary art, of immersive installations, of live audio/video underwater broadcasts, of environments to study the energy of the sea, and 'observe' the chaotic phenomena of the Straits, deep sea fish, fossils, archaeological remains, of diving and sailing schools.

The second cluster is the Father P. Puglisi Foundation, founded to fight usury and the criminal economy and as a financial instrument to promote a social and ethical economy. Its founders are the Archdiocese of Messina, Lipari, and S. Lucia del Mela; FISAC-CGIL, Arci-Sicilia and Mo.VI Nazionale.

The third socio-economic cluster is the Sol.E Consortium of the CGM circuit. It includes 15 actors of Messina's social economy and it is the creator and manages the Parco Sociale of Forte Petrazza, located in a large military building of the times of King Umberto, for years occupied illegally by the Mafia, and then rebuilt and restored at its own expense. The park is designed as a place of social integration in the world of knowledge (advanced training in business and social work), of the knowledge of doing (it is the agency for developing and testing models of community welfare), of the knowledge of relationship (it is the space for socialising – guest house, cultural facilities, cafeteria).

These three clusters and their networks are based on participatory processes of development and co-organisation of a local partnership scheme, one which is very large, as we have seen, and characterised by a shared vision and a complementary function which is expressed in systematic relationships and interdependencies and/or supplies. Over the years the group has added high value to product design ideas and manufacturing quality.

The socio-economic system has, in recent years, put online:

- Co-marketing actions;
- Advanced management;
- Research, development and transfer of technological innovation;
- Business ethics services;

- Targeted Training;
 - Internal economies;
 - Online services;
- and resulted in the gradual development of:
- Internal economies;
 - Professionalisation of human resources and the capacity building of diffused management;
 - Strengthening of the existing and overall bargaining power;
 - Creation of new businesses.

The public partner of the local clusters, which co-founded the *Fondazione di Comunità*, is the Health Agency of the province of Messina which, for many years, has experimented with innovative models of community welfare consistent with the strategic perspectives explained in this work. Its presence certainly strengthens the institutional weight of the Foundation, as well as that of *Confindustria Messina* which is heavily engaged, in this historical period, in the fight against the Mafia and, in particular, against the extortion racket.

In addition to this extensive local network, the co-founders of the *Fondazione di Comunità* were:

- The *Banca Popolare Etica*, one of the main European leaders in business ethics;
- *Caritas Italiana*, which hopes to open a new way, strategically oriented towards change, to build marks of civilian witnesses in southern Italy;
- *Parsec*, a Roman cluster that will support networking and social communication at the national level of the Foundation;
- The *Paediatrician Cultural Association* which will support community projects for children.

From its establishment the Fondazione di Comunità will be part, in a structured way, as a member, of SEFEA (European Society of Ethical and Alternative Finance) and of the main network of cities and regions of Europe for the Promotion of Social Economy, REVES. Such important actors of the EU will support the processes of internationalisation of the Foundation, its investment in the green economy, and the experimentations of the participatory approaches of the SRT ® (Socially Responsible Territories).

6.2 The Fund

In its first year of operation, the Foundation has collected a fund of approximately €6,500,000 and, with a financial contribution of Banca Popolare Etica and SEFEA, it is spending approximately €15,000,000 to create a demonstration park of all means of renewable energy production from the sun, sea, and wind and a working park with photovoltaic technologies comprising:

- Three meso-systems, on properties confiscated from the Mafia, already being used by members of the District. These facilities are aimed at creating organic agricultural holdings for organic farming on abandoned land. The initiative is a flagship project that contrasts with the de-anthroposizing processes and the consequent desertification of our abandoned countryside. It is obvious that such lands are also changing into educational infrastructures on the subjects of legality, the fight against the Mafia, and sustainable development, making sites available to formal and informal educational institutions. In this case the energy credit (the incentive which the Italian State pays back to those who produce energy from renewable sources) and the entire

- energy production will be entirely donated to the Community Foundation to fund programs in the Socially Developed District;
- Approximately 80 plants in buildings belonging to public utilities (actors in the social economy, hospitals, churches, research institutions, municipalities, etc.). In this case the energy credit will be passed to the Community Foundation, while the value of the energy production will be redirected to the partner institutions who will redirect the resulting savings to institutional initiatives that fight poverty;
 - Approximately 160 installations of 3–6 kilowatt on buildings of average-size families. Even in this case the energy credit will be passed entirely to the Community Foundation, while the energy produced will benefit the families who, by joining the initiative, in fact constitute a large purchasing group that will extend its interest from just energy to other products (food, goods of daily and occasional consumption) that relate to freedom and of social and environmental responsibility.

6.3 The actions of the Community Foundation of Messina

The yield generated by the investment in the green economy, as described above, allows for self-financing in the long run of the activities of social, cultural, economic solidarity, of setting-up a participatory democracy, of research and development, of higher education, and of ethical financing of the District.

Consistent with the strategic explanation previously synthesised, the Community Foundation will operate within these macro-areas of action corresponding to the policy that it wants to promote and which are the pillars of a modern and innovative idea of social infrastructure in the south.

To make its action more effective, the Foundation will activate permanent programmes aimed at involving and widening of its social base and its stakeholders:

- the SRT ® (Socially Responsible Territories – introduced in literature and in European practice by REVES – G. Giunta, L. Martignetti, and R. Schlüter, 2007) participatory process. It aims to promote socially and environmentally responsible approaches in a territory and to encourage the convergence of public policies and the practices of businesses and organizations to principles and desires in which local communities and citizens can recognize themselves. The TSR ® process is thus a tool for building social cohesion, while providing support to the assessment, planning, processes of community involvement as well as the level of communication itself. It will form the main support to the governance of the Foundation, which will thus be increasingly recognized as a tool of the whole community;
- Educational pact among all schools, the formal and informal educational agencies of the territory as an alternative to the fragmentation and discontinuity of the work for projects, trying to steer policy educational programmes, care, laboratories, etc. to strategic educational junctions. We will use experimental methods borrowed from the philosophy of education;
- Structuring permanent projects on the territory to promote social accessibility, reading, and music from the birth of children in the most fragile areas of the city, as a long-term tool for possible future social emancipation. Regarding these methodologies there already exists encouraging experimentation and evaluation research validated by WHO;

- Structuring an agency aimed at developing the social economy on the territory. It will promote: incentive policies to promote clusters of non-state actors who are in the territorial process such as TSR® (to support investment and means of capitalizing firms in the network, to facilitate the reuse of assets confiscated from the Mafia and unutilized state-owned spaces to support processes of spin-offs, to promote trade and productive partnerships at regional, national, and international levels, to promote ethical venture capital); territorial policies (developing ethical finance and specialized financing for the third system); policies to increase the human capital (according to the methodology of the customized projects, organized according to the axes of support for living, socializing, training, and income from work); policies for the creation of trusted networks (promoting responsible consumption and demand that does not only look at the price, but also the stories of oppression or liberation that the products themselves narrate).

The Community Foundation will operate in line with the strategic perspective built and tested in the previous chapters. It will cover:

- actions meant to contaminate the strategic choices of the Area Plans of the territories, to guide them towards a more innovative and emancipated logic of community welfare;
- projects for the actors who participate in the educational agreement, described in section 4.2.3;
- actions in the context of initiatives open to the Social Development of the Social Economy and Solidarity Agency. Among these, it is interesting to note

- The attraction of creative talent and experiences, aimed at developing the social economy;
- To fund engineering prototypes and pre-competitive research on which CNR, local universities and the Horcynus Orca Foundation can work to be connected to spin-off operations of productive social enterprises.
- Projects selected through calls and/or through forms of territorial concertation built by structuring in an interdependent way actions aimed at the system (business projects and clusters of micro-enterprise, hybrid forms of autonomous and cooperative employment, actions aimed at environmental regeneration and the transformation of urban landscapes, support for territorial pacts) and personalised inclusion projects according to the operations identified in section 4. Consider, for example, some form of micro-entrepreneurship and income support in ultra-popular areas related to the generation of energy from renewable sources or from the recovery and recycling of biomass, or by the self-construction and management of district services (playgrounds, social centres, public parks, etc.) paths always built within the logic of social pacts that require, for example, combating children leaving school early, etc.
- Complex programmes associated with large available collections. The first of these programmes is called Light and Freedom (for its implementation the fines fund of the Italian Ministry of Justice has supported the establishment of the Community Foundation of Messina). It aims to release 56 inmates from the Judicial Psychiatric Hospital in Barcelona PG (ME). The incomes from photo-voltaic production will support over a long

period (20 years) the cost of the model of community welfare support in the process of de-institutionalization and inclusion of persons who benefit from it in the world of stable and lasting employment. No other traditional output project (e.g. short-term employment grants) has so far provided similar results, although the yearly costs per person is much higher. The project will also support actions to develop partner social enterprises that will ensure stability and quality in job-placements, carrying out the functions of a development agency for social economy. Customised projects will be managed according to a mix of mature management models both in parallel and in an interdependent manner. These include: social housing actions, training activities, dynamics of socialisation, progressive actions to boost citizenship income (long-term) leading to personal salaries.

Ultimately, the processes activated by the Community Foundation will be able to substantiate the strategies developed in the preceding paragraphs and weave oriented actions by:

- participation and quality of governance – TSR ® process;
- strengthening the quality of the educational system of local communities;
- developing the social economy and the promotion of responsible consumption;
- strengthening the quality of the cultural offer and supporting the process of internationalization, attracting creative talents and developing local talent;
- finalising the production of knowledge and research and development;

- experimenting with forms of local welfare strictly oriented to empowering local communities and the citizens.

Notes:

- 1 Thanks to G. Malescio of the Physics Department for the important scientific discussions we had together.
- 2 The variance is, in actual fact, a measure of the distance of a statistical unit from the average, the centroid of the cluster.
- 3 The cluster analysis is a specific methodology of multivariate statistics that allows the drawing up of a classification in homogeneous groups of the statistical units considered according to criteria of the 'nearness' of the values of the indicators used.
- 4 The qualified workers tend to move on the markets of the south.
- 5 The prohibition of *gharar* and *maysir* implies that any transaction or contract must be free from any type of risk or uncertainty. While the prohibition of *riba* is absolute, *ghara* is only prohibited if relevant. Some juridical interpretations, in fact, compare excessive uncertainty to gambling (*al-gimar*) which is expressly prohibited by Islamic law.
- 6 The *Sharia* prohibits the consumption or the investment in economic activities connected with the production and distribution of alcohol, arms, pork, gambling, pornography, and tobacco.
- 7 The ultimate Paretian (or allocative efficiency) is obtained when no reorganization of production is possible which will improve the conditions of at least one person without diminishing those of others. In such a situation, the utility of a person cannot be increased only by the diminution of the utility of anybody else; that is nobody can improve his condition without somebody else worsening his.

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BUILDING ON THE
ITALIAN EXPERIENCE
An ethical bank for Palestine?

The story of ethical finance worldwide has proved that having a dream is often really important. Naturally, to achieve that dream one has to bring together individuals and organisations in such a way as to set up a network in motion: all together they strive to achieve what may seem at first to be a very difficult goal. To attain such an objective, one needs strong-willed, determined persons who are capable of committing and involving others. But such leaders have to own and be led by a clearly defined set of values and be capable of formulating and implementing coherent proposals.

Thus, for example, we cannot state with certainty that the dream to create an ethical bank in Palestine will one day materialise. But we can say that there are many individuals, groups of like minded-people, and organisations that seem bent to undertake that commitment. They are strengthened in their resolve by the encouraging positive results registered by Banca Popolare Etica in Italy, although of course the socio-economic and political environments are somewhat different.

This intervention highlights the main features that make up Banca Etica and traces the efforts being made to create an ethical bank in Palestine.

Banca Popolare Etica

Banca Etica was set up on the first of March 1999. It has at present more than 33,000 members, including ten regions and three hundred town councils. Its customers exceed 50,000 and funds amount to 800 million euro. Over the decade of its existence, the Bank financed more than 10,000 enterprises and, thus, contributed to the generation of around 100,000 jobs spread among the following sectors: (i) Social co-operation; (ii) International co-operation and fair trade; (iii) Safeguarding the natural environment and encouraging organic farming; (iv) The formation of new associations. Besides, the Bank set up the cultural foundation, Etica Sgr., to sustain initiatives that contribute to the identification of national and local heritage and to promote education and culture.

The Bank has recently become more committed to the financing of projects related to renewable energy – namely, wind, sun and photovoltaic - and to sustain the microcredit sector. It is working to set up a national microcredit agency in Italy.

For some years now, also thanks to the support from FEBEA, Banca Etica has been involved in a project that could one day lead to the setting up of a European Co-operative Bank together with its French and Spanish partners, NEF and Fiare. Other FEBEA members are also interested in this initiative, namely Oikogeno/Femu Qui. We are planning to take this project further than the 'concept' stage in 2011.

These experiences have encouraged us to look outside the European Union to disseminate the ideas that may one day realise similar projects elsewhere. Indeed, we thought that the model could be a useful instrument to introduce in the Middle East in an attempt to bring together members from different ethnic communities to provide a regular flow of financial resources or savings, direct them to specific sectors or industries, in an attempt to promote economic growth and employment. It will serve as an example of social solidarity apart from being a mechanism to gather resources destined to enhance the well-being of people living in a relatively unsettled region. This idea has been the wish of Banca Etica members who have been specifically asking for solutions to issues arising outside the European Union region.

Ethical Bank in Palestine

The idea of an 'ethical bank in Palestine' came through a request from PARC, a Palestinian NGO operating in the rural areas, with which ACS, a Padova NGO and a Banca Etica member, have been working for over two years together with ETIMOS. This co-operation programme was supported by funds from the Italian Ministry for Foreign Affairs in the context of projects meant to sustain access to credit for Palestinian craftsmen and farmers.

In the political and social context prevailing in the region, the traditional finance system and microfinance institutions cannot give credit to 'weak' enterprises that are consequently considered a high banking risk. Therefore, as a result, obtaining credit and hence the resources that are meant to increase a potential entrepreneur's savings is hard indeed.

Meetings also involved the International Fund for Agricultural Development (IFAD) and SIDI, a FEBEA member with presence in Palestine for over fifteen years. The first results emerged from these discussions: REEF – Rural Economic Empowerment Foundation – a microfinance institution linked to PARC. Banca Etica contributed €150,000 to this project. REEF is registered in Gaza as an NGO. It operates in both the Gaza strip and the West Bank and was formally launched on the first of January 2008. REEF mainly grants credit to women and farmer co-operatives which, in turn, grant loans to their members.

SEFEA (Società Europea Finanza Etica e Alternativa – European Ethical and Alternative Financing Company) has always been active in this context. Since its foundation in 2002 it has sustained the finance initiatives of Etica Krk in Kosovo, Cultura in Norway, Merkur in Denmark and the establishment of COOPEST which operates all over Eastern Europe. Besides Palestine, SEFEA has been called recently by the Canadian ‘Caisse Solidaire’ to help set up a financial tool in Central America, in Costa Rica and Mexico in particular, to sustain farmers and small enterprises in the region.

The next steps

The next step depends on the availability of capital. Once this is obtained, from government support programmes for example, the immediate task will be to develop further microfinance institutions in Palestine and evaluate the feasibility of turning one of these institutions, say REEF, into a Bank to support microcredit initiatives. Meetings in Ramallah held with the Governor of the Central Bank

of Palestine were useful in contributing to the charting of this potential strategy programme.

The Banca Etica approach has always been based on involving the Israelis. To this effect, bank officials held several meetings with Jeuda Paz, leader of the Kibbutz movements, to assess the interest in this initiative. There are positive signs that such a project could be realisable. Indeed, it emerged that there appears to be a gap in the financial spectrum of institutions in Israel; there are no social vocation banks. The Kibbutz movement is represented by around 40% of farming sector turnover and 10% of industry. It does not have a reference bank.

But everything hinges on the availability of capital to set this process further.

The dream

The dream can go further. In Israel/Palestine an Israeli and a Palestinian cannot set up a company together. However, if, say, a European company opens an office, for example in Jerusalem, then Israelis and Palestinians can meet in its offices. This is our dream and our conviction. By using monetary resources responsibly, we can create a better future for a larger number of people, a future where peace and well-being can support each other in the interest of many. It is our dream that people bordering the Mediterranean will believe is this project, and others based on the model, in the interest of all concerned.

MICRO FINANCE IN NORWAY Cultura Bank and Access to the European Investment Fund's Loan Guarantee arrangement for micro-credits

Introduction

First of all, my thanks to APS Bank and to FEBEA for the opportunity to present Cultura Bank's experience with micro credits at this symposium. This occasion serves to represent the various tools that microcredit institutions may resort to in carrying out their work.

Cultura Bank is a Norwegian savings bank established as a full bank in 1997 after more than 10 years' history as a savings and loans co-operative. Today the bank has 15 employees, about 4000 customers and total assets amount to €40 million, whereof €37.5 million are loans, mostly to small businesses. In addition the bank grants housing loans to private customers. The bank is fully financed by equity certificates (€5 million issued) and customer deposits.

Cultura Bank was established to offer an alternative to the development of the conventional banks themselves that were increasingly engaging in pure financial activities perhaps at the expense of supporting a sound development of the real economy. Like other FEBEA member banks, it practises the principle of ethical and

environmental standards for its lending as well as full insight in the loan book.

Cultura Bank's Micro Finance History

Back in 2003 the bank was invited to co-fund a small trust called MicroInvest. The other partners were a county near the town of Bergen in western Norway and a humanitarian organisation called The Norwegian Peoples' Aid. Based on the founding capital of NOK 300,000 (€37,500) and a subordinated loan from a state agency called Innovation Norway, it was possible to start lending to small groups, mostly consisting of immigrant women, all organised by Network Credit Norway which also provided basic business training to the participants. Since many immigrants, and women in particular, are shut off from the ordinary labour market, the loans granted were crucial in creating self-employment for these groups.

In 2006 the loan book of MicroInvest was incorporated into the bank and the same year Cultura Bank applied for the loan guarantee arrangement under the EU MAP (Multi Annual Programme for Enterprise) programme. This guarantee, which was applicable for loans of up to €25,000, would cover up to 75 % of an eventual loss. Under this facility the bank granted more than 90 loans for a total of about €1 million. Cultura Bank is now entering into a new period under the Competition and Innovation Programme (CIP) which runs through 2011 for a total limit of €1.4 million.

The micro finance activities of the bank are mainly run by one person using the same banking infrastructure and thus incurring the same overheads as the rest of the bank.

The Competition and Innovation Programme (CIP)

The CIP is managed by the European Investment Fund on behalf of the European Commission.

Its main purpose is to:

- Encourage the competitiveness of European enterprises
- Support innovation and entrepreneurship activities
- Provide better access to finance
- Promote the increased use of renewable energies and energy efficiency

Products offered include:

- Guarantees: SME Guarantee Facility
- Free of charge capped guarantees provided for additional risk-taking by intermediaries (like Cultura Bank) resulting in enhanced access to finance for SMEs.
- Venture capital: High growth and Innovative SME Facility

The Guarantee Facility:

- Free of charge capped guarantees provided for additional risk-taking by intermediaries (like Cultura Bank) resulting in enhanced access to finance for SMEs
- Shall enable lenders in the current economic environment to further support SMEs (tighter lending criteria to be relaxed)
- Selection of intermediaries with wide geographical cover in each country so that as many SMEs as possible have access
- Minimum selection criteria (commitment to SME financing, financing volumes, and geographical reach)

- Visibility and promotion e.g. EIF support

CIP SME Guarantee Facility Instruments

There are four business lines, known as “windows”, namely:

- *Loan Guarantee* Coverage of portfolios of mid- to long-term debt finance targeting SMEs and focused on investment financing. (Flagship window thanks to its flexibility and wide-ranging characteristics)
- *Micro-Credit Guarantee* Coverage of portfolios of microcredits to encourage financial institutions to provide financing to microenterprises, especially start-ups (Cultura Bank)
- *Equity Guarantee* Coverage of portfolios of equity and mezzanine investments in SMEs in the seed and start-up phases. Aim to help SMEs improve their financial structure
- *Securitisation Guarantees* to support securitisation transactions so that financial institutions may mobilise additional debt financing for SMEs

General Features

- Free of charge guarantee
- *Enhanced access to finance requirement*, which means that the Guarantee Facility covers risk that is additional to the one already taken by the intermediary
 - Increasing volumes, maturities, rate of financing covered
 - Waiver of collateral requirements
 - Riskier target groups (start-ups, new areas of operation)

The requirement is translated into specific and quantified obligations

Target volumes

- Guarantee conditional on achieving specific volumes
- Special Focus on eco-innovation, business transfers, and so on
- Capped Guarantees at a pre-agreed level taking into account expected default and recovery rates, risk premium charged by the intermediary, requirements as to Enhanced Access to Finance

Other features

- Commitment fee in case target not reached (not applicable to Micro Credit Window)
- Visibility: SMEs have to be informed of the EC support
- State Aid rules are applicable to EU guarantees (e.g. de minimis), except for the Securitization Window (where guarantee fees are charged)
- Quarterly and annual reporting requirements and monitoring

Specifics about the Micro-Credit guarantee

- Purposes of financing: investments, working capital
- Minimum maturity: priority to minimum 12 months, at least 6 months
- Maximum amount: €25,000
- Borrowers: micro enterprises according to EU definition (less than 10 employees)
- Guarantee rate: up to 75%
- Guarantee maturity: final maturity up to 5 years
- Guarantee cap rate: max. 20% based on expected loss

- Technical support: €200 per borrower financed, max €50,000 for the whole period
- Free of charge guarantee

The Application Process

- Application process:
 - Pre-selection if application is in line with requirements
 - Requirement for further information if necessary
 - Due diligence meeting
 - Proposal to EIF Board and to EC for approval
 - Agreement implementation
- Timing: 3-6 months (depending on quality of information provided)

Selection Criteria

Intermediaries shall be selected having regard to the following selection criteria, in no particular order of priority:

The financial standing and the operational capability of the Intermediary and its ability to manage risk and to comply with the terms and conditions of the SME Guarantee Facility;

And, where appropriate:

Whether the Intermediary guarantees Micro-Credit Financing extended by a wide range of lenders;

The extent to which the Intermediary has the possibility to provide mentoring schemes and/or business support; and

The willingness to accept the criteria for Enhanced Access to Finance.

Cultura's Experience

Having cooperated with the EIF for over four years, I may draw several observations that other micro credit institutions may find useful in reaching their objectives.

The facility has been of great help, because it really enhances the bank's ability to fund small entrepreneurs.

But there is one major challenge for a bank that has as an objective the generation of a reasonable net of return on investment for its shareholders/investors. The net result of the guarantee facility is still negative. The technical support arising under the programme (€200 per loan) does not cover the high cost of establishing and following up a micro loan portfolio. It will therefore have to be subsidised from other 'profitable' activities.

Since Cultura Bank has a well-defined social profile, it is able to support such activities and, at the same time, communicate with those who provide the capital with which it operates.

In addition, it must be pointed out that the reporting requirements can be quite time-consuming. A financial institution's software set-up may not be able to incorporate directly the forms provided by the EIF for normal reporting purposes, be it internal or external.

Although the EIF staff has always been accessible and helpful throughout the applications, audit processes and daily business, yet these inbedded extra costs have to be faced.

In summary, financial instruments are useful to fill in certain gaps in the raising of resources-lending-follow up process for sustaining micro-credit activities. But there are basic administrative overheads and running costs that have to be borne by the micro-credit institution. Such an institution must ideally be in a position to cover

economic surpluses from other 'profitable' activities in order to be in a position to support certain loss-making initiatives. Investors must be fully aware of these cross-subsidising undertakings so that they can understand better the sources that, ultimately, register the ratio of return on capital and condition the way in which they can guarantee the generation of resources in future.

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