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Micro-Lending – A Case for Regulation

A. EXECUTIVE SUMMARY	3
I. Definitions	3
II. Findings.....	4
III. Propositions	5
III.1. General	5
III.2. EU Bank Law and Social Micro-lending.....	5
III.2.1. Considerations	5
III.2.2. Recommendation	7
B. INTRODUCTION	9
C. MICRO-LENDING – A CASE FOR REGULATION	10
I. Deregulation for Micro-credit by Non-Banks?	10
II. Micro-lending in Practice	12
II.1. Elements of Micro-lending.....	13
II.2. Micro-lenders or micro-lending?	15
II.3. The Purpose of Micro-lending.....	18
II.3.1. Micro-Lending as a Tool	19
II.3.2. Micro-Lending, Social Work and Financial Education.....	20
II.4. Micro-lending and Banking.....	23
II.4.1. Micro-lending where no banking system has yet been developed to satisfy the credit needs of small businesses (Third World Micro-lending)	25
II.4.2. Micro-lending where existing banks no longer satisfy the credit needs of micro-enterprises ("Fourth World" Micro-lending).....	27
II.4.2.1 Micro-credit in the most advanced Banking Environment.....	27
II.4.2.2 The Trend towards Exclusion from Banking Services	27
II.4.2.3 “Unbankable” or not “Creditworthy” for Business Credit Products?	29
Respite	30
II.4.2.4 Excluded from Bank Services	31
III. Bank Regulation and Micro-Lending in Europe – An Overview.....	35
III.1. The Philosophy of Bank Regulation in Europe	35
III.1.1. The Principle: Safety and Soundness.....	35
III.1.2. Bank Safety Standards and its Limits	37
III.1.3. Bank Soundness	38
III.2. Micro-lending and Bank Law : Overlapping Circles.....	39
III.3. The EU Banking Directives: A European Minimum with Exemptions.....	41
III.4. An open System: Micro-lending in the UK	44
III.5. Credit-Unions and Micro-lending in Ireland	46
III.6. Free Access to Lenders: The Belgian Coops and Micro-lending.....	48
III.7. Credit for Social Purpose: Microlending in France	49
III.8. Credit Monopoly and State Activity: Micro-lending in Germany	52
III.9. Social credit from the State: Micro-lending in the Netherlands.....	55
III.10. Social Co-operatives and Guarantee Schemes: Micro-lending in Italy	57
III.11. A Scattered regulatory Landscape in Europe: An Overview	59
IV. Conclusion.....	62
V. Ancillary.....	63
V.1. Case Studies from the New Economic Foundation	63
V.2. Literature	63

A. Executive Summary

I. Definitions

“Micro-lending” is a range of social policy initiatives in which public or non-profit agencies use credit as a tool to further objectives such as social welfare, employment, urban development, financial education, and not least to develop the self-esteem of people excluded from ordinary economic activity. It is used to advance business initiatives by private individuals seeking to earn their living through independent work. The primary purpose of micro-lending is therefore not banking. It does, however, incorporate core banking functions, such as lending, deposit-taking or guarantee business.

- “**Micro-loans**” are small loans used for business purposes by private individuals who seek to earn their living through independent work.
- “**Micro-lenders**” may be banks or any other institution able to fulfil micro-lending objectives. Typically, micro-lenders acquire legal personality as a charity, a co-operative, a union, an association or an administrative or semi-administrative public body.
- Micro-lending involves **banking techniques** such as extension of interest-bearing loans and guarantees. It may involve savings schemes (“savings into loans”), capital participation or refinancing through credit within the banking system. Micro-lending may be used in forms other than loans, such as factoring, leasing or seed capital.

The word “micro-lending” embraces two different phenomena and in both of them, lack of access to financial services impedes the economic development of certain groups and areas:

- Where banking remains under-developed as in “third world” countries or rural areas (“**unbanked**”), micro-lending sows the seeds of a future banking structure through non-banks which will increase in size and become banks in due course. (“**pre-bank micro-lending**”)
- In developed banking systems micro-lending by non-banks addresses those who are excluded from banking (“**unbankable**”) because they are not considered sufficiently profitable as bank customers (“**social micro-lending**”).

While pre-bank micro-lending offers capital and banking services at first hand, social micro-lending targets the long-term unemployed specifically, in order to help them gain skills and eventually to become bankable.

For pre-bank micro-lending through co-operatives, self-help associations, savings groups etc. in areas where banking has yet to be developed, the EU should consider more general exemptions to the banking directives to favour small organisations in their development into ordinary banking. The focus of the present study is on social micro-lending.

“Social micro-lending” has:

- a **financial** aspect, in which banking services on a small scale are extended to people of moderate means and little or no financial security, in order to recover the costs of lending as well as of refinancing the amount loaned.
- a **labour market** aspect, where creating self-employment through credit provision aims to reduce unemployment and poverty
- a **community development** aspect, where channelling capital into under-served and deprived communities or countries boosts the local economy.

- a **social welfare** aspect, where subsidies, normally granted by the welfare state in developed countries, or through development agencies in the third world, are replaced at least in part by recoverable credit, or made redundant through the creation of own income. As a result, the cost is reduced to donors, the funds are used more productively and the positive effects are more sustainable.

Bank regulation has been tightened up against a background of major international bank crisis, caused by inadequate own capital funds, unsafe credit provision, speculation and general criminal behaviour. It results are seen in limited access to banking, the imposition of supervision and information provision obligations, adherence to collective security systems, requirement of own or at least safe capital to underpin each credit commitment, transparency of risks in the bank balance sheet and, most importantly, a minimum size for banks, as well as skilled bankers. All of these requirements make micro-lending at reasonable cost impossible for banks. This is true not only for specialised micro-lenders who want to obtain a bank licence, but also for banks which are already licensed and who want to start a micro-lending programme.

II. Findings

While EU law only forbids deposit-taking simultaneously with lending and taking guarantees at the same time as participations while remaining unregulated, the Member States have in the main employed stricter approaches to lending while developing a system of regulatory exemptions which facilitate micro-lending.

Three approaches may be distinguished for regulation of social micro-lending:

- **The market approach:** the United Kingdom has left the financial sector, including its social aspects, to the market. Banking in general has had little involvement in social affairs. Consequently non-banks have been given considerable scope to act as social lenders but have received little state support. Within this context, lending is permitted. This approach represents the minimum approach to bank supervision of micro-lending which is also inherent in EU bank supervision legislation. This legal framework is also shared by Ireland and Belgium.
- **The welfare state approach:** Some countries such as Germany and the Netherlands retain significant public involvement in banking and there is substantial state involvement in social lending. They employ guarantee schemes, tax subsidies as well as state administrative resources and state-owned banks to promote social objectives within the financial sector. This approach only permits very minor private lending and all other lending activities are reserved to financial institutions and banks.
- **The social lending approach:** France and, in some respects, Italy have an explicit approach to social lending. Social lending is supported officially and linked to non-profit, employment programmes and social welfare activities. While France addresses social lending directly, Italy and, in some respects Ireland and Belgium as well, favour certain types of lender which are presumed to engage in social lending.

In addition to these three approaches to social micro-lending, almost all states retain traditional, small banking institutions and also grant exemptions from bank supervision in respect of such small amounts as are too small even for micro-lenders. In addition Italy has a vast body of social and non-profit co-operatives engaged in lending and mutual guarantees. Ireland and the UK have exempted credit unions, the Netherlands and Germany use their system of community owned banks, while France supports direct involvement of official institutions in the economic development of regions and grants direct exemptions for social micro-lending.

France has a unique approach in granting exemptions to micro-lending from banking law on its own merits. This approach seems to suffice to prevent exemptions for small lenders under banking law from being abused by predatory lenders.

III. Propositions

III.1. General

Social micro-lending in industrialised areas with a highly developed banking system is not in fact banking but a social policy initiative which uses credit for specific purposes. It should not be covered by banking legislation if it is restricted to credit and credit-related financial activities which do not necessitate bank supervision.

National approaches to facilitating micro-lending through non-banks in the main follow the approach of granting exemptions from bank law to certain institutions. This report instead recommends that the only requirement be that micro-lenders should have the status of having a legal personality, rather than being treated as individuals. It strongly recommends that micro-lending be assessed without regard to specialist legal structures for micro-lending institutions such as associations or co-operatives and that any institution able and willing to meet the criteria of micro-lending should be permitted to engage in it.

In the place of bank supervisory law, social micro-lending should be subject to adequate protective private law such as the Consumer Credit Directive and usury legislation.

The EU should amend the banking directives to clarify the wording relating to their application to non-banks. Further, the main effort to promote micro-lending in the EU must lie with the Member States. In furtherance of that activity and to harmonise and co-ordinate it, the EU should pass a recommendation the contents of which are below.

III.2. EU Bank Law and Social Micro-lending

III.2.1. Considerations

Given

1. that the European Union has, in different programmes, expressed its commitment to furthering employment and especially to combating long term unemployment,
2. that additional employment in the future will primarily stem from the creation and development of small and medium size enterprises and that the EU has dedicated several programmes to help such business creation
3. that the barriers to the creation of micro-enterprises in particular stem from lack of skills and education on the part of those who could seek employment through self-employment, from a lack of own capital and the need at least for access to all forms of credit and
4. that banks, due to their increasing size, international competition and standardisation, are reluctant to take on the task of education and start-up help in conjunction with their traditional role as credit provider, that in some countries even retail banking has contracted to the detriment of economically weak individuals and areas,
5. that small business creation requires tailor-made financial services and personal advice where the interest earned is very low in relation to the integrated additional help and monitoring needed to make these investments sustainable. The banks therefore have difficulty offering such services, especially if the price of lending is either capped by law or by market image and if additional social and educational skills in particular have to be acquired to meet the specific needs of this clientele,

6. that instead of the increase needed in sophisticated, locally available credit, banks have reduced their presence and the personal services to such clients,
7. that the experience of micro-lenders in third world countries as well as in certain industrialised countries has shown that new approaches to lending are possible which significantly lower the cost of credit provision by integrating it into social work and educational programmes and by using soft approaches to credit scoring, securities and guarantees as well as to repayment methods and
8. that such approaches have created significant incentives for people to create micro-enterprises and jobs, helping to reduce the burdens of unemployment and welfare benefit payments, they have created a nucleus for a newly emerging local economy in run-down areas, and they have created financial literacy among groups which otherwise would gradually be excluded from financial services in general,
9. that without exemption from bank supervision, such micro-lending schemes have been offered through non-banks within existing banking legislation, but banking legislation in most countries still assumes that the extension of money loans, irrespective of their amount, purpose, and relation to other activities should be seen as a banking activity or at least as a near-banking activity and regulated as such. Non-banks are thus regulated in accordance with prudential banking considerations and are thereby significantly impeded in fulfilling their specific objective and indeed even banks are hindered from creating specialist micro-lending units,
10. that on the other hand there is good reason not to create loop-holes in banking legislation which is designed to further the stability of the unified European money system, to prevent the development of predatory lending through unskilled, immoral and unscrupulous lenders which exploit the difficult situation of those seeking self-employment and the creation of micro-enterprises,
11. that provision of money loans is a highly developed and sophisticated professional task, including instruments of risk assessment, guarantees and monitoring and that there should not be incentives or even the possibility to create a shadow market for the poor alone, where banking for the poor turns into poor banking. There should therefore also be a guarantee that banks remain accessible and involved in the development of their prospective clients and areas,
12. that micro-lending in areas not yet banked (pre-bank micro-lending) may be different from micro-lending in areas where the number of unbankable people is rising (social micro-lending), and that pre-bank micro-lending in developing countries and even areas within the European Union certainly requires more opportunities for small loans while social micro-lending merely needs legal acceptance and public support as a means to bridge the gap between the developed banking system and those who are otherwise excluded,
13. that credit as well as deposit-taking has never been seen in general as a bank activity in so far as all forms of indirect credit such as instalment purchases, leasing and factoring have been seen as ancillary to the main purpose of bank business. The credit function has therefore not been covered by banking legislation but instead by special credit legislation such as the Consumer Credit Directive. The same also applies to such deposit-taking as does not amount to savings but investments or associated activities for other businesses (especially pre-payments) and
14. that in social micro-lending credit and savings can be seen as activities ancillary to financial education and business start-up assistance, as well as to local development

the council gives the following recommendations to the Member States.

III.2.2. Recommendation

1. The Member States should incorporate EU banking legislation into their national legal orders in such a way that social micro-lending through non-banks is permissible by law and the additional costs in terms of risks, education, urban development and advice are subsidised so that a reasonable return on the loans can be realised.
2. Social Micro-lending
 - is a scheme of instalment credit for up to Euros 10.000 with fixed interest rates and fixed repayments, granted to individuals with little or no available security or adequate credit history and therefore insufficient access to bank business loans. Guarantees from the client, a group of clients (“peer group”) or from third persons may be required in order to create joint responsibilities and networks. Pre-payments for a prospective loan (“savings into loan” schemes) may also be required in order to accustom clients to credit payments. Loans may also be increased step by step (“stepped loans”).
 - Its purpose is the education of potential borrowers in financial issues (“financial literacy”) and the creation of self-employment and micro-enterprises. (“self-help”). It combats unemployment and develops the local economy in urban areas threatened by economic decline. (“community development”)
 - It includes extensive coaching, monitoring and direct help in order finally to (re-)integrate the target group into the general mechanisms of the market economy. Access to banking and autonomous economic behaviour is the primary goal.
 - Social micro-lending is a non-profit activity ancillary to non-banking activities. It differs from bank business lending in so far as expectations in terms of repayment are based mainly on assistance given through the lender for income generation through credit provision.
3. EU Directives on banks and near banks do not require bank supervision of micro-lending as such, nor do they require supervision of guarantees given by borrowers or third persons to make micro-lending safe. Member States should harmonise their legislation with the effect that micro-lending provided by any legal entity meeting its criteria should not be subject to banking law in general. As micro-lending is an ancillary activity to non-financial social policy measures, it should be treated just as other non-bank credit which is connected to the selling of non-financial goods and services. (i.e. leasing, factoring).
4. On the other hand Member States should apply the standards of the Consumer Credit Directive to micro-lending and take preventive measures against usury and predatory lending in order to guarantee minimum quality standards in respect of the loans, as well as transparent information and comprehensible terms and conditions. As far as their lending activities are concerned, micro-lenders should have at least the same supervision as credit brokers in each Member State.
5. Payment-into-loan schemes in which savings are not higher than the instalment of the prospective loan should be regarded as part of the credit and exempted from the prohibition against taking public funds, provided they are secured either through bank or public authority guarantees, through special insurance or through being deposited in a safe bank account in the name of the client. Such view conforms with a comprehensible application of the banking directives.
6. Micro-lenders should be given easy access to refinancing. For this purpose they should be permitted to take out bank loans and use own capital in whatever form of investment they receive from the public. Investments outside banking supervision should be carefully

defined by the law, the application of which should be enforced. For such investments, investors carry the risks of credit failure and shares should only be withdrawn after an initial period of no less than 2 years on condition that the own capital of the micro-lending institution is not reduced.

7. Member States should facilitate group guarantee schemes, which extend guarantees either to borrowers to obtain access to the general financial services market or to guarantee micro-lenders' refinancing activities. Subsidies to micro-lending organisations should be directed to the coaching, monitoring and educational functions of the main activity and not to the lending itself.
8. Member States should further legislate to create public awareness on access to financial services for business start-ups. There should be incentives for banks to advance micro-lending schemes through co-operation, refinancing and technical assistance, by offering minimum bank accounts and other financial services in support of business start-ups. These incentives may consist in a legal obligation to disclose the impact of bank lending upon the community ("social auditing"), through a legal obligation imposed on the public banks to fulfil compensatory tasks or through direct state involvement in micro-lending.
9. Member States should report to the Commission on the circumstances of those elements of their respective populations which are in need of access to financial services for employment purposes on a tri-annual basis.

B. Introduction

The present research has investigated the legal situation of micro-lending in seven EU Member States. In most EU countries, most micro-lending organisations which extend or intend to extend small amounts of credit to poor people, in order to facilitate self-employment and to combat unemployment, claim that banking legislation in the name of safety and soundness erects barriers to banking services delivered by non-banks. While the impact on employment policies, social welfare and community development of many existing micro-lending institutions has already been extensively researched, the debate on the impact of banking legislation on micro-lending is fairly recent and the emphasis has been on social policy rather than legal aspects. At first glance, the European legal situation does not seem to demand such an investigation because the applicable rules are simple and very general.

With the exception of draft French legislation, there is no specific micro-lending regulation in Europe. EU banking directives do not relate to credit alone and therefore do not directly affect or restrict micro-lending. EU contract law does not regulate micro-lending because, unlike consumer credit, it is a credit for commercial use only. If micro-lending by non-banks is as significant as almost all those involved in the assume, the answer to our question seems to be easy: make EU regulation general for all countries by giving a single passport to non-banks involved in micro-lending as well. Deregulation of access, of minimum capital, of supervision and protection law could all have the desirable effect of creating a flourishing micro-lending scheme in Europe to the benefit of the poor. This report could be confined to the identification of open and hidden legal and administrative obstacles to micro-lending in the Member States and use much of the expertise already available on the regulation of micro-lending.¹

We have chosen a different approach. As well as considering the implications of the law for micro-lending, we question the implications of micro-lending in very different economic, social and political environments for the objectives of the law. We assume that the discussion on micro-lending contains some startling contradictions in which causes of poverty and mechanisms to cope with it develop into a certain complementarity which may make specific answers to a general problem questionable.² Some participants in the discussions on micro-lending regulation, for example, call for deregulation without taking into account that, traditionally, the law has been seen as protecting the weak. They demand self-help in market sectors where it is the markets that have disempowered the long-term unemployed in particular. They promulgate credit for those who do not even have an investment opportunity for their labour, they promise to replace welfare income through personal debt, they create

¹ Otero, M; Rock, R. From Margin to Mainstream: The Regulation and Supervision of Microfinance, Accion International Monograph Series No. 11; Vogel, R.C., Other People's Money: Regulatory Issues Facing Micro-enterprise Finance, IMCC Corporate Offices Miami, Florida 1995; Churchill, C. (ed.) Regulation and Supervision of Microfinance Institutions, Case Studies, The MicroFinance Network Occasional Paper No. 2, The Micro Finance Network Washington D.C. 1997; Integration of the socially excluded through self-employment and micro-credit in Europe — Identification of the legislative and regulatory framework, Paris 1999 (in French Etude sur l'intégration des exclus par le travail indépendant et le microcrédit en Europe); Lyman, T.R. A Regional Overview of the Legal and Regulatory Environment for Microfinance, Paper on file with IFF London 10th of June 2000; Mayo, E./Mulineux, A. Bootstraps or Braces? Regulation of Community Development financial Institutions, Research Report for the Joseph Rowntree Foundation on Community Development Financial Institutions. New Economics Foundation London 2000; Lynch, M, 1997b, Legal Regulations of Social Economy Finance Organisations; Micro-enterprise Development Review, 1998, Regulating Microfinance, vol.1, no.2, page 1 – 7, Inter-American Development Bank, Washington

² see for a better description Rifkin, The Age of Access, N.Y. 2000 or Caplovitz, D. The Poor Pay More, N.Y. 1962

areas of banking business exclusively for the poor without regard to the need for more general access to financial services a.s.o.

Micro-lending as a technique may not only give opportunities to individuals but also remove them collectively if it creates a ghetto economy. Micro-lending may not only create income individually but take it away collectively if such schemes are used to withdraw welfare resources from its clients. Micro-lending may not only give access for otherwise excluded people to banking services but also create very underdeveloped and outdated banking services with less skilled and less paid agents for poor people, which may in the end give rise to more hardship than opportunities for them.

The most knowledgeable American micro-lending organisation "Working Capital" draws a quite modest preliminary conclusion on its own work when Jeffrey Ashe³ states:

"Despite its undeniable benefits, Working Capital has concluded that micro-enterprise development is not the 'magic bullet' for alleviating poverty, or for moving many from welfare to work, that it hoped for initially. At best, it may be of help to the one in ten in the active labor force who has the interest, commitment, and skills that it takes to build a business. Furthermore, developing micro-enterprises is not sufficient as a strategy to turn around failing or declining local economies. (...) Carrying out a substantial micro-enterprise program in this country and sustaining it year after year has proved to be an exceedingly difficult undertaking as evidenced by the fact that only five programs across the United States make more than one hundred loans per year, and all the programs taken together reach less than seventy thousand businesses. After years of tinkering with the model, Working Capital has accepted that it is unlikely to cover as much as half of its operating costs through interest and fees and still serve the population it seeks to reach with the range of services it believes necessary."

Just like medicine, financial tools may in one context cure the evil and create it in another. Regulators should keep this in mind especially at EU level where the temptation to favour unified approaches is bigger than on the national level. If micro-lending is taken as a special technique within a generally accessible financial system to cope with risks and costs then it will serve as a school for all members of society, lenders and borrowers, to learn how to develop an economy in which poverty is not fate but a temporary and specific situation which can be overcome.

C. Micro-lending – A Case for Regulation

I. Deregulation for Micro-credit by Non-Banks?

Regulation on Micro-credit has become an important issue in international politics since the UN⁴, the World Bank⁵, the European Union⁶, the OECD⁷ the International Labour

³ Microfinance in the United States - The Working Capital Experience - Ten Years of Lending and Learning, in: Journal of Microfinance, Vol. 2. No. 2 (Fall 2000) p.22 ff, 29

⁴ Micro Start ... a Guide for Planning, Starting and Managing a Microfinance Programme, United Nations development Program.

⁵ see v. Pischke, J.D. Finance at the Frontier: Debt Capacity and the role of Credit in the private Economy. Washington D.C.: World Bank 1991; Yaron, J. "What makes rural Financial Institutions successful." World Bank Research Observer Vol. 9, No. 1. January. Washington D.C: World Bank

⁶ see for example European Commission: Local Development and Employment Initiatives, an Investigation in the European Union; March 1995 - Sec 564/95; Plan of Action by the EC for the conversion of the financial market framework (KOM(1999)232, 11 May 1999)

⁷ for the contents of a conference organised jointly by OECD and IRED Nord see Reifner U., Evers J. (1998), Credit and New entrepreneurs, Nomos Verlagsgesellschaft, Baden-Baden

Organisation⁸, the English⁹, the French¹⁰ and the US government¹¹ started to look at it as a possible contribution the fight against poverty and un(der)-employment. Mohammad Yunus from the Granmeen Bank in Bangladesh stated at the Paris Conference in 2000¹²: "Where there is poverty, micro-lending is necessary."

In the light of unsatisfactory results of employment policies on the continent, the need to promote entrepreneurship to catch up with the dynamics of the ICT world¹³, a tendency towards out-sourcing and smaller units in the corporate world, and a general mistrust of subsidy driven systems of state intervention, micro-entrepreneurship seems to be a promising solution for many evils of modern market economies. Entrepreneurship needs capital. Those who should have access to self-employment do not have the capital for investment into either their business ideas or into their labour power or the machinery they will need before they can achieve a turnover. Direct venture capital investments can help in cases where highly skilled workers in extremely profitable areas, already with a prospective return on investment of about 30% p.a. in the first year, may compensate for the risks involved. But where it is a matter of anti-poverty programmes in areas and for people where society can expect to be pleased if they just manage to cover the cost of their own labour investment at large and feed their own children, in order to reduce the social welfare statistics, the other form of capital supply, "credit", is the only means for getting such micro-businesses off the ground.

It is not the purpose of this study to answer the question of whether micro-lending in general is a valid tool to achieve the goals associated with it.¹⁴ That research has been done in another context and come to a generally positive conclusion.¹⁵ Our question is what impact it has on banking regulation and vice versa.

Credit has become highly regulated banking business in most EU Member States. Once developed to facilitate commerce in upper Italy, such capital agglomerations spread the

⁸ International Labour Office, *Microfinance for Self-Employment - Enterprise Creation By the Unemployed - Research Papers: Factors of Success: What determines the survival and success of self-employed coming out of employment?*, 2000

⁹ HM Treasury, *Enterprise and Social Exclusion: national strategy for neighbourhood renewal: policy action team 3*, London 1999

¹⁰ see below FN 12

¹¹ for a recent overview see Ashe, J. *Microfinance in the United States - The Working Capital Experience - Ten Years of Lending and Learning*, in: *Journal of Microfinance*, Vol. 2. No. 2 (Fall 2000) p.22 ff

¹² Mohammad Yunus from Granmeen Bank is widely seen as the "father of micro-lending" and appeared as such in the recent conference on Micro-lending in Paris December 2000 organised by the French Ministry of Economics (Maria Novak is counsellor to the ministry and also head of ADIE France; see also Nowak, M. *La Banquière de l'Espoir*, 1994) Maria Nowak ran an Anti-Poverty Programme supported by the European Union from 1994 to 1998 which has become a well known actor in the discussion on regulation.; see also MacLennan, B. *Finance, Gender and Structural Change in the European Union*, Draft Chapter 8 5 February, 2001 Fn 14

¹³ see Commission Financial Services Action Plan
http://europa.eu.int/comm/internal_market/en/finances/general/action.htm.

¹⁴ doubts have been expressed in news paper articles in Germany see *Die Tageszeitung* vom 4.7.1995: Ein zweifelhafter Weg aus der Erwerbslosigkeit; *Die Tageszeitung* vom 3.5.1998: Bloß nicht überstürzt losrennen, *Die Woche* vom 11.10.1996: Zwischen Erfolg und Scheitern; *Kultur der Selbständigkeit*

¹⁵ see for such IFF research the benchmarking case study by Evers, J./Jack, S./Loeff, A./Siewertsen, H. *Reducing Cost and Managing Risk in Lending to Micro Enterprises - Handbook for Micro-Lending in Europe*, Institut für Finanzdienstleistungen (IFF) Hamburg February 2000; Wiley, C./Kempson, E. *Banks and Micro-Lending - Support, Co-operation and Learning*; Personal Finance Research Center and Institut für Finanzdienstleistungen, Hamburg and Bristol March 2000; Evers, J./Jung, M./Krüger, U. *Modellprojekt Micro Lending in Hamburg - Konzept und Geschäftsplan* – study for the Vereinsbank Hamburg March 1999; Ellerbrock, B./ Pierret, D./Evers, J. , *Insertion économique des exclus par le travail indépendant et le microcrédit : obstacles et initiatives -Le cas de l'Allemagne* (for ADIE) Hamburg June 1999;

technique to all sectors in a market society in order to make the savings of individuals collectively accessible for direct investment. Ever increasing capital demands have created multi-national banking trusts which favour huge credit sums where the ratio between the cost of acquisition and servicing and earned interest is much more favourable than in small business credit where unskilled customers incur costs of at least €1,500 for each credit irrespective of its size.¹⁶ Bigger amounts of credit linked to savings have made bank safety and soundness a major concern for all industrialised societies. Regulation, supervision, transparency, minimum capital requirements and permanent duties to report every detail to banking authorities are the answers which have increased the cost of credit by item instead of amount and have put important additional obstacles to the provision of small credit to business start-ups and the self-employed. In order to make these policies effective, continental governments in particular have monopolised credit with banks who are highly regulated.

The question is therefore whether this regulation in fact unnecessarily impedes micro-lending by banks or non-banks and what could be done to facilitate micro-lending as a form of market driven anti-poverty and employment programmes.

This discussion is not without bias. There are too many stake-holders with a vested interest in the outcome; labour administrations may use micro-lending schemes as a means to shift responsibility to the unemployed. If credit capital and the opportunity to make use of it are provided, the remaining obstacles to re-entering the labour market may be attributed to lack of initiative on the part of the people concerned. Big employers may justify lay-offs by pointing to the opportunities of self-employment and micro-lending. Politicians may use this scheme to replace expensive labour market programmes and social welfare by the provision of comparably small amounts of money to a apparently self-financing system. Commercial banks may welcome state support for micro-lending because it assists them to drive out unprofitable business and protect them from public scrutiny.¹⁷ Finally the existing sector of micro-finance institutions has its own institutional interests which compete with the traditional social sector for public support and finance. Their aspirations, hopes and beliefs are valuable contributions for innovation but have to be evaluated from a broader perspective in which micro-lending is seen as a tool and not as an end in itself.

II. Micro-lending in Practice

Organisations which are directly or indirectly involved in credit provision for social purposes¹⁸ argue that banking legislation is inadequate and that they are hindered by bureaucratic obstacles from carrying out their task.

¹⁶ this figure was given by German savings banks for an average small business credit.

¹⁷ Chase Manhattan Bank in New York for example supports Accion; French banks support ADIE; English banks although very sceptical of the

¹⁸ see New Economics Foundation, *Freedom to Smallness? (Social and micro-finance in the EU: living with the legal framework)*, March 2000 (London); Courtoux, P./Wasseige, M. *Quel financement Pour le Troisième Système? - Recherche-action en Espagne, France, Belgique et Portugal*, IRED Nord Rome 1999; INAISE, *Financial Instruments of the Social Economy (FISE) in Europe and their impact on job creation*, Brussels 1997; Lynch, M., 1997a, *Social Investment and Other Financing Techniques for Voluntary Organisations*, CAF, Kent; Lynch, M., 1997b, *Legal Regulations of Social Economy Finance Organisations*; *Micro-enterprise Development Review*, 1998, *Regulating Microfinance*, vol.1, no.2, page 1 – 7, Inter-American Development Bank, Washington; Jacob, Hans-Reinhard/Warg, Marcus, *Micro-lending-Ansätze für das klassische Kreditgeschäft*, Bank 1997, 335 ff.; ADIE, *Etude sur l'intégration des exclus par le travail indépendant et le microcrédit en Europe*, 1999; Granger B., *Banquiers du futur*, Editions Charles Léopold Mayer, Paris, 1998; Guerin I., Vallat D., *les banques et le financement du micro entreprenariat en France : l'émergence de nouveaux partenariats*, à paraître *Revue d'Economie Financière*; IFF, Malcolm Lynch, EFICEA, *The social responsibility of Crédit Institutions in the EU (Reports on France, Germany, United Kingdom)*, Nomos: Baden-Baden 1997; INAISE, *Banking and social cohesion*, 1999; *First Step, Creation of Enterprise Through Self-Employment*, Dublin 2000;

II.1. Elements of Micro-lending

Working Capital, Accion or Women's Self Help of Chicago in the USA, ADIE in France, MAC 2 in Italy, Credal in Belgium, Fundusz Mikro in Poland, Streets in the UK, Finnvera in Finland, Women's World Banking in Spain are cited as the most well-known but relatively recent examples of successful micro-credit models.¹⁹ They all are largely influenced by experiences in the third world. Granmeen Bank of Bangladesh²⁰, Accion in South America²¹, Women's World Banking in India, Badan Kredit Desa in Indonesia²², Finansol in Colombia²³, Multicredit Bank in Panama²⁴, Banco Solidario in Bolivia²⁵, the Tantine exchange system of some West-African states or similar activities in other developing countries²⁶ are models in which small amounts of credit are given to poor people to enable them to work on their own as micro-entrepreneurs.

Technically speaking micro-lending is a scheme of instalment credit with fixed payments for the purpose of creating self-employment and micro-enterprises. Different from ordinary instalment credit, which is mostly used for consumption purposes, micro-credit is extended to people who have no security and no adequate credit history to show that they are able to repay the loan. The sole security is the expectation of future income through the use of the borrowed capital. This is why the lender is typically also involved in the investment process of the borrower, helping to make the business viable through advice, information, opportunities and links to the business world. Unlike banks, micro-lenders save on acquisition costs by using very simplistic methods of credit scoring but invest time and money into the phases after credit has been extended.

A core element of micro-lending is the way people are educated to cope with credit and debt. It has been called a "step by step" approach. The first step may be the obligation to save

International Labour Office, Enterprise Creation by the Unemployed: Microfinance in Industrialised Countries - Ireland Stock-Taking Exercise, 1998; Carraro, Le "Casse Peote" del Veneto e la nuova legge bancaria, Banca, borsa, tit, cred. 2000; Crisculo, Il fallimento della "banca di fatto": una conferma, ivi., 1999, II, p. 227; Nazzicone, L. Profili della "banca di fatto" nell'ordinamento giuridico italiano, in Quaderni giuridici dell'impresa, 1989, n.2. p. 62 ff; Spena, A. La raccolta del risparmio tra il pubblico e la posizione dell'impresa bancaria nell'ordinamento creditizio (a proposito della sentenza n. 2579 del 1988 delle Sezioni Unite della Cassazione), Diritto banca, 1991 I, p. 339 ff;

¹⁹ for a benchmarking case study see Evers, J./Jack, S./Loeff, A./Siewertsen, H. Reducing Cost and Managing Risk in Lending to Micro Enterprises - Handbook for Micro-Lending in Europe, Institut für Finanzdienstleistungen (IFF) Hamburg February 2000; Wiley, C./Kempson, E. Banks and Micro-Lending - Support, Co-operation and Learning; Personal Finance Research Center and Institut für Finanzdienstleistungen, Hamburg and Bristol March 2000

²⁰ see for the Granmeen Bank Carpenter, J. Bangladesh in: Churchill, C. (ed.) Regulation and Supervision of Microfinance Institutions, Case Studies, The MicroFinance Network Occasional Paper No. 2 p. 15 ff

²¹ see Otero, M; Rock, R. From Margin to Mainstream: The Regulation and Supervision of Microfinance, Accion International Monograph Series No. 11; Otero, M., Rhyne, M. (ed.) The New world of Microenterprise Finance: building Healthy Financial Institutions for the Poor. West Hartford, CT 1994; Kumarian; von Pischke, J.D. Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy, Washington, DC, World Bank

²² Berenbach, S. Indonesia, in Churchill, C. (ed.) Regulation and Supervision of Microfinance Institutions, Case Studies, The MicroFinance Network Occasional Paper No. 2 p. 5 ff

²³ Rock, R./Otero, M. op.cit. p. 93 ff

²⁴ Rock, R./Otero, M. op.cit. p. 100 ff

²⁵ Rock, R./Otero, M. op.cit. p. 65-86 ff

²⁶ for Asia see The Policy and Regulatory Environment for Microfinance in Asia, Main Report, The foundation for Development Cooperation on behalf of The Banking with the Poor Network, Brisbane Australia 1995

for about one or two years into a savings plan in order to test credibility and to accustom prospective borrowers to making regular payments. These regular savings are also used in financial literacy campaigns in the USA where poor people are encouraged to save into a subsidised individual development account (IDA)²⁷. In micro-credit borrowers get a “stepped loan” after a successful savings period which, after proper repayments are made, increases in size and duration.

Borrowers are, in effect, assessed for a credit line, which is delivered in a series of discrete loans, beginning with small amounts lent for a short period and then increasing in size and length depending on the customer’s repayment history. In such cases, a typical first loan would be around 1,000 Euro, and would be repayable in less than a year, although this clearly varies with the type of micro-entrepreneur.²⁸

It can be combined with guarantee schemes from third parties or with group liability for the total of the extended credit by a peer group of borrowers, who may obtain a more favourable interest rate in return for this additional security.

Borrowers from Working Capital have a group ‘*buffer fund*’ into which they pay 10 per cent of all loans they are granted. Group members meet monthly to collect together their loan repayments, which the group Treasurer then forwards to Working Capital. If any member is unable to make their repayment, the group can decide to draw upon the *buffer fund* to make up the shortfall until the defaulting member can afford to pay.

Fundusz Mikro groups, however, operate slightly differently and are, essentially, a mutual guarantee scheme. In fact encouragement to form groups is built into the design of Fundusz Mikro’s price and loan guarantee structure. Individuals may apply for a loan, but must supply up to three guarantors and pay a higher interest rate. Both the number of guarantors and the loan interest rate fall the more people who form themselves into a group. So that groups of four or more people require no guarantors at all and pay the lowest interest rates.²⁹

Micro-lending therefore includes extensive coaching, monitoring, a phase of pre-saving and a special form of sureties: Peer Groups.³⁰

As micro-lending is mostly used by non-banks, refinancing becomes a separate problem which is not linked directly to micro-lending but to the restrictions of banking law. A non-bank which needs credit capital may, subject to national legislative barriers, use the collective savings of prospective borrowers, ethical investment from private or public sources or own capital from similar participations. It may also refinance through bank loans, which appears to be the dominant source of refinance in the developed countries.

Non-banks who engage in banking activities have very varied structures, conditions, outreach and objectives. Given the different stages of development of social credit countries such as Bangladesh and the USA, Poland and Germany on the one hand, given the difference in the banking systems of the UK and Italy, the attitude of the welfare state towards unemployment in the Netherlands and the UK or South American countries on the other, it would seem superficial to discuss the regulation of micro-credit irrespective of the conditions under which it takes place.

²⁷ Germany has since long a state subsidy system where people who save regularly Euro 39 per month for at least seven years receive a state premium which drives the effective return to 20% p.a.. In the American IDA scheme which runs for 2 years an APR of 100% for a relatively small sum can be reached.

²⁸ taken from the Micro-lending Handbook op.cit. (FN 19)

²⁹ taken from the Micro-lending Handbook op.cit. (FN 19)

³⁰ for a more detailed analysis of the elements of micro-lending from a banking perspective see the German Report

But indeed all micro-lending schemes share other characteristics which go beyond the literal meaning of the word micro-credit or micro-loan and thus even further beyond the use of credit in economic and banking terms.

The OECD definition of micro-lending focuses on exclusion when it defines micro-credit as "access to finance for small projects, for marginalised people who intend to create their own employment because they often have no other professional perspectives and because they are excluded from ordinary resources of credit."³¹

ADIE relates micro-credit directly to self-employment and characterises micro-lending by its target group which has "limited capacity for repayment and risk taking, requiring small relatively short-term loans, ease of access, corresponding to the often limited educational level of borrowers and the fear of "paperwork" exacerbated by the experience of state benefits, bureaucracy, continuing access to credit beyond the first loan and the progressive availability of banking facilities to clients."³²

Exclusion, lack of access to bank credit, and anti-poverty activities are often linked directly to micro-credit.

"Micro-credit" has:

- a **financial** aspect in which banking services on a small scale are extended to people with moderate means and little to no material security in order to recover the cost of lending as well as of refinancing the extended amount.
- a **labour market** aspect in which the goal of creating self-employment through credit extension is intended to reduce unemployment and poverty
- a **community development** aspect by channeling capital into underserved and deprived communities or countries seeking to boost the local economy.
- a **social welfare** aspect in which subsidies, normally granted by welfare and labour administrations in the developed world or through development agencies in developing countries, should either be replaced by at least partly recoverable credit or made redundant through the creation of own income, thus reducing cost to the donors, making use of the subsidies more responsible and its effects more sustainable.

Only where provision of small credit also serves labour market, community and welfare purposes is it generally accepted as micro-credit.³³

II.2. Micro-lenders or micro-lending?

Non-bank loan providers who define themselves as micro-lenders require special regulations concerning their tax status and legal structures as well access to certain banking services.

Predominant structures of micro-lending organisations are difficult to compare; the non-profit sector in particular is structured differently in different legal cultures. Most countries emphasise a democratic structure based on membership of the lender organisation allowing non-profit activity in micro-finance; in Italy, Belgium and Ireland this gives rise to co-operative legal forms, while in France the form of the association is dominant. The UK favours a charity approach in which the tradition of private engagement for public goods is

³¹ translated from the French citation in Courtoux, P./Wasseige, M. op.cit.p. 11 ff

³² Nowak, M. (ADIE) Integration of the socially excluded through self-employment and micro-credit in Europe - Identification of the legislative and regulatory framework, Synthesis report Paris November 1999 p.7

³³ see Courtoux, P./Wasseige, M. op.cit.p. 11 ff

recognised in different legal forms, notably foundation-type institutions which have the name of co-operatives but are “run by their goals” and less by their members. Germany and also the Netherlands assume that an active state should attend to these tasks employing either state or near state agencies (Netherlands) or state-owned banks.

	Belgium	France	Germany	Ireland	Italy	Netherlands	UK
Associations	Le Pivot; Netwerk Vlaanderen	ADIE; FIR; Secours Catholique ; AFACE				Mama cash	Street
Co-operatives Credit Unions	Credal	NEF; Caisse Solidaire Nord Pas de Calais		Credit Unions (North London Chamber & Enterprise CU)	MAG; social co- operatives; cassa rurale; co- operative di garanzia		Credit Unions
Funds/Foun- dations/Cha- rities	King Baudouin Foundation ;	Fonds de garantie France Active		BTWAS, First Step; ICE		Stason	Aston Reinvestm ent Fund; CDFIs; Industrial & Provident Society
		CDC	City of Bremen			Social welfare: De bijstand (BBZ); Twinning; BBMK	Small Firms Loan Guarante e Scheme
Limited companies/ banking licence		Caisse d'epargne	Savings Banks; Bürgschaft sbank		Banca Etica	Municipal Credit Banks	

Can micro-lending therefore be defined by the form of the micro-lending organisation or in the terms of bank law? Is there a need for regulation of micro-lenders just as the banking directives address banks, or is micro-lending a similar type of credit provision to consumer credit and does it need regulation similar to the Consumer Credit Directive which do not target the lender but the lending?

In order to distinguish themselves from other lenders, micro-lenders generally point to three characteristics:

Micro-lenders are often assumed to be small³⁴, with a co-operative structure³⁵ and acknowledged as non-profit institutions?³⁶

Unlike ordinary banks most micro-lending institutions, with the exception of such schemes in India, Bangladesh and Poland, are relatively small. But is this a necessary pre-requisite for extending small loans? It is not the small size of the lender but the small size of the loans which is a prerequisite for a "first-step"³⁷ into self-reliance. Micro-lending itself is a gateway into banking, which characterises it as a bridge between small and large. A closer look at the emphasis on smallness in the relevant literature reveals a different underlying motive. It is widely assumed in the alternative sector that smallness furthers **local concerns** in contrast to the globalisation of the banking world. But although this assumption has some empirical evidence, it is not clear that the issue is the success of small entities in local affairs or whether in fact it is the failure of bigger entities to adapt to local needs. The assumption that "small is beautiful" is less logical than ideological. The advantages of larger economic entities over smaller ones is widely researched and easy to comprehend. Further, in finance larger entities may use local branches or develop "community branches"³⁸, create networks confined to a local environment by law such as the German savings banks³⁹ which are able to combine centralised services with local presence. American banks, forced by the Community Reinvestment Act to show local presence, sometimes acquire small local banks like the Continental Bank of Chicago or create a co-operative network with local agents to get a better CRA rating.⁴⁰ As smallness is neither a guarantee nor largeness an impediment to outreach towards the local economy, it is not the small size of the institution itself but its local focus which characterises micro-lending.

It is the focus on the local economy which characterises Micro-lending.

The democratic structure of the lending institution based on individual members and personal relations instead of capital shares is preferred in French and Irish but especially in Italian and Belgian legislation, giving specific legal forms such as co-operatives, credit unions or associations the right to extend micro-credit. Again, however, this cannot be seen in itself as a guarantee of the success of micro-lending. In allowing co-operatives, which are by definition non-profit organisations in Italy, to extend small amounts of credit as long as it is based on their own capital, Italian banking law seems to assume that the legal form of the lender guarantees non-profit objectives. In Ireland and the UK similar assumptions are made for the credit union movement. Their solidarity approach in particular seems to qualify them as micro-lenders. In Germany, savings banks whose public status oblige them to further the public good, are also seen as natural candidates for micro-lending.

³⁴ see New Economics Foundation, *Freedom to Smallness? (Social and micro-finance in the EU: living with the legal framework)*, March 2000 (London)

³⁵ co-operatives in Italy and Belgium, credit unions in the UK and Ireland, associations in France

³⁶ see above Fn 18

³⁷ so the name of the Irish micro-lending institution

³⁸ IFF is presently (2001) involved in a project with the commercial HypoVereinsbank to develop such concept in a project called "Banklocal" financed by the German Ministry of Research and Technology.

³⁹ see for the so-called "Regionalprinzip" Reifner, U./Siebert, D./Evers, J. *Community Reinvestment - Eine amerikanische Besonderheit für den deutschen Sparkassenmarkt?* Nomos: Baden-Baden 1998 p. 77 ff; for a short overlook in English Evers, J./Reifner, U. (Eds) *The social Responsibility of Credit Institutions* op. cit. p. 62 ff

⁴⁰ op. cit. Fn 34

But this approach assumes that the internal structure of micro-lending organisations automatically guarantees a non-profit relationship with their customers. This is only the case where all customers are also members, just as it was originally the case in the early stages of rural banking as well as in the credit union movement. But the special purpose of helping the poor, and especially those who are not able to participate in self-organisation and self-help, has led to a division between clients and members even in cooperative lending institutions. This has been acknowledged especially in Italy in the social co-operatives. If, as is the case in Germany, all customers are automatically members of the Coop-Banks or, as is the case in US credit unions, open to all employees in a particular firm, membership is purely formal and has no relation to true participation. In Italy, France and Belgium the main focus of coops are even non-members. The co-operative approach is therefore more of a tool than an end. It expresses the objectives of micro-lending to **create a non-profit relationship of solidarity between lender and borrower** different from the mere logic of exchange which governs the relevant relationships in commercial lending.

French law (Article 11 of the Bank Act) on micro-lending draws this conclusion literally. It requires that only those non-banks may extend credit who act as "non-profits". In this respect micro-lenders are not necessarily different from ordinary banks. Special purpose non-profit banking has deep historical roots. In the early twentieth century, trade unions in Germany held more than 15 banks which then merged to form the Bank für Gemeinwirtschaft (Bank for Community Economy) and was sold only in the 1990s to the private sector. The anthroposophical community has flourishing "Gemeinschaftsbanken" (GLS, Triodos etc) which made "giving, lending, donating" (GLS) their primary business goals. Many of the rural coop banks in the Raiffeisen-movement were never intended to make profit but just to support their members. Credit is not only a commodity designed for an exchange system but can also be used in a non-market economy in order to centralise individual resources for a more collectively defined use.

Even if micro-lending institutions have a non-profit status, which is mostly defined by tax law, this does not guarantee a solidarity approach. Firstly non-profit status is very differently defined in the legislation of different nations. Some countries link it to public goals while others use a much wider definition, in which any activity which is not done in the form of direct and individual self-interest (especially for leisure) qualifies for this status.⁴¹ Secondly the status is often defined by the objectives laid down in the organisation's charter, which does not guarantee that these goals are in fact achieved. As the only firm criteria for an effective non-profit status lie in the question of whether profit has been taken out of the business for individual purposes, many other businesses share the same fate because they keep reinvesting their profits and enjoy the success of the business in the form of salaries. Further, being non-profit does not exclude a focus on income instead of other goals because cost efficiency teaches the institutions in question to maximise income and to minimise expenditure just as ordinary businesses do.

<p>There are no born micro-lenders but only those who do it.</p>

From a regulatory perspective the qualification of an institution as a micro-lender irrespective of detailed evaluation of each loan is neither possible nor desirable.

II.3. The Purpose of Micro-lending

As an economic activity, credit has no purpose in itself. Unlike renting a house, or buying a car or machinery, credit only allocates financial resources by advancing future purchasing

⁴¹ In Germany the profi-football associations as well as associations who further the bread of dogs enjoy the status of non-profits. („Gemeinnützigkeit“)

power and making it immediately available. Credit is therefore always linked to some other economic or social goal. If credit is merely seen as a bank business then it is tacitly assumed that the credit aspect of the activity is the most important aspect.

But this is far from the existing practice. Nearly all economic activities have a credit aspect. Whenever the fulfilment of a legal obligation is postponed there is technically an extension of credit. Paying the grocer at the end of the week is credit but a grocer who offers this opportunity would normally not think so. Tax authorities have discovered only recently that late payment in taxes or late refunds for overpaid taxes are credits which have to be priced.

If the credit link within other economic transactions becomes a regular commercial element with its own price, suppliers may increase their revenue from credit without seeing themselves as banks. Instalment purchases and hire purchase agreements are historical forms of such linked credit, while more modern forms are finance leasing, factoring, credit card payments or time-sharing. No legislation assumes that such business can only be exercised by supervised banks. Even money loans are not seen as bank credit if, for example, they are a relatively unimportant part of another business (for example loans from employers to workers or loans from insurance companies which are linked and specifically paid out of the insurance product).

Regulated bank credit is therefore only credit in which the credit aspect dominates the whole transaction and appears to be independent from other purposes.

II.3.1. Micro-Lending as a Tool

Micro-lending is a tool to meet legally unenforceable social ends.

A credit contract is defined in Art. 1 of the EU Consumer Credit Directive as a contract in which the timely use of money is compensated for by the payment of interest. This definition accords both parties only one interest: to get capital for own use (liquidity) and to receive interest (return). Additional purposes are not necessary. The same logic lies at the root of bank supervisory law. It is only in the case of consumer credit legislation that the further purpose of the borrower using the credit for non-commercial ends is taken into account, not for the sake of the lender but to protect the interests of the consumer.

To the extent that micro-lending is defined by an additional goal linked to the supply of credit, it is therefore of little interest to the law. Freedom of contract and freedom of enterprise as legal principles leave it to the participants in the transaction to decide how they wish to use the money. The borrower is therefore free to use the acquired sum for consumption purposes or for repayment of existing debts even if the credit was initially extended to create self-employment opportunities. Micro-lenders know that some of their credit is used to buy cars for personal purposes or to repay debts.

Private law has no instrument for guaranteeing such purposes. If the parties make the social objective of the loan into part of the contract, the contract could be cancelled early if the term were disregarded. But this threat is empty where borrowers are poor and, once the credit has been spent, they are unable to repay it earlier anyway. The lender will be satisfied if it recovers the instalments as originally agreed.

This situation will only change if significant public subsidies are at stake. If, for example, the lender enjoys additional support in advice, subsidies or venture capital participation, extension of such help may be linked to its effective use for self-employment. In such cases, the borrower may be obliged to re-pay the subsidy or to compensate for mis-used public funds. If the subsidy consists of guarantees, the guarantee may be revoked. Such public law

resources are also available when donations are given by private foundations to apply pressure to the clients to pursue micro-lending's additional objective.

From a contractual perspective, all institutions extending small amounts of credit to start-ups can claim to be conducting micro-lending if micro-lending were only defined by these additional purposes.

German Savings Banks for example see themselves as micro-lenders because they extend credit in small amounts for self-employment with empirically verifiable *effects* in terms of the labour market, community development and social welfare. Predatory lenders with high interest credit such as pawn brokers or Talleyman in the UK, notably finance companies in the US and Swiss and Liechtenstein financial institutions, which extend credit to overindebted individuals through credit brokers in Germany also claim that their high interest products reach the excluded and facilitate start-ups.

Historically micro-credit may have even been invented by the pure self-interest of the American Singer Company to sell their goods in the middle of the 19th century. It was the first time that credit was used to further self-employment when it sold its sewing machines to women in Europe through instalment purchase or hire purchase agreements enabling them to repay the loan out of their earnings from the use of the machines. These and similar practices in small credit extension led to a wave of consumer protection legislation on hire purchase, instalment purchase and other forms of delayed payment credit at the end of the 19th century in Europe. The legislator did not assume that this form of micro-credit was real social progress.

Some micro-lenders in developing countries, as well as Fundusz Micro in Poland, which carry out micro-lending on a big scale, have been forced to emphasise the banking aspect in which earned interest has to cover all costs and losses, while smaller micro-lending institutions, and those in the EU in particular, rely primarily on additional subsidies.⁴² The bigger the scale of micro-lending, the more it will tread the historical path from mutual capital sharing in small groups to modern banking. Already the more successful organisations who manage to make money out of the interest margin no longer focus on the poorest but on people in work with good expectations, while those which effectively reach truly unbankable peoplesuch as ADIE and Working Capital, can only do so because they enjoy substantial State support

Micro-lending as a form of lending cannot be regulated apart from other forms of credit if it is only the purpose of the loan that distinguishes it from other bank lending.

II.3.2. Micro-Lending, Social Work and Financial Education

Micro-lending is often less a form of banking than an contribution to social work and education.

German and, even more so, Dutch welfare administration is allowed by law to have recourse to low or no interest credit as a means of social welfare subsidies. As one of the major objectives of modern welfare policies is the creation of clients' own income resources through expenditure from the welfare budget, the administration is entitled to extend small credit for self-employment just as is envisaged by micro-lending. When the Berlin student aid administration (Studentenwerk) which, unlike the unemployment and welfare administration

⁴² The lack of subsidies may also force traditional non-profits to focus on the banking aspect by for example hiring experienced bankers who will then focus on more profitable clients.(Interview at Accion in New York Spring 2000)

had no legal permit enabling it to provide credit, tried to bridge students' cash problems during the exams when their student grants had expired through micro-credits, the Berlin administrative court held that the amounts involved were not negligible and a special dispensation or a bank licence was required.⁴³

In these circumstances, welfare administrations see the extension of credit less as banking business and more as a form of more flexible and cheaper subsidy.⁴⁴ In a workshop on micro-lending a representative of a local French micro-lender revealed a default rate among his clients of an average of 70%. Confronted with the argument that credit is defined by repayment he pointed out that every credit has a built-in prospect of default. A default rate of 100% would still be a credit if extended as such, so that welfare subsidies could be defined as a form of lost credit. A default rate of 70% would mean that 30% of the welfare subsidy was recoverable, which he thought represented good progress compared with traditional welfare spending.

Some micro-lenders who reveal a very low default rate of less than 5% invest an substantial amount of money to prevent their clients from failing.

“People entering marginal self-employment often need intensive support and mentoring, both before applying for a loan and after. Most need practical assistance with the financial side of their business – developing financial plans and monitoring cash flows. In addition, some need moral support and encouragement; some require help with marketing and business planning; and some need technical assistance. Micro-lenders operating in this market tend to provide this support in-house.

ADIE in France and the Prince's Trust in the UK provide this support through a team of volunteer mentors who work alongside the micro-entrepreneur. For the most part, these mentors are people with relevant experience in banking or business. In addition, ADIE has developed specific training sessions, including three games: *Cash-flow* on cash handling and constructing a budget, *General Management* on running a business, such as customer service and *Stocks and Inventories* as a further development of small-scale accounting practice. Working Capital, on the other hand, provides this support mainly through their groups. Monthly meetings of new groups act as the focus for working through a practical handbook, covering among other things how to produce cash flow statements and business plans. At every stage this handbook encourages entrepreneurs to assess the strengths and weaknesses of their businesses and how best to develop them.”⁴⁵

Success in financial literacy and self-employment may be such an important goal that expenses amounting to more than ten times the loan are justified. Micro-lenders enabled by the availability of public subsidies to provide support for their borrowers measure their success not in the terms of credit cost, which would make many of these credit contracts asomething like 1000% loss if calculated properly. The hidden returns of micro-lending lie in savings in unemployment benefits and welfare subsidies. Some institutions like ADIE or the micro-lending programme of the City of Bremen as well as the efforts of the German public KfW Bank or the "loans into self-employment" programmes of some labour administrations emphasise labour market outcomes rather than credit returns. Others, like the Aston Reinvestment Trust, evaluate success in terms of community development, in this instance in the Aston district of Birmingham. Some micro-lending programmes focus on the social outcome for specific groups, in particular access of women or ethnic minorities to credit like Women's Self Help of Chicago or the Rochester Community Development Financial Institution in the State of New York.

⁴³ see German Report below

⁴⁴ see Ellerbrock, Barbara/Fahsel, Jens_(1997), *Existenzgründung aus Arbeitslosigkeit und Sozialhilfe*, Hamburg

⁴⁵ see Micro-lending Handbook op. cit. (FN 19)

Nearly all micro-lenders point to the educational role of credit where it is used instead of subsidies. In the New Testament, Jesus uses credit as a means for education when, in the parable of the “attributed pounds”, the owner gives each of his disciples an equal number of pounds (credit) and when, he comes back and finds that only one had used this pound to increase his wealth, takes the money away from the other who did not use it for investment and gives it to the first. Repaying credit is often seen as a practical way of educating people unaccustomed to operating in the marketplace in the fact that investing and meeting commitments, along with conscientious bookkeeping are indispensable virtues in a market society. This is why, for example, a Brooklyn school created a credit union for its pupils who extend credit to each other out of their collective savings.

Table 1: Functions of Micro-lending

	Banking	Welfare	Education	Development	Care, Advice
Activity	Supply of capital for machinery	Transformation of lost into recoverable welfare subsidies	Education for the management of household finance	Creation of business startups	Marketing help, help with children,
Legal Form	Loan contracts	Subsidy	Subsidy	Subsidy	Subsidy
Examples	Streets UK	De bijstand NL	ADIE France	ART UK	First Step IRL

There is little information on how the resources of micro-lending organisations are distributed between these different functions. A more sophisticated data-collection system may reveal that banking functions play only a secondary role in micro-lending. In debt collection, for example, some micro-lenders employ methods to keep clients in business which demand substantial personal resources. These resources are spent overtly on preventing credit failure. But no bank would invest so much in recovery of such relatively small amounts of credit. These costs would be allocated more accurately to education and support.

Anti-poverty programmes, for example, allocate their main resources into education, care and support and may use loans only to make their programmes more effective or to give some flexibility to their borrowers.

On the assumption that micro-lending is defined by its non-banking goals, the lending technique, which in itself is neutral in relation to any social goals, should therefore always be seen as merely one tool in a wider range of social activities. In that way, micro-lending would always be an ancillary activity to education, welfare, development and support. But some micro-lenders argue that lending to poor people seeking start-up capital will, without further intervention, create the desired social effects. In their eyes, the exclusion of potential start-ups from ordinary bank credit prevents them from earning their own living.

Table 1: Reasons for Micro-lending

	Access	Responsibility	Financial Literacy	Slums	No own capital
Reason	No bank loans available because too small, too risky	Extensive use of subsidies	Helping to prevent over-indebtedness, compensating for financial illiteracy	Lack of local economic activity	Lack of start-up capital

Micro-lending can be either a core activity as a form of banking or an ancillary activity to education, welfare spending, urban development and capital allocation.

II.4. Micro-lending and Banking

In the IFF study of benchmarking micro-lending, the differences between (traditional) banking and micro-lending has been summarised in the following table which can be summed up as a passive, cautious approach to bank lending versus an active risk-taking approach to micro-lending.

Traditional banking	Micro-lending
Lending practices	
Collateral needed	Peer pressure or alternative collateral (e.g. mortgage) accepted
Appraisal based on business plan and financial records (cash-flow, experience.)	Appraisal takes into account other criteria like motivation, recommendation by social network
Repayment enforced by legal action (collateral, guarantee)	Positive enforcement of repayment (stepped or sequential loans, peer pressure)
Asset-based lending	Cash-flow based lending
Difficult procedures, high transaction costs for small loans	Special techniques to reduce administrative costs
Prefers existing enterprise with track record	Accepts new start-up enterprises
Institutional Setting	
Formal financial institutions ruled by the Central Bank Act	Differing legal status are possible: e.g. foundation, trust, limited company, NGO
Staff are professional bankers	Staff often have a non-banking background
Centralisation of decision-making (often hierarchic organisation)	Decentralisation of decision-making (subsidiary principle)
Promotional policies	
Banks wait for clients to ask for credit, clients are approached in a formal way and have to defend their credit requests in front of bank staff	The need for credit is systematically identified, contacts are more informal, group meetings are used to exchange experiences and gain self-confidence.
Clients are self-confident enough to visit the bank and know how to present themselves	Clients do not have the confidence to approach a bank
Promotion of banking services in general is done through the media and word of mouth: in small enterprise lending most banks do not actively promote their services.	Clients recruit new clients (self selection) and partner networks (enterprise agencies, social workers) refer potential clients

These differences imply that micro-lending is an alternative to banking. But this does not conform to the image micro-lending institutions often have of themselves. Micro-lending is sometimes even seen as better banking for the target group.

II.4.1. Micro-lending where no banking system has yet been developed to satisfy the credit needs of small businesses (Third World Micro-lending)

Micro-lending by non-banks is often justified by lack of access by micro-enterprises to start-up capital. This implies that loans are less available for micro-enterprises than for other potential borrowers.⁴⁶

In this respect it is important to draw a clear line between micro-lending in the third world and in industrialised countries. In third world countries there is an absence of banks which could supply credit to small farmers which, as in Bangladesh, perhaps only need a few dollars. The underdevelopment of the banking system in these countries makes micro-lending necessary and also defines its forms.

In this respect, such systems resemble the first self-organised systems in rural areas of Europe in the 19th century. These systems were basically forms of centralisation of the participants' own money. Pubs were used as savings institutions and the collectively acquired sum of money was used to finance bigger investments. While 100 farmers each needed 10 years to save for a particular investment worth Euro 1000 if they could only afford each to save Euro 100 per year, collective savings enabled them to buy the first machine after only 40 days and 10 machines in the first year. As savings and trust were necessary prerequisites for credit, co-operatives became the first models of banking for self-employment, which explains its continuing importance in some countries. If capital is not available through the banking system, self-refinancing based on mutual trust between savers and borrowers was the only solution. Such self-refinancing systems started in rural areas and were later used in the development of insurance systems through the labour movement.

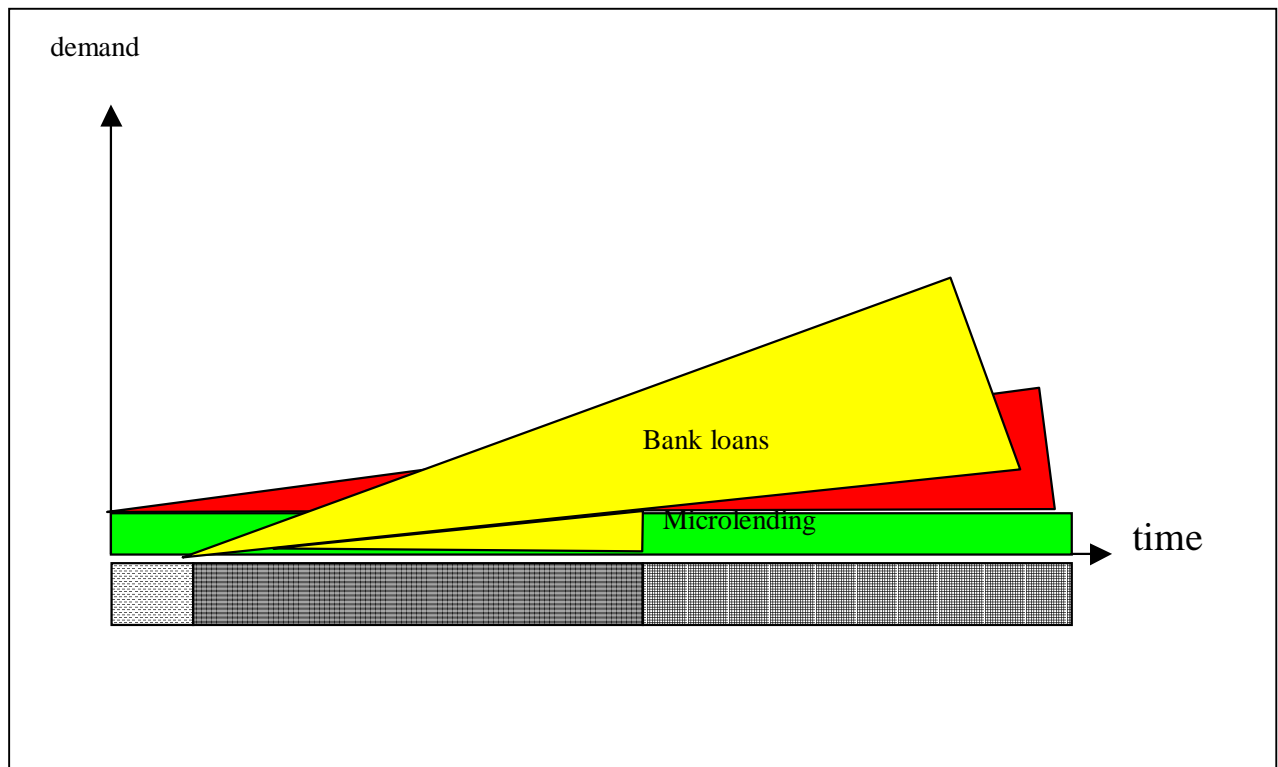
Third world micro-lending schemes as well as micro-lending schemes in countries where, following the breakdown of state socialism, no sane banking system has been developed amount to early form of banking.

In the following chart the need for capital for small enterprises (in red) rises historically.

Where no bank loans are available, forms of micro-lending develop as pre-bank loans. Subsequently, "micro-lenders" were gradually replaced by banks who were more efficient in extending refinancing to society as a whole using economies of scale. Self-help organisations vanished in metropolitan areas, surviving only in rural areas.

In industrialised societies, banks with high productivity and international access to capital markets learned that setting a minimum loan amount helps to save costs and increase profits in a competitive environment. Increasingly, they withdraw loan availability from those who need small amounts because these needs no longer develop into valuable demand.

⁴⁶ see „Is there a Case for Public Support to Micro-Enterprise/ Finance Programmes Targeted at the Unemployed?“ A contribution to the ILO Action Programme on „Enterprise Creation by the Unemployed - The Role of Microfinance in Industrialized Countries“ forthcoming 2001



From a purely formal point of view, phases one (underdevelopment (marked by short stripes)) and three (overdevelopment (marked by a net pattern)) resemble each other. In both situations, poor people do not have access to bank credit (marked in red). This is why micro-lenders in the first and the third world ally and lobby together. But they have a more negative identity in that both have a shortage of credit supply for certain groups.

But alongside these similarities are significant differences in structure and prospects as is shown by the following table.

Table 2 : Micro-lending in Non-Banked and Banked Societies

	Underdeveloped Banking System	Overdeveloped Banking System
Reason	no banks	exclusion from sophisticated banking
Regulation	little to none	highly regulated
Amount of money extended	< €200	< €20,000
Perspective	Rapid growth and transformation into a bank	stagnating figures; transferral of clients to the banking sector
Relation to welfare programmes	None	part of such programmes
Resources	From lenders own savings	from third parties
Cost of Acquisition and Servicing	Low	high
Products	Simple	sophisticated
Security	Personal family and group liability	individual personal as well as the prospects of the business
Relation to other banking services	No other products necessary	bank account, insurance, old age pensions schemes, risk instruments

II.4.2. Micro-lending where existing banks no longer satisfy the credit needs of micro-enterprises ("Fourth World" Micro-lending)

II.4.2.1 Micro-credit in the most advanced Banking Environment

Micro-lending schemes in the USA and the UK by non-banks were developed within what is perhaps the world's most sophisticated banking environment. Both countries are said to host the world's most important financial centres, "the City" and "Wall Street". In this environment it may be assumed that existing credit systems in these countries are the most productive and cost efficient in the world.

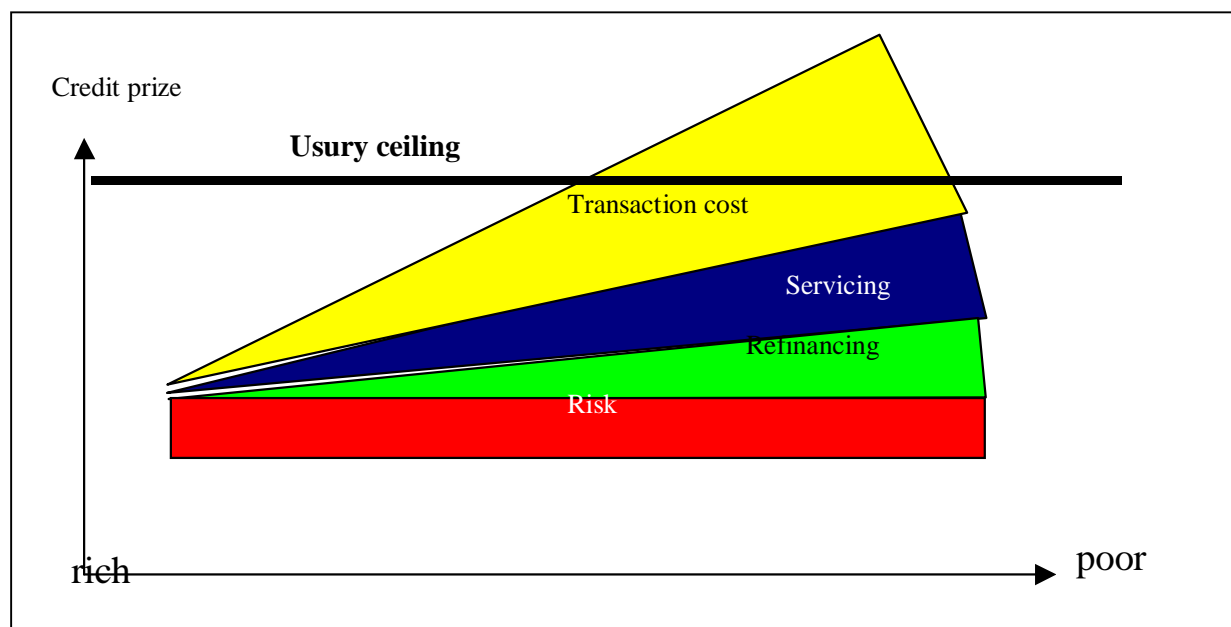
This is not only true in investment banking but also in the small loan sector in particular. Citibank is the world's leading consumer credit bank, Barclays is a leading credit card bank. They have invented highly standardised revolving credit systems which are profitable even in small amounts. The combination of instalment credit and overdraft credit, together with the extensive use of credit card credit (which in fact is a major resource for people seeking finance for self-employment) is the least costly and most flexible system of "micro-credit" in the world, but it is certainly not the best form of investment credit for micro-enterprises.

II.4.2.2 The Trend towards Exclusion from Banking Services

As long as 20 years ago, phenomena such as "red-lining" in the US excluded whole districts from access to mortgage loans. In Germany, minimum amounts of credit are the rule even in Savings Banks. Blacklisting of unemployed and poor people, refusal to provide them with a bank account and the denial of fresh credit have created concern about the rise of a group called the "unbankable". This development was aggravated by official policies which created needs for credit, especially accompanied by an emphasis on self-help and self-

employment in relation to the needs of poorer population groups, as well as homeownership, the financing of education and private retirement savings in order to cut state expenditure. Access to credit has become a need in a society where financial services instead of state support are the means of bridging liquidity crises and income and expenditure fluctuations in the different phases of life.⁴⁷

Exclusion of the poor from banking services follows a simple economic logic, in which the most standardised and simple commodity on the market, money, is also most affected by the



principle of economies of scale. As long as the credit service is linked to the amount of credit and priced according to time and amount (% p.a.) in the form of interest, micro-credit will lose its significance.

The price of credit consists of the cost of refinancing, the transaction costs entailed in concluding the credit agreement and the cost of servicing the credit as well as the cost of the risks incurred by the lender, plus the element of the lender's profit.

A contract with a small business concluded by a branch office, including personnel, advertising, back office etc. costs a minimum of about €1,500 today. A credit of €10,000 would need an interest rate in the first year of 15% p.a. just to cover these costs. If the cost of refinancing is 5% and the costs of servicing the loan are €500 per year (= 5% p.a.) and a risk of 1.2% has to be added, the interest rate including a 1% profit margin would have to be set at a minimum of 25.2% p.a.. This still assumes that a minimum size for cost-efficient banking is achieved which is unattainable by non-banks acting as micro-lenders on their own.

If a borrower instead takes out a loan of €1,000,000, significantly more manpower and input of human resources would not be required and the interest rate would be 5% refinancing + 0.1% acquisition + 0.05% servicing plus 1.2% risk rate plus 1% profit = 6.15% p.a.

If the bank were allowed to charge 25.2% p.a. for the business start-up and if at the same time there were a sufficient number requests for such credit, would provide the credit as it does in the case of consumer credit. But there is a different logic to the business start-up. The profit margin of a business start-up would have to be above 25% p.a. as well, compared with the profit margin of a large enterprise, which can remain as low as 7% and still be profitable.

⁴⁷ for more information about the difficulties of poor people to get access to banking services see especially the English report

In business start-ups, with the exception of cases in which new inventions and new markets attract highly skilled and sophisticated labour in the form of micro-enterprises (the "venture capital market"), where poor people are seeking self-employment, a break-even point is not usually reached for at least the first three years. Interest is paid from the income generated by the borrower's labour, which reduces their available resources quite often below the minimum survival threshold.

This is why France, Germany, the Netherlands, Belgium (as well as all Scandinavian countries) and recently Italy as well have introduced a legal usury ceiling for credit which, at less than 10% in France is especially low for small business credit.

Tabelle 3: Usury Ceilings in the EU for Micro-Credit

	Belgium	France	Germany	Ireland	Italy	Netherlands	UK
Consumer Credit	18%	18%	double of the average 20%	none	18%	18%	none
Small Business Credit	18%	9.2%	20%	None	none	18%	none

Even if there is no ceiling, banks are unable to recover as much interest as they would need to cover their likely costs in a micro-credit transaction. There are important image problems linked to highly priced credit products. It is difficult to convince customers that existing rates only affect other customer groups. That is why, for example, high pricing consumer credit banks have problems selling cheap mortgage loans. They are simply not associated with this market sector. High pricing banks are therefore threatened with the loss of their private banking customers. Micro-credit for micro-enterprises is not easy to distinguish from instalment credit and, similarly, from small loans for growing businesses which a bank wants to retain anyway as a client in its commercial department for future development.

Many commercial banks have therefore created subsidiaries like the German Teilzahlungsbanken or Sofinco in France, but this has only been achieved for consumer credit and not for business loans. In the US, small business loans are extended generally by finance companies who refinance themselves through the banking system. Their extremely high interest rates function as a catalyst, where those who survive the first two years are healthy businesses which can then go to the banking sector and secure lower rates as an extra reward for their success. For those who do not succeed the high interest credit makes their fate even worse.

II.4.2.3 “Unbankable” or not “Creditworthy” for Business Credit Products?

Are the “unbankable” an old group of bank customers who are singled out and excluded or are they a new group for banks to whom official policies would like to allocate credit but who do not meet the creditworthiness criteria?

It is politically very tempting to argue that banks have turned away from self-employment credit, leaving it to the public sector again to create economic initiatives outside the banking

sector.⁴⁸ This may be true to a certain extent, but in general the access to small amounts of credit by ordinary individuals, far from decreasing, has steadily increased. Credit cards have become a major source of credit for self-employed people and there is little obstacle, apart from their own credit history, preventing them from obtaining credit.

Table 4: Alternative Credit Sources for Micro-Enterprises

Respite	Leasing	Hire Purchase
Participations	Franchising	
	Tacit participations	Workers' shares
Grey Credit Market	Family loans	Predatory Lenders (Talleyman, Broker)
Consumer Credit	Credit Card	Instalment Credit

It is less the accessibility of credit in general than inappropriate products and psychological barriers that exclude such start-ups from access to credit.⁴⁹

It is not credit as such that is needed, but credit especially designed for businesses like credit lines, investment credit and most of all fixed-term credit associated with adequate advice, the amount of which is defined by future expectations of a return rather than by credit history. From this perspective banks, are approached by borrowers who have not been customers in this sector previously. Under the existing conditions they would never become customers because they are not seen as entrepreneurs

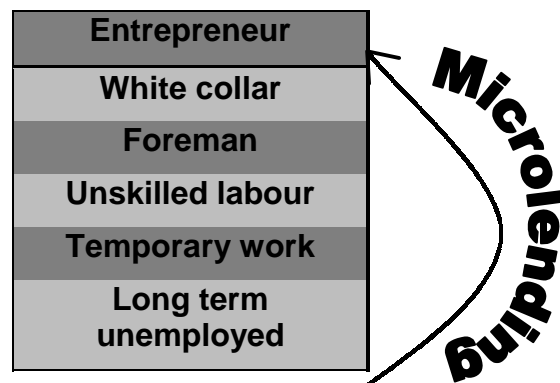
Neither these unemployed people, nor society in general is able to give such an investment enough economic credibility to make it a target for traditional banking. Families who have worked as wage earners for generations do not have the skills to survive in self-employment without additional help. This is especially true for the long-term unemployed who are the weakest sector of the wage earner group. Micro-lending takes the weakest group in society in order to convert them into the strongest group as entrepreneurs. In the eyes of bankers, this is not very realistic. In practice, micro-lending projects in the US, as it has been noted in the initial statement from Working Capital, see their success less in creating enduring new businesses but more in teaching participants in these programmes how to become responsible and rational workers who then have better opportunities in the labour market. Success is then measured by the number of people who found work after the expiry of the micro-loan.

Continental European societies still punish those who try and fail morally and in some cases also through the law. All EU Member States do not even have a personal bankruptcy procedure which discharges failed entrepreneurs from their personal debts after failure. In addition, losing a job and failing in self-employment have significantly different consequences in terms of unemployment benefits. Micro-lending's aspiration to cut out the traditional steps leading from the bottom of the labour hierarchy to the top of the entrepreneurship ladder is, in the eyes of rational banking and credit extension, a somewhat romantic approach if it is not combined with a programme which helps borrowers to achieve their goals and at the same time shields them from sanctions by the rest of society.⁵⁰

⁴⁸ see Novak, M. et al., Integration of the socially excluded through self-employment and micro-credit in Europe – Identification of the legislative and regulatory framework, ADIE Paris November 1999 p.6;

⁴⁹ Whiley, C./Kempson, E. Banks and Micro-lending, pfrc/iff April 2000 pp.14 ff

⁵⁰ A German proverb says: "Schuster bleib bei deinen Leisten" ("Shoemaker stay with your instruments")



Many of the target group of Micro-lenders are not unbankable for business credit products because banks have withdrawn. They are unbankable because they form a newly created target group which does not meet traditional credit provision requirements. The high failure rate of such business start-ups, estimated at up to 60% within the first three years taking into account not only bankruptcies but all forms of business terminations creates high risks.

It cannot be seen as a task of traditional banking to create sustainable businesses for people who would not otherwise be able to achieve them. Banking means the supply of capital for those who are already creditworthy and not for those who are to be made creditworthy by the process of credit investment. Banking only takes away all risks associated with short term liquidity crises as well as other “temporary” financial risks, but not other inadequacies in conducting a business venture.

If 70% of all small businesses do not keep books properly, banks may be able to help with book-keeping but this is not a core banking business.



II.4.2.4 Excluded from Bank Services

It is true that some potential micro-enterprises are excluded from credit because banks withdraw opportunities from them under to a new policy which favours those with significant higher Lifetime Values (LTV), which is an individual's or prospective future earnings or business returns in the course of his or her lifetime. But this is certainly not the case for most clients of existing micro-lenders. These people would have never before have obtained an appropriate commercial credit to enable them to start their own businesses.

Discussion of micro-lending should therefore not be confused with discussion of the supply of capital needed by small businesses, where existing enterprises a turnover of less than a million Euros face increasing difficulties in obtaining adequate and sufficient credit at

reasonable prices. These deficiencies are being researched⁵¹ and have been adequately described by the three round table reports mandated by the European Commission on Small business financing.⁵² Micro-lending through non-banks is certainly not an answer to the crisis which structural changes in banking have created for formerly well-served small businesses which lose their bank branch, direct and local access as well as personal advice from their bankers. Solutions in this problem area can only lie within and not outside the banking sector if safety and soundness standards underlying the bank monopoly in Europe are not to be abandoned completely.

This thesis is underscored by the observation that the least regulated micro-lending by non-banks seems to occur in those EU Member States where micro-lending organisations demand more freedom and development opportunities and point to their impact in terms of discriminatory banking practice. Countries like Germany and the Netherlands, where state-owned banks can be approached politically on behalf of the needs of micro-enterprises, pay less attention to micro-lending than the USA, the UK, Italy, France and Belgium. This also gives rise to the opposite hypothesis. While micro-lending is seen as necessary because banks withdraw their services from the poor, banks may also withdraw their services from the poor more easily where micro-lending through non-banks exists.

Table 5 : Small without Credit

Problems	Entrepreneurs	Size	Remedy	Actor
Lost contact and credit supply from banks	Experienced entrepreneurs	< 50	Specialized small business approaches; state guarantee schemes	Banks/State
Risky Innovations	Innovative independent entrepreneurial persons	< 5	Venture capital funds	Private Investors
Start-up	High skilled workers	< 3	Seed capital	Banks
Unemployed	Unskilled; lack of selfesteem	= 1	Social Microlending	Non-Banks
Poor Farmers in underdeveloped areas	Little contact with modern forms of production	= 1	Bank Micro-lending	Pre-Banks and Banks

While micro-lending for the unbanked is questionable, micro-lending is also no answer for another important public discussion relating to bank failure to supply sufficient credit. The unmet needs for venture capital concern highly skilled entrepreneurs, which need to give effect to their high tech ideas through start-ups.⁵³ Venture capital requires a minimum return

⁵¹ IFF presently conducts two other research projects on inadequate financing of small businesses and business failures for the German Volkswagen Foundation (Legal Aspects) and for the German Ministry of Research (Remedies, Mistakes etc.)

⁵² „In lending capital to specific segments of the SME market, such as start-ups, micro-businesses and high-tech companies, banks are often confronted with unacceptably high credit risks and low margins on the business.“ (Third Round Table of Bankers and SMEs Final Report, 2000)

⁵³ Commission Report on the Information Society presented in Brussels March 2, 2001

of up to 30% already in the first year. It is somewhat short term and involves high amounts of credit. Even in its less challenging form of “seed capital”, designed to help traditional start-ups to obtain sufficient own capital, it has little in common with micro-lending.

From a banker`s standpoint micro-lending only has the actual form of credit in common with bank credit. In all other respect it replaces traditional preconditions for lending with external resources such as education, help, guarantees from state agencies and marketing.

Table 6: Banklending and Micro-lending

	Banklending	Micro-lending
Demand for credit through Securities	Customer Real Estate, machines	Supplier None
Personal Expectation for Return on Investment	Good Credit History High	No or bad credit history Low
Role of Lender in the Investment itself	Minimal	Very important
Further goals outside capital supply	None	Education, back to work, less welfare dependency, self-esteem etc.

Micro-lending – Definitions for Regulation

- **"Micro-loans"** are small loans used for business purposes by private individuals who seek to earn their living through independent work.
- **"Micro-lenders"** may be banks or any other institution able to fulfil micro-lending objectives. Typically, micro-lenders acquire legal personality as a charity, a co-operative, a union, an association or an administrative or semi-administrative public body.

Micro-lending involves banking techniques such as extension of interest-bearing loans and guarantees. It may involve savings schemes (“savings into loans”), capital participation or refinancing through credit within the banking system. Micro-lending may be used in forms other than loans, such as factoring, leasing or seed capital-lending. Typically micro-lenders will be organised as legal entities in the form of a charity, a co-operative, a union, an association or an administrative or semi-administrative public body.

- Micro-lending necessarily involves such techniques as the extension of interest-bearing loans as well as guarantees. It may involve savings schemes, capital participations or refinancing through the banking system by way of credit. Micro-lending may be used in forms other than loans such as factoring, leasing or seed capital.
- “Micro-lending” is a range of social policy initiatives in which public or non-profit agencies use credit as a tool to further objectives such as social welfare, employment, urban development, financial education, and not least to develop the self-esteem of people excluded from ordinary economic activity. It is used to advance business initiatives by private individuals seeking to earn their living through independent work. The primary purpose of micro-lending is therefore not banking.
- Micro-lending is defined through its relationship with the (non-)existing banking system.

- Where banking remains under-developed as in "third world" countries or rural areas micro-lending sows the seeds of a future banking structure through non-banks which will increase in size and become banks in due course. Regulations concerning full blown commercial banks should therefore pay tribute to the smallness of these "banks in a nutshell" and save them from the rules which have developed in response to the scale of the banks which are now.
- If there are sophisticated banking systems offering small loans which no longer reach the target group, micro-lending by non-banks derives its function from whether the target group is **unbankable** or merely **unbanked**.
- If the target group of the long-term unemployed is **unbankable**, micro-lending is a tool for educating this group helping it to develop into a bankable clientele. In this respect, lending is only a more or less significant element in general assistance for this group. The success of such "**social micro-lending**" lies where its customers in time become ordinary bank customers.
- If the targeted group has been bankable before but remains **unbanked** because cost efficiency and rationalisation have turned banks away from them "**bank micro-lending**" may be at best ambiguous. Such a policy may create shadow markets for poor people a far cry from the general standards of mainstream banking. It may enable banks who abuse their monopoly in discriminatory practices to justify their retreat. **Micro-lending for the poor may become poor Micro-lending**. These groups, even though the amounts of credit involved are very small, still fall into the category of small enterprises whose access to bank credit is discussed separately. They should instead be given alternatives in order to become integrated into the banking system. Public pressure on banks (Community Reinvestment Legislation; Equal Opportunity Legislation), subsidies to compensate for the additional costs in meeting the banking needs of these groups (Small Business Administration Support) and the creation of special intermediaries (Guarantee Banks; KfW) could help banks and potential bank customers to form a more integrated market for all citizens. This is a core candidate for state legislation if the existing monopoly is to be maintained.

III. Bank Regulation and Micro-Lending in Europe – An Overview

III.1. The Philosophy of Bank Regulation in Europe

III.1.1. The Principle: Safety and Soundness

Banking regulation has grown alongside the importance of banking in modern societies. Labeling modern societies as credit societies conveys the central role of those who offer and distribute credit in society as well as the “trust” inherent in the meaning of the word “credit” (*credere* lat. to trust), a core attitude necessary to the functioning of the credit system.

In this respect it has to be noted that credit in an economic sense has a much broader meaning than its technical use in money loans. Any transferral of money where between payment and repayment using a given purchasing power lies a time span which gives right to certain advantages like interest or fees or even risk coverage is a credit in the economic sense.

Therefore also savings and investments are a form of credit seen from the perspective of the investor. Even insurance can be seen as a credit in which the insured confine their money collectively to an insurance company which then pays it back to the insured in the form of individual coverage of damages occurred through collectively insured risks. Thus all three important financial services, credit, savings and insurance can be seen as forms of credit in a larger sense. But this is still not broad enough. Roman law distinguished three different ways of using capital from others for own purposes without owning it as credit with the same word “*locatio*” or rent - renting money, things and labour.

All three forms of this “rent” remain interchangeable. Instead of buying machinery on credit a micro-enterprise can lease it, instead of employing somebody it can finance the acquirement of expertise, instead of renting the premises it can buy them using a mortgage loan.

Long before legislation regulated banks to the present extent, banks have occupied the heart of the financial system and thus led to a much narrower definition of credit. From the viewpoint of a bank, only money loans and among them only such loans as are advanced by the banks (and not those which it receives) are defined as credit.⁵⁴

But although banks are often styled “credit institutions” (Kreditinstitute, credit unions, Crédit Suisse, Kredietbanken), the public function regulated and most protected by legislators and states is the savings function inherent in the word “bank” (Kasse, Caisse, Cassa di risparmio, Savingsbank, Sparkassen, Spaarbanken). The savings ratio of industrialised societies is still an important sign of economic health. This is why the “safety and soundness” of banks is of particular psychological importance. It is only if potential savers believe in the safety of their assets that they will save with a bank in a manner which makes the savings available for investment.⁵⁵ Any disturbance such as the bank crash of the 1920s can for example cause a rush on the banks undermining the credibility of the national money system and hampering economic development for years. Trust in the safety of banks has become even more important as an EU issue since the introduction of the Euro, which has created more mutual dependency in terms of the stability of the Euro.

The most important threat to the safety of assets is of course bank credit. Bad credit will, as the current Japanese banking crisis with its enormous real estate lending demonstrates, undermine the safety of savings. Finally the State has to bail out banks because they are “too big to fail”, an expression illustrating the psychological importance of bank stability in any

⁵⁴ Art.1 Consumer Credit Directive 87/102/EEC 22.12.86: litter c)

⁵⁵ the actual negative savings ratio in the US has led to a number of initiative like the Individual Development Accounts in order to bring saving back to the population.

economy. Finland, Norway, the United States and Japan as well as France have experienced such forced bail-outs for some of their banks during the last 20 years.⁵⁶

The main areas of concern are highlighted by the experience of the American Savings & Loan crisis, of small banks including Norwegian and Finnish banks trying to compete with bigger banks through unsafe investments especially in junk bonds, the huge hazardous investments made by the French Crédit Lyonnais, the German Bayerische Hypotheken und Wechselbank as well as the Japanese banks into a fragile real estate market, speculative investments in bonds which led to the bankruptcy of the German Herstatt Bank or to the near bankruptcy of the English Barings bank, the criminal behaviour at BCCI or the Bank of New York or some Italian banks in laundering drug money, incompetence and bad management in small banks such as lately in the German ethical bank Ökobank, the Zürich Kantonalbank, or the Fischer Bank in Hamburg which bought fraudulently created claims from a factoring organisation circumventing the restrictions on big loans. All involve bad credit, speculation, incompetence, overinvestment in one area and, in some instances, criminal behaviour.

The regulatory answer to this dilemma has different dimensions⁵⁷. They include limited access to banking, supervision and information duties, adherence to collective safety systems, requirement of own or at least safe capital to underpin each credit engagement⁵⁸, transparency of risks in the bank balance sheet and especially a minimum size for banks, which is at present set at Euro 5 million. All of these requirements make micro-lending at reasonable cost impossible. This is not only true for specialist micro-lenders who want to obtain a bank licence but also for banks which are already licenced and which want to start a micro-lending programme. The safety and soundness obligations for bank credit are designed for traditional credit systems where expectations of profitable investment and safe repayments are clear before the credit commitment is made. They do not fit micro-lending institutions.

Table 7: Bank Safety and Soundness Requirements and Micro-lenders

	Safety System	Minimum Size	Soundness	Rating	Transparency
Regulation	Directive on Bank Safety Systems	Directive on Capital Requirements		Basle Committee decision	Balance Sheet directive
Contents	General coverage of assets up to Euro 15.000	Euro 5 Mio	Experienced bankers	Rating of each credit	Auditing, duties to disclose each credit
Effects for Micro-credit	No chance to be	Barrier for small	Too expensive and wrong	Impossible	Unnecessarily cost

⁵⁶ Reifner, Bank Safety – A General Introduction in: Reifner, U. (Ed.) (1996) Bank Safety and Soundness– The Bergamo Report, Conference on Bank Safety and Responsibility towards the Consumer, Proceedings of the 3rd. International Conference on Financial Services in Bergamo, Italy Institut für Finanzdienstleistungen: Hamburg 1996, S. 13 – 44

⁵⁷ for a detailed description of the safety regulations concerning banks see the French report who can be taken as representative for for all other countries under EU law.

⁵⁸ the average ratio is 8% for all credit extension but is presently discussed according to the proposals of the Basle Banking Committee of leading Central Bankers who favour a more flexible system according to credit ratings.

	accepted	lenders	skills	burden
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It comes as no surprise that, according to the national reports, there is no European micro-lending institution which has a bank licence. On the other hand, it appears that there is still no European bank that extends credit in the form of micro-credit as credit ancillary to social policy activities.

III.1.2. Bank Safety Standards and its Limits

It is also clear from the historical background that it is asset-taking which is the core concern in terms of bank safety, and its psychological impact on society. Credit extension alone is only a threat to the lender itself if it is not using public funds. But credit plays an important role in the **protection of assets**. If an asset-taking institution extends credit at the same time, the assets become especially vulnerable. That is why savings are given more protection if they are combined with credit.

This philosophy of bank safety and soundness also makes it clear that assets clearly given with an expectation of risk and thus with no claim to safe repayment do not fall into the category of bank safety. Thus, all **participations in the capital of enterprises** in whatever form be it as shares, bonds (there is a question about bank bonds), futures, options are exempted from the bank law. Bank law is directed to assets which are within the banking sector either as savings or for transportation (payment system).⁵⁹

History provides a **case against smallness**. With globalisation and increased competition where there are reduced possibilities for cross-subsidy, with the ability of big banks to reach out over the internet even to formerly exclusively banked areas and people, small banks face the dilemma that on the one hand they have to offer the same advantages and prices as bigger banks to clients no longer willing to pay purely for local presence, while on the other hand they have no comparable access to cheap capital and transnational products and services. They are then either be forced to merge with other small banks or be swallowed up by bigger banks, hence the present move for mergers and acquisitions in the banking sector. If they do not participate in this process, they are tempted to resort to the hazards of exchanging low profits for high risks.

But smallness alone is no reason for increased vulnerability. It has to be combined with banking competition. This is why all states have created a minimum threshold for the application of bank supervisory legislation, which lies between 49 and 100 loans per year with an additional cap on the total amount of outstanding credit.

More important are exemptions where smallness is no obstacle to the use of bank techniques. This occurs in many countries where **non-profits** are exempted. The UK and Ireland have exempted credit unions, Italy and Belgium social co-operatives. All countries, however, apply special legislation to these organisations. France exempts credit for special purposes and Germany as well as the Netherlands offer micro-loans through state administration, in particular employment agencies or social welfare institutions. Where, as in the case of Germany (as well as the Netherlands), a vast network of savings banks owned by municipal authorities and regulated through special legislation exists, through which these institutions are obliged to pursue non-profit goals, similar effects are at least to be expected from the banking sector and seem at least to prevent the actual growth of the group of “unbanked”, while the “unbankable” are left to public initiatives. The federally owned Kreditanstalt für Wiederaufbau (KfW), which has its homologue in France and Italy, is also

⁵⁹ Similar prudential rules apply to insurance money.

an important tool for bringing capital to small businesses and has even tried to induce banks into micro-lending.

In the following table, the philosophy of bank legislation as expressed in the principle of “bank safety and soundness” shows that, where certain criteria are fulfilled, the increase in supervision (marked by darker shading) does in principle not affect “social micro-lending” where banking is an activity ancillary to social action.

Table 8: Required Bank Safety

	Savings + Loans	Savings only	Big Loans only	Small Loans only	Participations
Big (profit)	Comercial banks	Trusts			Investment funds
Small (profit)	Savingsbanks				Ltds
Big (non profit)	State banks (Post, Gurant)	???			Churches, ethical Funds
Small (non profit)	Credit unions, Bank ML	???		Social Micro-lender	Ethical investment

If social micro-lending does not

- ◆ threaten any assets of third parties,
 - ◆ is not exposed to bank competition,
 - ◆ does not involve big loans
- the philosophy of bank safety does not apply.

III.1.3. Bank Soundness

In terms of bank supervision bank soundness is defined specifically as the moral integrity of bank personnel. It implies the obligation to create and observe ethical rules, especially with regard to insider trading and a prohibition against the combination of banking with other business.

In this respect, it may be said that banking and micro-lending are in contradiction. While “social micro-lending” is an activity ancillary to social work, social work is alien to banking and would not even be permitted to form part of a bank’s activity.

There has been, however, a further significant development. With the new EU approach of national control and the single EU bank passport, bank soundness standards are now enforced less directly and bank supervision is exercised from a distant location in the bank's country of origin. Soundness standards are increasingly regulated through product-specific legislation in financial services. Investment products, credit cards, electronic transfer of funds, distance-selling of financial products, consumer credit and mortgage loans have been regulated or are about to be regulated, so that many of the soundness rules no longer fall within bank supervisory legislation but apply irrespective who offers such products.

In this respect, price disclosure rules as well as credit legislation have to be observed. In some countries, small credit to business start-ups is regulated under consumer credit legislation, in which in some special rate caps occur.

Many micro-lenders complain about the cost of observing such rules. This is especially the case for “bank micro-lenders”, which are close to banking and carry the burden of disclosure rules and advice obligations designed for higher amounts of credit. For “social micro-credit”, the complaints are less understandable if it is assumed that one of the major tasks of this form of lending is to turn socially weak borrowers into ordinary bank customers. As most of the product specific regulations are consumer/customer protection rules, whose main task is to teach customers about credit, about its cost structure and its implications for their livelihood or business, it is difficult to understand why these extra costs should be excluded from micro-lending. In this respect the costs argument should be referred to the non-credit parts of the service.

III.2. Micro-lending and Bank Law : Overlapping Circles

Micro-lending and banking form two overlapping circles. In social micro-lending in particular, banking techniques are used as a tool to achieve certain social goals. From a banking perspective, micro-lending includes money loans, the asset-taking and taking guarantees from the borrower as well as from third parties and it also involves financial advice, debt recovery and the use of some risk instruments like insurance or rate caps.

The following table differentiates between core activities in micro-lending which require regulated bank techniques and other tools which are either accidental or can be replaced by using the services of third parties. Only the field with dark shading marks core activities of micro-lending and it is in one field only that there seems to be a direct conflict between bank safety standards and core micro-lending activities. In all other fields, micro-lenders are able to remain outside bank safety concerns.

Table 9: Bank Techniques used in Micro-lending

Banking Micro-lending	Credit	Factoring / Leasing	Savings	Payment Services	Guarantees	Participations	Insurance
Money Loans			!!Savings into Credit!!	Bank account	Co-Liability of Peer Groups		Credit Life
Refinance	Bank Credit		Assets from Members or Non-members		Guarantees from public authorities or banks	Participation from members, securitisation ?	
Eth. Fund			Membership service			Membership service	
Bank Safety Standards ?	Only in connection with savings yes	no	yes	In some countries	In most countries no	no	no

Nor do the savings into loan techniques attain the goals of bank safety. Closer scrutiny of this technique, widely used in the third world to educate and accustom prospective borrowers to regular financial behaviour, shows that it indeed is not saving but an early repayment of loans which have not yet been extended.

The payments are directly linked to a loan. Under existing law at least in Germany the courts have held that interest may be paid even before a credit is extended. This is often the case where mortgage loans are already paid to the notary's account, who continues to hold it on behalf of the bank until all conditions for paying it to the vendor of the property have been fulfilled. In this instance, the borrower pays money into a bank account which is certainly not a savings account.

In the UK, the Netherlands and Germany, a specific form of whole life insurance mortgage loans exists, in which the borrower pays a monthly amount into a whole life insurance policy instead of repaying his or her mortgage, which at maturity pays for the mortgage.⁶⁰ In this case the "saving" into a capital life insurance, which is a form of an old age savings contract is nothing other than a legally distinct mortgage instalment. According to Art. 1A of the Consumer Credit Directive, both products must be seen as one, ie. as a credit, because no savings functions actually arise. The same occurs where the savings-and-loan schemes of building societies are pre-financed, which means that the amount the borrower will have to save to obtain a cheaper mortgage loan is advanced through another loan. In this construct there is actually no saving at all in economic terms, but a credit where parts are held back by the bank to fulfil certain legal conditions for granting mortgages.

If savings are used only for the credit of the saver, there is no threat to the safety of the savings unless brought about by the saver him- or herself, unless the money is used to refinance other debts. Any micro-lender which would deposit credit-savings into a bank account such as those used by notaries, to which creditors have access where the borrower is not even in bankruptcy, would not have taken savings at all but would be using the guarantee of the banking system. No safety concerns could arise. Only if the money is used directly for refinancing the micro-lender would safety standards have to be provided.

Micro-lending which uses only savings into credit components, which uses bank credit or forms of capital participation for refinancing and which out-sources all other bank and insurance activities do not come into conflict with any of the bank safety concerns described above. On the other hand, a bank directly involved in social micro-lending would have to perform many of the activities which are in conflict with the rules of banking soundness.

⁶⁰ See for a further description Reifner, Rechtsprobleme der Lebensversicherungshypothek, Zeitschrift für Bankrecht und Bankwirtschaft (ZBB) 1999 (H.12) p. 349 - 366 (Legal Problems of capital life insurance combined with mortgage credit)

Table 10: Social Activities of Micro-lending and Banking Standards

Micro-lending Rules for sound banking	Counseling for Entrepreneurship	Education	Marketing of Products of Clients	Legal help in social welfare	Waiting with foreclosure if other help is possible	Positive Discrimination of Weak Borrowers	No formal credit rating
Separation of Credit and Enterprise Advice		Meeting clients not on equal footing	Factual Ingerence in the Borrowers Business		Conflict with the Bar/Legal Aid		
Conflict of Interest						No equal conditions for all customers	
Prudent Banking					Duty to recover on bad credit; to keep default rate low		Scoring duties
Contradictions with Soundness?	Yes	Yes	Yes	Yes	Yes	Yes	Yes

This table shows that the rule against involvement into the business being financed itself, keeping lending and entrepreneurship apart, has to be broken in micro-lending if it were a bank business. The core activity of micro-lending is precisely this interference. American and German courts and express French banking law hold that a bank enters into a conflict of interest where it in fact manages the enterprise which it wants to repay the debt. Entrepreneurship needs liquidity while banking needs safety. They cannot always be reconciled. If the enterprise fails the bank is liable⁶¹

Social micro-lending does not concern bank safety and soundness rules but if integrated into a bank's business would come into conflict with these rules.

III.3. The EU Banking Directives: A European Minimum with Exemptions⁶²

The European Union has not passed regulations relating specifically to micro-lending. Basically, in the financial services sector, on the one hand the bank supervisory Directives apply, which were aimed at credit institutions and were not relevant the investment funds of micro-lending institutions. On the other hand, the Consumer Credit Directive contains provisions which do not expressly address the issue of credit for productive purposes, a prerequisite for micro-lending. For that reason one can only rely on interpretation of the Banking Directives.

⁶¹ see Köndgen, Neue Juristische Wochenschrift 2000, 468, 470

⁶² the following summary is taken from the special report on EU law by A.Bornemann

Under Art. 1 of the 1st Banking Directive,⁶³ certain transactions are reserved to banks alone. If banks fulfil the criteria they become euro-credit institutions, which enjoy the system established by Art.18 I of the 2nd Banking Directive of mutual recognition and supervision (home country control) and can therefore operate throughout the EU under a licence.⁶⁴

For that reason banks require a specific licence from their national authorities, which may only be granted if they have a minimum level of capital, they belong to an investment fund, have qualified staff, a specific legal structure with a legal personality and a series of safety standards concerning the relationship between own capital and their investment business. They must also produce a balance sheet under criteria laid down by the Directive on the principles of a true and fair view. Where an institution has a bank licence, the Directives impose no restrictions directly which would prevent the banks from legally conducting micro-lending business. The demands on banking business are so stringent, however, that in practice a bank specialising in micro-lending would appear to be ruled out. In view of the regulatory requirements, would seem unlikely to be viable for a Universal Bank to conduct this business either.

The decisive issue for micro-lending is the extent to which the bank monopoly over certain financial services prevents micro-lending by non-banks.

According to the 1st Banking Directive, a credit institution is an *"operation whose activity consists of taking deposits or other repayable funds of the public and granting credits for its own account"*. This was confirmed by the new (3rd Directive on the "take-up and pursuit of the business of credit institutions" of 20.03.2000 (2000/12/EC)⁶⁵. According to Art.1 No.1, it is, as previously, a matter of taking deposits or other repayable funds of the public and the grant of credits. In European law, the conduct of investment and deposit-taking business defines a credit institution (a **"Euro-credit institution"**⁶⁶), that is to say, therefore **both** deposit-taking **and** investment⁶⁷ business. Pursuit of deposit-taking business alone without credit business or, conversely, credit business without deposit-taking would accordingly not suffice.⁶⁸

Art. 3 of the 2nd (now 3rd Banking Directive) prohibits in a very general way all non-credit institutions from conducting deposit-taking business. The result is that **the isolated conduct of credit business does not of itself make an operation into a credit institution**. Conversely, a bank, which could conduct deposit-taking business under its licence, but which provides credit alone, does amount to a euro-credit institution..⁶⁹

⁶³ 77/780/EWG

⁶⁴ SOUSSI-ROUBI, Droit bancaire européen, Rdnr. 251; VERHEUGD, Definitions, Seite 34;

⁶⁵ Abl. L 126/1 vom 26.05.2000.

⁶⁶ KÜMPEL, Bank- und Kapitalmarktrecht, Rdnr. 18.9; HAMMEN, WM 1998, 741, 747.

⁶⁷ Hier und im folgenden wird – soweit keine anderweitige Klarstellung erfolgt – zur Vereinfachung des Sprachgebrauches unter dem Einlagengeschäft auch die Ausgabe von Schuldverschreibungen an das Publikum verstanden. Zu beachten ist aber, daß das deutsche Bankaufsichtsrecht die Ausgabe von Schuldverschreibungen gerade aus dem Kreis der Einlagegeschäfte ausschließt (§ 1 I 2 Nr. 1 KWG).

⁶⁸ SOUSSI-ROUBI, aaO (vorige Fußnote), Rdnr. 118; CLAROTTI, aaO (vorige Fußnote), Seite 74; die gegenteilige Auffassung von KNOBL, Europabankrecht, Seite 80 dürfte damit zu erklären sein, daß KNOBL von einem unrichtigen Wortlaut des Richtlinien textes ausgeht (" ... oder ...").

⁶⁹ CLAROTTI, aaO (Fn 46).

The concepts of deposit-taking⁷⁰ - and credit business remain undefined in the Directives in order to achieve the **protection of savings** in new forms as they emerge. "Deposit-taking business" thus encompasses all receipts of funds which have to be repaid. To provide the most comprehensive protection for depositors, the issue of debentures is also considered to require supervision.⁷¹

Credit business is the provision of a loan of funds irrespective of whether the loan attracts interest or not.⁷²

It is open to question whether sureties and other **guarantee business** amount to credit within the meaning of the Directives. This question has been mainly answered in the negative, because guarantee business is listed in Appendix I of the 3rd Banking Directive, which, it is argued, would have been superfluous if it was a credit transaction anyway.⁷³ Moreover, guarantees and sureties are included within the concept of credit contained in the Major Credits Directive (92/121/EEC), which comes up in the Directive as "the take-up and pursuit of the business of credit institutions".⁷⁴ At the end of the day, this is not significant for micro-lending, because credit-business is not regulated either.

On the other hand, EU law does not prohibit the Member States from imposing banking supervision on the isolated pursuit of credit business. Both imposition of supervision on credit providers and their exemption from it can be reconciled with the Banking Directives..

Micro-lending is, however, affected under Art. 3 1 of the Banking Directive where the Directive relates to deposit-taking by non-banks, or operations not subject to (European) banking supervision. In this respect there is no differentiation. An interpretation that credit related deposits do not fall within the definition of deposit is scarcely conceivable, because it was intended that the concept of deposit contained in the Directive should be as wide as possible. The wording of the Directive does prevent the typical micro-lending procedure of saving with the purpose of borrowing.

The Directive can also be reconciled with the European Treaty. It is true that most Special Banks with a concession purely for credit, are thereby given preference in their home country if national law does not impose banking supervision.⁷⁵ However, they do not have the benefit of the European Passport either.⁷⁶ The enactment and implementation of the Directive on services relating to the creation of securities bring the regulation of numerous other financial services. From the European law perspective this does not affect pure credit providers. The fact that they are subject to supervision under German law (section 1 I 2 nos. 2, 8 KWG) while remaining free of it in other Member States (as in Great Britain, section 6 (1) Banking Act (1987)) does not conflict with the Treaty.

⁷⁰ Auf obigen Hinweis sei nochmals hingewiesen.

⁷¹ EuGH, aaO (Fußnote 57).

⁷² Troberg, Europäische Aufsicht über das Kreditwesen, Seite 14.

⁷³ KNOBL, Europabankrecht, Seite 81, dortige Fn. 14.

⁷⁴ KNOBL, aaO.

⁷⁵ KUNTZE, aaO (vorige Fn.).

⁷⁶ SOUSI-ROUBI, Droit bancaire européen, Rdnr. 251; VERHEUGD, Definitions, Seite 27.

Even the absence of differentiation between "small" and "large" institutions, and the absence of an exception for small institutions (see above I 2) can only amount to an infringement of the law requiring freedom of competition if the resulting or anticipated restrictions on competition cannot be justified objectively and to that extent appear arbitrary. If that were so, however, imposing the same supervision and regulation on smaller operations would be untenable in the economy as a whole. The organs of the EU have allowed scope for discretion in this respect, with the effect that the absence of special regulation of bank micro-lending in the Directives does not conflict with requirement of free competition contained in Art. 3 I lit g EEC, even if distortions in competition arise in practice. In terms of social micro-lending there is no real competition situation.

Moreover, the prohibition against deposit-taking by micro-lenders is also compatible with the Treaty because of the overwhelming importance of security in banking in Europe.

Under EU law, micro-lending by non-banks is permissible, provided micro-lending organisations do not take deposits when refinancing through bank credits or own capital or issue micro-loans guaranteed through many securities. European law has granted exceptions to some states, and Credit Unions and Co-op Banks in particular have taken advantage of them.

III.4. An open System: Micro-lending in the UK⁷⁷

The United Kingdom distinguishes between deposit-taking and the provision of credit. It is not necessary to be a bank to be engaged in the provision of credit. Normally, a deposit-taker must be a bank, but there are some exceptions, most importantly credit unions, which are co-operative (mutual) savings and loans organisations, whose members have a common characteristic such as residence in a geographical area and/or employment with the same employer. Credit unions are the subject of a transitional exemption under the Banking Directives. Lenders may provide credit through the use of their own funds or, if they are an authorised institution or a credit union, through the deposits which they collect.

Bank lending to small businesses with turnovers of less than £1 million (≈€1.67 million) levelled off in the early 1990s at just under £40 billion (≈€66.7 billion). Other forms of lending have increased during the 1990s, including hire purchase/leasing finance, factoring and invoice discounting. 41% of British SMEs use leasing arrangements compared with the EU average of 33%. Factoring and invoice discounting are not readily applicable to businesses with turnovers of less than £500,000 (≈€833,000). Lending to the UK small business market is controlled by what is possibly a complex monopoly situation among the big four UK banks, who incidentally are also the major players in leasing finance.

Finance for small business can be particularly difficult for those who are unemployed entrepreneurs setting up in business or who operate their businesses from deprived communities. Banks do not want to be seen for regulatory purposes to be engaged in what they consider high risk areas of lending. They may also provide incentives for staff based not only on the number of loans they make but also on the level of bad debt and default in their portfolio. Finance leasing companies are also engaged in sub-prime lending, although the Bank of England's first report on finance for small businesses in deprived communities does not examine their activity in detail. Banks have been criticised for closing branches in deprived areas and for over-charging small business customers.

Community Development Finance Institutions (CDFIs), mutual guarantee societies and credit unions have developed in order to offer credit for social purposes such as support for

⁷⁷ Executive Summary of the English Report by David Boyd and Malcolm Lynch

small businesses, the unemployed setting up their own businesses and housing in under-invested communities. CDFIs provide flexible loans, support and encouragement to the unemployed and small businesses which are excluded from mainstream finance.

These organisations have had varying levels of public support and cover a spectrum which at one end is entirely independent of public or private subsidy and at the other is entirely dependant on public sector and/or private sector grants and donations. Banks have played a significant role in supporting CDFIs, and more recently credit unions, although they are competitors of credit unions. The number of CDFIs which compete with banks is much smaller, but some do exist.

The activities of accepting deposits from the public and extending credit are regulated separately in the UK. Deposit-taking is regulated by the Financial Services Authority whilst credit extension is the responsibility of the Office of Fair Trading. Deposit-taking is defined as a regulated activity under the Financial Services and Markets Act 2000, under which the FSA will operate a single regulatory regime for banks, investment businesses, insurance companies, credit unions and co-operative societies. However, credit extension, whether in the form of overdrafts, term loans, credit cards, hire purchase or leasing agreements, is licensed by the Office of Fair Trading under the Consumer Credit Act 1974. Unlike the position in other EU Member States, the UK system provides protection for small businesses seeking credit where they are sole traders or in partnership.

There have been some legislative developments to support CDFIs and credit unions. Businesses which make donations to CDFIs structured as Local Enterprise Agencies are able to deduct their contributions from profits before calculating income and corporation tax. This permits this form of CDFI to attract grants from the business community. Credit unions operate within an exemption from the Banking Directives and the UK Banking Acts which permit them to accept deposits although they are not a bank. This is a significant exception and entirely justified since credit unions offer competition to banks in savings and credit, particularly (but not exclusively) in savings and credit for social purposes. The UK legislation has been restrictive which may have contributed to the general absence of failure of these institutions, although there are some which are considered by the FSA to be insolvent.

It should be expected that those credit unions which reach the capital adequacy thresholds operate more like banks, but are also permitted to engage in a similar range of activities to banks. The European Commission should give careful consideration to making the exemption for credit unions in the United Kingdom a permanent exemption. If there is a similar absence of competition for social lending in other European countries, the European Commission should give wider consideration to whether there should be similar exemptions in other Member States. The experience of the United Kingdom demonstrates that the Banking Directives have not been a sufficient platform to ensure that there are adequate facilities for savings and credit for social purposes, or for preventing the possible creation of complex monopoly situations in small business lending. In the absence of the exemption for credit unions in the Banking Directives, there may have been difficulties in creating organisations which can accept savings and loans which might compete with banks.

The co-operative form of organisation has featured in this study as one which has traditionally combined an economic and social purpose, even as a financial institution. The Romanelli case, whilst not involving a co-operative, has been very useful in making the distinction between share capital which may be risk capital and share capital which may be a deposit. CDFIs which attract variable share capital have been able to use this distinction to enable them to build up funds for social lending.

With the resources which banks have at their disposal, it is no surprise that the Government has taken the view that, if they wish to ensure relevant access to credit for social purposes,

they should firstly engage the banks in that process. The UK Government has done this over the last few years through several policy initiatives which have been backed up by the threat of legislation, in the absence of movement from banks, rather than a tax on windfall profits. These have included the introduction of a basic bank account which permits savings and withdrawals whilst the account is in credit. It has required the banks to co-operate with the Bank of England on the provision of information to it regarding lending in deprived communities. This has enabled the Bank of England to undertake a first report into lending by banks to businesses in deprived communities. The report is a voluntary approach to the disclosure of information that is required in the United States under the Community Reinvestment Act. The Bank of England's first report recognises the importance of CDFIs working with banks in extending lending to entrepreneurs and small businesses in deprived communities.

There has been lack of progress in some areas of the extension of credit for social purposes. There is a suggestion that some lenders are hampered by a certain number of regulatory obstacles. Credit unions are constrained by tight restrictions on the size of loans and the length of repayment periods, and are prevented from borrowing money from external sources and from charging fees for providing ancillary services. The burdens imposed by the Consumer Credit Act which go beyond the requirements of the European Consumer Credit Directives may discourage leasing companies from providing small loans to unincorporated businesses. There should at least be consideration of whether the protection offered by the Consumer Credit Act to sole traders and partnership should be lifted after a person has been in business for three years. There is also a strong argument for exempting CDFIs from the Consumer Credit Act provided that their loans are capped at the same interest rate as those of credit unions.

The development of mutual guarantee societies has been prevented by the operation of the Insurance Companies Act 1982 and insufficient public policy commitment towards them. Arguably, the General Insurance Directives permit mutual institutions providing insurance for social purposes to be exempt from the Directives, and an appropriate exemption should be provided at a national level. The European Commission should examine the operation of mutual guarantee societies in the different Member States in order to see whether there might be lessons of general application which might be acted on by different Member States.

The effect of the Banking Directives appears to be at one and the same time the introduction of a level playing field for competition between banks in the European Union and, as a result of competition, the reduction of the level of lending for social purposes. If so, it is important that the Banking Directives should permit, or at least not prevent, for existing as well as future Member States, the possibility of the development of credit and savings organisations whose purpose is to provide credit extension for social purposes.

III.5. Credit-Unions and Micro-lending in Ireland

Ireland's business banking sector exhibits similar features of concentration as that of the United Kingdom. With encouragement and pressure from the Irish Government at the end of the 1980's and start of the 1990's Irish banks have supported Government initiatives in business start-ups and small business development and tailored some of their own products to build on these initiatives.

With a buoyant Irish economy and unemployment running at less than 4% of the total labour force credit extension to assist the unemployed into business may seem peripheral in generating economic activity. Nonetheless, there remain pockets of high unemployment in Ireland both in Dublin and some rural areas, with three generations of unemployment not being uncommon. Lending to assist such person move into self-employment is often regarded as social lending by banks and outside their legitimate sphere of activity since the loss rates

are too high to bear from a regulatory and investor standpoint if undertaken in significant quantity. Other alternatives are required.

The four year tapering welfare support program to assist a person move from unemployment into self-employment has seen an increasing number of unemployed people seek self-employment. Whilst the long support period might be seen as a subsidy to a business which will not succeed, its term is more realistic of the measures required to change a culture of dependence into self-employment. It has also permitted banks to feel more secure in lending to some people on these programs.

Competing with banks for lending to the unemployed, if not the biggest lenders to the unemployed for business creation, are credit unions, the co-operative savings and loans organisations. Exempt from the Banking Directives they have their own body of regulation as savings and loans organisations for a social purpose which ensures relevant prudential supervision. Their extensive growth in Ireland has created a IR£2.8 billion savings and loans network encompassing 1.8 million people, nearly one in two of the population of the Republic of Ireland.

101 credit unions in Ireland had assets greater than the minimum capital requirement under Irish banking law. Whilst their primary activity is lending for consumer purposes with an interest rate limited to 12.68 APR, they are engaged in lending to individuals for business purposes which was estimated at IR£125 million in 1996.

Credit unions themselves do not make a specific distinction between this lending and lending for consumer purposes. Whilst banks also treat much small business lending as personal lending it can be argued that some special expertise is required for this lending and that identifying this lending would be a first step to raising experience in it.

Credit union growth has been fostered by being exempt from Banking legislation. Prudential supervision has been maintained by a separate body of law and separate regulator. Proposals for a single financial services authority in Ireland may lead to credit union regulation moving closer to that of banks. Whilst some credit unions wish to expand their services it will be important to adapt bank regulation so as to make it relevant for credit unions. Credit unions have a social purpose established by law. There is a danger that the social purpose of credit unions becomes more difficult to achieve if they are regulated more like banks.

There is a case for strengthening the social audit reporting of credit unions and banks. For credit unions it will assist the registrar in assessing the extent to which they are complying with their legal obligations. For banks it will permit an examination of their complaints that credit unions receive special treatment. If banks are engaged to the same extent as credit unions in social lending then arguably there is no special case for exempting credit unions from banking act regulation. At the moment there is insufficient information about bank lending to evidence such a case.

It is possible that a different approach to co-operation between credit unions is required in order to increase quality standards. Irish credit union legislation does not envisage credit unions federating in groups so as to share back-office facilities. This, however, has been a successful model for co-operative financial models elsewhere, for example, France, Germany and Canada. It may be more in sympathy with the retention of the ideal of local autonomy and decision making but at the same time permit closer links between credit unions. This model of credit union co-operation should be more closely examined.

A strong case is made for the transitional exemption for credit unions in the Banking Directives to be made permanent and for similar opportunities to be given in other Member States. This would ensure that there will remain an opportunity for competition to exist in the

provision of savings and loans services for social purposes. Without such organisations competition in banking services for the accounts of the socially excluded is unlikely to come about voluntarily or at least without the threat of specific legislation being introduced for that purpose, such as a Community Reinvestment Act as exists in the United States.

There are limits to bank and credit union lending for social purposes where a non-profit lender has a role. First Step and Inner City Enterprise are examples of companies which have received charitable status from the Revenue Commissioners engaged in micro-finance lending to the unemployed. A special tax relief was introduced in Ireland to permit tax relief on corporate donations to First Step. This has been a major source of funding for First Step. This tax relief for business was expanded in 1988 to permit limited corporate donations to organisations with charitable status, such as Inner City Enterprise. Such an extension of tax relief may be one way of assisting the sustainability of such lending organisations who enter the market when banks and credit unions become risk averse.

There may be a need for organisations to continue with loan funding to the new business starter who still find it difficult to secure bank lending. A special business credit union drawn from among clients of First Step or a social investment industrial and provident society may be routes which might be explored.

Credit extension for social purposes in Ireland is in many ways quite extensive as a result of the existence of credit unions. The welfare support system for enterprise creation has permitted banks to have some engagement in this market. With limited exceptions such as First Step the lessons of the experience of that lending do not appear to be widely disseminated or shared which may present problems for such lending in an economy in recession where such lending is riskier.

III.6. Free Access to Lenders: The Belgian Coops and Micro-lending

Belgian banking law offers several possibilities for the practice of micro-finance. Basically there are no restrictions on the lending side as long as it is practiced without deposit(-type) funds. In other words, micro-credit is not restricted as such in Belgium and does not require a banking licence.

There are, however, also possibilities on the deposit side. First of all, public banking institutions, such as the Post Office bank, are exempted from banking supervision. Social pre-savings schemes such as the pre-marital savings schemes are also exempted. It remains open, therefore, whether a partnership could be set up with a public bank, or whether the pre-savings schemes could serve as a precedent for setting up similar pre-saving mechanisms to serve micro-credit. Finally, a discretionary administrative practice adopted by the Banking Commission allows any organisation to gather savings from up to 49 people without a bank licence.

Besides bank supervision consumer credit is regulated by the Ministry of Economic affairs, which makes sure that (1) loan contracts are transparent and present the full cost of a loan, and (2) which sets periodically the maximum interest rates that may be applied. Unfortunately “professional loans” are not covered by these protective measures, which leaves micro-finance potentially open to abusive.

Belgium has a large spectrum of financial organisations practising social and micro-loans, none of which is covered by supervision.

- Mont-de-Piété, the oldest micro-lender on the European continent, is owned by the municipality. It uses the traditional pawn broking technique, which is especially appreciated by borrowers for its easy access. Although not being a micro-credit

organisation as understood in this study, it has in certain historical periods shown that it could serve as a lender to very small businesses.

- The largest credit organisation for small businesses in Belgium is the government funded Fonds de Participation, serving the unemployed and small businesses at the lower end of bankability. Its major drawback has to do with its public nature, which forbids it to compete with the private sector. It has thereby adopted a safety approach closer to the mainstream banking sector which has helped to reduce default rates, but has somehow changed its function in helping the banking sector to retract from less profitable market segments.
- Micro-lenders have to form an organisation if they want to benefit from several advantages, especially tax advantages. The set-up cost as well as the cost of management are extremely low. Tax exemptions qualify them for donations and save them from any spending constraints. Most of these are very small, using the possibility of grouping less than 50 savers, as tolerated by the Banking Commission. This is fine for organisations which are happy to remain small, but is a clear limitation for those organisations that wish to grow, who also need stronger accounting and management in order to remain credible.
- A foundation instead could attract larger donations thanks to the tax advantages it offers to the donors. But foundations do not have an institutional framework designed specifically for credit undertakings.
- The co-operative status is appropriate for those credit organisations that mobilise a larger number of members. It may use the possibility of taking up to 49 (deposit-like) loans. The rest of the capital is provided in the form of co-operative shares that are fairly flexible. These shares are retractable and their total amount is flexible but there are no tax benefits associated with them. Only combining a co-operative with an association or a foundation can provide these advantages.
- With the associative and co-operative status, the Belgian legal context offers an interesting combination enabling micro-finance organisations to start up on a small scale at low cost, able to raise capital through co-operative shares in connection with tax-exempted donations to an association or a foundation.

III.7. Credit for Social Purpose: Microlending in France

In France, credit provision is traditionally the domain of the banks or other institutions subject to the same regulatory regime. The Banking Act of 1984 accordingly applies not only to deposit-taking operations in the narrow meaning of the term, but to all operations in the business of extending credit irrespective of the origins of the repayable funds used for that purpose.

Under article 3, the concept of credit maintained by the act is very wide and is defined as follows:

«a credit transaction is any act whereby a person provides or undertakes to provide in return for payment funds for the use of another or who takes, on behalf of another, a signed agreement such as a security, a guarantee or a surety.»

Whereas banks hold a monopoly of credit provision, they are under no duty to offer credit. It is this discrepancy (monopoly/duty) which makes the availability of credit inadequate for certain categories of client, because the monopoly situation prevents the development of alternatives.

With regard to the collection of funds, the bank monopoly is again very broad. Under article 2 of the Banking Act,

«all funds amount to funds received from the public which are funds received from a third party, in particular in the form of a deposit, with the right to use those funds for own purposes but under the obligation to repay them ».

The banking monopoly is restricted, however, to the receipt of funds repayable within less than two years (article 10).

«Article 10: Any person other than a credit institution is prohibited from pursuing activities which fall within the scope of usual banking business.

It is further prohibited that any person other than a credit institution shall receive funds from the public repayable upon a term of less than two years.»

Exercise of activities expressed to be banking activities (grant of credit, collection of savings) is thus strictly regulated and reserved to institutions licenced by the Banque de France and subject to special supervision. Small-scale operations may obtain a licence by forming alliances. Under article 14 of statutory instrument no°84-708 of 24 July 1984, the CECEI (Comité des Etablissements de Crédit et des Entreprises d'Investissement - Committee on Credit and Investment Institutions) may, with the permission of the central authorities, grant a collective accreditation to a regional or federal savings institution for its own use and for local funds affiliated to it on behalf of mutualist and cooperative networks, provided the liquidity and solvency of the local funds are guaranteed by such an affiliation. Institutions licenced in that manner then constitute a single institution for the purposes of the application of prudential regulation.

Banking law distinguishes two principal types of credit institution, those which operate under a full licence (banks, mutual or cooperative banks, municipal credit funds) and those which operate under a qualified licence (finance companies and specialist finance institutions). Only the former is authorised to receive funds from the public, and finance companies are only entitled to collect funds which are not repayable until the expiry of a period of at least two years. Finally, the minimum amount of capital required to create finance companies is lower (FF 7.5 million as opposed to FF 35 million for a fully licenced institution).

«Article 18: Finance companies may only conduct banking operations either authorised under the licence granted to them or in accordance with legislative and regulatory provisions specific to them (...) Specialist finance institutions are credit institutions to which the state accords a permanent public interest mission. They may not conduct other banking business than those pertaining to that mission, unless ancillary to it.»

While certain social credit organisations have adopted the status of finance company, it is clear that most activity in the social credit sector occurs within the framework of exemption from banking law. Banking law indeed envisages a dispensation under article 11 for non-profit organisations.

«Article 11 : the prohibition relating to credit operations shall not apply to non-profit organisations which, as part of their mission and for the benefit of society, grant loans from own funds on preferential terms to certain citizens associated with the organisation »

This apparently wide exemption has been interpreted restrictively by the Banque de France.

- The exemptions only apply to **non-profit organisations**, which excludes legal entities constituted with a view to commercial activity.
- Such organisations may only conduct credit transactions **from own funds**. Non-banks are prohibited by law from becoming indebted to members of the public or to the banking sector in order to fund loans granted by them. Funds created by gifts, grants or subscriptions (whether repayable or not) may, on the other hand, be allocated to loans.

Returnable contributions subject to deducted losses are also considered as own funds (under the condition that the provider of the funds is informed of the risks).

- **These organisations must already be in existence at the time of the finance project.** The finance activity they undertake must be an instrument rather than an end in itself.
- Loans must be granted **in furtherance of the common good**. Objective criteria exist such as financial circumstances or the family circumstances of the individuals concerned. In principle the amount of each loan should be limited, but there is nothing to prevent indirect finance, such as the extension of loans or guarantees to other organisations of a similar type, subject to an instruction that the second organisation proceed to grant a direct loan.
- Loans are in principle **provided on preferential terms**. The principal objective of any remuneration is coverage of the lender's administration costs, which are often limited
- Loans are granted to **citizens associated with the organisation**, and the beneficiaries are accordingly supposed to be members of the operation which grants them the loan.

Another exemption is given through Art. 3 of the Banking Act, under which interest-free credit does not require a banking licence.

Social credit organisations (finance companies or associations) use funds largely supplied by the public authorities. For example, one-third of the capital of the Caisse Solidaire du Nord Pas de Calais (Solidarity Fund of Nord Pas de Calais) is owned by the regional council, the guarantee funds are provided by the FFA (Fondation France Active - French Action Foundation) or the PFIL (plates-formes d'initiatives locales - local initiative springboards) which systematically apply local community funds.

The following instruments are used:

- Grant converted into loan
- Grant for guarantee fund
- Repayable advances which are treated as own funds

Access to this type of resources enables associations in particular to bypass the obligation imposed upon them to lend only from own funds. A proposed amendment of the Banking Act, which would allow micro-credit organisations to borrow directly from the banking system is currently under consideration. Associations would then be able to refinance through the banks, or "borrow to lend", which is not possible under banking law as it stands.

The amendment supported by ADIE and a number of French banks relates to paragraph 5 of article 11 and is as follows:

The prohibition relating to credit operations shall not apply to "non-profit associations extending loans from own funds and from funds raised through loans obtained from credit institutions or service providers specified in the Article, for the creation and development of enterprises by the unemployed or by recipients of state benefits, as authorised and monitored under terms laid down in regulations by the Conseil d'Etat. »

The state is also involved in terms of support for social credit through SOFARIS, the EDEN device (Encourager le Développement des Entreprises Nouvelles - Support for the Development of New Enterprises) or PCE (Prêt pour la Création d'Entreprise - Enterprise Creation Loan). Through these initiatives, the state endeavours both to sustain enterprise creation programmes and to encourage the banking sector to become involved in financing micro-enterprises.

While on the one hand French law exempts lending practices with a social objective, on the other hand it heavily regulates lending in general.

Suppression of usury arises in the Code de la Consommation (Consumer Code) (articles L.313-3 to L.313-6), recently amended by regulation n°89-1010 of 31 December 1989 in relation to overindebted households.

Average effective rates are determined every three months by the Banque de France, following a survey of certain institutions which are considered to be representative. At present it stands at 8.29% for loans of an initial term of more than two years at a variable rate and at 10.39% for loans of an initial term of two years or less.

Whether within the traditional banking sector or in the association sector, whether through state provision or through private initiative, there has been a considerable increase in social credit activity over the past ten years. The most sensitive issue for organisations operating outside the banking sector remains finance for their activity. The costs of extending small loans is high and receipts from interest payments are insufficient to cover those costs. Economies of scale offer the sole prospect of coverage of operating costs.

Two possible scenarios emerge today. One is the development of structures favouring the involvement of banks as intermediaries and envisaging a greater role for traditional banks in financing micro-enterprises. The other is recognition of a specific micro-credit status with a defined role within the banking sector.

III.8. Credit Monopoly and State Activity: Micro-lending in Germany

Micro-credit is a banking activity in Germany which is reserved to licensed banks or state administrations. But in both forms of organisation, Germany seems to have a unique system of a fairly active state and a public banking system which has in the past smoothed the effects of the withdrawal of commercial banks from small business lending.⁷⁸

In contrast with other countries and in spite of its highly concentrated commercial banking system, Germany is still marked by several thousand formally independent local banks. The public chartered savings banks, together with co-op banks, which are formally owned by their clients, have a particular responsibility for small credit. The savings banks, which provide more than 50% of consumer and small business credit are owned and guaranteed⁷⁹ by municipal authorities and have the formal obligation to lend money on a non-profit basis for urban development and local, mainly small-scale business. Most savings banks are subject to legislation passed by the Laender compelling them actively to work against overindebtedness, to make bank products available to the socially disadvantaged and to engage in local development. The "regional principle" obliges these banks to remain in their defined area and not to compete with other savings banks. In that way it could be argued that the savings banks fulfil many of the functions attributed to micro-lending. Germany may as a result have fewer "unbanked" people than would otherwise have been the case. But the increase of the numbers of "unbankable" people is a problem which is beyond the ability of savings banks to

⁷⁸ There is also a growing concern among commercial banks and savings banks that the public will not tolerate any withdrawal from these segments of customers. The Savings Bank Association has started an annual nation wide campaign which is called „Start-up“ a competition for the best business ideas and their financing in which IFF participated since the beginning. The Dresdener Bank has a similar ongoing project linked to the small business journal Impulse called „MindChange“ which make surveys and held a meeting with more than 600 participants March 14, 2001 in the former German Bundestag. The German Bankers Association in a joint statement for all commercial banks claimed in a formal statement to the public in early 2001 that it would not abandon small business lending.

⁷⁹ This has led to formal complaints of the commercial banks to the European Commission which then has partly seen forbidden subsidies inherent in such guarantees if there is no visible counterpart. It is not the question whether the „non-financial“ and not-for-profit input of these banks can be evaluated as an exchange value for state support which in any case would be an important step forward towards a more socially minded attitude of the EU Commission towards social responsibility in economic issues.

solve. This is why the German Association of Savings Banks, some of the larger savings banks such as the savings bank of Aachen as well as major German commercial banks have begun to consider prospects of promoting micro-lending programmes. Current law, however, is very strict and does not allow exemptions for social purposes, partly perhaps because it seems less urgent than in other countries.

Pursuit of credit and guarantee business is subject to supervision under section 1 I 2 nos.2,8 KWG, irrespective of whether the operation concerned simultaneously conducts another form of business, deposit-taking business in particular. Credit and guarantee business must be supervised if it is pursued commercially (ie. with the intention of making a profit) or if it pursued in such a manner as requires a commercially constituted operation. There is a presumption that a commercially constituted operation is necessary if more than 100 individual loans are made or if total credit in excess of DM 1,000,000 is extended and more than 20 loans are granted. If guarantee business is pursued at the same time, the limit is 100 individual transactions (credit and guarantees) or a total sum of DM 1,000,000 is exceeded (credit and securities combined) and there are more than 20 transactions.

There is a further barrier, which applies even to banks, to pursuing targeted savings programmes, whereby prospective borrowers initially save a certain amount with the credit provider. These are prohibited by section 3 no.2 KWG if more than 50% of borrowers are subject to a compulsory savings programme, the sole exception being building societies.

Numerous reports produced by IFF for German banks and savings banks on the prospects for micro-lending have shown that this type of business cannot be costs-neutral within banks under existing supervision requirements and that it cannot be adapted to ordinary banking practice.⁸⁰

Even where banks are prepared to make part of their infra-structure available for micro-lending, legal problems arise. In the credit transmission model, which is not particularly attractive to banks, the micro-lender provides the credit which the bank then issues, and the micro-lender then acquires the status of credit provider. However, there would be no supervision requirement as far as the micro-lender was concerned, provided only one bank were involved, because there would be less than 20 individual credits which would not need to exceed Euros 500,000.

Outsourcing parts of the credit transaction from a credit institution to an external organisation (an out-source organisation) is in principle permitted. If out-sourcing involves the type of activity which creates or can affect risks typical of banking (as where the external organisation can conclude credit agreements as representative of the out-sourcing institution or when it take on *monitoring* existing credit) out-sourcing is only permitted if the out-sourcing institution applies strict, pre-determined and verifiable decision-making criteria and checks that they are adhered to. These criteria would, on the other hand, amount to the implementation of bank guidelines. Where the external organisation, in the course of conducting the out-sourced activities, takes part in credit business, for example by making available funds for lending through the trust model, thereby taking on the credit risk, the external organisation could be presumed to be actually conducting the credit transaction and, in consequence, to require a licence and supervision. This really only applies where the limits of permissible out-sourcing are exceeded

A foreign micro-lender would also be subject to supervision under section 53 II KWG because, from the national perspective only deposit-taking credit institutions (1 III d KWG),

⁸⁰ This is also the opinion of Chase Manhattan Bank New York who therefore supports the Micro-lending Organisation Accion logistically and financially.

which have obtained a licence conforming to the bank regulation and supervision Directive in a Member State in the European Union are exempt, section 53 I 2 KWG.

This stringent legal situation gives very little scope for micro-lending by non-banks in Germany. In addition, micro-lending would also fall under the Consumer Credit Act which goes beyond the scope of the EEC-Directive on Consumer Credit and covers all credit contracts below Euro 50.000 for business start-ups. Jurisprudence has extended the scope of the Act to the initial start-up period which may be more than a year. This law requires not only full transparency of credit contracts (APR, instalments, additional cost), it also gives a one week revocation period, limits the right to cancellation and makes preliminary talks obligatory and finally provides a socially adapted system after cancellation. The default rate is capped at 5% over the bank basic rate, repayments have first to be compounded on the capital while the outstanding interest can only bear interest at a rate of 4% p.a. Further, jurisprudence has applied the usury ceilings are fixed by the courts at double the average interest rate applicable to the relevant form of credit to all borrowers protected by the Consumer Credit Act. At present, micro-lenders could not charge more than 20% p.a.

This makes micro-credit unattractive for banks, but helps small businesses to overcome temporary crises and protects them from predatory lending. It has also helped to create alternatives to credit cancellation in consumer credit, although small businesses still suffer from rigorous methods of early termination and debt collection; it has also tended to exacerbate exclusion at least from commercial banks.

Administration at state level has taken direct measures to promote micro-lending, to the point of creating guarantee banks in co-operation with the banking sector, in order to further small business lending.

The German administrative system of financing and promoting business start-ups consists of the two elements, **credit** and **guarantee**. It is a powerful instrument in a large number of tasks. Its problems lie mainly in the field of micro-financing and thus affect the target group we are concerned with here in particular. The largest scheme, rated according to the number of cases of funding is "Überbrückungsgeld" (bridging allowance). It is characteristic of the German situation that this scheme is designed as a pure subsidy programme. Germany still has some way to go before it will have a highly developed and efficient "micro financing system". This is proved by the fact that few creators of micro-businesses are able to make use of public funds when financing their project with loans.

"Überbrückungsgeld" as an important example of micro-financing in Germany is seen as controversial because it is pure subsidy.⁸¹ Moreover no market mechanisms are included in this measure (credit standing investigation, etc.), so there is no selection mechanism to identify viable start-up projects. This, however, is not one of the scheme's claims, as this is a service provided by the labour office its own discretion on the basis of a claim associated with unemployment benefit. Nevertheless, the criteria for the exercise of this discretion are debatable if market criteria fail to help to achieve gains in efficiency. At the same time it must be noted that, within the prevailing system of obstacles to obtaining marketable credits, bridging allowances have a vital function as an outlet. Start-up businesses with start-up capital needs of under 10 or 20 TDM have hardly any hope of obtaining bank credit. This is particularly true of unemployed enterprise creators. Bridging allowance is, as previously, a valid opportunity for the unemployed, even if the grant is formally for subsistence and not for investment. IFF findings show that typically finance is supplemented by private advance on current account and instalment credits (sometimes even under pretence of purchasing consumer goods). In this way at least bridging allowances have served to show that there is a significant number of unemployed people

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Because of its design *Überbrückungsgeld* figures in a special way in German start-up financing, making comparisons with other micro financing schemes very difficult. This will be explained in more detail in the other parts of the German study.

with both a desire to start up a business and a chance of survival. This chance, however, could be much greater if the bridging allowance could actually serve its initial purpose of subsistence. This can only be achieved if access to credits for small investment sums is secured. The coming years will show in how far Startgeld can achieve this, and also in how far it reduces the outlet function of the bridging allowance. The providers of bridging allowances should help to provide the necessary conditions by creating transparency about the clients' access to credits while and after receiving an allowance. The failure rate evaluated by the IAB of 30% after three years is being frequently discussed and judged too low.⁸² However, we do not regard this a relevant point here, as a) it does not impair the programme's merits as described, and b) potential of further improvement is, at any rate, to be found in the following points:⁸³

Unaffected by this there are structural problems of access to finance and subsidy means for creators of ultra-small businesses and enterprise creators leaving unemployment. The market mechanism will not be able to settle these problems in the future. The key problem is expenditure for monitoring, counselling and administration in credit standing investigation, rendering small loan amounts inefficient for the banks – regardless of the banks' willingness to be responsive to the enterprise creator. This problem is even greater with unemployed persons, as the individual risks are higher and the details of the projects possibly are less well planned.

Some of the difficulties arising from this have been noticed already and are taken up within the promotional programmes. Innovative approaches as the *DtA-Startgeld* (DtA-start-up-money) or the offerings from the *Brandenburgische Bürgschaftsbank* (guarantee bank in the state of Brandenburg) prove this.

There are many concerns about the efficiency of the Guarantee Banks of the Laender as well as of the “Überbrückungsgeld”. While the bridging money contains no guarantee of success and lacks in particular the social policy aspects of monitoring and coaching, the Guarantee Banks rely on ordinary bank business and tend equally to exclude very small enterprises. Germany will therefore probably have to liberalise its legislation at least for banks which want attempt micro-lending through subsidiaries or with fully responsible intermediaries.

III.9. Social credit from the State: Micro-lending in the Netherlands

Micro-lending in the Netherlands is still based on the informal sector of family and friends. Two-thirds of start-ups rely upon own money or money obtained through friends and family.⁸⁴ In the official sector conditions are similar to those in Germany.

In the banking sector it is very hard for small entrepreneurs to obtain credit. The more or less standard conditions set by the banks are too strict for start-ups. But there are two exemptions:

The Municipal Credit Banks owned by the cities and the Rabobank co-operative banks.

The Municipal Credit Banks (Social Banks) help the inhabitants of a city or a whole region with financial issues. One of their core activities is helping individuals with their financial problems and trying to reach an agreement with his or her creditors, having been given more power for this goal by new legislation.

The Rabobank Group consists of more than 400 local co-operative banks. The Rabobank stems from the rural co-op movement of Raiffeisen and emphasises their relationship with their customer. The Rabobank has special facilities for micro-entrepreneurs. Its special Stimuleringsregeling is an exponent of the Raiffeissen theory. It is possible to obtain a

⁸² cf. Struck, J., et al., op. cit., p.20

⁸³ This part is taken from the ILO report op. cit. (FN 46)

⁸⁴ See the report :“de ondernemende samenleving” of 16th September 1999.

subordinated loan from the Rabobank for all kind of undertakings. During the first five years there is no repayment obligation.

The state in the Netherlands is also very active in structures that come close to micro-lending. For inhabitants of the Netherlands⁸⁵ who have permanent financial problems, and the long-term unemployed in particular, there is a social benefit called "de bijstand" which includes the possibility to start an own small company.⁸⁶ New regulations in force since April 2000 give the opportunity to start an enterprise or to help an enterprise which already exists.⁸⁷

Those who want to start a company need to follow a training programme. The training and orientation period is approximately a year. During this period the normal Bijstand payment continues. Costs in relation to the trainee and orientation period can be declared up to the sum of HFL 5.000,-.⁸⁸

After the period of orientation and training there must be a sound plan. If there is, the government is willing to grant a loan of maximum HFL 60.000,- and a periodical grant during a maximum period of 36 months. The interest on the loan is 5 % a year and the maximum period before the loan must be paid back is 10 years. The most likely scenario is that the loan will be obtained through a bank and that the local government will guarantee the repayment of the money to the bank.

If the banks are not willing to grant the loan, the loan will be supplied by the local government itself. During the first year of the enterprise there may be a need for special and expertise and help. Costs for help will be covered up to a maximum Euros 1.400 through the local government.

Some other instruments the government uses are:

- Het Besluit Borgstelling Midden en Kleinbedrijf, that provides sureties for undertakings, which want to borrow money through a commercial institution.
- The Twinning project, that stimulates entrepreneurship by giving expertise and loans.
- The Twinning project, which is a direct aid program from the government to provide venture capital for start-ups in the ICT sector together with information and help.
- The Besluit borgstelling MKB kredieten is a guarantee facility for small and medium size enterprises which are not able to provide the money themselves, have good prospects, are not able to provide their own security for the loan and seek support for a new loan.

Besides this the rules for banking are very strict.

Art. 82 of the bank law (Wet toezicht kredietwezen) forbids obtaining money from the public and extending credit, if the company is not registered as a credit institution.⁸⁹

In Art. 2 of the Uitvoeringsregeling ex artikel 1 van de Wet toezicht kredietwezen 1992⁹⁰ the municipal banks, as well as companies which provide loans to other companies in their own group, are exempted.

⁸⁵ Requirement is that you have the Dutch nationality or that you have a permit to stay in the Netherlands

⁸⁶ Het Besluit bijstandverlening zelfstandigen. (Bbz)

⁸⁷ The regulation is based on article 8 paragraph 6 of the Algemene Bijstandswet. (the general social benefit law)

⁸⁸ The money can be used e.g. for a market review.

⁸⁹ See article 82 paragraph 2 sub a Wtk.

⁹⁰ This is a law that directly relates to the Wtk.

A special licence is required by the Consumer Credit Act for those companies which offer credit facilities to consumers⁹¹

There seems to be some scope for non-banks to get involved in credit projects sometimes on the at the borderline of banking law but with official tolerance and even encouragement.

The facility that stimulates private financing undertakings, called, Tante Agatha (Aunt Agatha), is very popular. It reduces the risk to those who provide a subordinated participative loan to a start-up company. The benefit is that the interest paid is tax free. If the company goes bankrupt the losses can be written off from taxable income up to a maximum of Euros 23.000.

While this addresses the public, Mama cash and Stason are perhaps the best known micro-lending associations. Mama Cash provides money for women start-ups with loans of a maximum of about Euro 23.000 or guarantees for bank loans. As it provides no more than 20 loans or guarantees a year it seems to escape bank supervisory laws. Mama Cash refinances its work from donations, income from legacies and own equity.

Stason is a support foundation for immigrants in the Netherlands.⁹² Fund-raising is done quite successfully with contributors such as Shell and the Rabobank. Stason policy is that they provide loans or guarantees to a maximum of DFL 50.000 if a bank or other organisation provides at least the same amount of money.

Factoring and Leasing are widely used in the Netherlands but do not help small companies because the required annual turnover is too high for them. Instead leasing is used widely by small companies. It is a good way – and sometimes the only way - in which credit can be obtained. There is no special regulation for leasing in the Netherlands but it cannot of course provide working capital but only inventory.

In conclusion, credit for micro-enterprises in the Netherlands can be obtained but according to the research of the Institute for medium and small sized companies the entrepreneurs do often not know where to turn. There is a need for an institute in which the government, the corporate sector and others participate to distribute this information and to centralise requests. The institute should help (starting) micro-undertakings with expertise and perhaps even with providing micro-credit under favourable conditions. The government is presently actively seeking further solutions for micro-credit.

III.10. Social Co-operatives and Guarantee Schemes: Micro-lending in Italy

Italy has no legal bank monopoly for money-lending but restrains it through additional legislation. Historically, the Italian civil code from 1943 has already made mention of non-banks as credit institutions. In Art. 2517 it. Civil Code "mutuals that exercise credit business" are regulated by the general rules on mutuals (Art. 2511 ff. CC) as well as by special rules. Today most of the financial mutuals have become the Popular Banks or the Co-operative Banks of Italy, all of which have a banking licence.

The Umbrella Bank Law "Testo Unico Bancaria" from September 1, 1993 as amended by Law No. 342 of the Law of August 4, 1999 has defined a "banking activity" in line with the wording of the third EU banking directive as "**taking assets from the public and giving credit**" followed by the statement that banking activities are reserved exclusively to banks.⁹³

⁹¹ See the articles 9 and 11 of the CCA, without a licence you are committing a criminal offence.

⁹² The Dutch name is "Steunfonds Alloctone ondernemers".

⁹³ see Santorio, V. *Eccercizio di Fatto di Attività Bancarie e Finanziarie*, in:m. Rispoli Farina (Ed.) *La Nuova Legge Bancaria*, Jovene Editore 1995 p. 323, 327ff

Art. 10 al. 2 and 3 TUB: "La raccolta di risparmio tra il pubblico e l'esercizio del credito costituiscono l'attività bancaria. L'esercizio dell'attività bancaria è riservato alle banche."

In Art. 11 taking assets is defined as collecting funds with the obligation to pay them back.

Art. 11 alinea 1: "Ai fini del presente decreto legislativo è raccolta del risparmio l'acquisizione di fondi con obbligo di rimborso, sia sotto forma di depositi sia sotto altra forma."

Art. 11 al. 2 TUB states that "it is forbidden to any other entity but banks to take assets from the public"⁹⁴ which makes it clear that also stand-alone asset-taking is covered by the bank monopoly. Credit alone is therefore not a banking activity.

There is only one exemption, and it applies to consumer credit. It is reserved to licenced banks but does not encompass loans to start-ups and the self-employed for business purposes.

But Italy in contrast with other countries has applied the Investment Fund directives to all forms of money loans, including micro-lending. This Directive has created Euro-financial institutions which also need special admission and supervision as well as compliance with certain rules. They are rewarded also by a single passport for other countries. This Directive does not apply to money lenders and the UK as well as Belgium did not apply it to these categories. Italy has put these other financial institutions collectively under the heading "financial intermediaries". The relevant rules require at least a minimum capital of €500,000 and some personal, organisational conditions of safe and sound business. They further demand a special legal form of enterprise with limited responsibility including a co-operative. Although the Bank of Italy assumes that non-profit also lending falls under this category, the literature still expresses some doubts about the question whether Art. 105 TUB covers pure business lending as "other financial activities"

There is no doubt that any form of taking repayable assets by non-banks is forbidden and sanctioned by penal law. Only participations in capital are exempted. Vast discussion and jurisprudence on these issues have narrowed down the possibilities for circumventing this interdiction through the use of withdrawable shares. The law further makes it clear that the use of savings into credit schemes is in general prohibited.

But the Italian system has institutionalised an area where the criteria of non-profit, mutuality, democratic control and social aspirations are institutionalised in the form of a co-operative. The long tradition, especially strong in northern Italy, of a co-operative movement has left some scope for this organisational form to engage in micro-lending.

Co-operatives which use their own capital are allowed to lend money. But their activities are restricted by special regulation by the Credit Supervisory board. It focuses on supervision of the form of generating own capital. It has also restricted the lending activities of companies and co-operatives to between 3 to 5 times of the assented capital of the preceding year.

There is a certain loop-hole for refinancing from the public whereby Italy (in contradiction to the interpretation of the third banking directive given in this report) allows co-operatives or consortiums (a form of organisation between several businesses especially for creating guarantee funds) to issue obligations. But if they do so they are again regulated as financial intermediaries and are therefore subject to the restrictions mentioned above in addition to the restrictions contained in the law on co-operatives and consortia.

The introduction of regulation of financial intermediaries with similar restrictions to those on for banks has hit Italian models of micro-lending as they had developed particularly in the form of "bank micro-lending" and had been made famous by the MAGs. This movement has

⁹⁴ La raccolta del risparmio tra il pubblico è vietata ai soggetti diversi delle banche.

now allied and, together with a number of social organisations, created the Ethical Bank (Banca Etica) as a tool to develop such products in the future. The present state of development does not show whether this will have success for micro-lending.

As well as the continuing severe restrictions for micro-lending through supervisory legislation on financial intermediaries two forms of micro-lending by non banks remain:

1. Guarantees through co-operatives or consortiums, which collect money from their members and place it in a bank account serving as a guarantee fund for the bank when it extends credit to the members of the co-operative, are neither subject to the rules of bank supervision nor to the rules of the supervision of financial intermediaries. But they are barred from all other financial activities. Such guarantee funds guarantee 50% of the claims of the bank against the borrowers and levy up to 20 times more than the value of the fund in credit for its members. They thus induce banks to engage in small loans although this does not directly concern micro-lenders whose borrowers cannot be organised into such co-operatives.
2. After the central bank has tried in vain for several years to prevent micro-lending by very small local co-operatives, the law has finally exempted small and insignificant micro-lenders like the "Cassa Peote" and small Financial Co-operatives if they act locally and do not trespass beyond the narrow limits of asset-taking and credit extension set by the Credit Supervisory Board.

While co-operatives are at the heart of Italian social life, and cover all kinds of community activity from housing to child care to unemployment projects and park custody, micro-lending would be well-suited to this environment. But prospects of micro-lending through non-banks in Italy are poor because approach of bank and financial legislation has been far too general. This tolerates some rural forms of bank micro-lending but gives no room for new forms of social micro-lending. Furthermore, regulation of co-operatives tends to require a larger scale, forcing them to merge with larger co-operatives and moving the movement into the social enterprise sector, as has been the case in Germany, where co-ops in commerce, banking and production are today indistinguishable from other businesses in the relevant sector.

Micro-lending could be especially significant for the South of Italy where usurious loans are still privately extended by predatory lenders, sometimes in the control of organised crime, making access to credit for micro-enterprises hazardous.

III.11. A Scattered regulatory Landscape in Europe: An Overview

The European landscape of bank regulation projects a diffuse image. While European banking directives prohibit neither micro-lending functions such as the extension of loans nor the taking or giving of guarantees through non-banks, some countries have imposed banking legislation on lending in general (Germany, France, the Netherlands) and Germany has also extended the Consumer Credit Directive to potential micro-lending. Italy has enacted the EU legislation as such but then applied the regulation of financial intermediaries to micro-lending, thus creating similar obstacles for them as those in Germany. On the other hand the UK, with no restrictions on micro-lending as such, has made guarantees difficult by applying insurance legislation to them.

As far as asset taking is concerned, Italy has allowed obligations to be issued while most countries do not allow this form in-between assets and own capital.

An even more scattered picture is given if exemptions are taken into account. Germany and the Netherlands widely use the exemption for state loans. The UK and Ireland have exempted credit unions in general. Italy has exempted all bank micro-lending including asset-taking for

very small local historical co-operatives. Germany and Belgium use size as a means to exempt small lenders with less than 50 or 100 loans and less than Euro 500.000 in general. Only France has developed a direct approach to address the goals of micro-lending and employment initiatives explicitly, allowing micro-loans and probably also savings into credit schemes. Furthermore France does not see interest-free loans as a bank activity.

No country has touched on other forms of credit than loans. Factoring, leasing and instalment purchase can be used by anybody without a licence and special supervision in Europe. Only consumer credit legislation applies where, as in Germany, start-up credit is included in such consumer protection.

The following table summarises this overview.

Tabelle 11: Micro-lending – Permitted for Non-Banks?

	Credit			Assets				Guarantees		Bank Credit	Alternatives to ML
	Bank Activity	Exemptions	Other legislation	Saving into Loan	Refinancing	Public Assets	Participations	Funds	Peer Groups	Refinancing	State, Banks
EU	Yes	-	-	No	No	No	Yes	Yes	Yes	Yes	-
United Kingdom	Yes	-	-	No (credit unions yes)	No		Yes	No (insurance law)	Yes	Yes	No
Ireland	Yes	-	-	No (credit unions yes)	No	No	Yes	Yes	Yes	Yes	Credit Unions
Belgium	Yes	-	-	No	No	No	Yes	Yes	Yes	Yes	No
France	No	Not for profit, ML, interest free, State	Decrees	No	No	No	Yes	Yes	Yes	Not for ML	Regions
Germany	No	< 50	Consumer Credit Act	No (also forbidden for banks)	No	No	Yes	No	No	-	State, savings banks
Netherlands	No	Yes	-	No	No	No	Yes	No	No	?	State, Munpl Banks
Italy	Yes	Social co-operatives	Financ. Intermediaries	No (small co-operatives exempted)	No (small co-operatives exempted)	No	Yes	Yes (co-operatives/consortium)	No	Not for ML	No

Three approaches may be distinguished for the regulation in social micro-lending:

1. **The market approach:** Some more liberal states have left the financial sector, including its social questions, to the private sphere. These states have little involvement in banking or in general in social affairs. They consequently have also a liberal attitude towards social lenders and give non-banks a wide range of possibilities to act but more or less without state support. In this approach all lending is permitted.
2. **The welfare state approach:** Some still have substantial public involvement in banking and provide significant state activities for social lending. They use guarantee schemes, tax subsidies and their own administration and state-owned banks to further social goals in the financial sector. In this approach small and private lending is permitted.
3. **The social lending approach:** there is a specific attitude towards social lending. It is supported officially and linked to non-profit, employment and

The UK, Ireland and partly Belgium broadly take the market approach. Germany and the Netherlands, and the more general aspects of Italian legislation are closer to the welfare state approach. France has a special status in that it is the only country which, in addition to or partly also in replacement of state involvement, tries to develop specific micro-lending policies.

As well as these three approaches to social micro-lending nearly all states retain remnants of bank micro-lending in the past, which they partly try to revitalise as small units for social lending. This is especially true for Italy, which may also represent other Mediterranean states and give important examples for eastern applicants for entry into the EU. In Poland, for example, micro-lending seems to represent the beginnings of rural co-operative banking. But also Ireland and the UK with their exempted credit unions, the Dutch and the German system of banks owned by the communities, which has its homologues in the communal credit programmes in France, represent micro-lending as a form of "banking development".

The question of refinancing arises primarily in those states with a market approach. Where where public involvement through state administration or banking legislation is typical, refinancing problems seem to be less significant.

Existing regulation still assumes that smallness is the reason for allowing non-banks to get involved in micro-lending. Only France and indirectly Italy, with its legislation on social co-operatives which are given a monopoly in social finance, assume that the social dimension needs specific exemption in banking legislation. On the other hand, Germany alone protects micro-borrowers with specific legislation against predatory lenders through the extension of consumer credit protection to micro-enterprises.

It can be concluded that all states assume that forms of social lending targeted at people seeking self-employment in particular are significant in terms of social and economic welfare. Only the UK, Belgium and France make special reference to third world and American experience in micro-lending. Other countries create similar effects using traditional systems, but considering whether, in the wake of the globalisation of banking, additional scope should be given to private participants in the social arena.

To understand the social effects of existing banking legislation one has to consider whether the need for micro-lending stems from under- or from overdeveloped banking in this country. Rural areas or indeed entire countries with underdeveloped banking still exist in Europe in large numbers. For them, the rigid banking legislation of the EU, which creates a bank monopoly on the assumption that a significant size (impeding the development of new banks) is necessary as a guarantee for bank safety and soundness. To consider the effect of this situation, there should be a specific investigation of the conditions for the development banking with special reference to the historical development of co-operative and communal

banking in Europe in the 19th century. Such work should concern especially the Mediterranean and eastern European states.

For micro-lending in "overbanked" areas, the situation can only be assessed in the context of all the compensatory measures available to the state for coping with exclusion and poverty.

Accepting micro-lending as an important modern tool for educating people with little access to the labour market and for supplying the means for entering active life means accepting social banking as special purpose lending. French general legislation on micro-lending in the form of French banking law is the most best and most direct example of new elements in banking legislation.

It finds its homologues in the more partial legislation on savings banks in Germany, the charters of the Dutch municipal banks, the Italian legislation on social co-operatives and the charters of Belgian public foundations.

It gives a legislative framework for what in the Anglo-American context is called a "community development financial institution" (CDFI) to which some social credit unions, especially in Ireland, adhere. But as has already been mentioned in the introduction, the CDFI approach is an institutional approach. It protects micro-lenders and not directly micro-lending, it does not aim at effects but at the authors of micro-lending. There is some risk that such actors may create a new shadow economy for the poor, distinct from other social work and from ordinary banking.

IV. Conclusion

(Social) Micro-lending, if properly assessed and defined in industrialised areas with a highly developed banking system, is not banking but a social policy activity using credit for other purposes. It should not be covered by banking legislation if it is restricted to such credit and credit-related financial activities which do not necessitate any bank supervision.

National approaches to facilitate micro-lending through non-banks mostly follow an approach in which certain institutions are exempted from bank law. This report instead recommends that the only requirement be that micro-lenders should not be treated as individuals but as legal entities. It strongly recommends that micro-lending be considered without recourse to special legal forms for micro-lending institutions such as associations or co-operatives, but that any institution able and willing to fulfil the relevant criteria be allowed to engage in micro-lending.

Instead of supervisory law micro-lending should be covered by adequate protective private law such as the Consumer Credit Directive and usury legislation.

The EU should clarify the banking directives in terms of their application to non-banks. In other respects, the main effort to further micro-lending in the EU must to lie with the Member States. To further their activities and to harmonise and co-ordinate them, the EU could pass a recommendation whose contents is indicated below.

For micro-lending in areas where banking has yet to be developed by its inhabitants and which need to create capital accumulations with the help of co-operatives, self-help associations, savings groups etc., the EU should consider more general exemptions to the banking directives which favour small entities in the process of development towards ordinary banking. This kind of micro-lending has not been the focus of this study.

V. Ancillary

V.1. Case Studies from the New Economic Foundation

V.2. Literature

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