

## Microfinance in Germany and Europe.



## Market Overview and Best Practice Examples.

Frankfurt am Main, April 2007.

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## **Editorial.**

The importance of microfinance in Europe has been growing in recent years. Microfinance approaches first showed their positive economic and social impact in the developing countries in the 70ies and 80ies. In those countries, many people from the poorer sections of the population had no access to small credits or simple financial services. This access was established by microfinance programs enabling poor people to earn their own living by running their own – small – businesses.

This principle of microfinance – helping people to help themselves – gets more and more recognized by economic and social policy makers in Europe. Although in most European countries there is a highly efficient banking sector, many small and micro businesses have sizeable difficulties in obtaining loans for their investments. As seen by traditional financial intermediaries, small scale customers often mean an unfavourable cost/income ratio. But, financing problems that could be avoided slow down investments and are, therefore, an impediment for job creation.

Furthermore, microfinance programs in Europe are often addressed to groups with specific economic and social difficulties. For example, a lot of start-up entrepreneurs who were formerly unemployed need small loans as a basis for the development and growth of their businesses. Since many of them have difficulties to demonstrate their creditworthiness by providing documentary evidence of past economic success and rarely have assets which are usable as collaterals, banks often refuse to give financing to them. Small loans granted by microfinance institutions are, therefore, crucial to give unemployed people a chance to earn their own living being self-employed.

As in the developing countries, we also find many microfinance approaches in Europe with differing structures and strategic approaches. Actually, they have to be diverse to take account of the wide range of people's living situations. How to create a microfinance program which efficiently solves the economic and social problems of the specific target group is an important question for European policy makers. Because the more efficient microfinance works, the bigger is the positive impact we can achieve with limited resources.

Against this background, the objective of this volume is to give an overview over microfinance initiatives in Europe and to get some more insights into the functioning and the structures of successful programs. Efficiency gains by mutual learning in Europe enable us to achieve stronger impacts.

We are happy that we could win several European partner institutions to create this volume on microfinance – *ADIE (Association pour le Droit à l'Initiative Economique)*, *The European Microfinance Network*, *Evers & Jung* and *Fundusz Mikro*. And, we especially want to thank the contributing authors.

## **Microcredit in the European Union: An Overview.**

Microcredit came to prominence in the 1980s as a tool to alleviate poverty in Asia, Latin America and Africa. In Western Europe, a handful of organisations pioneered microcredit schemes in the 1990s. The majority active today began lending in the present decade, however. In this period, persistent unemployment and pressure on the welfare state focused attention on microcredit as a tool to foster self-employment for financially and socially excluded persons. Most funds receive public sector subsidies and many microlenders focus on promoting social and financial inclusion.

In Eastern Europe, microfinance began in the 1990s after the economic transition from centrally planned to market economies, which led to large numbers of unemployed urban and rural workers. Microfinance institutions were created with significant donor support. Their purpose was to provide services to people not reached by formal financial institutions due to the collapse of the financial sector. The priority was to create viable and sustainable financial institutions that could reach large numbers of unemployed and poor workers.

This article will mainly focus on microcredit programmes within the European Union with the accepted definition of microloans as loans of EUR 25,000 or less made to microenterprises, businesses with nine or fewer employees. It is based on recent studies conducted by the European Microfinance Network (EMN)<sup>1</sup>, especially the “Overview of the Microcredit sector in Europe 2004-2005” by Tamara Underwood and the last issue paper on “Status of Microfinance in Western Europe: an Academic Review” by EVERS and JUNG. The first part of the article will describe sector characteristics. The second part will analyse the main challenges faced by the microfinance actors and the third part, as a conclusion, looks at the potential for future development.

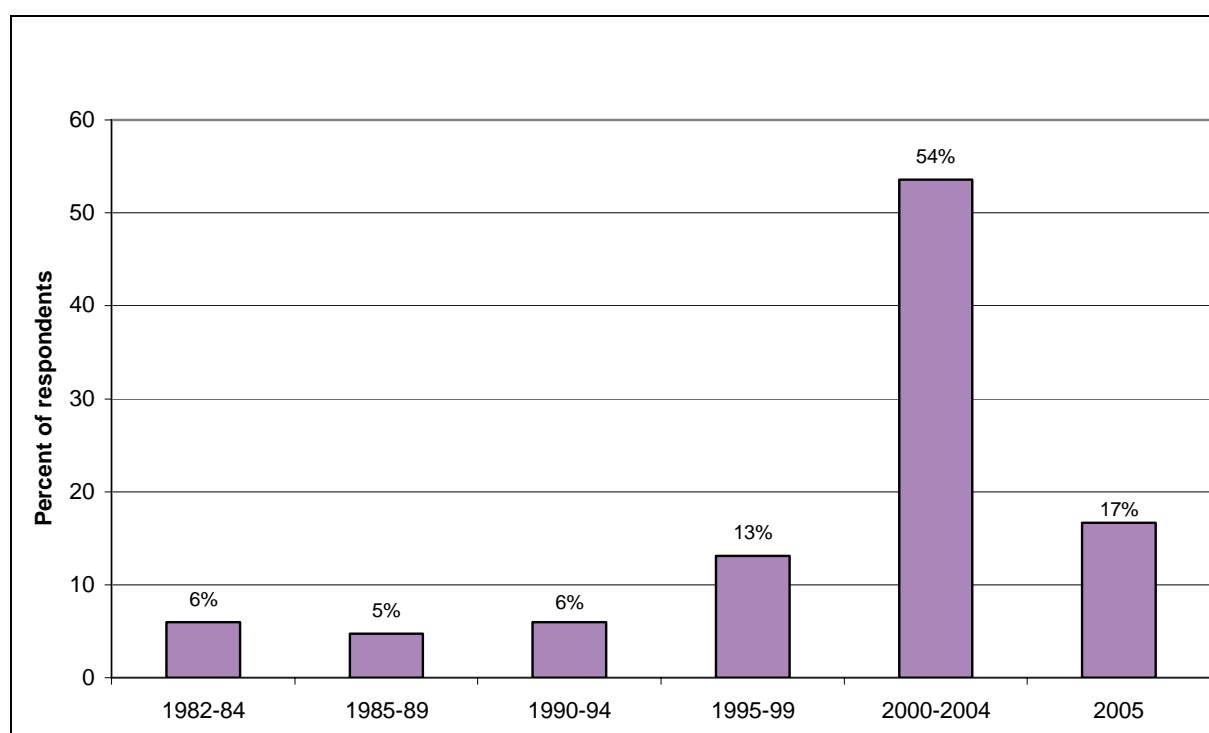
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<sup>1</sup> The European Microfinance Network (EMN) was created in 2003 with the mission to promote microfinance as a tool to fight social and economic exclusion and to promote micro-entrepreneurship and self-employment. As of early 2007 it has 54 members from 21 countries in Europe.

## 1. Characteristics of the sector in Europe.

### 1.1 A young sector.

Certainly one of the first characteristics of the sector is its youth. 70 % of organisations surveyed by EMN<sup>2</sup> have only been active since 2000. Of this group, 17 % began lending in 2005. An additional five actors started their programmes in 2005, but did not disburse their first loans until 2006. The next largest group of lenders (13 %) began in the period 1995-2000. When the new member states are included, there are slightly more lenders (19 %) founded in the period 1995 to 2000.



**Figure 1: First year of lending activity of the microfinance institutions (EU 15)**

The relatively young age of microlenders has consequences on scale and portfolio quality. Most actors are still in an experimental phase, developing and adapting methodologies to their local situations and to a target group that can be more difficult to reach than in developing countries.

<sup>2</sup> Underwood, T. (2006), Overview of the microcredit sector in Europe 2004-2005, p 17; the survey collected information from 110 microfinance programmes in 12 European countries.

## 1.2 Diversity of actors.

The second characteristic is the diversity of the actors, with different structures, missions and objectives, means and approaches. In their academic review,<sup>3</sup> EVERS and JUNG describe four different forms of microfinance business models existing in Europe:

- NGOs with a microfinance driven approach
- NGOs with a target group driven approach
- Support programmes initiated in existing institutions and development banks
- Specialised units of banks

NGOs with a microfinance driven approach focus on serving clients with mainly financial services. Some of these also have a very clear social mission. Well known examples are Adie (France), ANDC (Portugal), Aspire (UK, Northern Ireland) and Street UK (UK).

In the second model, NGOs serve specific target groups (women, unemployed, ethnic minorities, microentrepreneurs, migrants, youth) with a range of services usually related to employment. These NGOs include financial services in their overall programme. Examples include institutions such as the microloan fund of the city of Hamburg (Germany), Weetu (UK), IQ/Enterprise (Germany), Hordaland Network Credit (Norway).

The third model refers to existing institutions and development banks that have integrated support programmes for micro and small enterprises in their regular portfolio. These organisations have established special microcredit windows. Examples are the micro and small enterprise programmes of Finnvera (Finland), KfW Bankengruppe (Germany), BDPME-Oséo (France) and ICO (Spain).

The fourth model is the most recent. Here specialised units within banks disburse microloans directly or through partner organisations. The model is prevalent in Spain, where savings banks such as La Caixa, Caixa de Catalunya, BBK or Caja Granada have played a leading role in developing the sector.

To the above four models we should add a fifth. Whilst not active in all countries, credit unions are particularly important in Poland and Romania and to a lesser extent in Ireland and

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<sup>3</sup> Evers, J./ Lahn, S./Jung, M. (2007), Status of microfinance in Western Europe: an academic review, p 15-20.

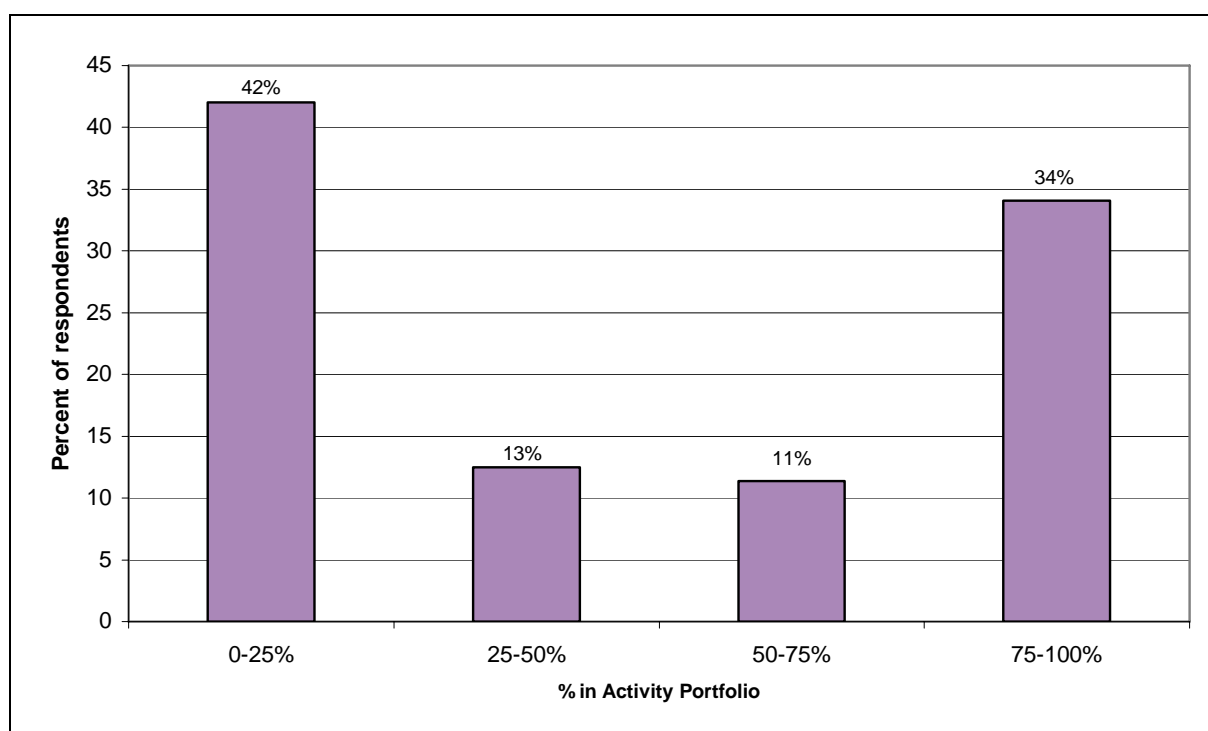


the United Kingdom. At present there is little information available on their microcredit activities. Most of their lending is restricted to credit union members and for purposes other than business start-up or development.

Two other types of actors could be also added here: mainstream banks and financial institutions that provide consumer loans used for business creation or development. At present, data is not available for their loans worth EUR 25,000 or less and whether these are used for business development and creation.

According to the most recent EMN survey 92 % of respondents have not-for-profit status and four out of ten are non-governmental organisations. The latter are responsible for half the loan volume in Europe. By country, NGOs dominate especially in France, Spain and the UK.<sup>4</sup>

One consequence of the diversity of the actors is that the relative focus on microlending varies widely from one institution to the next. According to the EMN survey, 16 % of respondents focus solely on microlending. The remaining 84 % of respondents undertake a number of other activities which are focused on financial and employment related services.<sup>5</sup>



**Figure 2: Microlending as a portion of activity portfolio (EU 15)**

The distinction between lenders in the 0-25 % range and those in the 75-100 % range is important (see figure 2). It underscores the fact that for half the sector microlending is not the

<sup>4</sup> Underwood, T. (2006), Overview of the microcredit sector in Europe 2004-2005, p 14.

<sup>5</sup> Ibid, p 16.

*main* focus but is one of many strategies or tools that supports wider employment and financial inclusion objectives. Organisations in this half of the sector tend to conceive of themselves as social and employment development organisations rather than financial institutions. These microlenders' ambitions regarding achieving scale and high microloan portfolio performance may differ significantly from those in the 75-100 % range.

## **2. Steady growth serves the socially excluded, unemployed and microenterprises.**

Even if the sector is young, the growth in the number of microloans disbursed between 2004 and 2005 was 15 %<sup>6</sup>. During the period 2003-2004, the growth rate was 11 %.<sup>7</sup> Increased coverage and new market entrants are responsible for this growth. In the new member states surveyed, growth in loan volume was 4 %, reflecting sector maturity and competition by downscaling banks.

Most non-bank lenders have a geographic scope limited to regions or localities and disburse fewer than 100 loans a year. Nationally based lenders in France and Finland disburse the greatest number of microloans in the EU 15. Such growth is encouraging, showing the sector's dynamism and potential.

Microlenders focus on start-up businesses and small microenterprises, those with five or fewer employees. Clients targeted in order of importance are financially excluded individuals followed by women, unemployed persons, the self-employed and immigrants. There is considerable overlap among many of these groups. The majority of lenders work to ensure social and economic inclusion of persons at risk of poverty and the unemployed. Others focus on job creation and some aim at stimulating growth, develop small and medium sized enterprises and address market failure.

Women are under-represented amongst microloan clients when compared to their proportion in the population and to microlending programmes operating in North America and in developing countries. In the EMN survey,<sup>8</sup> in 2005 in the EU 25, 41 % of microloan clients were women. However, this lending rate is greater than female entrepreneurship rates in Western Europe, which are estimated to be 30 %.<sup>9</sup>

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<sup>6</sup> Ibid, p 11-12.

<sup>7</sup> nef on behalf of EMN (2005), Overview of the Microfinance Sector in Europe.

<sup>8</sup> Underwood, T. (2006), Women and microlending in Western Europe.

<sup>9</sup> Middlesex University Business School (March, 2000), "Young Entrepreneurs, Women Entrepreneurs, Ethnic Minority Entrepreneurs and Co-Entrepreneurs in the European Union and Central and Eastern Europe".

Regarding immigrants and ethnic minorities, recent work conducted by EMN and some of its members<sup>10</sup> shows that these groups represent a significant proportion of microfinance programmes' clients and that this tool is particularly adapted to their needs. Data collection and definitional difficulties make it difficult to assess to what extent they are being reached in proportion to their representation in the population, however. This challenge is the same with regard to youth and disabled persons.

### **3. Microcredit, not yet microfinance.**

In the European Union, microcredit remains the main financial service offered. Microfinance, a broader concept integrating financial services such as savings, microinsurance or transfers, is very limited. NGOs in the UK and savings banks in Spain are the primary providers of this wider spectrum of services. This is mainly due to the fact that, on one hand, the financial services sector is well developed in the EU countries. On the other, in many countries regulatory environments restrict the financial activities of non-governmental organisations.

The average microloan size across the EU 25 is EUR 7,700. In the EU 15 the average microloan value is EUR 10,240 and in the new member states it is EUR 3,800. Lenders that focus on SME support, addressing market failure and job creation tend to lend larger sums while those focusing on social inclusion tend to disburse smaller microloans. Average microloan values adjusted for Gross National Income (GNI) per capita show a similar trend. Loans are reimbursed at the latest after five years. Most, however, must be reimbursed within five years of disbursement. The interest rate varies depending on national regulation, but in most countries is below 10 %, with the exception of the UK and Poland. Usury laws and related interest rate ceilings limit rates in most EU 15 countries. In terms of methodology, organisations disbursed individual loans. Experimentation with group lending is carried out mainly in France, the UK, Belgium and Norway.<sup>11</sup>

A large proportion of structures provide much more than financial services. Training, advice and support are elements critical to the success of new and existing businesses in the European context. According to the EMN survey, 75 % of organisations surveyed provide pre

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<sup>10</sup> Guzy, M./Underwood, T. (2006), Immigrant Participation in Microloan Programmes in Western Europe" and Guzy, M. (2006), Nurturing Immigrant Entrepreneurship: A handbook for microcredit and business support.

<sup>11</sup> Underwood, T. (2006), Overview of the microcredit sector in Europe 2004-2005, p 27-34.

and post-loan training and technical assistance. Most organisations that do not provide this support refer clients to appropriate service providers.<sup>12</sup>

#### **4. Operational performance is difficult to assess.**

Even if quite important for evaluating microlender programmes, obtaining clear information on the operational performance of the actors remains a challenge. As for its previous surveys, it has been difficult for EMN to collect information from microloan programmes on their repayment rates, their portfolio at risk, their write-offs or their rescheduled loans. This might be explained by under-developed management information systems which are a likely outcome of two factors, lender age and the relatively small place of microlending in the activity portfolio of 50 % of the organisations participating in the EMN survey.

Among organisations providing this data, loan portfolio performance ratios have remained steady since the last survey. The most frequently monitored ratios are repayment rates and portfolio at risk. The average repayment rate in 2005 was 92 %<sup>13</sup> and average portfolio at risk is 11 %.

#### **5. A sector requiring subsidies for its development.**

The most important strategic issues for the sector are related to funding and sustainability. Funding operational costs, in particular, is a significant challenge for lenders. Not a single lender in the EU 15 is operationally self-sustaining at present although sustainability is a long term goal for many. EU 15 lenders rely primarily on public and private funds to cover operational costs. In the new member states, operational costs are covered by earned income, public subsidy and private charity funds. Some lenders in the EU 15 are covering all their operational costs through earned income. These institutions are mainly banks, using their existing facilities. In the new member states, several organisations are even operationally sustainable. These lenders manage large microloan volumes and charge interest rates that cover operational costs and risk. Loan capital is funded, in order of frequency, by the public sector, private sector and private charities. Accessing loan capital is less of a challenge than accessing monies to cover operational costs.

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<sup>12</sup> Ibid, p 32-33.

<sup>13</sup> Ibid, p 35-37.

## **6. With important contributions to social inclusion and microenterprise and self-employment development.**

Micro lenders in Europe monitor jobs created and sustained. They also look at household income changes and business profitability. Monitoring changes in people's lives, their access to services and inclusion in society can be more difficult and is undertaken less frequently.<sup>14</sup>

In terms of business survival rates, microcredit clients perform as well as other entrepreneurs. Most businesses supported create between 1 and 1.5 jobs in their first year. Even when businesses fail, obtaining a microloan and running a business seems to improve clients' overall employment prospects. Owners of "failed" businesses sometimes sell their business and continue working for the new owner or find waged employment elsewhere. Organisations working with immigrants observe increased self-confidence with self-employment and in some cases family reunification thanks to improved income. Similarly, lenders working with women report gains in client self-confidence. Such results confirm the social value added of microcredit. These results also counterbalance the lack of sustainability and ongoing public sector support. Each job created represents reduced benefits payments and increased tax revenues.

## **7. The challenges.**

In the European Union, and especially in the EU 15, the main challenges faced by microcredit providers are improving outreach and operational performance, as well as reaching a certain "form" of sustainability.

### **7.1 Reaching more clients.**

Even if thousands of people have been able to create or develop microenterprises in Western Europe thanks to microcredit, the number of beneficiaries has not reached the scale of most programmes worldwide. In the last EMN survey, in 2005 the organisations surveyed disbursed a total of 27,000 microloans worth EUR 210 million.<sup>15</sup> 50 % declared 48,000 active borrowers at the end of 2005.

The greatest coverage is in Poland, France and Finland. In Finland and France, single organisations disburse 95-100 % of all microloans. Characteristics such as age and the weight of microlending in the organisation's activity portfolio, as seen before, influence these numbers as well as the capacity of organisations to reach clients.

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<sup>14</sup> Ibid, p 25-26.

<sup>15</sup> Ibid, p 10-11.

Levels of poverty and exclusion, the existence of the welfare state and extensive financial service coverage mean that the number of potential beneficiaries is unlikely to be as great as it is in Asia, Africa and Latin America. The EMN survey has not captured all the microlending taking place in Europe<sup>16</sup>. Even so, the data collected suggest that less than 1 % of the population of productive age received microcredit while the financial exclusion rates are estimated at 10 % of the population and 15 % are estimated to be at risk of poverty.<sup>17 18 19</sup>

90 % of businesses in the EU are microenterprises and a significant proportion is launched without a bank loan.<sup>20</sup> Microenterprises represent about 30 % of employment and 20.5 % of value added.<sup>21</sup> In 2005, self-employment corresponded to 16 % of total employment (19 % for males and 11 % for females).<sup>22</sup> In some countries, such as Germany, self-employment has grown from 1.4 to 2.1 million over the past ten years. The active workforce below the poverty threshold is estimated at 28 million persons; evidence indicates that many of them could rise out of exclusion by creating their own jobs or by formalising an activity currently in the informal sector.

The challenge in this context is to evaluate the demand for microcredit in Europe. There have been very few in-depth analyses of the potential demand for microcredit. However, two recent studies made interesting findings. In Poland a survey carried out on low-income households and microentrepreneurs estimated the potential demand for microcredit at around two million clients, of which 14 % comprised existing and 86 % new enterprises.<sup>23</sup> In

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<sup>16</sup> It was not possible, for example, to gather lending information from savings banks operating outside Spain. In addition, detailed data were not available for the public administration programme *Sviluppa Italia* in Italy and the commercial bank portion of the Spanish public administration programme, *ICO*. The survey also does not cover commercial bank enterprise lending worth EUR 25,000 or less for which data are not readily available. Consumer lending that is used to start or develop a business is also not captured by the survey.

<sup>17</sup> McDowell, M. (March, 2006), *Microcredit in Europe: the Experience of the Savings Banks*, p 7.

<sup>18</sup> "From Exclusion to Inclusion through Microfinance: Working Group 1 – Social and Financial Exclusion Map," MFC, EMN, **cdfa** (2007).

<sup>19</sup> Eurostat YearBook (2005), *Europe in Figures*.

<sup>20</sup> According to the Agence pour la Création d'Entreprises (APCE) Observatory, 63 % of new enterprises in France start without credit.

<sup>21</sup> Eurostat 2003 for the Europe of 25.

<sup>22</sup> Eurostat (2006).

<sup>23</sup> Microfinance Centre for Central and Eastern Europe and the NIS Countries (2006), *Microenterprises, Low Income Households, Aspirations for Self-Employment and Microcredit Market in Poland*, survey conducted for the EIF as part of the preparation of JEREMIE.

Germany a survey showed that 65 % of microenterprises interviewed had no bank loan during their first three years of existence and that 15 % of them needed recurrent financing.<sup>24</sup>

The practical experience of Adie in France demonstrates that offer creates demand! With a very small number of loans made each year in the early 1990s (a few hundred), new disbursements are growing by 20 % per year. Adie aims to make 9,000 loans in 2007 and to have more than 15,000 active borrowers.

The demand environment is also critical to reaching clients and facilitating the creation and development of microenterprises. In a study conducted by FACET, **nef** and EVERS and JUNG, with the support of EMN and MFC for the European Commission DG Employment, Social Affairs and Equal Opportunities<sup>25</sup> three main obstacles were identified: the entrepreneurial context, the policy environment for microenterprises and the welfare state.

The study underlined the necessity of having a society supporting and actively encouraging entrepreneurship for all of its members. Self-employment should be seen as a respectable alternative to wage employment. For example, entrepreneurship training as an integral part of the school curriculum would promote, at a young age, the idea that self-employment is a viable and valuable career option.

The enterprise policy environment should promote the creation and development of self-employment and microenterprise. Business support services especially developed for the needs of microenterprises should be available and offer a large variety of services. Administrative procedures and requirements for microenterprises should be reduced, as has been the case in the UK and more recently in France.

The welfare system should take welfare recipients smoothly from unemployment to employment, including self-employment. There should be “welfare bridges” that encourage the unemployed to become self-employed, without forcing them to pursue that avenue. Giving potential entrepreneurs’ time to test their new income generating activity before needing to declare formally their self-employment status and potentially loose benefits is important.

With an improved environment facilitating the creation and the development of microentreprises and helping people to move from welfare benefits to self-employment, the

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<sup>24</sup> GFA, Kritikos, A./Kneiding, C./Germelmann, C.C. (2006), Is there a market for microcredit in industrialised countries?

<sup>25</sup> FACET/**nef**/EVERS and JUNG (2005), Policy measures to promote the use of micro-credit for social inclusion.

demand for microcredit should increase significantly, giving microcredit providers the opportunity to achieve scale.

## **7.2 Improving operational performance.**

Reaching clients is not easy in the European context. Organisations need to have the capacity and resources to develop proper strategies, methodologies, appropriate financial products and to use adequate monitoring and evaluation tools. Microlenders also need to develop and improve efficiency and cost recovery strategies that include greater attention to deal flow, interest rates, fees, guarantee arrangements and portfolio performance.

In the EU 15 in particular, microloan clients are geographically dispersed. Because of years of unemployment or activity in the informal economy clients also tend to be excluded from mainstream communication channels and networks. Tailored and significant outreach and marketing is needed.

Besides reaching clients, there is the challenge of reaching people with the right products. Microloan clients are diverse. Their assets differ and their needs are determined by the characteristics of the sectors in which they launch their businesses. The demand study in Germany demonstrated that some lenders create products without paying sufficient attention to client needs and preferences.<sup>26</sup> Thorough market research is important but increases the per borrower cost of lending.

Similarly, greater attention needs to be paid to collecting, monitoring and using data on portfolio performance to improve practice. So far it has remained difficult because lenders in Western Europe have not yet adopted a standard set of performance monitoring ratios or standard methods for calculating each ratio. The last EMN survey report pointed out that some respondents reported on “numbers of loans” while others reported on “value of loans” when calculating various performance ratios.

Work on agreeing a set of ratios and calculation methods for the sector in Europe is under way. A set of social and financial indicators for Western Europe has been defined by European organisations through a joint project run by the MFC, EMN and the **cdfa** (Community Development Finance Association – UK) and will be disseminated amongst practitioners.

Implementation of common standards will greatly assist lenders to speak a common language and to assess their financial performance. Linked to that issue is the necessity for

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<sup>26</sup> GFA, Kritikos, A./Kneiding, C./Germelmann, C.C. (2006), Is there a market for microcredit in industrialised countries?



microcredit providers to use proper and efficient Management Information Systems (MIS), in order to provide accurate data in a timely manner. Efforts need to be made at this level.

Evaluation of impact – especially social impact – is extremely important. It is also directly linked to achieving sustainability. If microlenders can prove that it costs less to society to help a person create his own employment than to pay welfare benefits, then it will be acceptable to partly subsidise microlending. Already microfinance organisations are regularly assessing the cost and savings of moving people off welfare. It should be done more systematically by all operators.

The small size of most operators, linked to their young age and the fact that most of the time microfinance is not the main focus of the organisation, hinder the capacity of operators to develop their microcredit activities and to reach more clients.<sup>27</sup> There are clear needs for capacity building. Exchange on good practices existing internationally and in the European Union with more mature institutions could help the sector to grow more rapidly and effectively.

### **7.3 Reaching sustainability.**

Sustainability seems to be the ultimate goal for most microcredit programmes. In Europe it remains the “impossible dream”, due to a number of factors already described.

However, a more favourable environment will help microcredit providers to reach a higher level of sustainability by contributing to improved deal flow and cost recovery and a more secure future through innovative funding arrangements.

The Facet, EVERS and JUNG, and **nef** study pointed out the need to introduce specific regulation for microfinance providers. Such regulation should help non-banking financial institutions to provide financial services for greater numbers of financially excluded. For example, in France non-banks have recently been allowed to borrow for onward lending and interest rate caps have been relaxed.

Long-term funding needs to be secured with a mix of different instruments and sources. Public sources and (private) grants should compliment the self-generated income of microlenders. After all, the aim is to build bridges between mainstream institutions and socially excluded people. Performance ratings could help to ensure the cost-efficient use of funds.

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<sup>27</sup> 75 % of EMN surveyed organisations work at local and regional level and 45 % employ less than ten full-time equivalent persons.

While the environment needs to be improved, there are measures lenders can also take to enhance their financial position. Lenders need to track microlending costs separately from the cost of training and technical assistance. Separating these costs will enable lenders to work toward operational sustainability of the loan fund and seek grant monies for business development services. Efforts in this vein are currently under way in France and the United Kingdom. These should be able to demonstrate in the coming years that it *is* possible to cover costs for purely financial activities.

Interest rates and fee structures that cover the risks and costs of lending need to be developed. Adequate guarantee and risk mitigation strategies and close monitoring of portfolio performance are also required. In the UK several lenders are beginning to cover significant portions of their lending costs by adjusting their interest rates and focusing on deal flow.

The issue of guarantees is particularly interesting. 42 % of organisations in the EMN survey make unsecured loans.<sup>28</sup> This means that the majority of lenders do not have a way to recover unpaid loans. In some cases publicly supported guarantee schemes are unavailable. In others requiring clients to provide collateral and guarantees creates additional obstacles and discourages potential clients. Alternatives need to be found.

## **8. Future development.**

Microcredit is a reality for thousands of people in the European Union. This reality is the fruit of the efforts of a handful of pioneers. Their efforts have inspired a growing number of actors. The steady growth in new loan disbursements, the number of new microcredit providers and the survival rate of their clients' businesses have demonstrated that microcredit is an effective instrument in Western Europe, not only for the development of microenterprises but also for social inclusion.

Foreseen changes in the European economy, such as the growth of services and the recognition that self-employment and microenterprise can be a real opportunity to help people to move out of unemployment and have a decent life, mean that the demand for microcredit will keep growing and be more and more visible and tangible. The microcredit market can be considered as an emerging market with high potential.

However, realising this potential will require significant changes in the regulations of the various European Union members states. The Western European environment is quite different from that found in developing and transition countries. Several obstacles in welfare

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<sup>28</sup> Underwood, T. (2006), Overview of the microcredit sector in Europe 2004-2005, p 28.

states systems, financial services and banking regulation will have to be removed in order to create a favourable environment for microfinance and microentrepreneurs.

At the same time, existing microcredit providers need to be more proactive in understanding the potential and actual demand for microcredit. Strategies will need to be further adapted to ensure that appropriate products and non-financial services are available to this market.

It is certain that mainstream banks will play a growing role. If they adapt their strategy and at the same time use their significant capital resources, they will be able to increase greatly the base of microcredit activities. When this happens non-bank institutions should remain alert to reaching the most excluded and difficult to reach part of the market with a more socially driven approach.

Efforts should be made to improve operational performance in order to reduce cost and be more efficient. Funding operational costs remains the primary limit to sector development identified by lenders in both the West and the East. The regulatory environment, institutional capacity and access to funds for loan capital are also significant challenges.

In that regard the European Union and the member states can play a significant role in placing microcredit at the centre of their employment and social inclusion policies. Promising new initiatives will open new doors for supporting actors, regulating the sector and will give more and more people the opportunity to become self-employed microentrepreneurs thanks to an inclusive financial system in Europe.

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## **Microfinance in Germany - Needs, Problems and Ways Forward.**

### **1. Introduction.**

Microfinance in Germany comprises funding for start-up entrepreneurs and small to medium-sized enterprises (SMEs) not exceeding EUR 25,000. So for one, these finance measures entail relatively small amounts and for another they are carried out in connection with entrepreneurial activity. Despite an efficient banking sector, young and small enterprises in Germany often face special problems when they need small amounts of finance from external capital providers for their investment projects. Due to the adverse cost/earnings ratio, microfinance or microlending is often unprofitable for banks in Germany in the 'conventional' way of doing lending business.

The loan amounts are too small to offset high risk and operating costs due to borrower group specifics, such as difficulties in assessing the credit standing of start-up or small entrepreneurs or also high risk of default, resulting in insufficient earnings. Though economically viable, then, small-scale investment projects frequently fail to get off the ground due to the reluctance of banks and other financiers in the microsegment. So it is a matter of economic-policy interest to ascertain the size of demand for microloans and the extent of the problems start-up and small entrepreneurs encounter in financing their projects.

Information on market size is an initial help in answering the basic question of whether there is any need at all for government programmes to assist microborrowers. It is also important for designing assistance programmes or assessing which current private business schemes in the microlending sector are viable enough to merit aid.

First of all, the present paper makes an empirical estimate of prospective demand in the microfinance sector in Germany. The KfW Start-up Monitor and the KfW SME Panel provide two representative datasets for Germany that record the financial behaviour of start-up and small SME owners. Based on the two datasets, we also analyze how many start-up and small entrepreneurs in Germany seeking microloans have difficulties finding a financier for their investments. The findings show that there is a substantial demand for microloans in Germany and that some start-up and small entrepreneurs encounter difficulties raising finance.

Nevertheless, microfinance is more of a niche segment, not a mass market, as in developing and transition countries, for example. Among other problems inadequate quantity structures have so far thwarted business strategies that have already been successfully implemented in consumer lending business, which resembles microlending in several ways. The strategy

here has been to make 'radical' cost savings by maximizing standardization and exploiting economies of scale.

Up to now, microlending has not been made profitable enough in Germany to induce private financial intermediaries to serve this business segment sufficiently in their own commercial interest. This is why the present paper also looks in detail at the specific problems in microlending as seen by the credit institutions. Based on the various key components in loan costing, we first briefly address the various specific problems that make for earnings difficulties in microlending and then consider which strategies can improve efficiency at various points and where assistance programmes could make a difference.

The paper proceeds as follows: In Section 2 we assess the microfinance needs of start-up and small SME owners in Germany based on representative empirical data. This section also deals with the problems enterprises with microfinance needs face in acquiring external capital providers. Section 3 undertakes an analysis of the main cost components that play a specific role in the microlending business of banks. In Section 4, we discuss the direction possible strategies must take to make microfinance business more profitable through assistance or improvements in efficiency. Section 5 contains some concluding remarks.

## **2. Demand for microfinance.**

### **2.1 Business start-ups.**

The analysis of the microfinance needs of start-up entrepreneurs<sup>1</sup> is based on the data from the KfW Start-up Monitor,<sup>2</sup> a representative telephone survey of start-up activities in Germany carried out every year as of 2000. As the KfW Start-up Monitor covers a broad range of business ideas (all of them full-time and part-time business start-ups by people aged 14 to 67),<sup>3</sup> it conveys a detailed picture of start-up activities. In particular, it polls a large number of attributes of the start-up entrepreneur, his enterprise and financing aspects. We can summarize the features of the survey mode and the main contents of the KfW Start-up Monitor as follows:

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<sup>1</sup> Start-ups may denote new firms, take-overs or active participating holdings. The KfW Start-up Monitor refers to the start-up entrepreneur as a *person*. The beginning of self-employment need not therefore entail founding a new company; it can also consist in taking over an existing enterprise or acquiring a participating interest. Active participating interests designates company shares acquired with a view to bearing entrepreneurial responsibility. In 2005, 69.8 % of all business start-ups entailed the establishment of new companies (full-time or part-time employment), 6.5 % were takeovers and 23.7 %, active participating interests.

<sup>2</sup> Cf. Spengler, H./Tilleßen, P. (2006).

<sup>3</sup> In the survey carried out in 2006, whose results have not been fully evaluated and could not therefore be dealt with in the present paper, the minimum respondent age was raised to 18.

- The data is gathered by a market-research institute using so-called **computer-assisted telephone interviews (CATI)** solely in German.
- The resulting dataset is representative for persons resident in Germany between 14 and 67 years of age<sup>4</sup> with adequate proficiency in German and a fixed-network telephone connection in their household.
- About 40,000 persons are questioned every year in the Start-up Monitor.<sup>5</sup> Each year, approx. 1,000 said they had entered self-employment as business owners or freelancers in the last 12 months.
- The start-up entrepreneurs as defined on the basis of this information answer a detailed set of about 50 individual questions. This way, the Start-up Monitor can provide quite detailed information on the course and type of start-up, number of personnel, start-up advice, financing, the general climate for start-ups and the provenance and occupational history of the start-up entrepreneurs.
- For comparative analyses, information is also gathered from about 7,500 people who have not started up a business on their assessment of the climate for start-ups and their provenance and occupational history.
- Basic socio-economic attributes (e.g. age, gender, education, size of household, occupation, net household income) are available for the complete sample of start-up and non-start-up entrepreneurs.

The evaluation of the data from the KfW Start-up Monitor reveals that microfinance plays a considerable role in start-ups. On the one hand, Figure 1 shows the ratio of start-up entrepreneurs with a *basic need for microfinance*<sup>6</sup> (their own, that is, generated inside the enterprise or from the start-up entrepreneur's private assets and/or acquired from external capital providers such as banks) to all start-up entrepreneurs from 2000 to 2005. On the

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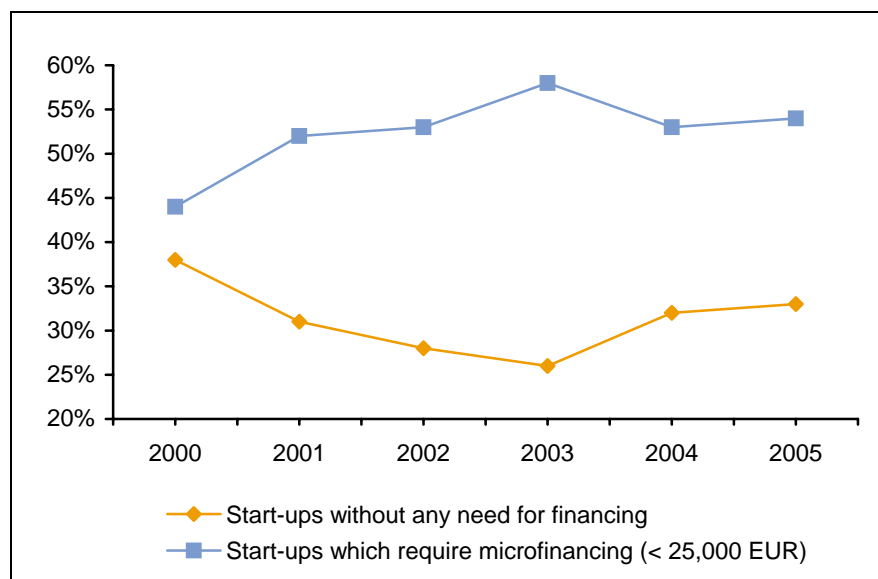
<sup>4</sup> Or.18 since the survey in 2006; see footnote above.

<sup>5</sup> In 2000 and 2001 between 20,000 and 30,000 start-up entrepreneurs were questioned. These survey numbers are also sufficient to obtain representative and statistically valid analytical findings.

<sup>6</sup> The data acquired in the Start-up Monitor shows that a considerable part of the start-up entrepreneurs cited finance requirements in connection with their project but did not acquire any funds from external sources (e.g. banks or other financial intermediaries), drawing on their own savings (internal funds) or current cash-flow already earned. On the term 'internal and external finance' see also Breuer, W. (1998), p. 7 ff. This is why a sharp distinction is drawn under start-up induced microfinance needs between 'pure' finance requirements, which can be met from in-company funds or the private assets of the start-up entrepreneur as well as from external sources, and *finance relations* with external capital providers *actually entered into or sought*.



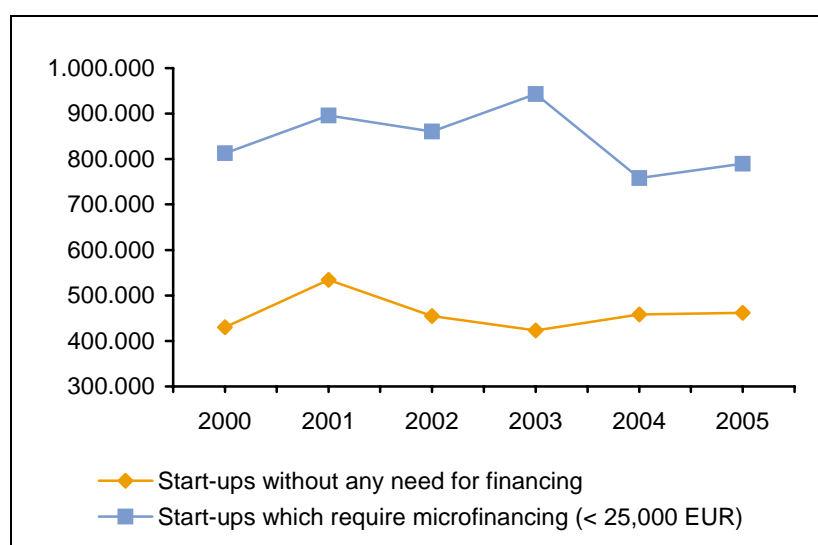
other, it shows the ratio of start-up entrepreneurs who *do not require finance (either internal or external)* to enter self-employment.



**Figure 1: Percentage of start-ups in need of (internal or external) finance (of up to EUR 25,000) and those with no requirements between 2000 and 2005**

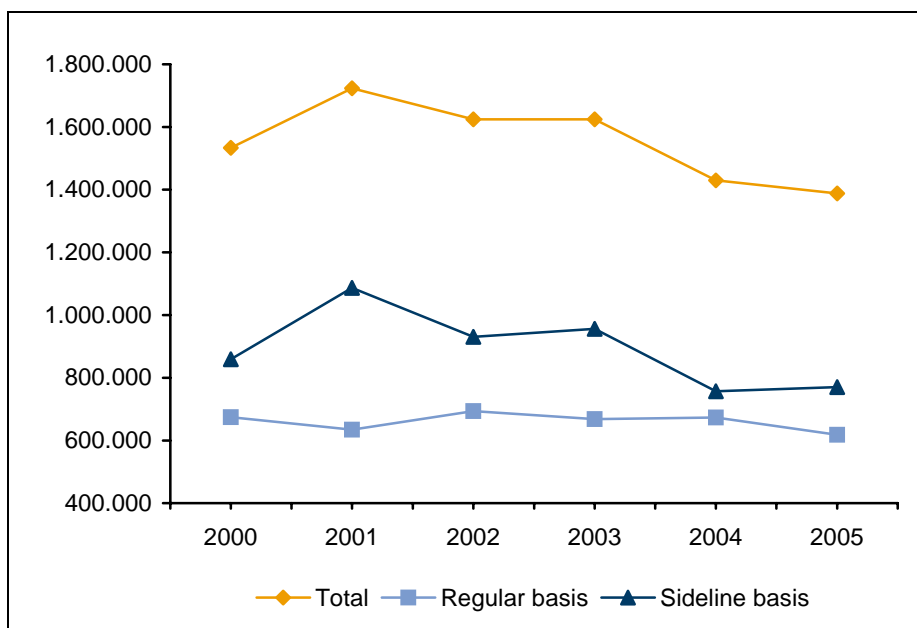
In the period under review, the share of start-up entrepreneurs with microfinance needs (not exceeding EUR 25,000) first rose from 38 % in 2000 to 58 % in 2003. Up to 2005, this figure then declined again slightly to 54 %. The ratio of start-up entrepreneurs requiring no finance to all start-up entrepreneurs charted the opposite course between 2000 and 2005, first declining from 38 % in 2000 to 26 % in 2003 and then rising slightly again to 33 % in 2005.

Because the sample of the KfW Start-up Monitor is representative, we can also obtain absolute figures on the start-ups under review through projections. Figure 2 shows the number of start-ups in need of microfinance and those in not needing any financing.



**Figure 2: Absolute figures on start-ups in need of (internal or external) finance (of up to EUR 25,000) and those with no requirements from 2000 to 2005**

The graph for the absolute figures on start-ups with microfinance needs and those with none looks slightly different from the one depicting ratios. This is due to fluctuations in start-up figures in Germany overall (Figure 3). Starting from 813,000 start-ups (full-time and part-time) with *internal or external* microfinance requirements in 2000, the number of start-ups first rose until 2003 to 943,000 and then fell back in the following two years to about 790,000. The number of start-up entrepreneurs without (internal or external) finance requirements peaked in 2001 at 534,000 after about 430,000 in 2000, followed by a decline up to 2003 to approximately the original level in 2000. Finally in 2005, 562,000 start-up entrepreneurs did not require finance.



**Figure 3: Number of start-ups in Germany overall and broken down by full-time and part-time from 2000 to 2005**

Particularly with start-up entrepreneurs a distinction has to be drawn between the number with a fundamental need for *internal or external* finance and the number of those who *actually acquired funds from external financiers (or also those that attempted to do this)*. Table 1 shows that out of 938,000 start-up entrepreneurs in 2005 who saw the need for finance to implement their business idea only 206,000 *actually acquired external funds*.

**Table1: Start-up entrepreneurs requiring finance *and* who availed themselves of external funds in 2005**

	Number of	As a percentage of start-ups overall %	As a percentage of above group %
<b>Start-ups overall:</b>	<b>1,400,000</b>	<b>100</b>	<b>100</b>
Of which start-ups requiring internal or external finance	983,000	67	67
Of which start-ups that acquired external finance	206,000	15	22
Of which start-ups acquiring external finance in the micro-finance range (< EUR 25,000)	132,000	9	64
Of which start-ups with difficulties in acquiring micro-finance	29,000	2	22

At 732,000 (that is, 938,000 less 206,000), a very large number of start-up entrepreneurs met their entrepreneurial finance requirements from their own savings or current cash-flow. Of the 206,000 start-up entrepreneurs who obtained external funds, however, almost two-thirds or 132,000 applied for finance in the microlending range. This figure represents the *realized demand for microloans* by start-up entrepreneurs or *the demand met by corresponding supply*, measured by the number of cases. If for the sake of simplification we assume an average loan amount in the micro range of EUR 10,000, the cases numbering about 130,000 give us a corresponding volume of demand amounting to about EUR 1.3 billion. Of the start-up entrepreneurs who applied for and received finance in the microloan range, the ratio of those who had difficulties is comparatively small at about 22 %. This contrasts with the very large group of start-up entrepreneurs who met their microfinance needs solely through savings or their own cash-flow (Table 2). This indicates that the *'potential' demand* for microloans, i.e. *the total of met and unmet demand for financial services*, is higher. Applying a rather 'conservative' estimation approach, we can ascertain the additional *unmet* requirements for external capital with the help of the KfW Start-up Monitor data on the number of start-up entrepreneurs who explicitly *intended to raise funds* in the microloan range but who then found *no capital provider* (cf. Table 2).

**Table 2: Start-up entrepreneurs requiring finance *but who did not avail themselves of external funds in 2005***

	Number of	As a percentage of start-ups overall %	As a percentage of above group %
<b>Start-ups overall:</b>	<b>1,400,000</b>	<b>100</b>	<b>100</b>
Of which start-ups requiring internal or external finance	938,000	67	67
Of which start-ups that did not acquire external finance	732,000	52	78
Of which start-ups in need of internal or external finance in the microfinance range (< EUR 25,000)	659,000	47	90
Of which start-ups that planned for external finance, but did not receive it	53,000	4	8

In 2005, these numbered 50,000. In all, this gives us a potential start-up-induced demand for 180,000 microloans (130,000 with met needs plus 50,000 with unmet needs). Premised on the simplified assumptions on individual loan amounts above, this corresponds to a 'maximum' volume of *met and unmet demand* amounting to about EUR 1.8 billion. We also need to take the large number of start-up entrepreneurs with microfinance needs into account who did not approach an external capital provider in the first place, about 610,000. This figure results from the difference between the 660,000 or so start-up entrepreneurs in need of microfinance who did not acquire external funds and approx. 50,000 start-up entrepreneurs who were refused finance (Table 2).

## **2.2 Established small and medium-sized enterprises (SMEs).**

We shall adduce the KfW SME Panel as a database for analyzing the finance needs and difficulties of small to medium-sized enterprises. The KfW SME Panel provides a representative longitudinal dataset for all scales of SME in Germany. It therefore also allows us to make projections for very small enterprises, which are relevant to demand for microfinance instruments in Germany besides the start-up entrepreneurs. The Panel data is gathered through a repeated written survey of small to medium-sized enterprises with a turnover of up to EUR 500 million a year in Germany. By this definition, there was a total of 3.5 million small to medium-sized enterprises in Germany in 2005. The first survey wave of the Panel was carried out in 2003 and has been repeated every year since with the same small to medium-sized enterprises. Three evaluated sets of surveys are now available.

The salient features of data acquisition in the KfW SME Panel and the main contents can be summarized as follows:

- All small and medium-sized enterprises in Germany make up the parent population. These include private enterprises in all industries in Germany whose annual turnover does not exceed EUR 500 million.
- The data is acquired via written questionnaires sent by post.
- In the initial survey in 2003, over 15,000 evaluable completed questionnaires were received from the enterprises. In the 2nd wave in 2004, almost 10,700 enterprises responded and over 11,000 in the third wave in 2005.
- The following topics are addressed in the questionnaire: corporate legal structure, owner-manager or partner/shareholders, personnel and recruitment trends, competition and sales, investments and financing, innovations and business performance.
- Breaking down the sample by type of enterprise, industry, scale of workforce and region ensures that representative results can be inferred from the parent population of all small to medium-sized enterprises in Germany.

Evaluations of the KfW SME Panel show that microfinance (up to EUR 25,000) plays quite a significant role for business start-ups but also for small to medium-sized enterprises. In 2005, 230,000 small and medium-sized enterprises said they needed external microfinance (up to EUR 25,000) and had therefore approached credit institutions (Table 3). This figure corresponds here with total *met and unmet demand*, because not all SME owners who applied to external capital providers for finance of up to EUR 25,000 received the requested amount and were able to invest it as planned.<sup>7</sup>

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<sup>7</sup> In financing aspects, the KfW SME Panel covers slightly different contents than the Start-up Monitor. In the Start-up Monitor, the finance requirements for implementing business ideas are those that can be met both from internal and external sources and also external funds actually acquired. The SME Panel, in contrast, provides information on the need for external funds applied for by the SME owners from external financiers, almost solely bank loans in the micro range of up to EUR 25,000.

**Table 3: Small and medium-sized enterprises in need of external funds that approached banks and others capital providers in 2005**

	Number of	As a percentage of SMEs overall %	As a percentage of above group %
<b>SMEs overall:</b>	<b>3,500,000</b>	<b>100</b>	<b>100</b>
Of which SMEs requiring external loan finance	690,000	20	20
Of which SMEs requiring external loan finance in the microfinance range (< EUR 25,000)	230,000	7	33
Of which had difficulties with loan finance	110,000	3	48
Of which			
- could invest as planned	36,000	1	33
- revised investments	48,000	1	44
- could not invest	25,000	1	23

To ascertain the demand met by corresponding financial services, we must deduct from the total of 230,000 applications for finance the number of applicants who then received no funds from their bank. Table 3 shows the number of requests for finance where problems arose, defined as failure in the first negotiating round. In 36,000 cases, the SME owners were nevertheless able to invest subsequently as planned, 48,000 had to revise their investment plans because they did not obtain the amount of credit requested, for example, and 25,000 applications for credit failed completely. If we deduct these from the total 230,000, we obtain a rounded 200,000 loans that satisfied demand.

If we again assume a simplified average finance amount of EUR 10,000 as a raising factor, the total met and unmet demand for the 230,000 cases comes to about EUR 2.3 billion, with the resulting met demand amounting to around EUR 2 billion, also assuming a simplified finance commitment of EUR 10,000 for the 48,000 SME owners who revised their investment plans.

### 2.3 Interim outcome.

Overall then, based on the data from the Start-up Monitor and the SME Panel we can deduce the number of applications for microfinance. By adding the met needs of start-up entrepreneurs and small SME owners, we then obtain a realized demand for microfinance in 330,000 cases in 2005. Adding up the simplified inferred demands gives us EUR 3.3 billion.

The aggregate potential of met and unmet demand amounts to 410,000 cases of microfinance or EUR 4.1 billion.

So compared with the size of the financial services market as a whole, the total volume of loans issued to enterprises in Germany in 2005 amounting to about EUR 600 billion,<sup>8</sup> microlending in Germany certainly does not make for a mass business segment, unlike the case in a number of developing countries. Nevertheless, the demand for microfinance instruments and the financing difficulties of the start-up entrepreneurs and SME owners seeking finance are not a factor that economic policy can afford to ignore. At a conservative estimate, potential demand for microfinance instruments, that is the sum of met and unmet demand, comes to some 80,000 finance seekers or just about 25 % more than that served by banks and other financial intermediaries. Based on the projection method used here, this amounts to an unmet demand of EUR 0.8 billion. First, we need to take into account here that in addition some of the start-up entrepreneurs and SME owners had to cope with borrowing difficulties but did then manage to find a capital provider for their project. In addition, we ascertained that about 610,000 start-up entrepreneurs cited microfinance needs to be met with internal or external funds but did not attempt to borrow from banks. As mentioned above, the demand overhang in the microfinance range in excess of the number of business start-ups with rejected finance applications is thus a conservative estimate.

### **3. Specific problem factors in microlending for banks in Germany.**

The main reasons for the finance difficulties faced by start-up entrepreneurs and SME owners in need of microcredit in Germany is the adverse cost/earnings ratio in this business segment as estimated by the banks. In microlending, major handling/operating components in credit standing assessment and loan post-approval processing, documentation and closure incur high (fixed) costs for banks, which pose severe profitability problems, particularly with small finance amounts and smaller-scale quantity structures.<sup>9</sup>

In costing for lending business, we can distinguish various components: handling costs for loan appraisal and post-approval processing/monitoring, direct risk costs commensurate with expected loss,<sup>10</sup> cost of capital, differentiating between costs of equity and debt capital. For almost all the cost components cited, except cost of capital, small loans for start-up entrepreneurs or SME owners are relatively unfavourable. Without countervailing measures to remedy these specific problems microfinance business would therefore often only prove

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<sup>8</sup> Source: German Bundesbank, own calculations.

<sup>9</sup> Cf. on this Kreuz, C. (2006).

<sup>10</sup> On this term and on questions of loan risk measurement and management, for example, see Altman, E.I./Saunders, A. (1997), Hartmann-Wendels, T./Pfungsten, A./Weber, M. (2004), p. 503, ff.

viable for banks at very high interest rates, some over 20 %. These kinds of interest rate are hardly practicable in Germany. On the one hand, German law prohibits lending business from charging very high interest rates ('usurious' interest) as an immoral legal transaction (§ 138 of the German Civil Code). On the other, interest rate rises beyond a certain threshold are also uneconomical for the bank as they result in adverse selection and moral hazard on the debtor side.<sup>11</sup> This problem in the microlending range leads to short supply (credit rationing), which has been empirically assessed above. Shortage of credit can require economic policy interventions to enable the financing of projects that make macroeconomic sense despite the profitability problems of the banks as business cases on the micro level. Particularly, for unemployed start-up entrepreneurs who would otherwise generally have to rely on public benefits, economic policymakers also need to take account of the related savings in the social welfare budget.

#### Handling costs (direct operating costs).

Higher handling costs are primarily incurred with microloans due to difficulties in assessing failure risk due to borrower default with sufficient precision. Inevitably with start-up entrepreneurs, there are no balance sheet histories and other comparable figures to refer to for assessing credit standing. Owing also to the graduation of disclosure requirements to scale of enterprise in Germany, relatively little informative company data is available for assessing the creditworthiness of SME owners. For these reasons, assessing credit standing in the microfinance range is based more on an analysis of personal factors from the life history or also 'soft' factors such as an appraisal of the management abilities or the character traits of the start-up or small entrepreneur. Owing to the narrower scope for standardization, these analyses often entail higher costs than credit assessments in more quantitative type rating procedures that draw on extensive data on balance sheet and indicator records. In principle, it is conceivable to develop standardized rating methods mostly adducing the above-mentioned personal and 'soft' factors, where more extensive experience has been gained with microloan cases. Many institutes, however, lack the requisite databases (number of cases) to be able to assess risk with adequate precision, because, as mentioned in part already, the market for microloans and similar finance in Germany is relatively and has a significant but limited volume. In addition, basic organisational requirements, including the young Minimum Requirements on Lending Activities by Credit Institutions (MaK) introduced in the course of Basel II in Germany, incur considerable fixed costs, which have a particularly adverse effect on yield in microlending due to smaller quantity structures as compared with conventional retail business, for example.

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<sup>11</sup> On fundamentals here see Stiglitz/Weiss (1981).



### Risk costs.

Risk of failure due to borrower default tends to be greater in the microloan range than in wholesale banking business with larger enterprises or in retail (consumer) lending, for example.<sup>12</sup> Smaller SME owners can generally draw on less equity reserves than the larger ones. Start-up entrepreneurs also often lack management know-how. As a consequence, higher risk premiums need to be charged for microloans to cover the expected loss. Added to this, start-up entrepreneurs and small SME owners often lack assets of intrinsic value that could serve as collateral to reduce loss given default.

### Cost of capital (equity and debt).

All other factors remaining equal, if banks take a higher risk in lending business, this makes for higher capital costs. This kind of capital cost effect can always be expected when entering microlending business if adding small loan risks to the lending portfolio causes a deterioration of the bank's overall risk position that cannot be offset through hedging transactions. Generally, capital cost effects pose less of a problem for the earnings position in microlending than direct risk costs due to credit exposure to (individual) borrower default and handling costs.<sup>13</sup> First, capital cost effects are as a rule negligible considering the small volume of microlending business in relation to other bank assets, except for very small institutes. Also, microloans are not necessarily less favourable than other bank assets in terms of capital costs. First of all, the high granularity of microloan portfolios should have a beneficial effect. With negative risk correlations between individual microloans, between the microloan portfolio and other asset classes, taking up microlending business could even improve the capital cost position for financial intermediaries. As to capital costs due solely to regulations (Basel II), microloans are not a cost driver, either, because they belong to the retail segment.<sup>14</sup>

As already mentioned, capital cost effects in microloans are low compared with individual borrower risk and handling cost effects so that possible capital cost savings cannot offset the other cost problems. Altogether then, in measures for raising profitability in microlending (except for very small banks), priority should be attached to problems with direct borrower risk and handling costs.

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<sup>12</sup> Cf. Kreuz, C. (2006).

<sup>13</sup> Cf. Kreuz, C. (2006).

<sup>14</sup> Ahrweiler, S./Börner, C.J./Rühle, J. (2007).

#### 4. Approaches to Microfinance Market Development.

One strategy to promote and develop the microfinance market is to address the specific cost problems of microlending we have identified:

- Handling/Operational costs
- Borrower risk costs (expected loss)
- Capital costs

As part of this paper, we shall broach some basic mechanisms for solving these problems.

Besides this, commercial banks could be relieved of costs *overall* (as well as risks) in microlending through handling cost subsidies and liability exemption. This is the approach that the KfW Group has adopted over the last eight years with its programmes: Microloan and Start-up Money. At some points, the programmes are also tailored to the specific problems of microbusiness actors. For example, KfW onlending banks receive fixed handling cost subsidies regardless of the volume of credit especially to alleviate the problem of an unfavourable cost/earnings ratio. In addition, they are relieved of 80 % of their credit exposure. Microloan and Start-up Money will be merged into one programme at the beginning of 2008 to address the finance problems in the microloan range even more effectively. KfW will then relieve the onlending banks of credit risk in full. To provide start-up entrepreneurs and small enterprises with improved facilities already, the interest rates for the ongoing programmes were reduced at the beginning of this year.

A key factor for success in microlending business is certainly an *efficient system for credit risk assessment* to reduce *handling and risk costs*. Considering the major role of personal and 'soft' factors in assessing the credit standing of borrowers in the microloan range, two approaches could be adopted: On the one hand, based on previous experience, a standardized, more *quantitative type of rating (or scoring) system* could be developed to reduce handling and, provided the forecasting quality is good enough, borrower risk costs as well. The scope and quality of the database is crucial to the success of this approach so that in view of the short history and small size of the microlending market in Germany these remedies can only be found in the medium to long term.

On the other hand, strategies that are particularly effective in microlending business seek to reduce risk costs by means of a precise assessment of borrower creditworthiness based on personal and soft indicators through *close interaction* (advice, support and monitoring) between specialized microloan agencies and start-up entrepreneurs or small entrepreneurs.

Approaches on this basis can be successful in the short run as they can largely do without extensive databases. In addition to monitoring, microloan agencies also support borrowers with special coaching measures. Comprehensive borrower advice is, however, personnel cost-intensive. So these kinds of measures can bring about considerable savings on borrower risk costs but incur high handling costs. Support measures in the microloan range can therefore often make sense if the advisory services can be rendered by institutions (supported by the government) that are specialized in this area and, in particular, already exist, so as to perform certain related social-policy tasks, for example. The Microfinance Fund Germany, which was planned and instigated by KfW in cooperation with the Federal Ministry of Economics and Technology and the Federal Ministry of Labour and Social Affairs as well as the GLS Bank, also applies this kind of approach of dovetailing financial and advisory services.<sup>15</sup> The Microfinance Fund Germany relies on cooperation between credit institutions which take over the job of issuing and administering the microloans and specialized consulting service providers that take care of borrowers but also carry out credit standing assessment and monitoring. Through a special liability and fee system, the interests of all cooperation partners are geared to minimising risk and handling costs.

A possible approach to *reducing capital costs* for banks engaged in microlending business would be *securitization*, for example, which enlarges the scope of credit institutions to manage their lending portfolio. Adverse risk effects resulting from taking microloan risks into the bank portfolio are easier to mitigate through securitization and secondary market trading so as to reduce capital costs. These kinds of instruments ought to be of primary interest to very small credit institutions, where the microlending segment is not insignificant compared with total assets.

## 5. Recap and conclusion.

In the present paper, the demand for microfinance instruments in Germany was assessed on the basis of representative datasets. Microfinance in Germany is usually understood to denote small loans and similar finance not exceeding EUR 25,000 to start-up entrepreneurs and small SMEs. Besides the size of demand, an empirical estimate was also made of the number of small enterprises with difficulties obtaining microloans.

It emerged for 2005 that 330,000 start-up and small entrepreneurs sought and *received* microfinance. This makes for a projected volume of EUR 3.3 billion. Aggregate potential *met and unmet demand* amounts to 410,000 cases or EUR 4.1 billion. The segment is thus of more than negligible size, although measured against the scale of the German financial

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<sup>15</sup> The Microfinance Fund will be dealt with in detail in a separate paper for the present collection.

services sector, it does not constitute a mass market. The difference between *met* and *potential* demand shows that start-up entrepreneurs and small SME owners in this country face quite substantial difficulties in obtaining finance for their projects.

Finally, the paper dealt with the main cost factors that make granting small loans commercially rather unattractive for traditional financial intermediaries in Germany, such as the banks. Earnings problems for the banks largely result from *high handling costs* for credit standing assessment and monitoring. Furthermore, microborrowers often pose high loan loss risks, thus incurring *high individual borrower risk costs*. For most banks (except for very small institutes), *capital cost effects*, however, are of minor importance when it comes to profitability in microlending.

In response to the earnings problems with individual cost components, we briefly discussed approaches for raising efficiency or government assistance programmes to help alleviate profitability problems and expand banking services in microfinance business in Germany.

One promising approach certainly is to address cost problems in connection with credit standing assessment and monitoring. KfW is engaged here via the Microfinance Fund Germany initiative. Besides this, it provides assistance programmes to relieve commercial banks of overall costs for granting microloans. The problem of the unfavourable costs/earnings ratio for the commercial banks is mitigated in particular by means of a fixed handling subsidy to support the banks' engagement in the microloan range.

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## **Status of Microlending in Germany: An Empirical Survey of Programmes in 2006.**

### **1. Introduction.**

Microfinancing is a success model of development cooperation. It refers to small financial transactions which are implemented very close to the clients, quickly and reliably through simplified procedures, and which support the clients in their economic independence.<sup>1</sup> The social objective is being increasingly backed by a business model and developed financial methodologies. Following Asia, Central and South America, now Central and Eastern Europe has become a region with high growth potentials and high returns on equity for microfinancing institutions. In Western Europe, microfinancing has been developing over the past ten to fifteen years and it is used primarily as an instrument for tackling unemployment and social marginalisation. In consequence, microlending in Western Europe concentrates more on start-ups than on growth financing. The focus is less on general financial services and more on small loans to be used for setting up or expanding businesses. The term microlending is used here to describe a loan of up to EUR 25,000. Despite the rising number of loan programmes and loans disbursed in Western Europe, the dynamic fails to match that of South-East Europe. An empirical survey by the European Microfinance Network (EMN) revealed that, of the 110 participating institutions in 2005, a total of 27,000 loans were disbursed and a growth rate of 15 % was reported. Only a few individual institutions can come up to the international standards with several thousand loans per year and even these, at best, break even without so far generating any return on equity.<sup>2</sup>

In Germany, the past decade has seen a growing interest in and practice of microlending. In recent years, a growing number of specialised microcredit programmes has been created for start-ups and micro-enterprises with low capital requirements. Early in 2007, EVERS & JUNG carried out its third survey of German microcredit programme providers for KfW Bankengruppe. This year 29 of the 33 programmes participated in the survey. A detailed analysis (including individual profiles of each programme) has been drawn up as an expert opinion and it will be summarised briefly here.

The objective of the survey was to provide an up-to-date overview of developments in the

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<sup>1</sup> Cf. Wisniewski, S. (2004), p. 1.

<sup>2</sup> A detailed description of the European situation commissioned by the European Microfinance Network will be published at the EMN Conference in April 2007: Evers, J./Lahn, S./Jung, M. (2007), *The Status of Microfinance in Western Europe*, Paris.

sector, including new providers, advances and trends. Following on the surveys of 2001/2002 and 2003, workshops were held aimed at positioning the sector and exchanging methods. Figures 1 and 2 set out the respective stages of development at the time.

Challenges	Summary: Microlending ...
<ol style="list-style-type: none"> <li><b>1 Methodology</b> Similar to banks or dependent on persons, hardly learning from international best practice</li> <li><b>2 Interest rates</b> Are interest rates inappropriate?</li> <li><b>3 Conflict of roles</b> Adviser and supporter versus money-lender</li> <li><b>4 Post-decision coaching and risk management</b> Hardly clear systems, rate of disappearance rarely established</li> <li><b>5 Economies of scale</b> High potential to reduce unit costs</li> </ol>	<ol style="list-style-type: none"> <li><b>1 ... is more than financing.</b> An instrument with which you can manage a company</li> <li><b>2 ... is not only the financing of start-ups.</b> Identifying existing companies as the target group</li> <li><b>3 ... has great potential in Germany.</b> Use of experience, co-operations, state support/private implementation</li> </ol>

**Figure 1: Summary of the first survey from 2001/02, discussed at the DtA-Workshop on 24.10.2002 in Berlin.**

What has been achieved?	Institutional challenges
<ol style="list-style-type: none"> <li><b>1 Target groups reached</b> As a rule the programmes do reach the target groups which receive no loans from credit institutions.</li> <li><b>2 Default rates</b> Default rates are partly below those of financial institutions in this market segment.</li> <li><b>3 Financing and advisory support</b> Many programmes link financing and advisory support in an innovative manner.</li> <li><b>4 Support effectiveness</b> Support through loans is more efficient, in economic and employment market terms, than through grants and subsidies (e.g. bridging money).</li> </ol>	<ol style="list-style-type: none"> <li><b>1 German Banking Act stipulations</b> Non-banks must cooperate with banks in granting loans. Regional and local authorities solve this by disbursing funds as repayable grants.</li> <li><b>2 Low number of loans per organisation</b> <ul style="list-style-type: none"> <li>• low-level standardisation of procedures</li> <li>• unfavourable relationship between total lendings and overhead costs</li> <li>• poor economies of scale</li> </ul> </li> <li><b>3 Need for professionalisation</b> Products, support concepts and organisational structures and procedures; International standards only partly implemented</li> <li><b>4 High level of subsidisation / sustainability</b> Many programmes are heavily subsidised under time-limited project promotions. Customary operational and financial sustainability parameters rarely recorded and disclosed.</li> </ol>

**Figure 2: Summary of the second survey from 2003, discussed at a meeting of experts on 25.3.2004 in Frankfurt/M.**

How microlending in Germany has evolved in practice over the years since this analysis will have to be assessed. The following points highlight important changes in overall conditions during this period.

- The increased participation of regional promotional banks (Landesförderinstitute) in microlending: The Landesförderinstitute are regional development banks and as such peculiar to Germany. Some offer microcredits directly (Investitionsbank Schleswig Holstein, Saarländische Investitionskreditbank), most however on-lend through principal bankers (L-Bank Baden-Württemberg, NRW-Bank and Investitionsbank Berlin).
- The establishment and expansion of the German Microfinance Institute (DMI), which now has 47 members and eight accredited microfinance institutions: In 2004 a funding tool

was set up in the form of the Microfinance Fund Germany to which the GLS Bank, the Federal Ministry of Economics and Technology and KfW Bankengruppe, among others, contributed.

- Improved empirical insights into the demand for microloans in Germany: According to the KfW-Gründungsmonitor, which monitors start-ups, almost half of all start-ups require funding of between 1,000 and 25,000 Euro. Even if nearly half of these in turn meet their needs from their own resources, the remaining half forms the ideal target group for microlenders.<sup>3</sup> In the KfW Mittelstandsmonitor, which monitors small and medium sized enterprises (SMEs), particular attention is drawn to the rise in the number of businesses with low financing requirements, part-time enterprises and start-ups from unemployment.<sup>4</sup> Kritikos et al. conclude on the basis of a survey of 213 enterprises that a substantial, albeit small (15 %), number of those surveyed would be prepared to pay interest rates of up to 20 % for quick, customer-friendly procedures. This group, with its demand for small working-capital loans following on the start-up stage is not reached by the banking system partly due to its bad experience and/or low expectations of banks.<sup>5</sup>
- The sharp rise in new business enterprises founded by unemployed people and promoted by funding from the German Federal Employment Agency (almost 1 million subsidised start-ups in the years 2003-2005), which at least in theory ought to be requiring follow-up funding after the start-up grant.

## **2. Number of programmes and business-policy orientation.**

Compared with the 2003 (2001) investigation, the number of identified microlending programmes has risen from 24 (21) to 33, of which 29 participated in the survey. Certainly, on the basis of the definition criteria in the international microfinancing literature, not all of these programmes would be covered by the term "microlending" in the narrow sense. Their profiles were therefore already described as "microcredit-type" programmes back in 2003.<sup>6</sup> However, the expectations vested in the procedures, products and results by microlenders have changed over recent years. It has become clear that microlending in a closely regulated

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<sup>3</sup> Cf. Lehnert, N. (2004), p. 19 f.

<sup>4</sup> Cf. Mittelstandsmonitor (2005).

<sup>5</sup> Cf. Kritikos, A.S. et al. (2006), pp. 23-25.

<sup>6</sup> Cf. Habschick, M./Evers, J./Jung, M. (2004), p. 43.



environment of highly industrialised welfare states has a different function to fulfil.<sup>7</sup> Whereas the dominant target group in international microlending is represented by existing micro-enterprises already integrated into economic life, microlending in Europe strongly supports not only, as already mentioned, start-ups and very young enterprises but also disadvantaged target groups excluded thereby from economic life.

This strategy is clearly expressed in the term first coined at European level in 2006<sup>8</sup>, namely *inclusion lending*. Inclusion lending targets the re-inclusion of financially and socially marginalised groups such as migrants and long-term unemployed persons, the so-called *non-bankables*. Inclusion lending is distinguished from *micro-enterprise lending*, which looks to *bankables* and *nearly bankables* as target groups, namely traditional start-ups and small businesses already established on the market. Inclusion lending calls for distinctly more intensive advisory and support services in order to attain a high repayment ratio and economic survival rate among the borrowing enterprises.

With such target groups it becomes clear that there cannot be one single ideal lending model for the microfinancing sector in Germany. A range of different models must be available.

Given this setting, the following table differentiates the various initiatives according to *micro-enterprise* or *inclusion lending* schemes.

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<sup>7</sup> Cf. Siewertsen, H./Evers, J. et al. (2005), *Policy Measures to Promote Microfinance*, Zeist/Brussels/Hamburg.

<sup>8</sup> Budapest Conference of the EMN and MFC (June 2006).

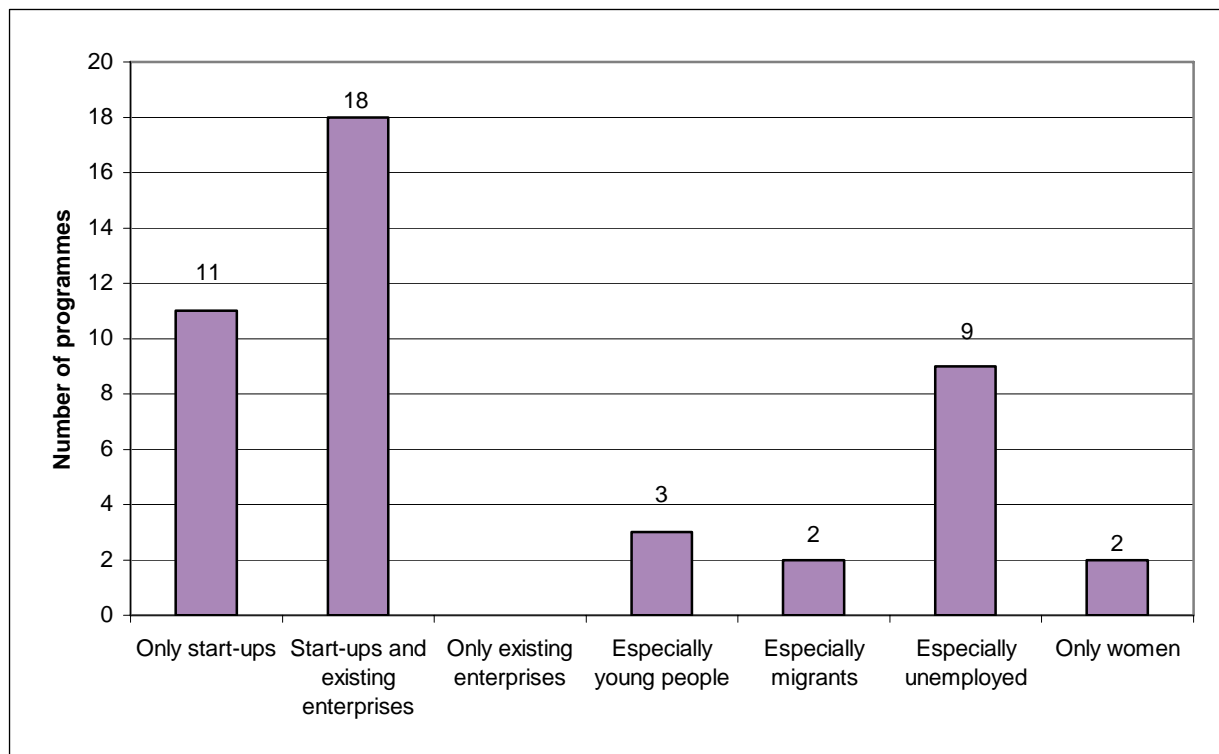
**Table 1: Exemplary division of German microcredit programmes according to type of target group<sup>9</sup>**

<b>Inclusion lending:</b>	<b>Micro-enterprise lending:</b>
<ul style="list-style-type: none"> <li>• KIZ Mikrofinanz, Offenbach</li> <li>• GÖBI-Fonds, Stadt und Landkreis Göttingen</li> <li>• Gründerinnen-Consult Hannover, Hannover</li> <li>• Mikrofinanzfonds MaGNet, Rheinhesisches Gründernetzwerk (run), Mainz und Rheinhessen</li> <li>• Mikrofinanzierungen für MigrantInnen, Mozaik Consulting, Bielefeld</li> <li>• ProGES, Arbeitsförderung Kassel-Stadt GmbH, Kassel</li> <li>• Mikrokredit des Ministeriums für Wirtschaft, Arbeit und Tourismus, Mecklenburg-Vorpommern</li> <li>• GUM-Mikrofinanzierung, Bayern und Sachsen</li> <li>• Enterbusiness GmbH, Berlin and Brandenburg</li> <li>• Projekt Enterprise, iq consult e.V., Brandenburg</li> <li>• Förderung der Gründung von Kleinstunternehmen durch Erwerbslose, BWA, Hamburg</li> <li>• Starthilfefonds, Senator für AFGJS, Bremen</li> </ul>	<ul style="list-style-type: none"> <li>• München Fonds, Stadt und Stadtparkasse München</li> <li>• Kooperationsvereinbarungen mit lokalen Akteuren der Wirtschaftsförderung, Sparkasse Düsseldorf, Düsseldorf</li> <li>• MikroDarlehen / Mikro 10, KfW</li> <li>• StartGeld, KfW</li> <li>• Berlin Start und KMU-Fonds, Investitionsbank Berlin, Berlin</li> <li>• Mikrofinanzzentrum Nordrhein-Westfalen/ Niedersachsen</li> <li>• Startkredit und Ziel 2 – Hochschulgründerfonds, NRW.Bank</li> <li>• Starthilfe, L-Bank, Baden-Württemberg</li> <li>• Starthilfe, Investitionsbank Schleswig-Holstein</li> <li>• Startkapital, Saarländische Investitionskreditbank AG, Saarland</li> </ul>

It is noticeable that the programmes of the regional promotional banks (*Landesförderinstitute*) and KfW Bankengruppe concentrate on micro-enterprise lending. The target group for inclusion lending, on the other hand, is not served by the regional and federal promotional banks. Here the main actors are start-up centres together with the authorities and ARGEs (joint ventures between social services and municipal authorities). The underlying rationale no doubt reflects the closeness to the respective target groups and the capacity to provide subsidies. This differentiation in the market makes sense. Specifically tailored programmes, where appropriate with specialised actors and with higher subsidy rates, ought to be available for target groups with weaker creditworthiness but whose successful independence is nonetheless socially desirable. The regional promotional banks (*Landesförderinstitute*) are probably not suitable bodies for handling inclusion lending efficiently. That at least is the conclusion reached by the Investitionsbank Berlin, which since the last survey has stopped its labour-market-policy programme of interest-free lending for start-ups from unemployment. Now instead it is offering a new programme, BerlinStart, in cooperation with the Bürgschaftsbank Berlin-Brandenburg. This is a microcredit programme

<sup>9</sup> The table only includes programmes where classification according to target group seemed possible and relevant. The classification indicates merely the target group to which the programmes tend in their loan disbursement.

for start-ups with markedly higher creditworthiness. In contrast, the Sächsische Aufbaubank - Förderbank-, which did not participate in this survey, has recently launched a programme financed by European funds under which interest-free loans are granted with low credit standing requirements of borrowers. No results are here available as yet. Figure 3 sets out a more detailed breakdown of the target groups of the programmes which participated in the current survey.



**Figure 3: Target groups**

Compared with the earlier surveys, the focus has shifted. Whereas in 2003 seven programmes concentrated on start-ups and existing enterprises and 13, almost twice as many, concentrated only on start-ups, the present ratio is 18 to 11. However, there is so far no programme devoted exclusively to existing enterprises.

### **3. Geographical coverage and institutional framework.**

Figure 3 sets out all the 29 loan programmes surveyed and shows that the great majority of the microloan programmes are offered at the local and regional level. The only nationwide actor in this sphere is KfW Mittelstandsbank with its two programmes StartGeld and MikroDarlehen.

**Table 2: Geographical coverage of German microcredit programmes 2006**

<p><b>Local/regional programmes:</b></p> <ul style="list-style-type: none"> <li>• KIZ Mikrofinanz, Offenbach</li> <li>• Feuerwehrfonds, Westerwälder Initiativen u. Betriebe Netz e.V. – WIBeN e.V., Altenkirchen und Westerwald</li> <li>• GÖBI-Fonds, Stadt und Landkreis Göttingen, Göttingen</li> <li>• Gründerfonds der Stadt Paderborn</li> <li>• Gründerinnen-Consult Hannover, Hannover</li> <li>• Kleinkreditprogramm des Landkreises Dahme-Spreewald</li> <li>• Mikrofinanzfonds MaGNet, Rheinhesisches Gründernetzwerk (run), Mainz und Rheinhessen</li> <li>• Mikrofinanzierung für MigrantInnen, Mozaik Consulting, Bielefeld</li> <li>• München-Fonds, Stadt und Stadtsparkasse München</li> <li>• ProGES, Arbeitsförderung Kassel-Stadt GmbH, Kassel</li> <li>• Kooperationsvereinbarungen mit lokalen Akteuren der Wirtschaftsförderung, Sparkasse Düsseldorf, Düsseldorf</li> <li>• ELGO! Emscher-Lippe Gründungsnetzwerk, Region Emscher-LippeGoldrausch – Frauennetzwerk Berlin e.V., Berlin</li> </ul> <p><b>National programmes:</b></p> <ul style="list-style-type: none"> <li>• MikroDarlehen / Mikro 10, KfW</li> <li>• StartGeld, KfW</li> </ul>	<p><b>Länder-level programmes:</b></p> <ul style="list-style-type: none"> <li>• Berlin Start und KMU-Fonds, Investitionsbank Berlin, Berlin</li> <li>• Mikrokredit des Ministeriums für Wirtschaft, Arbeit und Tourismus, Mecklenburg-Vorpommern</li> <li>• GUM-Mikrofinanzierung, Bayern und Sachsen</li> <li>• Enterbusiness GmbH, Berlin und Brandenburg</li> <li>• Projekt Enterprise, iq consult e.V., Brandenburg</li> <li>• Förderung der Gründung von Kleinstunternehmen durch Erwerbslose, BWA, Hamburg</li> <li>• Mikrofinanzagentur Thüringen</li> <li>• Mikrofinanzzentrum Nordrhein-Westfalen/ Niedersachsen</li> <li>• MONEX Mikrofinanzierung Baden-Württemberg e.V., Baden-Württemberg</li> <li>• Startkredit und Ziel 2 – Hochschulgründerfonds, NRW-Bank, Nordrhein-Westfalen</li> <li>• Starthilfe, L-Bank, Baden-Württemberg</li> <li>• Starthilfe, Investitionsbank Schleswig-Holstein</li> <li>• Starthilfefonds, Senator für AFGJS, Bremen</li> <li>• Startkapital, Saarländische Investitionskreditbank AG, Saarland</li> </ul>
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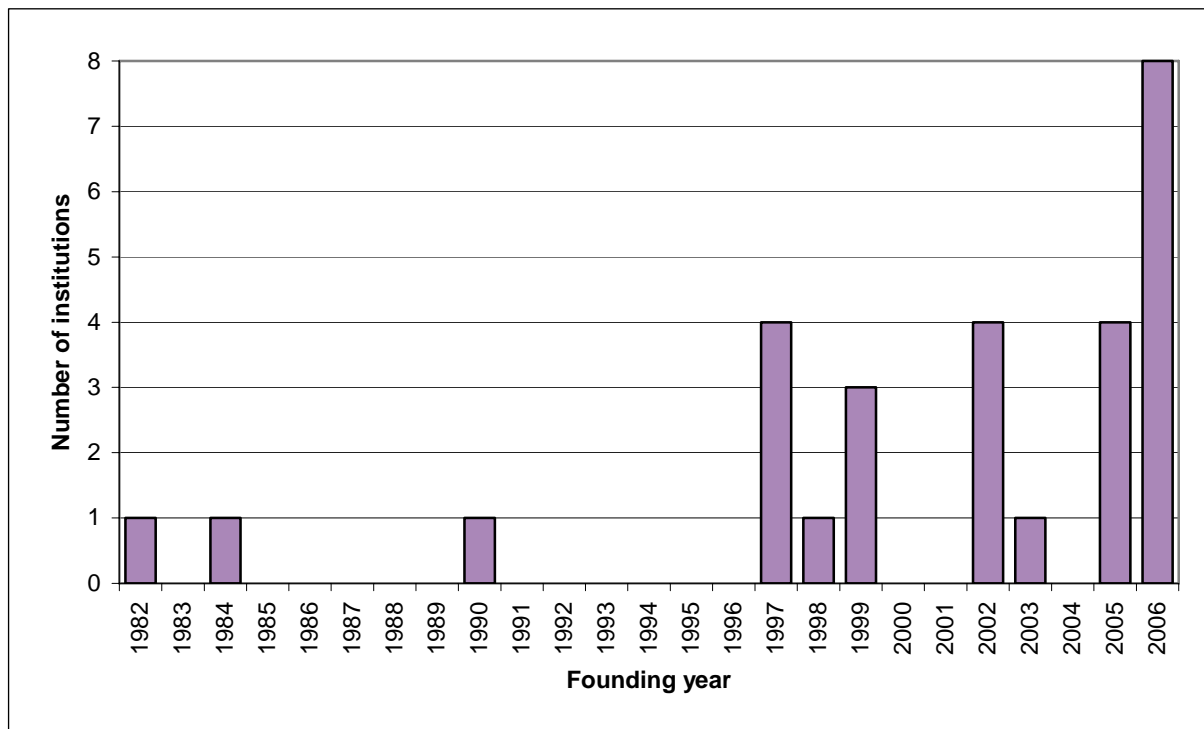
In Table 3, the programmes are listed according to their institutional background. The most important institutional settings in Germany are promotional institutions (the *Landesförderinstitute* and KfW Bankengruppe), public sponsoring institutions, and initiatives accredited by the DMI with a private background and with comparable group strength. Then there are also smaller institutional settings such as the Feuerwehrfonds (fire brigade fund) self-help initiative in Westerwald and Goldrausch in Berlin.

**Table 3: Institutional types of German microcredit programmes 2006/07**

<p><b>Publicly funded programmes:</b></p> <ul style="list-style-type: none"> <li>• Mikrokredit des Ministeriums für Wirtschaft, Arbeit und Tourismus, Mecklenburg-Vorpommern</li> <li>• Gründerfonds der Stadt Paderborn</li> <li>• Kleinkreditprogramm des Landkreises Dahme-Spreewald</li> <li>• Förderung der Gründung von Kleinstunternehmen durch Erwerbslose, BWA, Hamburg</li> <li>• München-Fonds, Stadt und Stadtsparkasse München</li> <li>• ProGES, Arbeitsförderung Kassel-Stadt GmbH, Kassel</li> <li>• Mikrofinanzfonds MaGNet, Rheinhesisches Gründernetzwerk (run), Mainz und Rheinhessen</li> <li>• Starthilfefonds, Senator für AFGJS, Bremen</li> </ul> <p><b>Development banks:</b></p> <ul style="list-style-type: none"> <li>• MikroDarlehen / Mikro 10, KfW</li> <li>• StartGeld, KfW</li> <li>• Startkredit und Ziel 2 – Hochschulgründerfonds, NRW-Bank, Nordrhein-Westfalen</li> <li>• Starthilfe, L-Bank, Baden-Württemberg</li> <li>• Starthilfe, Investitionsbank Schleswig-Holstein</li> <li>• Startkapital, Saarländische Investitionskreditbank AG, Saarland</li> <li>• Berlin Start und KMU-Fonds, Investitionsbank Berlin, Berlin</li> </ul>	<p><b>Programmes accredited by the German Microfinance Institute (DMI):</b></p> <ul style="list-style-type: none"> <li>• KIZ Mikrofinanz, Offenbach</li> <li>• Enterbusiness GmbH, Berlin und Brandenburg</li> <li>• Gründerinnen-Consult Hannover, Hannover</li> <li>• GUM-Mikrofinanzierung, Bayern und Sachsen</li> <li>• Mikrofinanzzentrum Nordrhein-Westfalen/ Niedersachsen</li> <li>• Mikrofinanzagentur Thüringen</li> <li>• MONEX Mikrofinanzierung Baden-Württemberg e.V., Baden-Württemberg</li> <li>• Mikrofinanzierung für MigrantInnen, Mozaik Consulting, Bielefeld</li> </ul> <p><b>Other microcredit programmes:</b></p> <ul style="list-style-type: none"> <li>• Feuerwehrfonds, Westerwälder Initiativen u. Betriebe Netz e.V. – WIBeN e.V., Altenkirchen and Westerwald</li> <li>• GÖBI-Fonds, Stadt und Landkreis Göttingen, Göttingen</li> <li>• Goldrausch – Frauennetzwerk Berlin e.V., Berlin</li> <li>• Projekt Enterprise, iq consult e.V., Brandenburg</li> <li>• ELGO! Emscher-Lippe Gründungsnetzwerk, Region Emscher-Lippe</li> <li>• Kooperationsvereinbarungen mit lokalen Akteuren der Wirtschaftsförderung, Sparkasse Düsseldorf, Düsseldorf</li> </ul>
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#### 4. Age of the programmes.

According to the survey, the number of institutions disbursing microcredits rose by 12 between 2003 and 2006. As is clear from the following diagram, most of the programmes were not started until after 2002. Four new microlending programmes each went onto the market in 2002 and 2004, with a further 8 in 2006.



**Figure 4: Age of German microcredit programmes**

Half of the new programmes created since the last survey in 2003 have been set up by the regional promotional banks (*Landesförderinstitute*). Five programmes appearing in the 2003 survey, on the other hand, are now no longer on the market: Enigma Siebte Säule Microlending GmbH and Emscher-Lippe Kleingründerfonds have ceased disbursing microloans. Three of these five programmes, however, are being continued in a radically modified form: the Investitionsbank Berlin's labour market policy programme has been transformed into Berlin Start; ProfiMannheim is a member of MONEX e.V and handles loan disbursements through the latter; while Dresdner Exis Europa e.V. profits from the microcredit programme of the Sächsische Aufbaubank -Förderbank-. The microcredit programme of the promotional bank N-Bank was launched after 2003 but was already taken from the market in January 2007 and is therefore not included here.

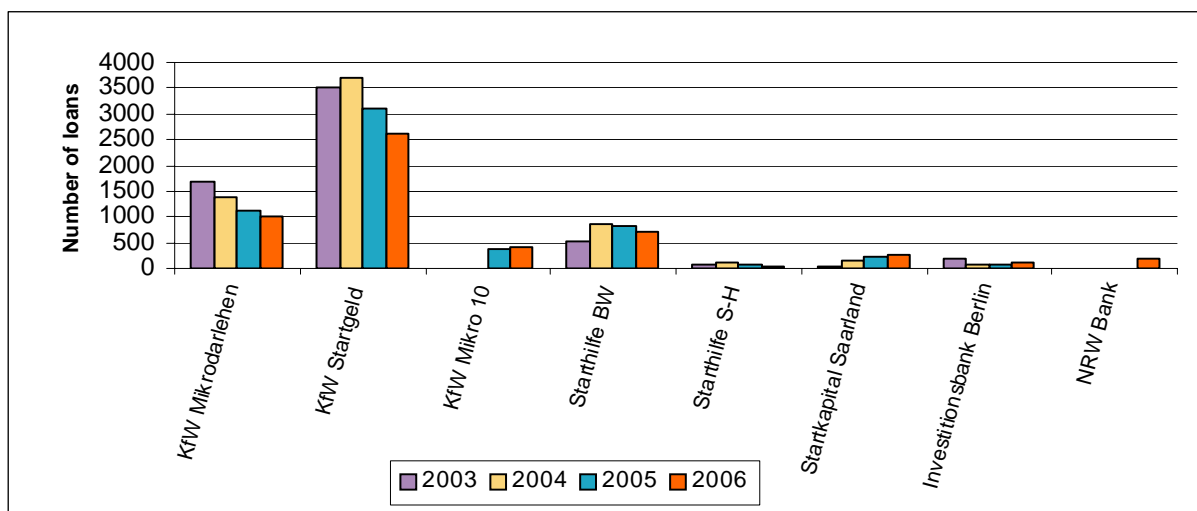
The discontinuation of the Enigma Siebte Säule credit programme illustrates a phenomenon: the feasibility of a credit programme linked with the start-up centre Enigma was examined as part of a publicly financed project, and its establishment was funded. After all the documentation procedures, marketing work, etc. had been completed, the first loans were disbursed – then the funding stopped and with it the loan disbursements. The main problem was that the allocated resources for refinancing the loans had to be used solely for founders of new businesses, which had not yet formally licensed their businesses and which explicitly had to be unemployed. However, the willingness is especially low in this target group to finance a start-up with a credit. In this respect Enigma Siebte Säule was confronted with a

double problem: it had to reject a high number of loan applicants, where at the same time the demand of still unemployed enterprise founders was missing. A further problem here was that the resources to cover the administration and advisory service costs, on the one hand, and the funding for the loans, on the other, had to be acquired from different sources, they did not become available at the same time, and they were geared towards different target groups. This further hindered the establishment of the scheme. One source of financing for many programmes in Germany and the rest of Europe is promotional funding through grants which is limited in time and has conditions attached in respect of target groups. This applies in particular to resources from EU Structural Funds and the EU EQUAL programme. Few projects manage to provide the follow-up financing by means of income, own resources or further promotional funding. They do not succeed in building up sustainable business models. This can be due to the brief length of the promotional funding scheme, wrong focuses set during the scheme, or indeed to the actors themselves. But it is a fact that massively hinders developments in the microfinance sector.

#### **5. Disbursement of loans: Number, terms and conditions, amount.**

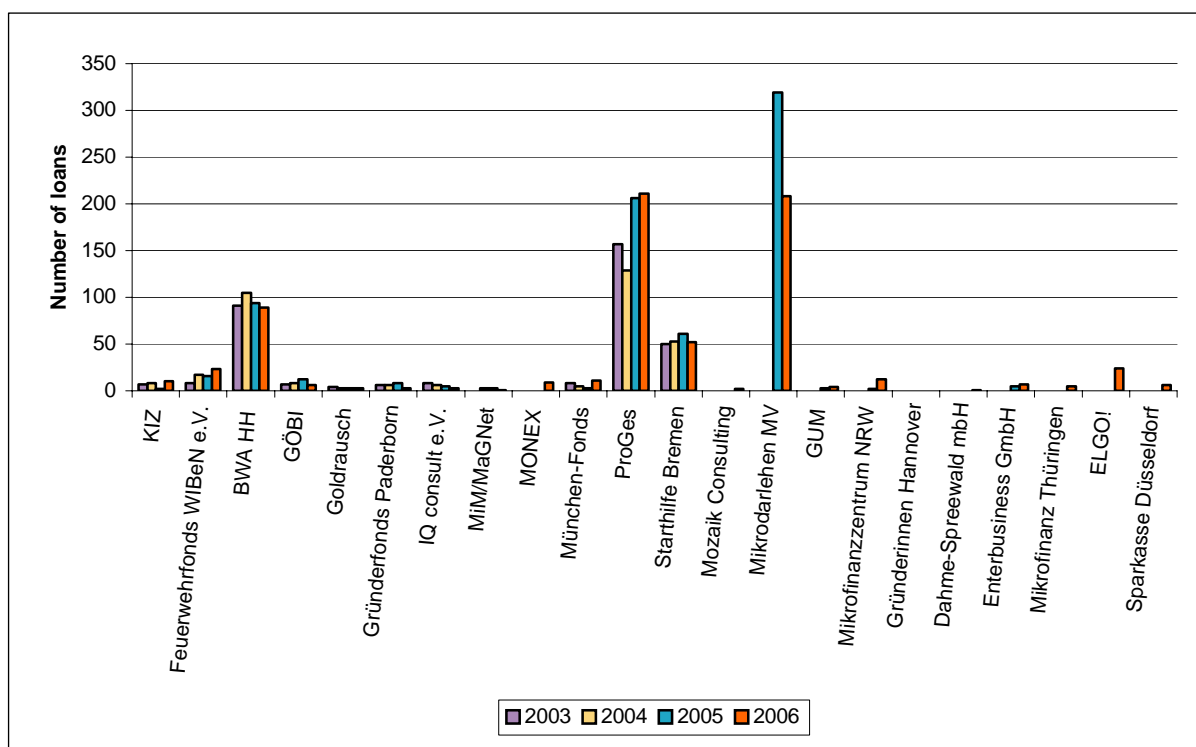
In Germany, the microfinance sector is still young: its programmes are on average only 6.3 years old. Still, six years is certainly a long enough period in which to log successes in the number of loans granted per year and the consequent rise in earnings from interest. To what extent have the German microlenders succeeded in this?

The number of loans granted dropped in the period in question from 6,335 in 2003 (4,665 in 2001) to 5,983 in 2006. On average, 199 loans are disbursed per year and provider. The statistical spread, however, is very wide for the various programmes. The high average value is due to the participation of KfW and the individual regional promotional banks (*Landesförderinstitute*) which make between several thousand (KfW) or several hundred commitments each year respectively and thereby markedly push up the average lending level of German microlending programmes. Figure 5 shows the programmes from the federal and regional promotional banks.



**Figure 5: Evolution of the number of loans disbursed by development banks 2003 - 2006**

Figure 5 reveals that the number of commitments by the Investitionsbank Berlin has stayed fairly constant while it has risen both in the Saarland and under the new programmes Kleinkredit NRW and KfW Mikro10. The larger established programmes, namely KfW's StartGeld and MikroDarlehen and Baden-Württemberg L-Bank's Starthilfe, in contrast, register a drop which more than counterbalances the above rises. Figure 6 looks at the remaining smaller programmes separately.



**Figure 6: Evolution of the number of loans disbursed by public programmes, DMI accredited programmes and other microfinance programmes 2003 - 2006**

Most of the programmes managed to push up the number of loans disbursed. Publicly



funded programmes in Hamburg and Bremen appear to have reached a reasonably steady commitment level with total disbursements varying just slightly per year. Only the microloan programme in Mecklenburg-Vorpommern shows a sharp drop from 2005 to 2006 – although this was after a first year in the microlending business that outshone all the others. On the whole, then, there was an average rise in commitments in 2004 and 2005 with a decrease in 2006.

Setting aside the programmes of KfW Bankengruppe and the regional promotional banks (*Landesförderinstitute*), the average credit commitments per year and provider look much less encouraging for the remaining programmes. As a rule, fewer than 50 commitments are made per provider. The average here stood at 49 in 2005 and 31 in 2006. At this low level, it is hardly possible to cut unit costs to an economically efficient level – the survey waived questions about a precise unit cost analysis in order not to overtax the respondents. At 65 commitments, the European average is also at an unsatisfactory level<sup>10</sup> but in Germany the picture is even more disappointing as far as the number of commitments for the programmes which are not managed by the regional promotional banks or the KfW are concerned.

The programmes certified by the German Microfinance Institute (DMI) largely reveal low loan commitments. Individual new members such as the Mikrofinanzzentrum NRW at least show high rates of increase between 2005 and 2006. Along with the new members the DMI can increase the number of disbursed loans from 12 in 2005 to 49 in 2006. If these growth rates can be maintained, the DMI could become an important institution regarding its impact in two to three years. At the present level, its impact is relatively low.

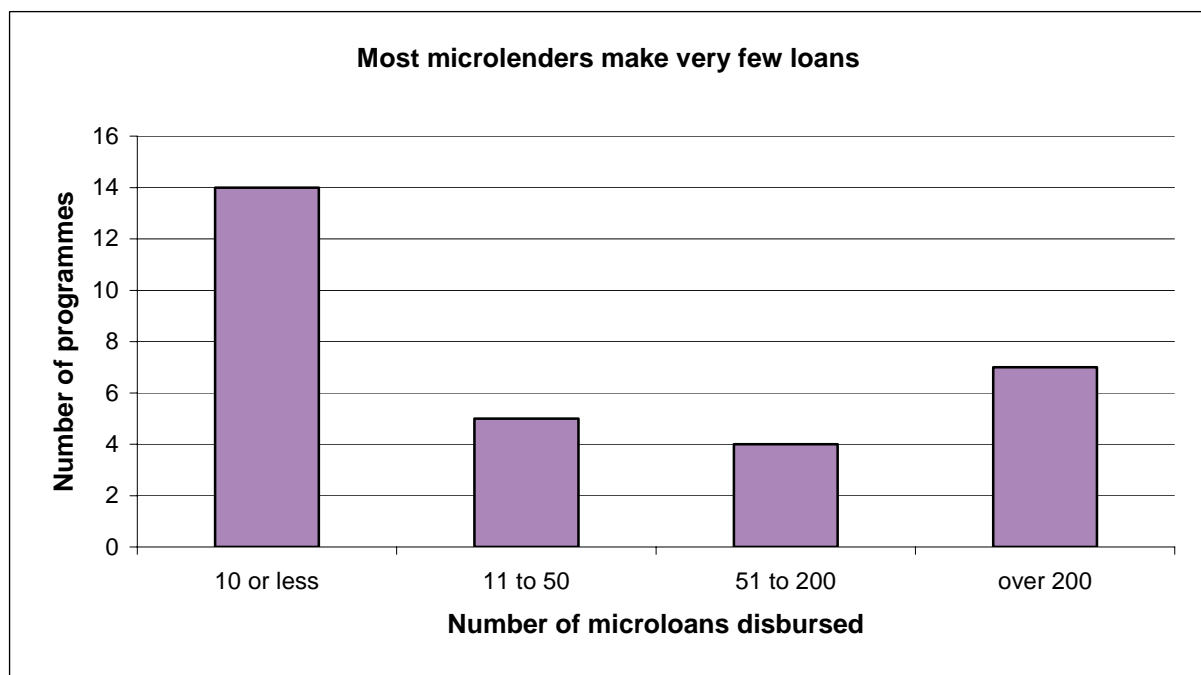
**Table 4: Number of loans disbursed by DMI accredited programmes**

<b>DMI Microlenders</b>	<b>2005</b>	<b>2006</b>
KIZ Mikrofinanz, Offenbach	2	10
Enterbusiness GmbH, Berlin und Brandenburg	5	7
Gründerinnen-Consult Hannover, Hannover	-	-
GUM-Mikrofinanzierung, Bayern und Sachsen	3	4
Mikrofinanzzentrum Nordrhein-Westfalen/Niedersachsen	2	12
Mikrofinanzagentur Thüringen	-	5
MONEX Mikrofinanzierung Baden-Württemberg e.V., Baden-Württemberg	-	9
Mikrofinanzierung für MigrantInnen, Mozaik Consulting, Bielefeld	-	2
<b>Total</b>	<b>12</b>	<b>49</b>

<sup>10</sup> Cf. Underwood, T. (2007), and the analysis of the results by Evers, J./Lahn, S./Jung, M. (2007) as quoted above.

Neither of the programmes linked directly to a savings bank, GÖBI-Fonds and the cooperation agreement of the Sparkasse Düsseldorf, are succeeding in reflecting the broad client base of the savings banks in the number of their commitments. The programme ELGO! set up in 2006 in the region Emscher Lippe collaborates with several savings banks and shows a good start with 24 loans disbursed in the first year.

The following diagram shows the distribution of the programmes grouped according to the number of disbursements.

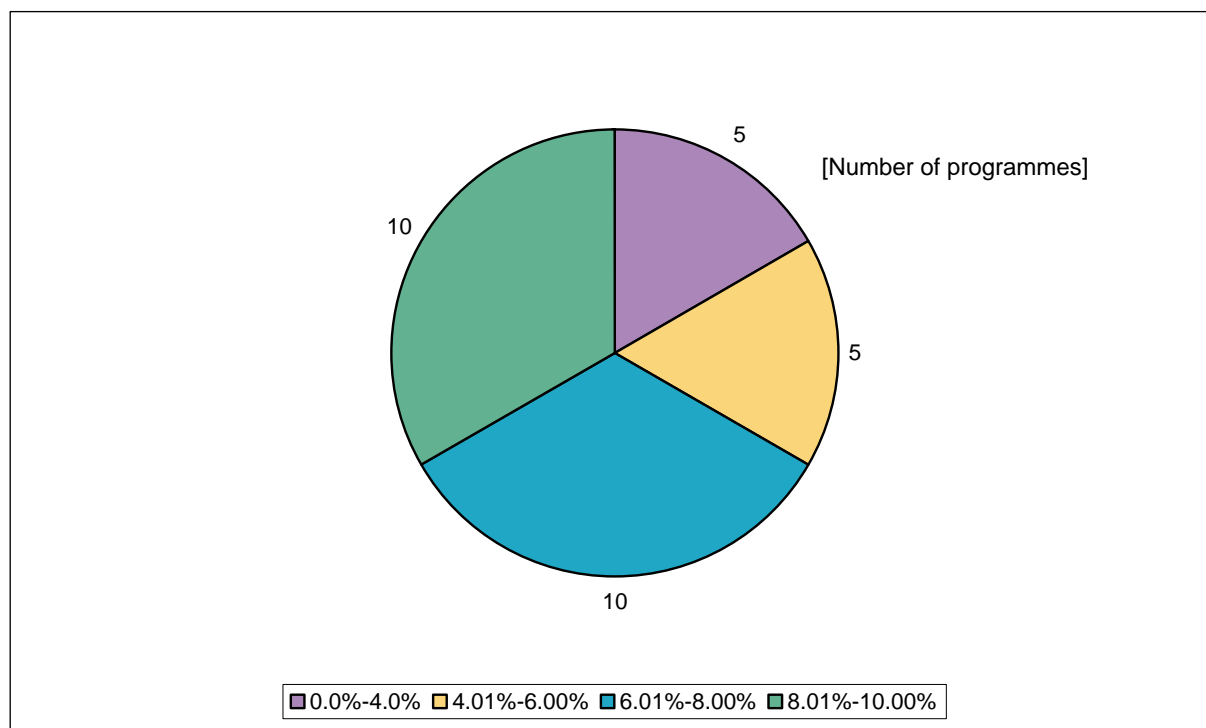


**Figure 7: Number of microcredit programmes in relation to loans disbursed by microcredit programmes**

Of the 29 programmes surveyed, 14 disbursed 10 or fewer loans in 2006, five disbursed 11 to 50, four disbursed 51 to 200 and seven programmes disbursed more than 200 loans. Five of these seven programmes belong to the group of business promotion institutions.

## **6. Loan interest and terms.**

Compared with the last survey in 2003, interest rates have risen by about 2 % to an average of 6.64 %. Most lie between 4 % and 8 %, the highest is 10 %. The number of programmes which do not charge interest has fallen from six to three. Real borrowing costs are heightened through fees such as application, administration or monitoring charges. Twelve programmes stated that they charged further fees in connection with the loan disbursement.



**Figure 8: Interest rate ranges in relation to programmes**

Higher interest rates and charges improve the sustainability of the programmes, since they generate earnings which can go at least some way towards meeting risk and handling costs. In the discussion of the results of the previous surveys, it was pointed out that interest levels from German microlenders were too low, and there was a discussion of whether market interest rates are in contradiction to social objectives. The change in practice and individual feedbacks testify to the convincing force of the argument that "lending rates above market rates of interest prevent bankable borrowers from becoming free-riders in the programmes and at the same time they enable those target groups to be reached which are particularly worthy of support"<sup>11</sup>. It can further be noted that the gap between German and European programmes, which charge an average interest rate of 10 %, has narrowed.

The reduction in loan interest charged by leading promotional microlenders is a move in the opposite direction. A possible reason is an attempt to encourage start-ups. The extent to which this succeeds remains to be seen. Be that as it may, the reduced interest charges could possibly make it more difficult for microlending institutions to have higher lending rates accepted on the market and improve their internal financing.

When it comes to loan durations, the picture is encouraging. Short terms are regarded as good practice internationally. Although terms of up to ten years are still occasionally offered,

<sup>11</sup> Underwood, T. (2007).

possible loan periods have become shorter, dropping from 62 months on average in 2003 to 55 months in 2006.

## **7. Cooperations.**

At the German microlenders' workshop discussions in 2002, and in the preceding survey, microlenders registered a keen interest in cooperating with business promotion institutions (88 %) and financial institutions (76 %). This is increasingly being implemented. Cooperative relationships exist in 19 of the 29 programmes, with the cooperation relating to individual procedures in the disbursement of the loan.

Under present legislation, commercial lending in Germany is restricted almost exclusively to financial institutions. Cooperating arrangements between microfinance providers and financial institutions are therefore often necessary. Thus, based on Guidelines worked out by KfW Bankengruppe with microlenders and start-up initiatives and associations as well as banking federations<sup>12</sup>, a series of cooperative agreements have been reached between financial institutions, in particular savings banks, and advisory centres. Sparkasse Düsseldorf, for instance, cooperates in the microlending disbursement process with several local actors in the local business promotion sphere while the ELGO! start-up network cooperates with several local savings banks. Both cooperation schemes state that the Guidelines were the starting point for their cooperating processes, but that they are the exceptions among the institutions surveyed.

A further eight initiatives have entered into cooperation agreements on the model developed by the DMI. Under this microcredit disbursement model, four partners (microlender, DMI, Microfinance Fund Germany and a bank) cooperate with each other in order to disburse microloans. Put in simplified terms, the work involved is handled by the individual partners as follows: The microlender attends to checking creditworthiness and monitoring the microloan. The Fund acquires and administers the risk capital. The bank (formally) handles the loan disbursement. The DMI accredits the microlender and accompanies and advises the partners in matters relating to the disbursement of the microloan.

A very far-reaching model of division of work is exemplified by the microcredit programme offered by the BWA, the Ministry for the Economy and Labour, in Hamburg. The BWA has outsourced several procedural stages within its microcredit programme to external service providers. One service provider largely takes over the pre-selection and the appraisal of the

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<sup>12</sup> Cf. KfW Bankengruppe (2005).

creditworthiness examination. Another attends to post-disbursement support and monitoring the borrowers. Outsourcing the tasks to specialised providers keeps costs low for the credit disbursement process as a whole (including the externally provided services) compared with the programmes of other microcredit actors: as regards the BWA, the program can in principle be operated and administered by one person with a half-day job for about 100 loans granted per year.

Cooperation between microlenders is a model which, as we see it, is still in its infancy. One opportunity for cutting unit costs, especially for the small German credit programmes, would be a division of tasks in the form of a central back office, such as the English microlender Street UK presents as part of its StreetServe offer.<sup>13</sup> Local partners can concentrate more closely on marketing and thereby increase the number of loans. This could possibly be a development path for DMI, where work is already in progress on central database functions. The biggest potential for cost reductions would arise from the DMI offering its members a standard product.

According to the majority of responses under the survey, cooperation between microlenders and financial institutions is still not functioning convincingly. Reasons for this are, for example, poor communication between the partners and the lack of commitment on the part of the principal banks. Above all, there is a call for major projects to be jointly financed, for the cooperating partners to show more willingness to share risks, to raise the number of credit commitments and to cut handling costs. These causes require further and closer investigation, but the topic is of particular importance in that KfW Bankengruppe's Mikro 10 product aims for just such cooperation.

## **8. Summary and evaluation.**

In Germany, the number of microcredit programmes has risen from 24 to 33. This clear sign of a dynamic process is not reflected in the number of loans disbursed, which is disappointingly low in practice. It makes sustained business development almost impossible: 14 of the programmes surveyed disburse only up to 10 loans and a further five programmes disburse up to 50.

After several regional promotional banks (*Landesförderinstitute*) and the KfW Bankengruppe launched their programmes, the average number of loans disbursed was 199 in 2006 (although without these the average is 31). This average distinctly exceeds the average

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<sup>13</sup> Cf. Copisarow, R. (2004), p. 40.

figures from 110 surveyed Western European microlenders. Nevertheless, this German approach denotes progress only for the *bankable and nearly bankable micro-enterprise* target groups defined above. In the *inclusion lending* sector, which targets the integration of disadvantaged groups into the economic process and which is a key aspect in Western European microlending, the target group is not being successfully reached. There are some other elements of the programmes of the regional promotional banks (*Landesförderinstitute*) and KfW Bankengruppe, which could be improved: Today, elements of credit or product design, processes, and customer relations have a focus on the 'traditional' way to start a business. Credit (and marketing) policy could leave a broader room for the great variety of the living situations and business models of microborrowers. In addition, elements of credit design and processes which have proven to be successful in many countries, as for example monthly constant rates for loan redemption and interest or step-lending, could also be realized by those promotion institutes. Moreover, to our view, the often obligatory involvement of principle banks lengthens application periods and increases expenses. All too often programmes are largely designed for start-ups and young enterprises requiring application for the loan before the project gets off the ground. Operational funding for already existing enterprises is available through hardly any of these programmes. The rise over recent years in funding demands from the part-time and low-budget start-up target groups – partly financed via own funds or those of acquaintances – and from start-ups from unemployment<sup>14</sup> can scarcely be met with 'traditional' start-up loans. Here lies perhaps the most important reason for the overall decrease in disbursement numbers by KfW Bankengruppe and regional promotional banks (*Landesförderinstitute*) in 2006. The rising average level of loans and NBank's withdrawal from offering microcredits indicate that the major business promotion institutions have their problems with small clients.

In the inclusion lending sphere, a growing number of activities by local joint ventures (ARGEs) are emerging. The city of Kassel has had a pioneering role here since 1997 with its successfully functioning ProGES-Programm. The opportunities offered to the ARGES in this sphere by the Social Code (SGB II) are currently being intensively analysed and exploited in, for instance, Hamburg, Frankfurt/M. and Münster.

So far, the establishment of the DMI has had no effect on the number of loans disbursed by its members. In fact they have the lowest number of disbursements compared with the other groups (excluding "Other microcredit programmes"). In the past three years, the investments

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<sup>14</sup> More than one million start-ups over the past four years funded by the German Federal Employment Agency – of which some 70 % were still on the market after two years.

directed towards the establishment of a multiplicative model have meant that a series of new actors have joined the microlending scene and are profiting from the expertise of the DMI network – although the programmes are not so far achieving a satisfactory number of borrowers, either individually or in total. This may be due to the complex structures required under German banking law – the loans are disbursed via the GLS Bank, securitised by capital stock and looked after by microlenders – or again it may be due to a suboptimal focus in the institution's structure. It may simply be that the model still needs more time to establish and prove itself. It will be interesting to see the outcome of the analysis of the type of DMI member organisations that survive in practice: those offering loans as a secondary line of business in their start-up consultancy service or those concentrating on microlending as the sole business focus. Of interest here is MONEX, which separated the credit business from the start-up context and now offers loans through its own sponsoring organisation.

Increasing account is being taken of the changed or better known funding demands of micro-enterprises: 18 programmes concentrate on founders and existing enterprises, with only 11 geared solely to start-ups. The empirical results from Kritikos et al., which are still very recent and require further confirmation, point to challenges in the marketing sphere which can be met through adaptations in marketing operations.<sup>15</sup> This may well apply equally to publicly funded programmes, programmes in the DMI scheme, and programmes from the regional promotional banks (*Landesförderinstitute*) and KfW Bankengruppe. The changing patterns in start-up procedures call for changing responses not only to the level of loans required but also in timing, loan terms and application targets as well as the processes.

The promising strategy of setting small, flexible marketing units as interfaces with the client, as the American microlender ACCION advocates and practises<sup>16</sup>, is difficult to locate on the German market. Mikro 10, with its attractive commission and promotion of local cooperating ventures, is a first step in this direction. The low number of loans it has placed possibly point to a lack of interest in the proposed target groups on the part of the principal banks, which have to be involved, or to suboptimal support systems.<sup>17</sup> A conceivable next step would be to

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<sup>15</sup> Kritikos, A.S./Kneiding, C./Germelmann, C.C. (2006) point out in the study quoted above, *Is there a Market for Micro-Lending in Industrialized Countries?*, that there is a substantial albeit small demand which is, however, not being reached due to inadequate demand studies by the microfinance providers. The consequences were a mistaken target group focus and wrong lending products (p.24). The authors also see as the background a delimitation of the target groups because of the link to support from public funds (p.3) and an inadequate demarcation from the Alternative Bank (p.25) in respect of speed and customer friendliness.

<sup>16</sup> Cf. Rhyne, E./Lopez, C. (2003).

<sup>17</sup> Cf. Evers, J. (2002).

further develop Mikro 10 into a wholesale product analogous to easy credit in the consumer sphere; it could then be disbursed locally without loan support systems. This might prove to be an especially promising model for the structures specific to Germany.

A look at other Western European countries reveals that three models in particular have proved to be relatively successful:

- Finnvera, Finland's state business-promotion bank, in consultation with the commercial banks for microloans, decided on the direct disbursement of loans and it implements the creditworthiness examination and support in its branches in key regional locations. The Finnish entrepreneurial base is less than one-tenth that of Germany, but Finnvera achieves 3,000 loans every year, which is quite a lot in comparison with the numbers achieved by the microfinance programmes of the Landesförderinstitut and the KfW Bankengruppe, which work in conjunction with the principal banking system. The Finnish banks, according to Finnvera, agreed to the direct disbursement because, at the next stage, Finnvera then again funds the small but established clients in conjunction with the banks. However, it has to be taken into account that the Landesförderinstitut as well as the KfW grant smaller loans up to EUR 25,000 also within their further 'conventional' business promotion programmes which are not 'explicitly' focused on microcredits.
- In Spain, a series of savings banks have invested massively in microlending structures in the past four years and they are recording high growth rates. Their strategies vary. La Caixa, for instance, is the biggest savings bank and it deals with clients in its own branches. The third-largest savings bank, Caixa Catalunya, has set up a separate foundation for its microcredit business, Un Sol Mon. Wholesale models, where marketing, preparation of the creditworthiness examination and follow-up support are structured into local partners on a commission basis, are at a pilot stage. All the models, however, have one thing in common: special structures are set up – at least for the back office – which then integrate the borrowers back into the standard business in the course of repayment. These examples could perhaps serve as models that might boost the number of microlenders in cooperation with German savings banks.
- The French microlending organisation Adie, with more than 6,000 loans disbursed in 2005, also cooperates closely with French banks, which so far have funded some 80% of the loans. Adie likewise functions as a local marketing partner. It has more than 100 branches and locations in France and with its specialised know-how it handles the creditworthiness examination and support for inclusion lending and then passes successful clients on to its bank partners. The dynamic rise in lending commitments



which the French microcredit organisation Adie has been demonstrating for years now, and which the microcredit initiatives of the Spanish savings banks have been emulating in the past few years, is nowhere to be seen on the German market.

In conclusion it must be said that things are indeed moving in Germany, but not sufficiently. The breakthrough in microfinancing is still not in sight. Yet there are clear signs of a dynamic development emerging. Microfinance will only become significant if more players accept responsibility and really look at the demands of micro-entrepreneurs and -enterprises, develop and implement lean processes, and enter (aggressively) the current financing market in order to make microfinance a core business.

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## Microfinance in France: The Experiences of Adie (L'Association pour le droit à l'Initiative Economique).

### 1. Origin.

Adie was established in December 1988 as a non-profit association. As a director at the French Development Agency (AFD), by then I had already successfully transferred the model of Bangladesh's Grameen Bank to West Africa, and I wanted to test it in France at the time when the Minimum Inclusion Income program (RMI), designed to help people without resources reintegrate into the labour market, was being instituted. I had proposed helping several French NGOs working in the fight against social exclusion to set up an experimental project. They all thought it was a good idea for developing countries but totally inappropriate for an industrial country blessed with a particularly generous welfare state. So I created Adie with two friends. We were all three volunteers and, like our future clients, bereft of start-up capital. Start-up was particularly difficult because we had to find a minimum of finance, identify our clientele (Figures 1 and 2) and develop methods adapted to the environment of an industrial country.

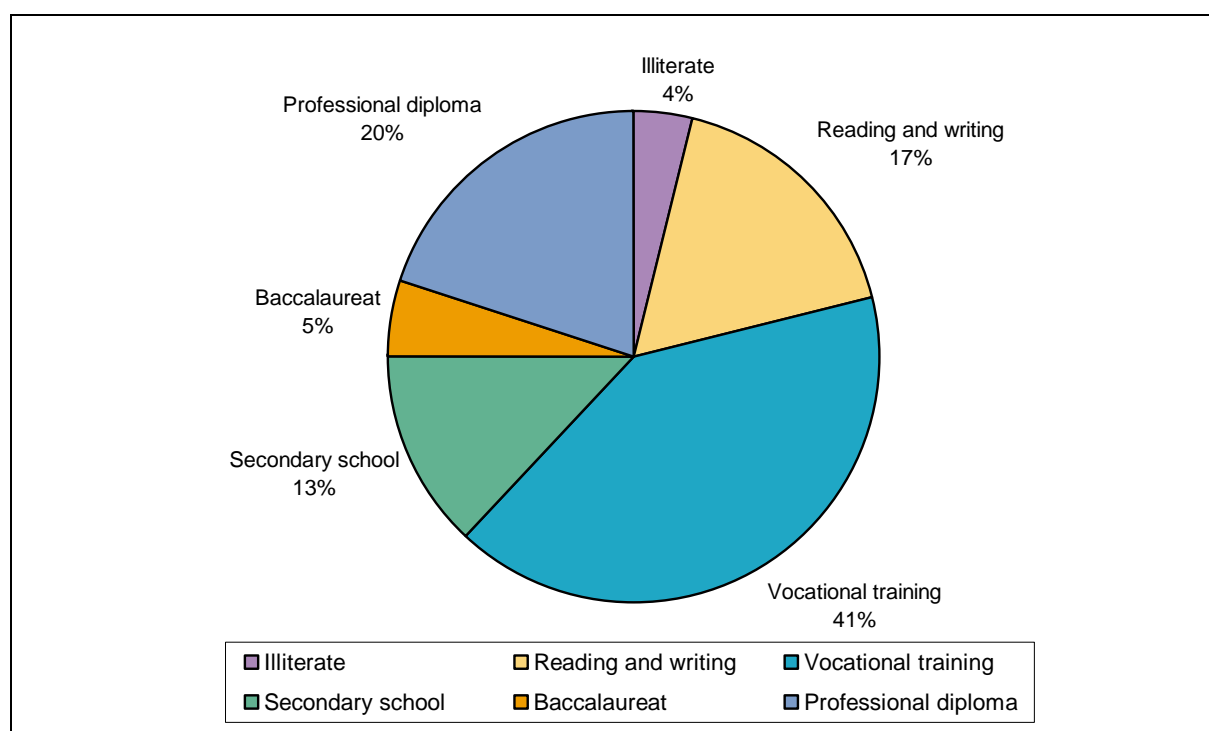
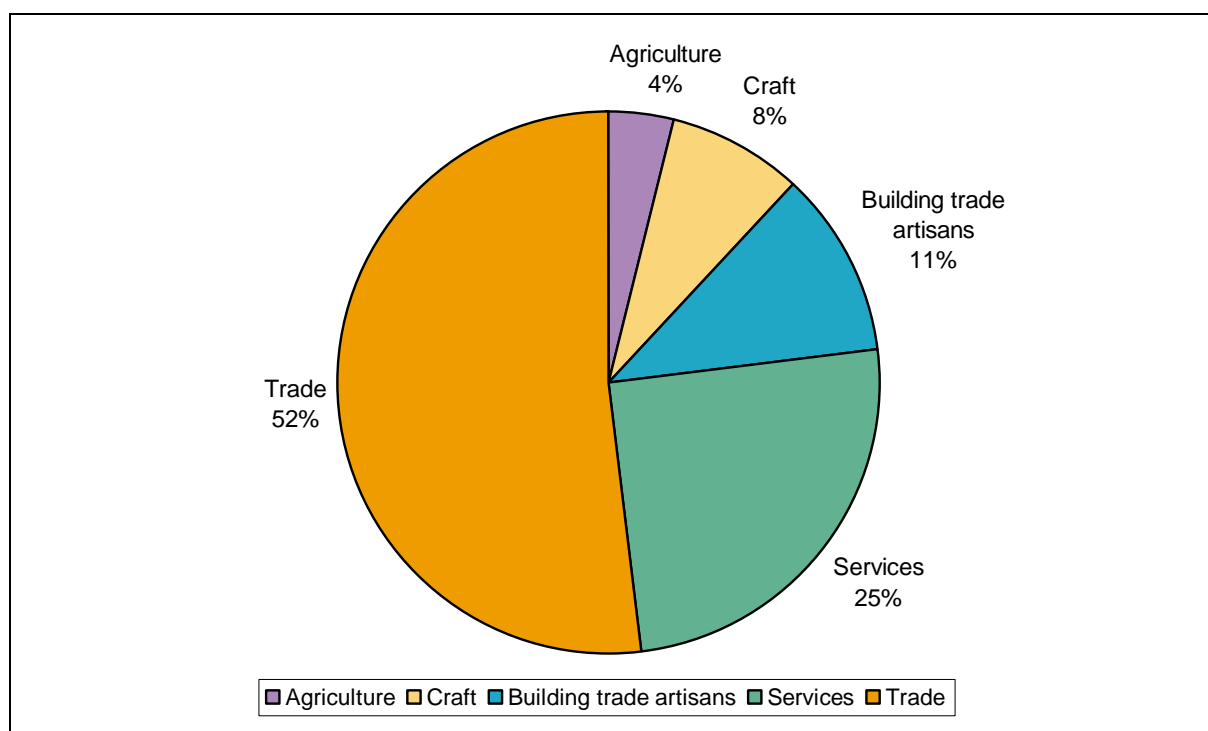


Figure 1: Educational level of Adie's microfinance clientele



**Figure 2: Distribution by principal activities of Adie's microfinance clientele**

Regarding funds, we were able to gain the support of some private foundations, the government, and a European anti-poverty programme. It was some time before we found our first clients; neither social workers nor agencies supporting business creation believed in our project. We sought our first clients by posting announcements in blocks of flats in poor districts. Our first loans were a failure: we sought to reproduce too exactly the solidarity group approach in a country where the rural exodus had destroyed social solidarity. The groups that we set up fell apart rapidly and only a few members repaid their loans. These difficult beginnings were an excellent lesson for what followed.

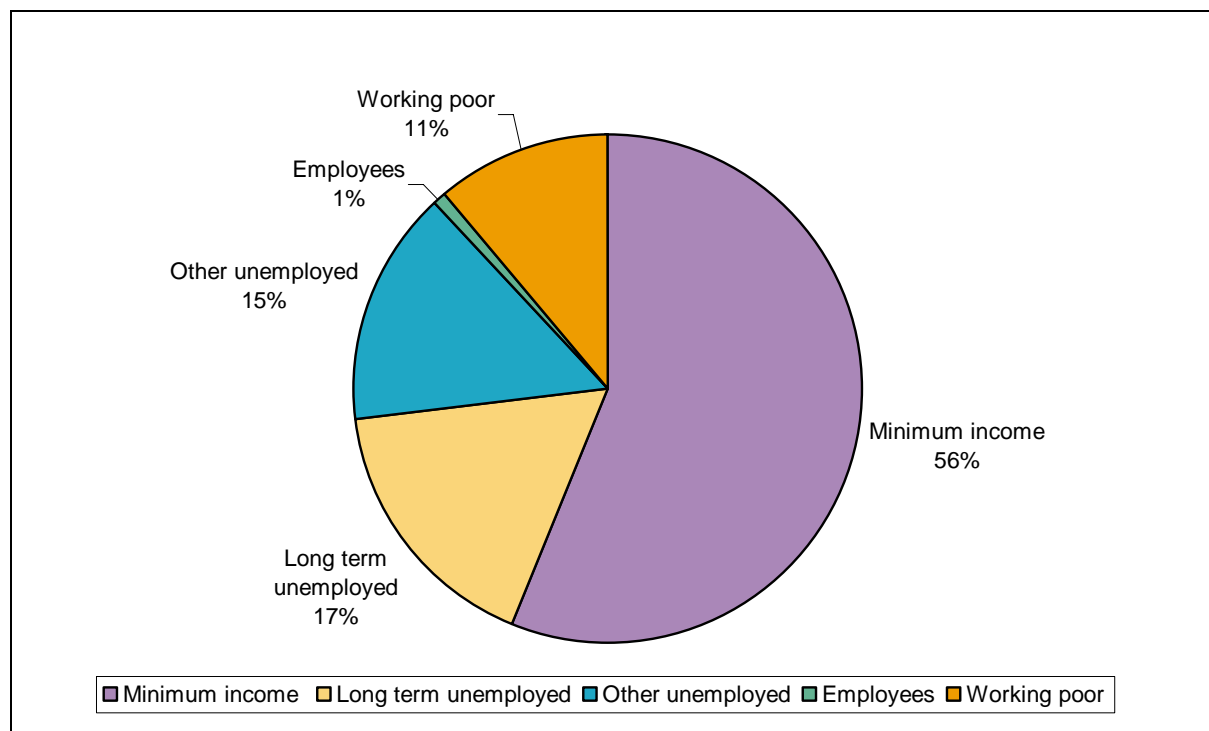
## **2. Objectives.**

While unable to adopt the Grameen Bank's methods, we retained its spirit via our activity's three objectives:

- To finance disadvantaged people in creating and developing their own jobs and, possibly, jobs for others;
- To provide business development services for the new enterprises to help them succeed;
- To use our activity as a social laboratory to help identify the obstacles to the development of economic initiative.

### 3. Clients.

The clientele to which we have remained faithful for 19 years is that of disadvantaged people desiring to create a microenterprise and lacking access to banks. Welfare recipients account for 56 % of our clients, 33 % are unemployed, many of them long-term jobless, and 11 % work in low-paid jobs (Figure 3).



**Figure 3: Target population of Adie**

About 35 % are women. Over a third are foreign-born or children of immigrants; these have the most difficulty finding wage-paid employment, while their entrepreneurial culture is often the most lively.

An interesting characteristic of this clientele is that 18 % are barely literate, while 20 % have higher education. The one group is as successful as the other, even if the enterprises occupy different niches.

### 4. Financial products.

The maximum amount of an Adie loan is EUR 5,500, with a maturity of no more than two years. The interest rate is 7.2 % plus a commission of 5 %. The average loan is EUR 2,800, for an average term of 18 months. In poor districts, progressively stepping loans start at EUR 1,000, increasing each time the preceding loan is repaid. As a general rule Adie requests multiple guarantees for half the loan amount. These guarantees, for a minimal amount, are designed to ensure that the borrower has a good reputation and that the people around him are ready to support him in implementing his project. In the rare cases where a

microentrepreneur refuses to repay the loan, the guarantees make it possible to exercise pressure on him. In some cases (e.g. recent immigrants) guarantees are not required from people who have no means of obtaining them.

Loans are supplemented by a minimum amount of equity or quasi-equity:

- “Loan of honour,” interest-free and without guarantee (commission = 5 %);
- In some regions, a start-up grant provided by the Regional Council to supplement Adie’s loan, often managed by the association;
- Repayable advance provided through the EDEN facility, managed by Adie for the government;
- Finally, for people who are hesitant about starting their business, an equipment loan (market facilities, pick-up truck, computer equipment, etc.) which sometimes makes it possible to test both the market and the entrepreneur’s capabilities.

Two new experiments are currently underway:

- Micro-insurance, adapted to the needs of fledgling entrepreneurs, is being tested in partnership with three insurance companies;
- Back-to-work microcredit, financing expenses for disadvantaged people to find wage-paid employment: vehicle, motor scooter, apprenticeship, eyeglasses, etc.

## **5. Methods.**

The lending process has evolved over time. It now consists of several phases:

### Contact.

Given Adie’s unique and toll-free phone number, in 75 % of the cases initial contact is made by telephone. The call is received by a full-time loan counsellor at the regional headquarters. This initial contact of about 15 minutes is intended to allow Adie to carry out the following checks.

- To verify the eligibility of the caller: is his need for credit compatible with the amount that Adie can lend him? Does it involve creation or development of an enterprise? Insofar as bank interest rates are lower than Adie’s, this initial contact also allows Adie to verify the person’s lack of access to bank credit.

- To verify the maturity of the project: is the candidate ready to move rapidly, or would it be better for him to prepare his project with, as appropriate, support from an advisory body?
- To measure certain risk criteria: level of indebtedness, inclusion in bank default files maintained by the Bank of France. These are not criteria for automatic rejection, but allow the loan counsellor to gain a first impression of the potential risk.

#### Instruction and decision process.

Following this telephone contact, for eligible persons a meeting is scheduled with a loan counsellor, who most often conducts a single interview (less often, two) to examine the credit application. At this stage the counsellor alone can decide to reject the application. In contrast, to obtain approval, he must submit the request either to the regional director (if the score computed by Adie's information system indicates low risk), or to a loan committee (if the score indicates medium or high risk.) During these meetings the counsellor does not follow a set list of questions, but rather develops the interview so as to bring out the information he is looking for. In order to present the loan application, he will have to complete a document in which he expresses his opinion on different criteria.

The criteria in question divide into three main categories:

- "Confidence in the person of the applicant:" the counsellor expresses his opinion about the applicant's capabilities: his experience, his ingenuity, his professional and family network, etc.
- "Confidence in the project:" more than examining the project itself in depth, the counsellor evaluates the applicant's capacity to manage and implement it.
- "Confidence in repayment:" the counsellor indicates the elements that ensure the applicant's capacity and intention to repay the loan.

The loan counsellor presents the loan application either to the regional director (within 48 hours) or to the loan committee (maximum of two weeks).

#### Back office.

Since the amendment to the banking law obtained by Adie, the association manages and disburses its loans directly. Loan (and guarantee) contracts are signed at the offices of Adie, which can proceed to disbursement into the client's bank account within 48 hours.

Business development services.

After a long period of unemployment and given the complexity of the environment in which to create enterprises, apart from finance, persons financed by Adie need appropriate advice and training. Again, Adie provides them with these services, oriented in the first instance towards help with administrative procedures, setting up of management and accounting, marketing and banking. Clients may benefit from coaching but also from specialised advice in certain areas such as, for example, legal advice. Along with individual advice and training, they may also have access to “creator circles” which meet regularly to provide the new entrepreneurs with ongoing training and let them exchange experience. A hotline is currently being set up to reply to the clients’ most urgent questions. The accompanying services are organised with major participation by volunteers, new retirees, and active professionals from the business and banking worlds, some of whom are former Adie clients who have developed their own enterprises and want to help others succeed.

In conjunction with socially responsible persons or companies, Adie also tries to develop different services of use to the clients:

Thus, Adie uses micro-computers discarded by large companies and refurbished in workshops employing jobless people, and sells them for EUR 90 after three-day training sessions offered by Microsoft.

Adie helps the new entrepreneurs expand their networks by putting them in contact with the appropriate professional milieux. Thus, plumbers are put in contact with Primagaz to install gas tanks in rural areas, carpenters with Vinci, and those working in fashion or design with the “Elle” Magazine Foundation or with other professionals.



## 6. The Adie network.

Currently Adie covers the entire country through a network of 119 agencies and 380 local offices. Outside France, it is established overseas in Réunion, Mayotte, Guyana, New Caledonia, and recently in Martinique. Adie's regional offices are responsible for client relations, business advice and training, and collection of funds from local authorities. As for the headquarters, it is in charge of all functions susceptible to economies of scale: methods, human resource management, training, financial management, accounting, back-office, computer services, etc.



Note: 22 regional offices; 110 branches; 380 contact point; 310 staff members; 1000 volunteers

Figure 4: Adie network

## **7. Financing.**

At this stage of its development, Adie still depends on external financing. Schematically:

Loan funds come essentially from banks, which provide Adie with lines of credit that it redistributes to its clients. This direct control allows for greater effectiveness than the system used at Adie's outset, when control was duplicated by Adie and the banks, which at the time had the sole authorisation to make loans.

Risk is shared between, on the one hand, banks (30 %), and on the other hand, Adie and its clients (70 %); Adie is counter guaranteed to 65 % by a government guarantee fund (Fonds de Garantie d'Insertion par l'Economie) and the European Investment Fund.

The extra costs of credit and accompanying services are financed by a variety of partners: the government, which is in the process of reducing its commitments as a result of decentralisation; the European Social Fund, which is also going to reduce its contribution as it gears itself to the new EU member countries; local authorities (Regions, Departments, Municipalities, etc.), whose participation has increased in the course of the last two years; and socially responsible companies, which are likewise increasingly supporting Adie.

## **8. Results.**

In relation to the three aforementioned objectives, the results of Adie's activity can be summarised as follows:

### Financing.

Initiated as a piece of research, the loan programme has evolved towards an increased initiative in contacting clients, in part thanks to changes in the legal framework, obtained by Adie. As regards methods, experience has led the Association towards a revision of the credit cycle, stressing risk analysis and simplification of procedures. As everywhere in the world, microentrepreneurs in France are more attuned to the rapidity and simplicity of procedures giving them access to credit than to the costs of the credit.

By the end of 2006, Adie had disbursed a total of about 44,000 loans since its set-up, the number increasing regularly each year. Moreover, it has disbursed 8,766 "loans of honour." In 2006 the number of loans disbursed rose to 7,570, and the total number of financial operations (including "loans of honour," regional start-up grants, and repayable EDEN advances) to 15,129.

On 31 December 2006, loans outstanding amounted to EUR 24 million, and “loans of honour” to EUR 10 million. On the same date, payment arrears amounted to 6.90 % and losses to 2.97 %.

#### Business development services.

As in the case of credit, non financial services have also evolved, while varying from one region to another in accordance with the number of participating volunteers. We are in the process of harmonising these methods, involving a substantial training effort for both staff and volunteers.

Overall results can be summarised as follows:

Since Adie was founded, 37,000 enterprises and 45,000 jobs have been created, including 6,508 enterprises and 7,802 jobs in 2006. The survival rate of enterprises is equal to the national average: 64 % after two years. As is often the case with microenterprises, a number disappears and then recreates itself. In other cases, persons who have gained self-confidence find wage-paid employment; altogether, the rate of inclusion, namely the percentage of people leaving social welfare definitively behind, is 75 %.

#### Institutional reform.

Adie's greatest accomplishment is to have contributed to a change in attitude towards disadvantaged people. The success of people who were marginalised and considered a burden on society, has shown that entrepreneurial capacity is within everyone's reach, regardless of their assets and even their educational level.

The repayment rate, higher than that obtained by banks for business start-ups, has shown that disadvantaged persons are good clients. This convincing demonstration has allowed Adie to obtain significant improvements in the environment for microcredit and microenterprises:

- As regards the legal framework for microcredit, the two principal advances have been (1) amendment of the banking law in 2003, allowing associations financing and serving unemployed and welfare recipients to borrow in order to lend, and (2) the removal in 2005 of the interest cap on loans to individual enterprises.
- As regards the legal framework for microenterprises, in 2005 Adie was able to gain recognition of enterprise creation as a mean of economic inclusion, allowing greater equality of treatment with applicants for wage-paid employment. It was likewise able to obtain simplification of some measures, notably aid to the unemployed creating an

enterprise (ACCRES). This assistance, involving exemption from social charges, was extended to all categories of unemployed, the period being lengthened to three years (with progressive reduction), for everyone with an income below the minimum wage level.

Although still insufficient, these provisions have significantly facilitated or will facilitate the creation of enterprises by disadvantaged persons.

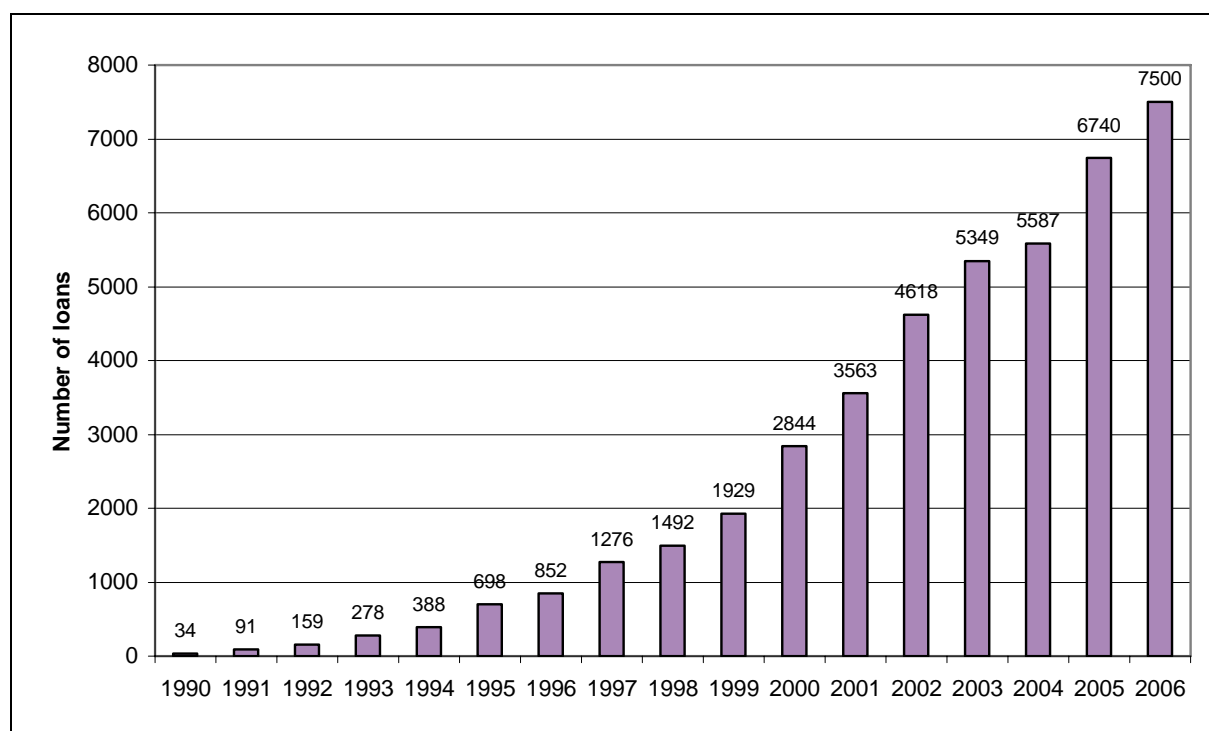


Figure 5: Loans granted by Adie

## 9. Future perspectives.

The legislative changes obtained thanks to Adie's actions are permitting in turn a substantial modification of its organisation:

### Separation of the credit and accompanying service poles.

As long as coverage of lending costs was inconceivable due to the cap of around 7 % on the interest rate on loans to individual enterprises, there was no good reason to separate the two functions. Removal of the interest rate cap is enabling Adie to create an organisation based on two specialised poles that will, of course, continue to work together. This reform will be implemented in the course of this year.

### Pilot branches.

The burden of social charges at start-up forces many self-employed persons to work outside the law. Its reduction should permit a significant number of informal activities to be duly registered. Adie plans to establish, in the course of this year, six pilot branches in districts where the target population is dense, in order to test the possibility of covering lending costs, while business development services remain subsidised.

### Project “Créajeunes”.

In poor districts, youth unemployment can be as high as 30 %. In order to respond to a significant demand from young people desiring to create microenterprises, Adie is going to undertake Project “Créajeunes” to finance and service a thousand of them. Apart from standard financial and accompanying services, Adie will provide these young people with targeted training, coaching and a start-up grant of EUR 2,000.

### Rural development project.

As in the inner city, depressed rural areas have a large number of unemployed and welfare recipients. Starting this year, Adie will test ways of serving this clientele by establishing mobile branches. It will also seek how to help small farmers develop multiple activities and work cooperatively to process and market farm products.

## **10. Lessons for Europe.**

Other European countries, especially those undertaking microcredit programmes, can draw a number of lessons from Adie’s experience. These include the following:

- Considering the relative expansion of services and new technologies, self-employment can only grow in importance. In countries with significant unemployment, self-employment can be an interesting alternative to insecure wage-paid labour.
- The demand for microcredit is growing *pari passu* with supply and, at this stage, seems virtually limitless.
- The methods and products of microcredit must be based on this demand and cannot be defined from above.
- Considering the diversity of different segments of microcredit’s clientele, it is important to create a veritable continuum of microfinance institutions: banks, credit unions, and non-

bank institutions. Partnerships between banks and non-bank institutions should be encouraged.

- In most Western European countries, it is difficult to implant microcredit without complementing training and management advisory services.
- Since the institutional environment is poorly adapted to the development of microcredit and microenterprises, it must be improved. The examples of other countries and the influence of European institutions can play an important role in national sensitisation, shortening the time it took to achieve this in France.
- Finally, it is important to maintain a balance between the social and financial performance of microcredit. Even if this balance is difficult to attain in present conditions in many European countries, the purpose of microcredit remains to “create an inclusive financial sector,” which means building sustainable credit systems from the outset by applying international best practices.

Author: Maria Nowak, President of Adie

## **Twelve Years' Experience of Microfinancing in Poland.**

### **1. Fundusz Mikro in a nutshell.**

Fundusz Mikro, an institution established by the Polish-American Enterprise Fund in 1994, realises the biggest programme of loans for microenterprises in Poland. According to the research, the results of which were published by the Polish Association of Loan Funds, Fundusz Mikro is the Polish leader in the number of loans granted (71 % of loans granted in total) and in the capital employed in companies of our clients (39 % of the capital from loan funds comes from Fundusz Mikro). In the twelfth year of the company's operation, the value of loans granted reached the amount of PLN 734 million (EUR 188 million). Capital of Fundusz Mikro has been used by nearly 45,000 clients, who have been granted over 95,000 loans in total. Such an amount means real financial resources given to the smallest SMEs, through which they can secure their position in the market, develop and – as entrepreneurs declare – create new jobs.

Loans taken from Fundusz Mikro usually do not exceed a few or about a dozen thousand Polish zlotys (EUR 1,000 – 5,000). However, there are also entrepreneurs – regular clients of Fundusz Mikro – who use significantly larger amounts, reaching as much as PLN 100,000 - 150,000 (up to EUR 38,000). What are the reasons for such divergences? The matter is actually quite simple – as simple as the procedures employed in Fundusz Mikro. Every client is treated individually throughout the entire process: from the first contact, through the loan period until its completion, or even longer. At the first meeting, clients declare their financial needs specifically connected with their economic activity. They can often already present specific ideas for their company's development and, encouraged by an adviser, they describe their plans. If the plans need more specific and detailed formulation, advisers help to express them in writing. Moreover, the plans always need financial and risk analysis and advisers are always there to support the clients in this respect. In order to correctly assess the risk of activity, the state of stocks and fixed assets, an adviser visits the client's company. Clients are happy to demonstrate their business, indicating certain drawbacks and deficiencies at the same time. In the context of the obstacles they encounter in the course of running their business, they present their development plans. They share their ideas, formulate their goals and face challenges that enable their realisation. As a result of such a visit, the adviser has a clear image of the business type and business needs of the client. After defining the purpose of the loan, the amount and maturity are specified. These parameters are meant to be advantageous for the client and to enable normal functioning of the business with a precisely calculated monthly loan instalment. The task of approving the

terms and conditions of the loan is performed by these employees who, because of their particular type of professional responsibilities, are authorised to approve such terms and conditions. After the approval, the loan agreement is signed in the branch of Fundusz Mikro. Sometimes this operation requires only the presence of the client taking a loan, but more frequently the loan guarantors are also invited to the meeting. Each of them receives one copy of the agreement. Fundusz Mikro keeps the original copy of the agreement and blank promissory notes with clauses securing the loan. The loan agreement document, together with Appendix 2, in which the client specifies the corporate bank account number, constitutes the entire documentation required for loan disbursement, i.e. for transferring the money to the corporate bank account of the client. The money is usually transferred to the client's bank account on the day following the execution of the agreement.

For the client's convenience, due to seasonal activity of the company or other current financial liabilities, the term of payment of the first instalment is arranged within two weeks from the month of loan disbursement.

What financial products are available to the clients of Fundusz Mikro? The loan offer includes several products, the most popular of which are: microloans, traditional loans, loan investment, as well as a start-up loan, i.e. a loan for people starting their business activity and a quick loan.

For microloans, the parameters of the product are so adjusted that entrepreneurs who do not demonstrate their profits or declare losses can use the loan with no limitations. The value of the first loan usually does not exceed PLN 10,000 (EUR 2,500), but in certain circumstances, it is possible to obtain PLN 20,000 (EUR 5,000) at the beginning of cooperation. Advisers of Fundusz Mikro have to check certain documents, including documents of registration of the company and documentation of settlements with the Tax Office. Clearance certificate from the Social Insurance Institution (ZUS) and the spouse's consent for taking the loan are also required. In order to ensure rational risk distribution, there is a requirement to provide guarantors, whose number depends on the loan value. A blank promissory note is issued by the client with the aval.

A traditional loan is a product for people who cannot provide loan guarantors. Since the risk involved in lending a certain amount of money is borne mainly by Fundusz Mikro, the loan value does not exceed the level of PLN 5,000 (EUR 1,250).

Loan investment is another matter. In this case, Fundusz Mikro employs larger amounts, reaching PLN 100,000 - 150,000 (up to EUR 38,000), while the minimum amount offered is PLN 20,000 (EUR 5,000). There are also more options of loan investment collateral. Apart



from the promissory note and the guarantee, transfer of ownership of fixed assets for security purposes, registered pledges and other legal measures are sometimes employed. The period of the loan repayment is longer; repayment of the loan within 36 months is possible. Moreover, a grace period can be granted, depending on the loan value – clients can typically count on prolonging the term of repayment by 3-6 months.

Loans for starting business activity are very popular, although less experienced entrepreneurs have to present their business concepts and ideas, present arguments for their financing needs and find guarantors willing to secure their liabilities in case the business is not successful.

While their loan is still being repaid, all regular clients of Fundusz Mikro can use so-called quick loans to regulate their financial liquidity or to immediately finance their current business needs. The amount that can be granted as a quick loan does not exceed PLN 3,000 (up to EUR 750).

Currently, Fundusz Mikro is expanding its offer by seasonal products and by-products designed especially for particular groups of entrepreneurs. For example, Fundusz Mikro has introduced a Christmas loan and a loan for doctors.

Regular clients of Fundusz Mikro are treated very specially by advisers. They have been invited to workshop meetings for discussions on issues directly connected with all aspects of entrepreneurship. They have particularly appreciated outdoor picnics, at which their families could have fun with music and a barbecue. Christmas evenings, with Christmas carols and plenty of food, are a kind of gift for most appreciated clients who have been cooperating with Fundusz Mikro for years. All clients, both those who have just started their cooperation with Fundusz Mikro and those who have been developing their companies owing to Fundusz Mikro financing, can use the loyalty programme and benefit from having Loyalty Cards. They receive information brochures, prepared especially for them, containing up-to-date information on accounting regulations applicable to small companies.

Procedures involved in the particular activity of Fundusz Mikro are constructed in such a way that they reduce the risk of Fundusz Mikro connected with granting a loan. Owing to such procedures, the company has been operating in the Polish market for over a 12 years and is currently developing very dynamically. It is enough to mention that the increase in the number of loans granted in financial year 2005/2006 was almost twice that of financial year 2003/2004. The number of people employed as advisers has also significantly increased in recent months. The corporate structure has been changed: new units have been established, responsible for comprehensive activities aimed at acquiring a large number of entrepreneurs

interested in financing their business activity. In such a state of affairs, Fundusz Mikro discerns a chance for the development of entrepreneurship in Poland.

## **2. Flood relief programs.**

### Summer – Autumn 1997.

After the flood devastated the south-western part of Poland in the summer of 1997, the Polish-American Enterprise Fund assigned USD 3.5 million to help small enterprises affected by the flood and made Fundusz Mikro responsible for designing and coordinating the aid programme. It was decided that the aid would be disbursed in the form of subsidised loans. Fundusz Mikro quickly prepared all the procedures and documents, defined fair criteria of loan distribution and managed the entire action. The first loan agreements with entrepreneurs affected by the flood were signed on 17 November and 1,834 people received capital and began to renovate their facilities, many of which had been destroyed entirely. Excellent coordination of the action was possible owing to good cooperation with self-government administration authorities in Wrocław, Opole and Kłodzko, which helped Fundusz Mikro to disseminate information and to distribute application forms as well as providing Fundusz Mikro with office premises. Fundusz Mikro also received invaluable help from the media – TV stations and newspapers – through which information about the programme quickly reached all potential borrowers.

Loans were to be repaid in one payment at the end of two years; 85 % of the borrowers repaid their loans on time, and another 10 % with small delays. 95 % of the borrowers managed to overcome the crisis and develop their businesses. For most of them, loans were the only form of help that they received after the flood.

### Summer 2001.

The experience gained during the first flood relief programme was used by Fundusz Mikro during another flood in 2001, in Gdansk and the southern regions of Poland. The action of disbursing subsidised loans was organised in cooperation with the Polish-American Freedom Foundation. Fundusz Mikro disbursed interest-free loans with a total value over PLN 1 million (EUR 250,000). The Polish-American Freedom Foundation covered the operating cost of action.

### **3. Small companies – big potential clients of Fundusz Mikro.**

Jaroslaw, Jan, Zenon Labuda, Private Partnership, Electroplating company.

The workshop of the Labuda brothers in Kedzierzyn-Kozle was destroyed by the flood of 1997. They contacted Fundusz Mikro for the first time then and received support from the flood relief programme. Since 1999, they have been regular clients and have repaid five subsequent loans.

There are very few electroplating companies left in the region of Opole. The three brothers still run the company established by their father in 1968. Although interior design of the workshop does not resemble a twenty-first century company, this branch of industry has also made major technological progress, requiring investment and expenditure. Every metal detail undergoes a long and complex process comprising more than ten strictly ordered operations. Orders can be placed for electroplating of any metal details which need to be rustproof with zinc or nickel coating. Electroplated elements include mixers, elements of compressed air and steam installations, screw and parts of mining machines. The company has nearly 80 regular clients.

Marek Olesinski and Jerzy Pyrzynski, Private Partnership JUMAR – Confectionery manufacturing company.

Jumar is a small company operating in the area of confectionery. It manufactures products made of dough with boiling water: straw puffs and pea-like puff pastry. In 1993 Marek Olesinski took out a loan from the Polish-American Enterprise Fund to purchase a rotary furnace. It was a foreign currency loan and was repaid within two years. The investment bought in a return very quickly. In September 1996, Mr Olesinski obtained his first loan from Fundusz Mikro – PLN 10,000 for purchasing a dough kneading machine. So far, Mr Olesinski and Mr Pyrzynski have repaid five loans with no delay, consequently increasing the quality and competitiveness of their products. The recent loans were spent on obtaining a HACCP certificate and on further investments: modernisation of the packing room, purchasing containers and trucks for transporting goods. The company currently employs eight people. Turnover has increased and their regular client list is growing. Among these clients, there are wholesalers, Warsaw retail outlets and – most recently – large chains stores.

Janusz Puderecki, Non-ferrous scrap metal yard.

Janusz Puderecki obtained his first, start-up loan from Fundusz Mikro in March 2003. The business idea, based on aluminium cans, literally lay on the pavement. Before establishing his business, Mr Puderecki researched the market for a year and a half. He had to learn to whom and for what price he could sell the cans that he would purchase from street collectors. He needed to find where such a scrapyards should be located and to calculate how much money to invest on start-up. Due to high competition and the specific character of the clients, non-ferrous scrap metal yard is not an easy business to run. It requires knowledge of how to cooperate with street scrap collectors and to build a relationship based on mutual respect.

The first loan was needed for purchasing scales for the first yard opened in the Praga district of Warsaw, as well as for working capital. Several months later the company had two yards. Mr Puderecki's experience tells him that everything is constantly changing, so he allows for the possibility that he might change the line of business in the future. He expects that the real-estate market may soon need professional managers; he has therefore recently received his BA from the Academy of Real-Estate Management.

Piotr Stefaniuk & Olga Podlewska-Stefaniuk, Private Partnership Craison – Trade and production of artificial jewellery and gifts.

Mr and Mrs Stefaniuk, who run a family business, have been using capital obtained from Fundusz Mikro since 1997. They are currently repaying their ninth loan. Mr Stefaniuk registered his business activity in 1992. His first company – “Bolszoj-bohema” – was a distributor of artificial jewellery. In 1993, his wife Olga established the “Craison” company operating in the same sector of the market and they have been working together since that time. The beginning was not easy for Stefaniuks – their skills and experience in trading and producing jewellery constituted the main capital of the company. Running such a business also required aesthetic taste as well as manual and artistic skills. The company was the first in that sector to start cooperation with the newly established megastores. Today, “Craison” is a jewellery wholesaler cooperating with nearly 20 stores all over the country and has its own two prestigious shopping centres in Warsaw. It is also a manufacturer of gifts. Plans for the near future include establishing a company in Germany – Mr Stefaniuk is currently researching the market opportunities.

On 18 November 2004, Mrs and Mr Stefaniuk rang the starting bell at the Warsaw Stock Exchange, which officially launched the International Year of Microcredit proclaimed by the United Nations Development Programme.

#### 4. Main risk and problems.

According to Fundusz Mikro's experiences micro-borrowers constitute the riskiest part of the market because of:

- The low level of their economic education and their lack of business experience
- Poor formal documentation
- Their attitude toward the State and financial institutions
- A lack of helpful examples to follow
- A lack of material collateral and small amounts of loans

#### 5. Spectacular award for Fundusz Mikro.

To conclude we are proud to highlight that on the USAID conference "Partners in Transition: Lessons for the next decade" held in Warsaw in October 1999, First Lady Hilary Clinton paid tribute to Fundusz Mikro for its excellent performance and for its work in promoting entrepreneurship.

#### 6. History and results 1994 – 2007.

Date of registration:	December 1994
First loan disbursed:	February 1995
Number of loans disbursed:	95,323
Number of current clients:	14,000
<b>Gender breakdown:</b>	
Women	44 %
Men	56 %
<b>Type of business:</b>	
Trade	50 %
Services	42 %
Production	8 %
<b>Loan purpose:</b>	
Working capital	37 %
Investments	63 %
Total number of employees	150
Local branches	37
Total value of disbursement (in EUR)	188,785,350
Total loans written off /0.37%/	705,100
Total value of repayments	169,102,320
Total value of balance outstanding	19,683,030

(Data as of February 2007)

Author: Krzysztof Jaczewski, President of Fundusz Mikro

## Microfinance Fund Germany.

### 1. Introduction.

The 'Mikrofinanzfonds Deutschland', or the Microfinance Fund Germany ("the Fund"), was launched in September 2006. It serves to build up and strengthen regional microfinance institutions and initiatives, which advise and accompany start-up and post start-up businesses, and moreover, provide them with micro loans (in a function as so-called micro lenders). At present there are still gaps in the availability of micro loans in Germany. The purpose of the Microfinance Fund is to contribute to extending the offer of such loans and support the microfinance institutions in professionalising their activities. At the same time the Fund aims at contributing to a more efficient use of funding by bringing advisory and financing services together. Currently start-ups can already access publicly-funded consulting services in many places, e.g. in specialized start-up centres. However, subsequent to the advisory process there are very often no loans available. The Fund is designed to help start-ups and young enterprises (up to five years from start-up) who have convincing business ideas to obtain loans of EUR 5,000, on average, with a term of about two years.

Basically, the Microfinance Fund Germany is a guarantee fund which, for a fee, relieves the participating banks of the entire default risk resulting from their micro loan business.

### 2. The Microfinance Fund Germany: How it works.

Entrepreneurs take their business ideas to a microfinance institution. These are start-up centres or management consultancies, which may have public or private backing and which have decided to build up an additional line of business in the field of microfinance. For approval by the Fund, microfinance institutions first have to pass through an *accreditation process* which ensures that all participating microfinance organisations dispose of the required expertise and conform to uniform quality standards. The accreditation process involves both, a financial and time wise commitment on the part of the applicants.

The Microfinance Fund Germany charged the German Microfinance Institute (DMI) with implementing the accreditation process for interested microfinance organisations. In April 2004, the DMI was set up as a "Verein", an association of organisations offering start-up advisory services. Main purpose of the DMI is to assist founders and young enterprises in obtaining funds. At present the DMI has 54 members throughout Germany.

Its key functions are:

- a) Supporting local microfinance institutions as they build up their organisation.
- b) Equipping them with the technical tools required for processing loans.
- c) Arranging capital funding to protect them from default risks.

There are currently 11 accredited microfinance institutions located in many different regions in Germany. (Further information on the organisations which are already accredited can be found at [www.mikrofinanz.net](http://www.mikrofinanz.net)).

The microfinance institution evaluates the start-up's business plan and may advise on its further development as appropriate. In case the micro lender comes to the conclusion that both, entrepreneur and business concept, are likely to succeed, he forwards a loan application to a cooperating bank together with a favourable *loan recommendation*. The latter contains specific details of the loan agreement, e.g. the term of the credit etc. In principle, all interested banks can cooperate with the Microfinance Fund Germany. If the micro lender does not find a cooperating bank locally, the GLS Bank, which is also an investor in the Fund, is willing to take on this role.

The cooperating bank is fully exempt from liability by the Microfinance Fund Germany. As a rule, therefore, it is likely to follow the loan recommendation submitted by the microlender and disburse the loan. Before doing so, it enters into a standardised loan agreement with the start-up or young enterprise. To comply with the provisions of banking legislation, the Fund's acceptance of liability towards the bank takes the form of a cash deposit. If a borrower defaults on a loan, the bank can immediately tap into this deposit.

The *scope of the product* currently provides for a maximum loan volume of EUR 10,000. As a rule, the term is around 18 months. Amortization usually takes on the form of monthly annuities, and there is no grace period. Loan interest currently amounts to 10 % p.a. The bank passes on part of its interest income (currently 5 % p.a.) to the Fund as a fee for the latter's acceptance of the loan liability. It also passes on the bank account data to the microfinance institution which advises the borrower.

The microfinance institution is particularly motivated to work well and only recommend loans for the benefit of start-up concepts which have real prospects to succeed. The main reason is that it assumes a 20 % *first-loss liability* on an annual basis on the portfolio of loans that it recommends.

The institution undertakes not only the appraisal of the business project and the issuance of the loan recommendation but also looks after the start-up for the entire term of the loan. If any difficulties arise, e.g. payment defaults, the institution is responsible for "crisis intervention". It is also responsible for pursuing damages and, if need be, the liquidation of securities.

As remuneration for its efforts in connection with the extension and management of the loans as well as the assumption of part of the credit risk, the Fund pays the microfinance institution a fee equal to 10 % of the repayments received by the cooperating bank on the recommended loans. That means, in effect, that successful microlenders stand to make a profit if their recommended loans default at a rate, which is lower than 10 %. In that case their fee income is higher than their expenditure under the first-loss liability.

The microfinance institution provides the DMI with regular reporting comprising critical data (e.g. total loan volume under management, loans with amended loan agreements and loans carrying particular risks). Since it is not involved in the individual credit decision, the Microfinance Fund Germany monitors these data closely to be able to anticipate emerging risks early-on and initiate appropriate action. For instance the microfinance institution must draw up a plausible action plan if the share of the loan portfolio at risk (e.g. loans featuring late repayments) exceeds 15 % of the total loan volume or its *annual default rate* exceeds 10 %. If necessary, the Fund can also stop an individual microlender from recommending further loans.

All the rights and obligations of the cooperating partners concerned (Microfinance Fund Germany, DMI, the cooperating bank and the microlender) are defined in advance in a comprehensive *Cooperation Agreement*.

The following chart shows the various partners' roles within the Microfinance-Fund Germany-scheme.



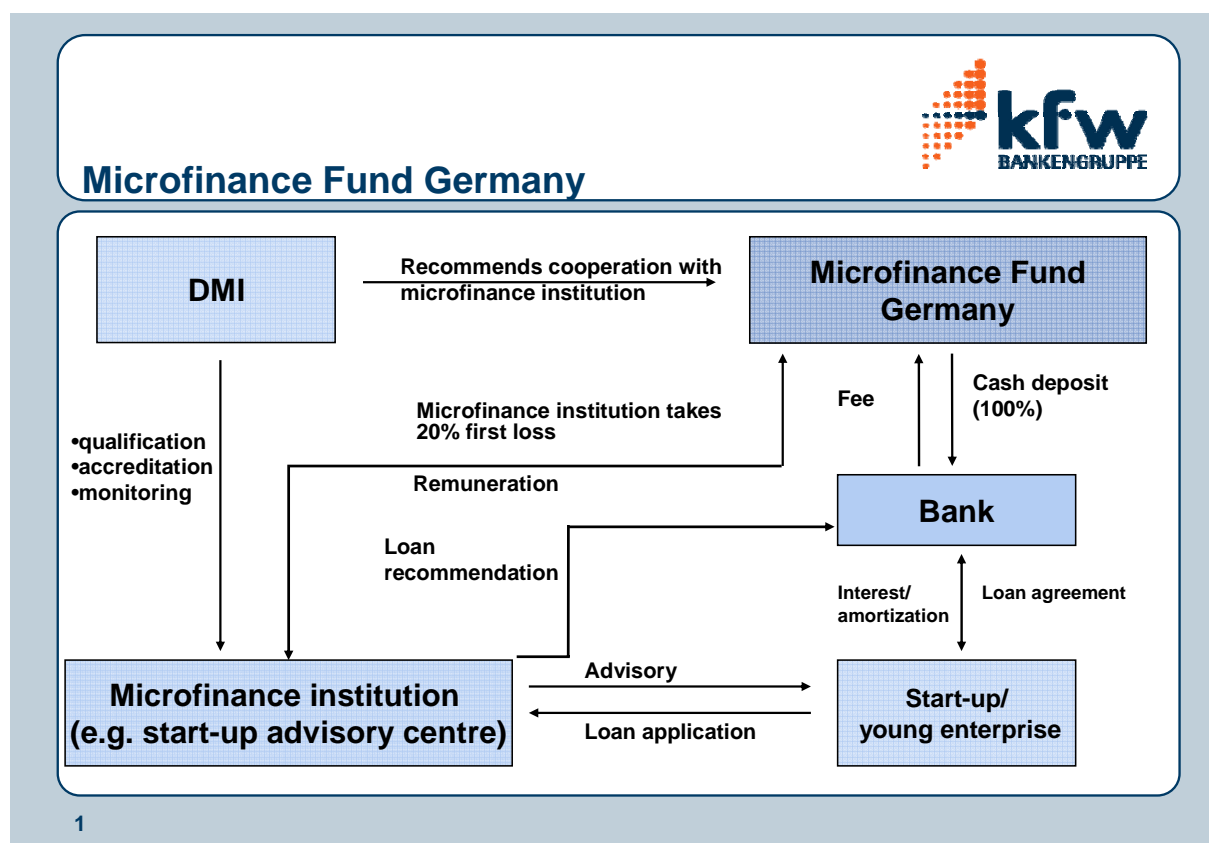


Figure 1: Microfinance Fund Germany

### 3. Organisation and economic efficiency of the fund.

The following institutions have participated as *investors* in the Microfinance Fund Germany, each contributing approx. EUR 500,000: GLS Bank (together with clients/business partners), the German Federal Ministry of Economics and Technology (funded by the ERP Special Fund), the German Federal Ministry for Labour and Social Affairs (funded by the European Social Fund – ESF – resources) and KfW Bankengruppe. Thus a fund volume of EUR 2 million is available for the pilot stage.

Legally the Fund is a special purpose vehicle within GLS Bank, which manages the Fund through a trust. The investors have appointed GLS Beteiligungsgesellschaft (a GLS Bank subsidiary) as trustee. The trustee administers the Fund's day-to-day business according to the stipulations of the governing board of the Microfinance Fund Germany. All investors are represented in the Fund's Board of Governors, which takes all the fundamental decisions. These include decisions on the product framework for the micro loans, the investment of Fund assets and the core elements of the Cooperation Agreement. The tasks of the Microfinance Fund Germany are laid down in its statutes.

The Fund's *economic efficiency* can be shown from the following:

As commission the Fund receives from the cooperating bank half of its interest income on the micro loans that it guarantees (i.e. 5 % p.a.). This low level of fee means that the Fund needs additional support to be able to cover a) its administration cost and b) the scheduled fee payments to the micro lenders (10 % of the repayments received by the cooperating bank) for their efforts in connection with the extension and management of the loans and the assumption of risk. However, since the investors are waiving interest on their capital contributions, the Microfinance Fund can generate the additionally required income from investing its assets. Here, an average interest income of 4 % p.a. on the investment is assumed. On the basis of the above assumptions (5 % p.a. commission for assumption of liability and 4 % p.a. interest income), the volume of loans guaranteed by the Fund must not be more than about half the Fund's assets for the Fund to have sufficient income at its disposal to pay the micro lenders' remuneration.

Since the microfinance institutions assume the first loss piece (up to 20 % of the volume of the loan portfolios they have recommended), the Fund's assets will only begin to shrink if the default rate of the loans guaranteed by the Fund exceeds 20 %. What the investors are aiming for is the preservation of the Fund's capital in real terms.

#### **4. Key conceptual aspects.**

The Microfinance Fund attempts to closely link the functions *financing* and *consultancy support*. This approach holds several advantages. For the start-up, it makes things easier because it can deal with one counterpart who is constantly available with advice and can also offer funding. Another important point is that the bank is relieved not only of the entire risk attached to the loans but also of a substantial part of the administration costs. This is of fundamental importance in encouraging the banks to extend micro loans.

For the offer of consultancy services, the Microfinance Fund Germany relies on advisory organisations which are either already established or are in the process of entering the market. These institutions participate in the advantages and risks of the microlending scheme through a sophisticated incentive system. The system comprises the assumption of the first-loss liability, a close monitoring scheme (with risk indicators such as portfolio-at-risk) and a remuneration arrangement. It prompts microlenders to be particularly careful in preparing and checking their credit decisions and in managing the loan portfolio and it is geared to ruling out moral hazard.

Resources from the European Social Fund (ESF) have been invested in the Microfinance Fund Germany via the German Federal Ministry for Labour and Social Affairs. To date this is

one of the few examples in Europe for this type of use of EU Structural Funds.. The advantage of such an "innovative use" of EU Structural Funds compared to granting subsidies is the revolving nature of the ESF support. As soon as the ESF funds are "released" from the cash deposit with the lending bank after the full repayment of the microloan, they can be used once more as collateral for further microcredits. In addition, the ESF funds generate interest income which accrues to the Microfinance Fund as an additional promotional element. This way the effectiveness of the ESF funds can be substantially increased when compared to the award of grants.

All in all, the Microfinance Fund represents an important step in the improvement and extension of the availability of microfinancing and the professionalisation of the microfinance scene in Germany. This also leads, ultimately, to a more effective deployment of public promotional funds. For while public support is already available in many places funding organisations advising young enterprises, the important next step, namely an appropriate offer of debt, financing has in the past often been missing.

## **5. Developments since the start of the Microfinance Fund Germany and prospects.**

As of March 2007 28 loans with a total loan volume of 200.000 EUR have been committed. Total lending is thus still low, but one has to keep in mind that this was the start-up phase of the Fund. In any event, the Fund's service has not been conceived as a "mass product". Only those banks and institutions which have a long-term strategic interest in the microfinance business, going beyond short-term profit considerations, will be considered as cooperating partners. After all, the cooperating partners must make the one time effort to check and implement the terms of cooperation. In addition, some microfinance institutions have problems committing the resources for the assumption of the 20 % first loss piece. In principle, though, the model offers institutions which are or want to become active in the microfinance business, many advantages. Cooperating banks can position themselves in this microcredit market without exposure to new credit risks and without having to fear the subsequent expenses inherent in the lending business (e.g. in connection with liquidating securities) which so often discourage them. Start-up advisers can now help their clients to obtain a loan after having gone through a successful advisory process, thereby tapping into new business opportunities for themselves. From 2008 onwards, the Microfinance Fund Germany anticipates to achieve an annual loan volume of approximately EUR 1 million spread over some 200 loans with an average loan value of 5,000 EUR.