September 2004

POLICY BRIEF
FINANCIAL LADDERS OUT OF SOCIAL EXCLUSION.
EQUAL MICRO-FINANCE[1]

1. THE PROBLEM

There is a recognised shortage in the *supply* of finance from banks to support small-scale income generating activities by under-represented groups[2] [3]. The most important reasons are:

- o The high transaction costs of managing loans of under 25,000 euros which lowers the returns to conventional financial institutions.
- o The fact that people who face discrimination in the labour market often lack both collateral and experience (a track record). This increases their risk to financial institutions according to traditional methods of assessment.

Studies also show that ethnic minorities refer to difficulties in accessing finance as the most important barrier to setting up a business, women as the second and young people as the third[4]. Regulatory reform[5] and the gradual withdrawal of traditional banks from the local and mutual economy, partially due to the pressure from the banking regulations and Basel II, are predicted to make things worse[6].

However, there is also evidence[7] that there are problems related to the *demand* for micro-credit. Not all projects and people are "investment ready". The take up of micro-credit is heavily affected by the competing availability of grants and the tax and social security implications of setting up a business.

In this highly complex scenario, it has become clear that it is not enough simply to increase investment in funds which offer smaller loans. On the one hand, the take up such funds has been slower and less than expected in some countries and regions. On the other, some people warn that an indiscriminate increase in small loans could simply increase problems of over-indebtedness (resulting from credit card and consumer loan abuse) among certain sections of the population. The key problem, therefore, appears to be not just *how much* finance is offered to groups that face discrimination in the labour market *but what kind*[8]

2. NEW SOLUTIONS : GOOD PRACTICE FOR EQUAL[9]

Although it cannot be said that the individual solutions being tested by EQUAL constitute global innovations to micro-finance methodology, they do provide a series of lessons of how to integrate different aspects of micro-finance and to adapt them to the real needs of specific target groups in quite different national and regional contexts.

RESEARCH INTO NEEDS AND EFFECTIVE OUTREACH FOR SPECIFIC TARGET GROUPS.

EQUAL[10] demonstrates how important it is to find out about the real (rather than assumed) financial and business needs of disadvantaged groups. Given the degree of financial and social insecurity some disadvantaged groups face, one needs to guard against taking steps which do not take into account that one or more sources of income (paid work, social security, informal work) could be jeopardised. A shift is required from simply selling a specific financial product to adjusting both products and services (based on solid experience of or research into the target groups) so that they genuinely help to increase income flows and the ability to repay the loan.

EQUAL has carried out more formal types of research[11] as well as supported efforts by seasoned micro-credit players that branch out and "feel" their way into providing finance for new groups such as ethnic minorities who rely wholly or partly on the informal economy[12] This demonstrates how effective marketing and outreach is essential to deliver finance to these groups.

CREATING A SENSITIVELY DESIGNED PACKAGE OF MENTORING AND BUSINESS SUPPORT TO COMPLEMENT MICROCREDIT

EQUAL shows the need within strong welfare states to complement financial products with a sensitively designed package of mentoring and business support to increase investment readiness. One can discern at least two models. Firstly there are schemes which focus on social support. In some cases, the financial support is totally dwarfed by the "soft" services and is just a small tool of the latter[13] (eg loans of under 500 euro). Secondly, there are approaches which focus more on innovation within the financial circuit. However, both types agree that the services should *never* be used to mask poorly designed financial products.

The content of the business support provided has to be designed to meet the needs of the specific target public and context. This often involves what has been called "financial capacity building" (teaching people how to manage diverse income flows in a way that they can gradually capitalise their activities). However, the initial process of screening and the knowledge that is built up about both the characteristics of the people and the strength of their business plan is also seen as a guarantee against excessive risk.

Mentoring of all kinds is probably the most extensively used form of support. Given the vagueness surrounding this term, EQUAL has worked towards common standards, benchmarks and systems of quality control for mentors[14].

Another associated support service is the provision of incubators (real or virtual) in order to tackle [15] the absence of consistent support after the business creation and loan provision.

ADAPTING FINANCIAL PRODUCTS AND METHODS TO THE SPECIFIC NEEDS OF CLIENTS.

At present, the main focus within EQUAL seems to have been on even *smaller sized* loans and exploring the use of the various techniques for controlling risk (substitutes for collateral). Many loans have been much below the 25,000 euro official definition of a micro-credit. Most seem to be around 5,000 euros with relatively few schemes with loans of over 15,000 euros.[16]

The need for *collateral* is seen as a major obstacle to credit. In addition to using guarantee schemes such as those of the EIF, EQUAL has demonstrated two ways to deal with this risk. As mentioned above, the first is to substitute a detailed knowledge of the person and the viability of the project for the need for material guarantees, with support services using various methods for simplifying and unifying the documents required for business plans and applications.[17]

The second method is to substitute individual guarantees with group or *peer* pressure[18]. Many of the same schemes also favour "*Step lending" -* starting with relatively small loans which are renewed progressively after short periods.

There seems to be a growing consensus that *interest rates* are not the most important factor and should be set close to market rates (and frequently higher) in order to increase the sustainability of the funds. Some funds make a fixed service charge in order to avoid religious objections to the payment of interest.

USING PARTNERSHIPS TO BRING IN ORGANISATIONS WITH FINANCIAL, BUSINESS AND SOCIAL EXPERTISE

EQUAL has been successful in bringing together the public sector, banks, specialist microcredit intermediaries (providing for example a credit board for approval of loans, collateral, supervision of repayments and debt collection) and organisations dedicated to providing the patient business support (in terms of training, coaching, mentoring, monitoring and control) required by hard to reach groups[19]. The non financial organisations often work as the port of entry to the financial organisation. [20]

ENGINEERING BOTH ORGANISATIONS AND FUNDING SOURCES TO MAXIMISE SUSTAINABILITY.

Although there are exceptions[21] most of the funds connected with EQUAL aim for operational sustainability[22]. The first strategy is to increase the critical mass of operations[23] by bringing fragmented microlending initiatives together. For example, the German EQUAL Thematic Group has brought together 22 microlending initiatives together to form the "Deutsches Mikrofinanz Institut and create a single Federal Fund for Microlending Initiatives backed by EIF guarantees. Local initiatives will tap into this fund by adopting a tripartite common local funding model, thereby, increasing their economies of scale.[24]

A second strategy, followed by many European organisations, is to shift many of the additional costs of dealing with disadvantaged groups onto the support side of the operation. After an initial start-up grant the financial activities themselves are expected to be self-sustaining whereas the necessary business support requires 70-100% public grants[25].

Several of the longer standing financial operators within EQUAL are able to provide excellent evidence of the cost-effectiveness of their support (for example one tenth of the annual cost of unemployment in France)[26]. In fact the average cost of support for MC schemes in Europe is reported to be under 5,000 euros per job created. [27] In purely economic terms this makes intervention worthwhile even if the job created only lasts a year. However, most EQUAL initiatives show business survival rates of well over 60% after 2 years. In addition, there is the change of mentality, confidence and capacity in people who start to feel that they are serious "clients" of a financial institution rather than the beneficiaries of social support.

Finally, the importance of networking, training and financial capacity building (especially in the use of structural funds and other funding sources[28]) is to be noted. Benchmarking and accreditation services have been provided. [29]

3. RELEVANCE AND POLICY IMPLICATIONS

At its meeting of 20 and 21st March 2003, the European Council highlighted the importance of promoting entrepreneurship through an action plan and measures to increase access to finance, and for the first time, stressed the importance of micro-credit.

In this context, the European Commission relies on two main instruments for promoting micro-credit. Firstly, there is the micro-credit guarantee window managed by the European Investment Fund (250 million euro). DG Enterprise recommends expanding this and other micro-credit instruments in its Action Plan on Entrepreneurship[30] and its recent consultation document for a new Community Support Programme for Entrepreneurship.[31]

Secondly, there are the various "risk capital" schemes, including micro-credit, financed through the Structural Funds in a decentralised way in the various Member States and regions of the EU. Total spending on these schemes now stands at around 1 billion euros between 2000-6 or approximately 15% of grant aid to SMEs.

DG Regio provides three reasons for expanding these schemes[32]. Firstly, that "despite many years of providing grant aid from the Structural Funds on a massive scale, regional disparities have not diminished significantly and alternatives therefore have to be considered." Secondly, risk capital financing methods are better suited to the knowledge economy. Finally, "with increasing demands on EU resources arising from the accession of Central and Eastern European countries there is a need to make funds work harder".

It is this last point that could drive an expansion of policy instruments directed at micro-credit. In the current financial climate micro-credit and other types of fund offer public officials a number of advantages over one-off grants: they are normally matched by at least 50% *private* co-funding, investment in the fund is treated as expenditure actually incurred (thus helping with automatic decommittment rules in cases of underspending of funds), and the loans returned to the fund can be reinvested without any restrictions (thereby contributing towards sustainable exit strategies for objective 1 and 2 regions).[33]

Until recently, most of the financial engineering supported by the Structural Funds has come from the Regional Fund. The Social Fund has traditionally focused on “soft” investments in human capital. However, as mentioned, there is now a growing recognition that one of the crucial factors in the success of micro-credit schemes is a sensitively designed package of finance and other services. As a result, there is now major interest in at least 7 Member States about how to use the Social Fund along side the Regional Fund to support micro-credit initiatives.

The experience of EQUAL can offer the following recommendations that are relevant to the European policy framework.

Financial initiatives to disadvantaged groups would benefit from:

- solid previous experience of the target group and/or sound research into financial needs
- an integrated package of mentoring and advice in order to build the financial capacities of the disadvantaged and reduce risk for the initiative (not necessarily provided by the same organisation)
- products and methods that are adapted to the target public, taking account of different methods of guaranteeing/covering risk. Far more experimentation is required particularly in the transition from welfare to entrepreneurship. Possibilities include mutual guarantees, micro guarantees, mezzanine products, insurance products to manage insolvency risk
- reinforcing sector specific national and European networks to increase sustainability and improve both hard and soft skills.
- using partnerships with social services and other frontline support workers for bringing financial institutions closer to disadvantaged clients

The European Social Fund and the Regional Fund programmes would benefit from further use of financial engineering, backed up with adequate training and technical assistance on how to use different EU financial instruments in more creative and productive ways. Existing microcredit networks are well placed to provide this kind of support.

Finally, there is a need to document and highlight the changes required in framework conditions. For this relevant public sector actors must involved in the partnerships. These conditions include: progressive tax regimes which facilitate the transition from the informal to the formal economy, the legal situation of migrant workers, the extension of unemployment benefits during the early stages of starting a business and interpretations of the banking regulations.

APPENDIX – SIMPLIFIED PROBLEM AND SOLUTION TREES

OVERVIEW OF PROBLEMS DEALT WITH BY THE POLICY BRIEFS

Insufficient jobs created to meet the Lisbon employment targets.

Wasted economic and social potential
Unmet social need

Lower rates of entrepreneurship among certain groups and areas

Perceived benefits of becoming an entrepreneur do not justify the risks

INFORMATION, ADVICE AND SUPPORT ON THESE AREAS DOES NOT MEET THE NEEDS OF GROUPS AND AREAS AND THAT FACE DISCRIMINATION IN THE LABOUR MARKET
WORKSHOP 1 – THREE BRIEFS

Specific socio –economic barriers (responsibility for caring, language, culture, access to buildings…)	Hurdles in: Taxes & benefits Legal restrictions Administrative procedures	Absence of role models. Poor entrepreneurial education	Lack of Skills	Lack of appropriate technology (ICT)	Poor access to finance Workshop 2 - two briefs	Poor access to markets

CERTAIN GROUPS AND AREAS HAVE WORSE ACCESS TO KEY RESOURCES <u>AND</u> SUFFER FROM SPECIFIC DISADVANTAGES IN SETTING UP A BUSINESS

PROBLEMS DEALT WITH IN THE BRIEFS ON MAKING FINANCE ACCESSIBLE TO ALL

THE RIGHT KIND OF FINANCE FOR SETTING UP A BUSINESS IS NOT ACCESSIBLE TO GROUPS THAT FACE DISCRIMINATION IN THE LABOUR MARKET OR TO SOCIAL ENTERPRISES
WORKSHOP 2 – TWO BRIEFS (4 + 5)

BRIEF 4	BRIEF 5
The right kind of finance is not accessible to <u>groups that face discrimination in the labour market</u>	The right kind of finance is not accessible to <u>social enterprises</u>.
There is a lack of information about financial needs and little contact with groups that face discrimination	There is little information about the financial needs of social enterprises
Many groups do not receive the kind of business support required for accessing and using the financial products on offer	Social enterprises often do not have the necessary skills in financial management
Financial products are not adapted to the needs of disadvantaged groups	Financial products are not adapted to the needs of the social economy
There is little contact between banks, business support and community workers	Social enterprises face particular problems in obtaining guarantees
Many financial initiatives for disadvantaged groups cannot survive without public subsidies	

BRIEF 4
EQUAL MICROFINANCE
CORRESPONDENCE BETWEEN PROBLEMS AND SOLUTIONS TESTED BY EQUAL

The right kind of finance is not accessible to groups that face discrimination in the labour market

PROBLEM	SOLUTION TESTED BY EQUAL
There is a lack of information about financial needs and little contact with groups that face discrimination. No clear targets	Research into needs and effective outreach
Many groups do not receive the kind of business support required for accessing and using the financial products on offer	Specially designed packages of mentoring and business support to accompany the finance
Financial products are not adapted to the needs of disadvantaged groups	Tailoring financial products and lending methods to specific needs
There is little contact between banks, business support and comunity workers+ government	Using partnerships to link organisations with financial, buisness and social expertise
Many financial initiatives for disadvantaged groups cannot survive without public subsidies	Organisational change and networks to increase sustainability
Lack of professionalisation (new; old)	Capacity building

FOOTNOTES AND REFERENCES TO POLICY AND GOOD PRACTICE

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[1] This is the first of two briefs on access to finance for all. It deals with all the strategies for both *finding out and reaching out to disadvantaged groups*. This brief deals with aspects of *micro-finance* and how to deal with social exclusion, while the second brief deals with *finance for social enterprises*. See the diagram in the appendix for an overview of the problems and solutions dealt within each brief.

[2] "Insufficient supply of micro-loans is a major issue, in particular where business creators are unemployed persons, women or ethnic minorities. Supporting micro-loan supply is, therefore, not only an issue of entrepreneurship and economic growth, but also of social inclusion."
Microcredit for Small Business and Business Creation: Bridging a Market Gap. DG Enterprise. 2003.
http://europa.eu.int/comm/enterprise/entrepreneurship/financing/docs/microcredit_report_en.pdf

[3] "Access to finance is harder for SMEs in particular geographical markets, stages of development and industries." Strategic Evaluation of Financial Assistance Schemes to SMEs. Final Report. DG Budget. 2003
http://europa.eu.int/comm/enterprise/entrepreneurship/financing/docs/microcredit_report_en.pdf

[4] Young Entrepreneurs, Women Entrepreneurs, Coentrepreneurs and Ethnic Minority Entrepreneurs in the European Union and Central and Eastern Europe. Final report to the European Commission. DG Enterprise. July 2000
http://europa.eu.int/comm/enterprise/entrepreneurship/craft/craft-studies/documents/completereport.pdf

[5] "Regulatory reform (Basel II) will make access to finance harder going forward" so that "the rationale for intervention will be even stronger in the future". Strategic Evaluation as in 4.

[6] Socially orientated financial networks like FEBEA point to the "general withdrawal of (mainstream) banks from the local economy" and of the "gradual loss the traditional banks of the local and mutual economy (e.g. credit cooperatives) by de-mutualisation, merger or privatisation". Banking regulations tend to place additional obstacles on these traditional forms of community finance and this can open the door to less scrupulous forms of lending. European Federation of Ethical and Alternative Banks and Financiers. Presentation. http://www.febea.org

[7] Entrepreneurship and Local Development. OECD 2003.

[8] All the evidence suggests that micro-credit works best in most environments with a strong welfare state when it is offered as part of an integrated package of support which is carefully adapted to deal with both the supply and demand constraints in each particular context. This means a radical shift in approach from simply selling a specific financial product to adjusting both products and services so that they genuinely help to increase income flows and the ability to repay the loan.

[9] Five national *Community Initiative Programmes* explicitly refer to better access to finance for groups and areas facing disadvantage within the labour market: the UK, Spain, Portugal, the Netherlands and Greece. This is reflected in the priorities of the *National Thematic Groups* of the same 5 countries. The German NTG has also taken up this issue with force.

There are also *11 Trans-national Cooperation Agreements* dealing with access to finance. Finally, a total of *26 Development Partnerships in 9 member states* have been identified as working on this issue. Appendix 1 provides tables of references to TCAs and DPs and some of the experience and tools that can be shared (separate document). The following examples highlight some of the main lessons:

[10] Benchmarking microlending schemes and facilities in the CEFT Partner countries. The study carried out by the CEFT Trans-national Partnership on Benchmarking Microlending Schemes points to the huge differences in institutional contexts, the target groups and the schemes included under micro-credit in just four member states (the UK, Germany, the Netherlands and the Czech Republic).Benchmarking microlending schemes and facilities in the CEFT Partner countries.

[11] For example, research by EQUAL projects in AWE DP and the Power Loan Fund in the UK show that many women prefer to set up businesses in a more tentative manner, requesting significantly smaller loans than their male counterparts (as low as 65-650 euros in some cases). Other significant barriers affecting women are the exclusion of part-time businesses and certain traditional sectors, low levels of benefit disregard and traditional risk assessment criteria.

[12] ADIE's consolidated branch structure, its links within the communities, and the word of mouth contacts fostered by lending groups have allowed it to progress rapidly using one EQUAL project to deliver 242 loans of between 1000 and 5000 euros in 2003 compared to 76 in 2002, mainly to African women in the informal economy. However, in most cases, the women's rise in income has not been sufficient to justify the leap in costs associated with regularising their activity. Another DP, Cyfenter (Wales), has taken up this issue of how to smooth itineraries into self employment through a comparative study of social security and tax regimes Wales and 6 other Member States and the US.

In Spain , Un Sol Mon has been able to build up a better understanding of the financial needs of gypsy and other ethnic minorities through close discussions with social services and the personalised programme of advice carried out the other project partners. This does allow their clients to present a viable plan for income earning activity, however modest. The financial services can then be more closely matched to real situation. However, in this case, the lack of solid community networks among the groups and organisation means that progress has been much slower.

All the partnerships stress the importance of good communication strategies. Nevertheless many argue that it can take *at least a year* to build up the relationship of trust required for lending to take off within hard to reach communities.

[13] For example, main financial product offered by Un Sol Mon, in Barcelona, is a loan of an from as little as 600 euros to a maximum of 15,000 euros with a fixed 6% interest rate (their average is 8.000 euros but many schemes offer loans of 2-3,000 euros).oans of under 500 euros by the Power Loan Fund

[14] Mentoring Trust, Cyfenter, Exzept and the German NTG…

[15] CEFT benchmarking exercise quoted above. An interesting exeption, is the aftercare system used by the WDA in Wales (Cyfenter DP).

[16].For example, the main financial product offered by Un Sol Mon, in Barcelona, is a loan from as little as 600 euros to a maximum of 15,000 eurso with a fixed 6% interest rate. Their average is 8,000 euros. However many schemes offer loans of 2-3,000 euros.

[17] Finance Wales (Cyfenter DP) has developed an electronically supported tool that allows for a fast track application of loans up to 10,000 pounds

[18] For example, one of the DPs in which ADIE is involved has set up 86 active groups of made up of 3 women immigrants in just two years. The groups not only take joint responsibility for the loan but also permit loan officers to deal with three parallel applications at a time. As a result one loan officer is able to deal with around 100 applications pa rather than the average 40. Variations of peer lending can be seen in the Credit Peer Scheme of Enigma Siebte Säule (Exzept), the Bangladeshi women involved with Street Cred in East London and the Full Circle Project in

Norfolk (AWE DP). 40 of the original 56 womens lending groups set up by Full Circle still meet after 5 years thus providing an informal system of after-support.

[19] For example, in the Sant Cosme Innova DP, Caixa de Cataluña provides part of the funds, Un Sol Mon Foundation provide the financial expertise while a specialist organisation called FIAS provide the expertise in the mentoring pathways required to support disadvantaged groups into self-employment. The Local Authority of Prat de Llobregat is responsible for the overall development of the neighbourhood and provides the public legitimacy for accessing the structural funds required to set up the micro-credit fund.

[20] The German Thematic Group on Entrepreneurship has in fact produced a national model for providing microcredit under the current German Credit Services Act. This involves a partnership between a start-up centre providing training, coaching, mentoring, monitoring and control, a bank and a specialist microcredit intermediary (credit board for approval of loans, collateral, supervision of repayments and debt collection). This has been taken up by the Deutsches Mikrofinanz Institut (see below).

Several DPs in Spain have formed partnerships between local savings banks (Cajas de Ahorro). and specialist support agencies with a strong focus on guarantee schemes. There is growing interest in this kind of partnership.

[21] The benchmarking exercise carried out by the CEFT TCA points out the need to distinguish between "social" microlending and microlending aimed at self-sustainability. The Princes of Wales Trust (an EQUAL partner) is an example of the former. It makes around 3,000 loans p.a. of up to 5,000 pounds to young people who have been rejected by the banking system and accepts default rates as high as 48%. However, even at these levels, it must be remembered that micro-credit funds lever in at least 50% private match funding. Even if a proportion of the loans are not repaid, part of the public investment returns to the fund after a period and become available for further rounds of lending. This is a far more sustainable use of public money than a one-off grant.

[22] For example, ADIE made just over 4,500 loans p.a. of up to 5,000 euros in 2002 with default rates of 6.8%. Un Sol Mon in Spain achieves similar rates in Spain.

[23] Both the Princes Trust (3000 loans) and ADIE (4,500 loans) are considered as relatively large micro-credit operators to disadvantaged groups. Most local funds are much smaller (many under 100 loans p.a.)

[24] The "Deutsches Mikrofinanz Institut is developing methodology, benchmarking, training and accredition. It publishes "Micro-Lending News and holds a series of promotional events. Many of the financial partners of EQUAL are closely integrated into the main European Microcredit Networks[24] and are actively providing training and technical assistance to new and existing projects.

[25] As mentioned before this strategy should not be used to mask poorly designed financial products. Some more finance focussed organisations either cannot spread costs in this way or prefer not to. In these cases there is a need for more flexibility in terms of the structural fund limits on management costs.

[26] ADIE estimates that its own costs are around 2,000 euros to provide the support required to create a micro-business. This is one tenth of the annual cost of an unemployed person in France. It is not surprising that ADIEs activity is increasing by 25-30% per year.

[27] Estimates of between 1 and 8,000 euros - Financial Instruments of the Social Economy in Europe and their impact on job creation, 1997. Under 5,000 - Finance for Local Development 2002: http://www.localdeveurope.org

[28] For example, EQUAL Credit, a pilot action of the ERDF Recite II programme, involving many of the main European microcredit players.

[29] The European Microcredit Network: http://www.european-microfinance.org INAISE: http://www.inaise.org FEBEA: http://www.febea.org

[30] Action Plan: The European Agenda for Entrepreneurship COM(2004) 70 final http://europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0070en01.pdf

[31] Consultation Document for a Community Support Programme for Entrepreneurship and Enterprise Competiveness 2006-2010. DG Enterprise 2004. http://europa.eu.int/comm/enterprise/enterprise_policy/spec/documents/pace_consultation_document.pdf

[32] Guide to Risk Capital Financing in Regional Policy. Directorate General for Regional Policy 2002. http://europa.eu.int/comm/regional_policy/newsroom/document/pdf/draft_venture_financing_guide.pdf

[33] These policies operate in a much larger and more complex context than is commonly supposed. For example, a *sample* of micro-credit operations covered in recent report by DG Enterprise totalled 3.5 billion euros[33]. In Italy alone there were estimated to be around 90,000 micro-credits per annum totalling some 1.5 billion euros. As has been mentioned, this is a market that was traditionally supplied by the credit cooperatives, mutuals and local savings banks which are now facing major difficulties, partially due to the pressure from the banking regulations and Basel II. Specialist micro-credit organisations and instruments play a small but vital role within a much larger sector