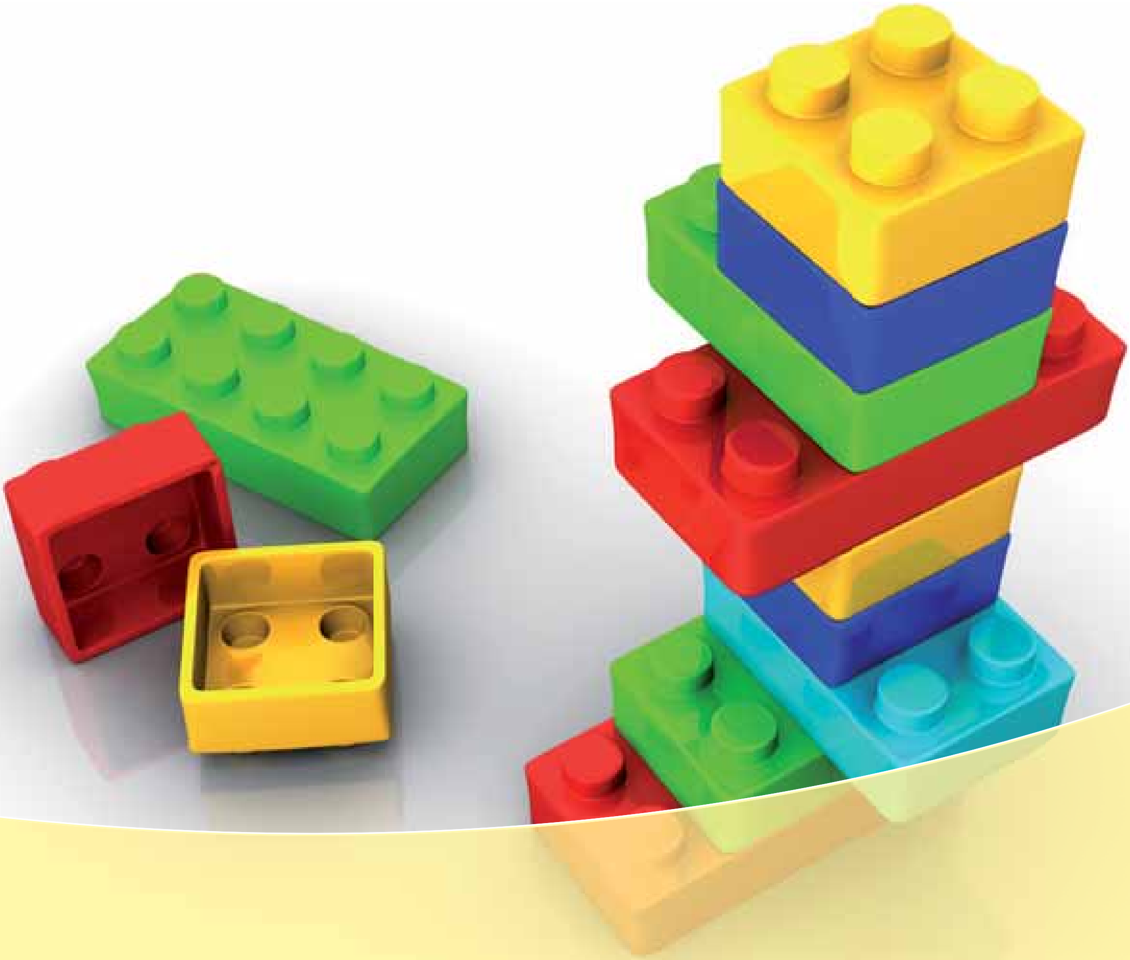

GAINING SCALE IN MICROCREDIT

Can banks make it happen?

A report on two workshops organised by the Directorate-General for Enterprise and Industry

cip competitiveness and innovation framework programme 2007–2013

European Commission
Enterprise and Industry

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Executive summary

For the European Commission, developing the supply of microcredit is important because it encourages new businesses, stimulates economic growth and can help counteract the effects of the financial and economic crisis.

Contrary to the more commonly known use of microcredit in developing countries, where it involves much smaller amounts and is focused on eradicating poverty, the European Commission views microcredit as a loan of up to EUR 25 000 for business initiatives, from any institution whose purpose includes lending smaller amounts to businesses.

In the past, surveys have shown that new entrepreneurs often find it difficult to borrow small amounts because many banks see microcredit, in particular microloans to start-ups, as a high-risk, low-return activity where overhead costs are high in relation to the amount lent.

The EU already has tools to increase the availability of microcredit, especially with the guarantees available under the competitiveness and innovation framework programme (CIP) ([1]) and through guarantees using the Structural Funds, in particular the 'Joint European resources for micro- to medium enterprises' (Jeremie) programme. The facility called 'Joint action to support microfinance institutions in Europe' (Jasmine) is managed by the European Investment Bank group (EIB and European Investment Fund) and seeks to support non-bank microfinance institutions by providing funding (co-financing facility) and technical assistance to microfinance institutions and microcredit providers. In order to alleviate the social impact of the crisis, the new European Microfinance Facility will help to deepen the outreach of microfinance to particular at-risk groups which face barriers in access to credit in a context of reduced credit supply. All these instruments should help to bridge market gaps.

In order to further develop its policies, the European Commission sought the views of market participants and other experts on **'The role of the banks for microcredit in Europe'**. The following specific topics were initially identified:

- **The business case**: Would microcredit clients get a loan and how would the loan product look? Is there enough on offer and what could banks do to improve this?
- **The level playing field**: What is the role of the non-banking sector in relation to the banking sector?
- **The trends**: How will the situation change due to the economic and financial crisis? How will the future of microcredit provided by banks look: a business to develop, or one to avoid?

Banking and non-banking experts discussed these questions in two workshops in November 2008 and March 2009. This report outlines the conclusions from those discussions.

Banks can play a significant role to gain scale and bring operational efficiency to the microcredit sector. Banks should see microcredit as an innovative and profitable way of participating in economic and social development. Only with the banks' involvement can the development of the sector be further accelerated. However, the examples presented in the workshop and market studies show that there is a great diversity in approaches, development level and performance to provide microcredit in the EU.

In particular the workshop recommended:

For banks

- To improve lending for micro-enterprises, banks could increase the weighting given to factors such as the qualities of the entrepreneur, business plan and cash-flow forecasts, instead of focusing on collateral.
- Banks should consider lending small amounts without collateral. For such loans, the costs of managing collateral might be too high in relation to the loan amount.
- Banks could refine their risk assessment by taking account of the reasons for the low default rates achieved by some microfinance institutions (MFIs).
- Banks should develop their cooperation with business support service providers. Complementary work can be a key factor for success and lead to more access to finance.

For MFIs

- Achieving a balance between financial sustainability and social performance would help the non-bank sector to keep its focus on its original tasks. For this, the gradual inclusion of microcredit customers in the banking sector is important.
- The more competent MFIs are and the higher their standards and the quality of service, the better they can cooperate with banks.
- Linked to this, key questions for the non-bank sector are:
  - Where does the capital come from?
  - Who should do the lending?
  - Should it be sustainable?

For policymakers

- Existing offers should be better promoted and information on them should be better disseminated. If there are several offers available, they should be coordinated.
- Any support for microcredit should not lead to market distortions. Support mechanisms should be neutral towards providers. Unfair competition between publicly funded MFIs and banks should be avoided.
- The exchange of best practices should be continued. This could include setting up databases on strategies, products and good practices from banks and MFIs.
- There is no 'one size fits all' approach for microcredit. Due to the differing environments in the Member States, various successful models have evolved. Any policy should respect this diversity.

([1]) Decision No 1639/2006/EC of the European Parliament and of the Council of 24 October 2006 establishing a competitiveness and innovation framework programme (2007–2013).

Context

In November 2007 the Commission launched the 'European initiative for the development of microcredit in support of growth and employment', which is currently being implemented by the Directorate-General for Regional Policy. This initiative focuses on unemployed or inactive people who want to go into self-employment but, for various reasons, do not have access to traditional banking services.

The initiative sets up a framework which is focused on four main areas: (1) the legal and institutional environment in the Member States; (2) further changing the climate in favour of entrepreneurship; (3) promoting the spread of best practices, including training; and (4) providing additional financial capital for microcredit institutions. The goal of the Commission is to develop the non-bank market in order to help integrate people who do not have access to bank loans and to make it possible for them to have access to bank financing and services later on.

Despite estimates of high demand in the non-bank sector, one cannot overlook the fact that the banking system is the most important channel for providing loans — including smaller loans — to small enterprises and individuals who want to start a business.

In this context, one has to consider that there are around 8 300 financial institutions with over 233 500 branches ([2]). For these institutions, loans to business comprise a major part of their core business activity. In comparison, half of the non-bank lenders disburse fewer than 50 loans per year, with 39 % disbursing fewer than 20 loans per year ([3]).

Therefore, while the majority of microloan customers are and will be served by banks, data on volumes, market share, client segments and default rates from the banks are scarce or non-existent ([4]). The main reasons for this lack of information seem to be that data are not being collected and that, when gathering data, the banks do not use the same definition for the 'microcustomer segment' as the Commission, which defines microcredit as a credit of up to EUR 25 000 for entrepreneurial activity.

Where we have figures available, for example from the public support programme KfW-Startgeld in Germany (see Graphic 1), the data show that some banking groups have a bigger market share in the microloan market than others.

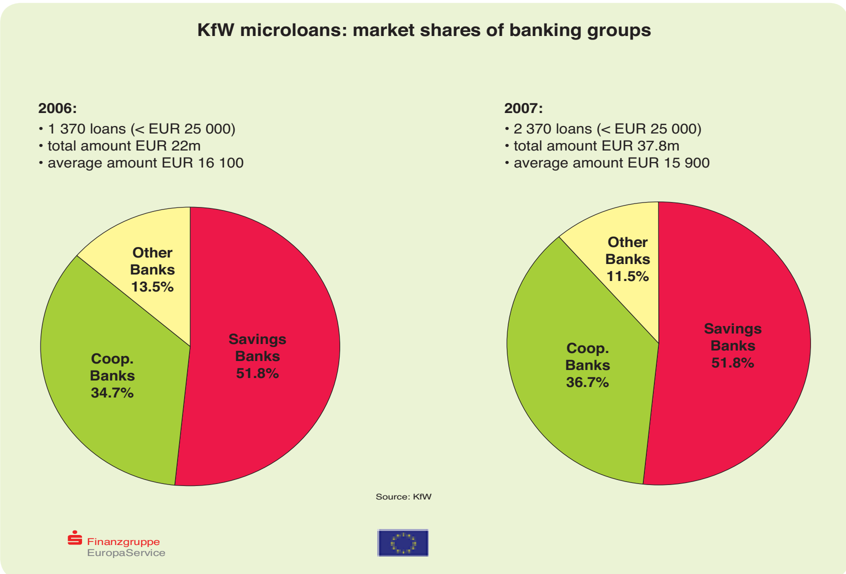
In **Germany**, of the 2 370 microloans totalling EUR 37.8 million in 2007, 51.8 % were distributed by savings banks, 36.7 % by cooperative banks and 11.5 % by other banks (see Graphic 1).

Traditionally, the argument has been that banks need collateral to be able to lend. Most often, start-ups do not have access to collateral and, in microcredit, the small sums involved make lending relatively unprofitable.

In order to make microcredit a viable option in the long run, sustainability is important. The participation of public actors in the microcredit market should contribute to business models that can survive on their own.

Bearing this in mind, the question is how banks see their role in the microcredit market. Are they serving the more mature market segments or can they also go into riskier segments? Are banks themselves doing microcredit operations or are they refinancing non-bank microcredit institutions? And how has the financial crisis changed the demand and supply situation of microcredit?

Graphic 1 — Data on market share and loan volumes in a public support programme in Germany (KfW-StartGeld)



Source: Presentation by Bertram Reddig, DSGV.

([2]) ECB, *EU banking structures*, October 2008.

([3]) See Jayo, B., Rico, S. et al., 'Overview of the microcredit sector in the European Union 2006-2007', European Microfinance Network, *EMN Working Paper No 5*, 2008, p. 12.

([4]) Exceptions to this lack of data are the banks which participate in the 'Overview of the microcredit sector of the European Union' survey, some of the Spanish savings banks and their foundations, and public support bodies. See Jayo, B., Rico, S. et al. (op. cit.).

The business case

Participants from the three main European banking groups (savings, cooperative and commercial banks, as well as public banks) were asked to reflect on a hypothetical case and to present their products, including how different categories of clients were served.

To facilitate discussion, the case was defined as follows: 'A person is asking for a loan up to the amount of EUR 25 000 for business purposes without collateral. As an example, the entrepreneur could be employed and would have relevant professional experience but has not run a business before; or the entrepreneur wants to start up after graduation from university; or the applicant is unemployed or from a migrant background.'

Start-up or existing business

The first and very decisive criterion in the credit application process is the distinction between an established enterprise and a start-up. Banks normally use annual turnover to define what a micro-enterprise is, which is not necessarily fully in line with the EU definition (5) of a micro-enterprise.

Banks evaluate loan applications based on experience of the applicant and on collateral for the specific project. For start-ups, the most important criteria were linked not to the size of the loan, but to its use and maturity (fixed investment or working capital; long- or short-term). To assess a loan application, an analysis would also look into the qualities of the entrepreneur and the merits of the project.

The Polish **BPH bank** offers the entrepreneur either an overdraft of up to EUR 8 000 secured by a property or an unsecured private individual loan (PID) of up to EUR 10 000 (see Graphic 2). To get a positive decision by the bank the applicant has to fulfil the following conditions: possession of adequate business experience, the availability of collateral (property) and a confirmed cash flow.

Furthermore, the entrepreneur would need to have a good private credit history. The price of this product would vary according to the loan amount. It would be composed of an upfront fee, from 1 % to 5 %, a further 2 % for the overdraft and an interest rate that can vary from 10 % (for the overdraft) up to 15 % for the PID cash loan.

Another example presented by the **German savings banks** is the case of a female entrepreneur taking over a physiotherapy practice in a small town in Germany. She had received support from a start-up office, had EUR 5 000 of her own funds and received a loan of EUR 25 000 from a promotional programme, the 'KfW-StartGeld'. This programme gives banks an 80 % exemption from liability for loans of up to EUR 50 000 with a maturity of either five or 10 years with a grace period of one or two years. The nominal interest rate is fixed at 4.85 % or 4.95 % (6). The KfW-StartGeld programme is partly supported by a guarantee from the EU's CIP framework programme.

Replies from banks to the first case, where the entrepreneur was employed and had relevant professional experience but had not run a business before, showed that without sufficient collateral the borrower would face serious difficulties in getting a loan. Moreover, additional security in the form of guarantees from a public source and cooperation with business support networks could be necessary. This was even more the case for the other variants of the model case.

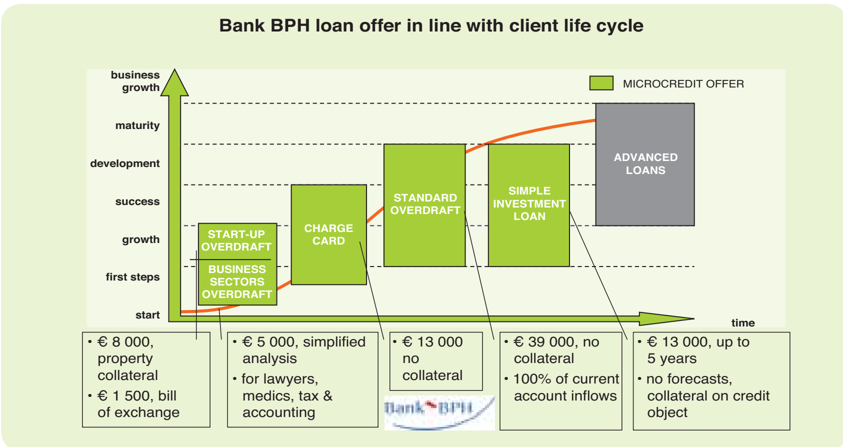
The banks' core business is to assess risk and this analysis can result in the need for collateral or a guarantee. However, the weighting given to collateral in the overall assessment could be decreased in favour of other factors such as the entrepreneur themselves, their business plan and their cash-flow forecast. At the moment risk assessment criteria generally leave relatively little margin for manoeuvre.

In addition, banks noted that dealing with collateral was expensive and could even be uneconomic for smaller loans. In these cases, a public–private partnership could be envisaged where the default risk would be covered by risk-sharing instruments such as guarantees. However, lending practices differ throughout the EU and it should be acknowledged that banks would not waive automatically collateral, fully or partially, to be provided by a microcredit borrower.

Having no collateral, or not enough, could also lead to a higher pricing of the loan. However, cooperative banks noted that they did not try to maximise their profit on each loan operation but to put the cost in the context of the global client relationship from a long-term perspective.

Problems in business proposals themselves, ranging from basic activities to innovative ones, might also contribute to the financing problems. Clearly, when managing their day-

Graphic 2 — BPH microloan products



Source: Presentation by Wojciech Ławecki, BPH.

(5) A micro-enterprise is an enterprise with fewer than 10 employees and a turnover or balance sheet of less than EUR 2 million; for the SME definition see Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro-, small and medium-sized enterprises (OJ L 124, 20.5.2003, p. 36).

(6) As of August 2009.

to-day business, bank employees have limited time to help complement their customers' loan applications. Nevertheless, experience from some banks, such as the Procredit banks in eastern Europe, shows that the time-consuming elements of loan processing can be reduced through clever use of standardisation and innovation in front and back offices.

The German savings banks also noted that viable projects with a financing demand below EUR 10 000 are comparatively rare. As smaller amounts are often needed for working capital, they are often covered by overdrafts. Because of their flexibility, start-ups often prefer these overdrafts despite the higher interest rates. It was also noted that the current products for start-ups are not high volume products for banks.

Banks are generally unwilling to enter a high-risk and possibly unprofitable business, so they require higher loan amounts, compensation for processing costs and risk-sharing arrangements. Participants agreed as well that loans to start-ups are a low-margin business due to the very high overhead costs per loan. An effective appraisal of and support for the loan applicant are expensive for banks. However, one cooperative bank noted that for 'professional' microloans, return on investment was positive even on relatively low loan amounts of under EUR 10 000.

On the riskiness of microloans, opinions were divided. While some participants argued that microcredit is a risky business, others argued it was not, as long as the risk analysis was done properly. One bank noted that default rates were very low in France, below 2 %, and even for doubtful cases they remained below 5 %.

A large part of the confusion can, however, be attributed to the fact that participants were referring to different segments of the microloan market, with financing for start-ups, for example, being more risky than giving working capital to established enterprises.

Several factors — no collateral or guarantees, risk or inadequately prepared entrepreneurs or business plans — can limit banks in their capacity to reach the full group of entrepreneurs that is serviceable in a population of 18 million micro-enterprises. The provision of business support and guarantees may address this.

Banks can cooperate with microfinance institutions either by sharing back office (processing) functions, by refinancing such institutions or by providing supplementary products, such as a current or savings account. Microfinance institutions (MFIs) can be a partner in the provision of services but methods for achieving cooperation vary across Europe.

Savings banks cooperate with local partners in coaching micro-start-ups. For example, in Germany, where there are 438 independent Sparkassen with a market share of 43.3 % in the business loan segment, their most common partners are chambers of commerce and industry (60 %), chambers of crafts (58 %), business development services (46 %), start-up or microfinance initiatives (28 %) and universities (12 %).

In France, **Crédit Mutuel** has created a 'toolbox' for each manager of its network to choose how to serve the demand best (see Graphic 3). Depending on the profile of the borrower and on their project (business plan, experience, credit history, collateral), alternatives include cooperation with partners such as ADIE (a non-bank MFI), France Initiative (a public support network) or France Active (an association). It enables the bank to sort or redirect the demand if it cannot serve it. If the project has a social impact on its region, or depending on the borrower's social situation, the manager can transfer the case to specific funds set up by one regional bank, the 'Creavenir' association. In 2008, Crédit Mutuel issued 800 loans using the Creavenir channel.

Credit lines to **ADIE** financed about 1 150 projects with a total volume of EUR 4 million in 2008. Crédit Mutuel also participated in local funds set up by France Initiative, which provides unsecured loans considered by the banks as equity at a zero interest rate. In 2007, 7 700 projects were supported by those funds, out of which 1 000 were complemented by a bank loan issued by Crédit Mutuel. This helped create 8 300 SMEs and 18 000 jobs.

Graphic 3 — Crédit Mutuel microloan products

The Business Case

The market overview : microcredit at Crédit Mutuel

Distribution circuit	Microcredit within partnerships				Direct microcredit
	ADIE	France Initiative Reseau			Creavenir
Objectives	CSR, social integration	CSR, local development, leverage effect			Mutualism
Type	Non-bankable microcredit	Bankable microcredit			Bankable/non-bankable MC
Nature of the loan	Microcredit	Co-financing plan	Prêt d'honneur	Complementary bankable loan	Prêt d'honneur
Maximum loan amount (euro)	5 500	unlimited	15 000	unlimited	12 000
Investment 2007 (millions / euro)	3.7		2.1 0.27 in 2007	63,4	

@ EACB 2008

Source: Presentation by Gérard Leseul, Crédit Mutuel.

France Initiative provides so-called 'honour loans' (*prêts d'honneur*), which are based on 'confidence', so no collateral is required. In 2007 the portfolio of *prêts d'honneur* was EUR 92.1 million, with an average amount of EUR 7 400. These loans are used to get a bank loan, creating a leverage effect of more than 7, i.e. a EUR 1 France Initiative loan is leveraged by a EUR 7.6 commercial loan.

Crédit Agricole's 39 regional banks, with over 7 000 local branches in France, see local development and social integration as strategic priorities (see Graphic 4). Therefore, the business start-up is a major focus and Crédit Agricole as a cooperative bank has developed various strategies to meet the microcredit demand. In particular, it has engaged in partnerships with the major specialised microcredit network in France: France Initiative, France Active and ADIE. In 2007, the cooperation with France Initiative alone enabled 13 500 start-ups or business transfers to get a loan. In total, commercial loans were EUR 618.1 million. Crédit Agricole supports this network by financing their activities and the *prêts d'honneur* fund. Crédit Agricole's regional banks granted about EUR 163 million of complementary loans in 2007. Furthermore, 16 regional banks granted nearly EUR 900 000 to the ADIE fund for 0 % rate loans and six of them opened credit lines of EUR 2.1 million. The regional banks also use the France Active guarantee system. To promote economic integration, 18 regional banks have created specific offers in addition to loans and cooperation with partners. The offers consist of specific low interest loans, a 0 % rate with and without a guarantee, and a subsidy as sponsorship and local development policy.

The survival rate of companies supported by France Initiative was 86 % after three years' business activity, which is considerably higher than the national average. For ADIE this rate was 65 % after two years. The majority of France Initiative clients, 66 % in 2007, are unemployed. ADIE only serves persons who are unemployed or recipients of social welfare minima, the so-called *RMI — revenue minimum d'insertion*. For its loans in 2007 ADIE charged an interest rate of 7.98 % plus a 5 % commission, whereas France Initiative's equity loans on trust are interest-free. Concerning portfolio quality, France Initiative reported a loan repayment rate of 96.9 % in 2007. ADIE had a delinquency rate of 6.4 % and a loan loss rate of 2.5 % (7).

The association ADIE is a single organisation with a centralised approach which has grown with continuous public support since the 1980s, while France Initiative is a network of 242 local independent associations that agree to a common charter, share a lot of functions and processes and use a single brand. The individual associations are often located in chambers of commerce and industry and focus on entrepreneurship development. France Initiative's mission is linked to the 'wealth' of a territory as entrepreneurs not only create wealth and jobs but also promote the entrepreneurial culture in a region.

Both organisations, ADIE and France Initiative, are primarily funded by public sources. ADIE also benefits from guarantees from the Fonds de Garantie d'Insertion par l'Economique, which is in turn funded by the Fonds de Cohésion Sociale, and the EU CIP framework programme. ADIE is striving to become more independent from public money and its loans are refinanced by banks, whereas France Initiative sees its engagement as a public mission: its equity loans are financed by grants and facilitate bank loans, to finance new businesses. Both organisations rely on volunteers, in particular regarding business development services, as well as on partnerships with public institutions and enterprises.

In France, the comprehensive approach of ADIE not only led to the reintegration of many recipients into society but also to the recognition

Graphic 4 — Crédit Agricole microloan products

FRANCE INITIATIVE

Partnerships: regional banks with France Initiative (2007 figures)

13 500 start-up business or company transfer
(+11% compared to 2006)
€ 92.1m of loans with an average amount of € 7 400 per loan
€ 618.1m of complementary banking loans
Leverage effect of loans on trust on banking loans: **7.6**

Survival rate after 3 years' activity: **86%**

66% of the micro-entrepreneurs France Initiative works with are unemployed

33% of micro-entrepreneurs are women

Leverage effect

Follow-up

Focus on Company transfer

KEY FIGURES 2004-2007

	Number of loans initiated by France Initiative during the year	Total amount of 0% rate loans (In million euros)	Total amount of banking loans granted during the year (In EUR million)	Total amount of Crédit Agricole's loans granted during the year (In EUR million)
2004	9 200	65	319 Without CA = 238	81
2007	13 500* + 10.65% / 2006	92 +10.6% / 2006	618 + 30.10% / 2006 Without CA = 455 + 31.12%	163 + 27.34% / 2006

@ EACB 2008

Source: Presentation by Delphine Bres, Crédit Agricole.

(7) *ADIE Activity Report 2007* and *France Initiative Annual Report 2007*.

Graphic 5 — Intesa Sanpaolo microloan products

Inclusion of the financially weak

		Activities in 2007	
Promoters	**Type of intervention**	**No. of loans**	**Amount (€)**
Compagnia di San Paolo (through 4 non-profit foundations in Turin, Genoa, Naples and Rome)	Microfinance (employability and economic activities)	198	2.3 million
Fondazione Lombarda Antiusura (Milan)	Anti-usury	25	375 500
Cassa di Risparmio di Venezia	Microfinance	26	63 000
Cassa di Risparmio di Padova e Rovigo	• personal loans • microfinance • first-home mortgages	• 35 personal loans • 5 microfinance loans • 11 mortgages	• 68 500 • 35 500 • 1 million
Banco di Napoli	Anti-usury	15	110 500
Total		**Nearly 4 million euro**	

INTESA SANPAOLO

Source: Presentation by Alessandra Dal Colle, Intesa Sanpaolo.

of the potential for successful entrepreneurship in marginalised groups.

As the case of France shows, the partnering of banks and microfinance institutions has helped to expand the outreach of microloans. Cooperation with local business support providers not only helps to reduce transaction costs for banks but also for MFIs. This is often complemented by a public guarantee.

In Italy, a unit of **Intesa Sanpaolo** (a bank with a network of 6 518 branches), the so-called Bank and Society LAB, is looking for solutions by finding institutions and partners to reach the financially excluded (see Graphic 5). Foundations such as Ethnoland and Lombardy Anti-usury Foundation not only contribute to a guarantee fund for the PR.IM.I project but also select the best proposals before sending them to the bank for credit risk evaluation and pricing. The PR.IM.I guarantee fund gives a 50 % guarantee for loans up to EUR 30 000 and should help 100 entrepreneurs per year with a migrant profile. The partners also provide information and consultancy.

In **Spain** the **La Caixa** savings bank group decided to establish a strategic venture for microcredit activity in accordance with a sustainable and robust framework, **MicroBank** (see Graphic 6). La Caixa is not only the third-largest financial institution in Spain but also strongly promotes social objectives: EUR 500 million of its profits were invested in welfare projects in 2008. MicroBank was set up to channel La Caixa's microcredit business through its network of over 5 000 branches but within a wholly owned subsidiary with a starting capital of EUR 75.5 million. It specialises in granting microcredits and small personal loans to encourage productivity, setting up micro-enterprises, job creation and personal and family development. MicroBank is aimed at persons and families who, due to their limited resources or lack of collateral, have difficulty in accessing the traditional banking system.

Graphic 6 — MicroBank microloan products

MicroBank: microcredit features

	MICROCREDIT		
	FINANCIAL FEATURES	**SOCIAL FEATURES**	**FAMILIES**
Beneficiaries	Self-employed and small business people who propose a business plan promoting productive activity and job creation.	People who have difficulties to access the traditional credit system and need the advice of a partner body to develop their business idea.	People with an income of less than €18 000 per year with family needs, to allow them to overcome temporary difficulties and aid their personal development.
Purpose	To encourage self-employement and the creation or expansion of micro-enterprises.	To encourage self-employment and the creation of micro-enterprises.	To deal with family needs and aid personal and family development.
Amount	Up to a maximum of €25 000	Up to a maximum of €15 000	Up to a maximum of €25 000
Guarantees	No real guarantee	No guarantee of any kind	No real guarantee
Terms	5 years + optional 2-year grace period	4 years + optional 6-month grace period	Up to 6 years (including optional 12-month grace period)
Requirements	Having a business plan that allows the feasibility of the project to be assessed.	Having a business plan that allows the feasibility of the project to be assessed.	

Source: Presentation by Núria Danés, MicroBank.

MicroBank's products are targeted at micro-entrepreneurs and the self-employed but also at families with an annual income below EUR 18 000 that need to overcome temporary difficulties (see Graphic 6). Its product offer includes not only loans but also current and savings accounts and a debit card. Between its launch in January 2008 and January 2009, MicroBank granted 26 929 loans totalling EUR 211 million. Part of MicroBank´s portfolio, financial and social microcredits, benefit from a 75 % guarantee under the CIP programme.

La Caixa's reasons for setting up a bank were, firstly, to serve a clientele with limited own resources and to develop products and services adapted to the needs of these people and, secondly, to be able to assess the business better and make it sustainable. Thirdly, having one single entity also makes it easier to cooperate with national and European institutions, which can provide guarantees or even capital (8).

In terms of scale, MicroBank is so far the biggest bank endeavour in the microcredit sector. It seems a promising attempt to reach out to low income groups via a bank, which is specifically organised and managed to serve its customers.

MicroBank counts on a network of more than 400 partners (local authorities, employment agencies, non-profit organisations) that offer complementary business services such as training, development of a business plan, monitoring and follow-up, and that contribute to guarantee the viability of business projects.

Although microloans target a clientele that in traditional banking is considered risky, partnerships with non-bank actors and public support services can help with the preparation, monitoring and follow-up activities that can make all the difference. As seen in most of the examples above, public support schemes, in particular guarantees, continue to play an important role in the provision of microcredit. The next two examples illustrate two such additional public support schemes.

In Hungary, 75 % of enterprises operate without a bank loan. There is a high concentration of loans, with 33 % of all loans being provided to 1 % of all companies, the large ones. Banks have been reluctant to deal with the microcredit sector because SMEs do not have a credit history, so they represent a higher risk, do not have collateral and transaction costs are high. Therefore, the goal of the Hungarian microcredit schemes is to make micro-enterprises more bankable. There are three programmes: the Microcredit Plus, the National Microcredit Fund and the 'New Hungary' programme (see Graphic 7).

The **Microcredit Plus** programme started at the end of 2005 and, with EUR 73.4 million, is the most important product of **MFB**, the state-owned Hungarian Development Bank.

Graphic 7 — Hungarian microloan guarantee schemes

MFB Hungarian Development Bank Plc.

3 pillars of microlending

	Funding avallable per year (million EUR)	Number of loans	Amount of loans (million EUR) in total	Participating organisations
Microcredit Plus Programme	65	411	14.4	In the lending the Hungarian Enterprise Development Fund and the county enterprise development centres participate (CEDC) as agents
National Microcredit Plus Programme	19.6	27 400	186.3	The Local Enterprise Development Fund with the coordination of the Hungarian Enterprise Development Fund
„New Hungary" Microcredit Programme	264.7	880	14.4	The Hungarian Venture-Financing Plc coordinates, micro-financing organizations, financial enterprises and credit institutions
Sum total	349.3	28.691	215.1	

Source: Presentation by Csaba Palickò, MFB.

(8) For example, a EUR 30 million loan provided by the Council of Europe Development Bank.

It is an investment loan of up to EUR 50 000 on preferential conditions distributed by a network of 10 agents who also monitor the loan repayment. The borrower has to have at least 15 % of the net investment value in own funds and the interest rate is currently 8.5 % with a maximum maturity of 10 years and a maximum grace period of two years.

The state-owned **National Microcredit Fund** operates with a network of regional development agencies. The loan agreements are managed centrally by the Hungarian Enterprise Development Foundation.

The third microcredit programme, **'New Hungary'**, is refinanced by the Jeremie [9] holding fund with an allocation of EUR 170 million. Microloans are intended to be disbursed by the participating financial intermediaries: banks, financial enterprises and local microfinancing institutions, which also contribute to the fund (a minimum of 25 % for banks and 10 % for the others). Microloans for investment cannot exceed EUR 32 680, with a maximum maturity of 10 years, and working capital loans can go up to EUR 19 600 with a maturity of a maximum three years. Whereas interest rates can be set by the MFIs without any limit, banks can ask for a maximum of 8.8 % [10]. Guarantees are also available as an option for the intermediaries.

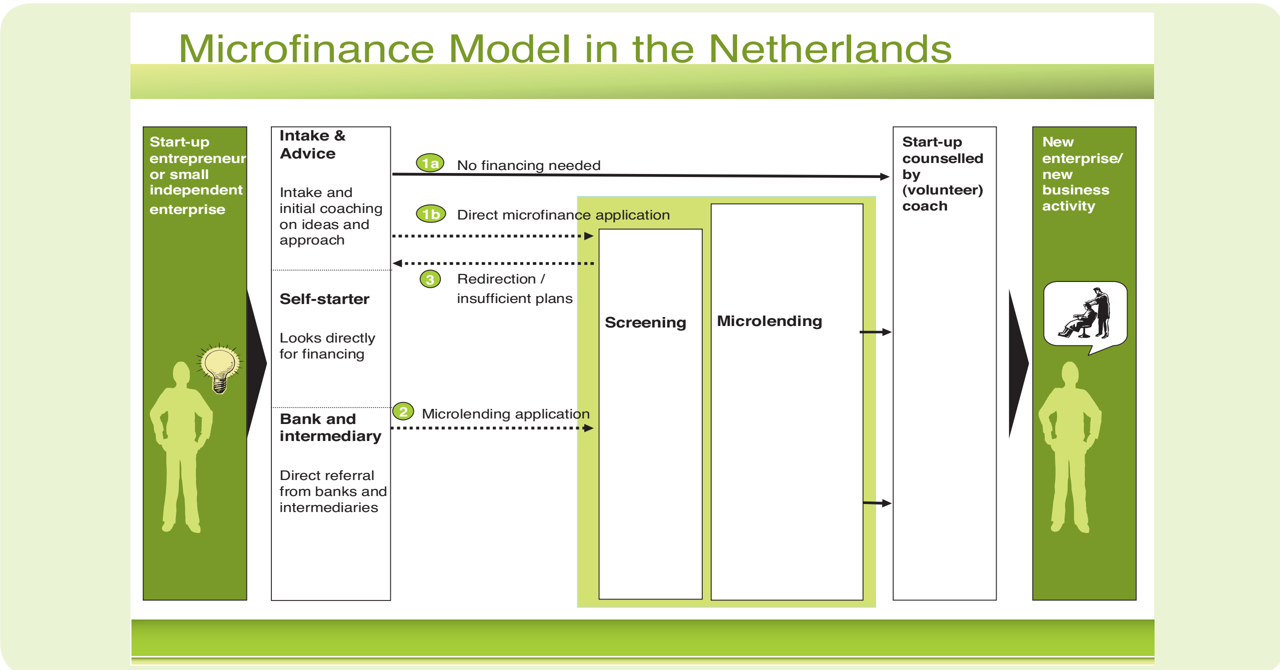
In the **Netherlands**, the new foundation Qredits, Microkrediet in Nederland, aims to better coordinate efforts with a top-down approach in order to increase the coverage and sustainability of Dutch microfinance. The Ministry of Economic Affairs decided to set up a project where business support services are offered locally but the credit facilities are managed centrally to create larger volumes at lower costs. In the period 2009–10 the plan is to screen 3 200 applications and to give 1 500 loans.

This project is financed with a public–private partnership, where a public subsidy of EUR 800 000 is complemented with an injection of EUR 1.2 million in working capital from ING, Rabobank and ABN Amro/Fortis Bank. To refinance lending, the Dutch Ministry has given an interest-free loan of EUR 15 million.

The main product in this scheme (see Graphic 8) is a loan with an average maturity of four years and an interest rate of about 9 %. However, it includes a variable pay-off rate based on the payback ability of the borrower. There is also the possibility to get life insurance, a bank account in a commercial bank and coaching for one to two years. The maximum loan amount is EUR 35 000. This product is supported by information on the sector the micro-entrepreneur is working in, their creditworthiness and credit ratings.

Bearing in mind the needs of the entrepreneur, the loan approval process is kept short. After the completion of the application, the credit decision should be taken within 10 working days. For the microcredit client, there can be a gap between what the entrepreneur may need, e.g. a fast loan decision or flexible credit, and what products are offered. If the offer — in

Graphic 8 — Dutch microloan scheme



Source: Presentation by Elwin Groenevelt, Qredits.

(9) With the Jeremie initiative ('Joint European resources for micro- to medium enterprises'), a new option has been created for the Member States to make more money available for microcredit operations by using the European Regional Development Fund (ERDF). The ERDF can also be used for financial instruments outside the Jeremie option based on Article 43 of Commission Regulation (EC) No 1828/2006. For example, in North Rhine-Westphalia the programme 'NRW/EUMikrodarlehen' offers loans up to EUR 25 000 with a grace period of one year without a need for collateral (http://www.nrwbank.de/de/existenzgruendungs-und-mittelstandsportal/existenzgruendung-und-festigung/nrw-eu-mikrodarlehen/index.html).

(10) Max. [(0.3*3m BUBOR) + 6 %].

particular support programmes — is not clear, potential beneficiaries can become confused.

A market study found that previously only 400 microloans were provided by NGOs and an earlier government support programme in the Netherlands. With the exception of Fortis and municipal banks, banks did not engage in microlending, but provided overdraft facilities. This study estimated an additional demand of 43 500 microloans of applications, out of which 60 % were considered 'unbankable' ([11]).

With the new model, the Netherlands is trying to overcome the previous fragmentation of the sector and the problems related to small-scale initiatives: high costs, low efficiency and difficulty in accessing funds. However, even with larger networks the challenge of reaching financial sustainability remains.

Cooperation with non-bank partners can help to overcome several problems: high transaction cost, risks linked to high failure rates and outreach into other market segments. Business support services can provide help in preparing the loan application process and in following up the repayment process. Moreover, business support measures were considered an important factor in lowering risk and increasing the survival rate of businesses.

Graphic 9 — Summary of bank microloan key figures

Organisation (country)	Year	Number of loans disbursed	Total value of loans disbursed (in EUR million)	Public guarantee	Average loan size	Average interest rate
Banca Intesa Sanpaolo (Italy)	2007	315	4	No	n.a.	n.a.
BPH (Poland)	2007	18 000	149.4	n.a.	8 300	12.2 %
Crédit Agricole (France)	2008	13 140 ([12])	291.3	Yes (France Active, OSEO)	n.a.	Zero rate, market rate, France Active and ADIE rate
Crédit Mutuel (France)	2008	9 600	100	Yes (France Active)	7 000/ 2 700 ([13])	Zero rate, market rate or ADIE rate (9 %) ([14])
KfW-StartGeld (Germany)	2007	2 370	37.8	Yes (CIP)	16 000	4.96 % (5 years) 5.06 % (10 years) ([15])
Sparkassen ([16]) (Germany)	2008	419 800	2 142	A few cases (CIP) ([17])	5 100	n.a.
MicroBank (Spain) ([18])	2008	9 582	120	Yes (CIP)	12 523	8.2 %
MFB (Hungary)	2008	28 691	215.1	Yes (public bank)	7 497	8.8 %

([11]) SEON/EMN (2007). See Jayo, B., Rico, S. et al., 'Overview of the microcredit sector in the European Union 2006-2007', European Microfinance Network, *EMN Working Paper No 5*, 2008, p. 14.

([12]) Only PCE *(prêts à la création d'entreprise)*, France Initiative loans and ADIE loans. Loans to very small enterprises (TPE) not included.

([13]) Depending on the partner or channel used.

([14]) Depending on the channel used.

([15]) Effective interest rate as of August 2009.

([16]) Loans up to EUR 10 000 and outstanding on 30 June 2009.

([17]) In 2008 the Sparkassen disbursed some 750 loans (up to EUR 10 000 for a total of EUR 6.1 million) which were covered by a public guarantee, partly from the CIP programme.

([18]) Key figures in 2008 (MicroBank started its full activity in January 2008) excluding family microcredits.

The workshop concluded:

Basic problems persist. The microlending segment is characterised by low returns and high transaction costs. Business start-ups are regarded as risky customers because of the high failure rate. In most cases, banks ask for collateral or third-party guarantees, otherwise the loan may become more expensive or even unavailable.

To overcome these problems risk-sharing instruments are a well-proven tool that can be used to stimulate microloan provision from banks. Another complementary way to reduce transaction costs and to improve the quality of projects is cooperation with business support services or microfinance institutions.

For the microcredit client, there can be a gap between what the entrepreneur may need (flexible credit) and what products are offered. If there are too many programmes targeting microcredit, potential beneficiaries might face a complex structure.

For the MFIs, the more competent they are and the higher their standards and the quality of service, the better they can cooperate with banks.

The workshop recommended:

FOR BANKS

- To improve lending for micro-enterprises, banks could increase the weight given to factors such as the qualities of the entrepreneur, business plan and cash-flow forecasts, instead of focusing on collateral.
- Banks should consider lending small amounts without collateral. For such loans, the costs of managing collateral might be too high in relation to the loan amount.
- Banks could refine their risk assessment by taking account of the reasons for the low default rates achieved by many microfinance institutions.
- Banks should develop their cooperation with business support service providers. Complementary work can be a key factor for success and lead to more access to finance.

FOR POLICYMAKERS

- Existing offers should be better promoted and information on them should be better disseminated. If there are several offers available, they should be coordinated.
- The exchange of best practices should be continued. This could include setting up databases on strategies, products and good practices from banks and MFIs. More data about the supply and demand of microcredit should be made available.
- The client base of microcredit should be strengthened through more effective and sustainable efforts to raise entrepreneurial levels in Europe and to support new forms of entrepreneurship.

A level playing field

Concerning the question about the sectors where non-banks could provide added value, banks underlined their own role in the microcredit market. With their existing network of over 233 500 branches, banks can potentially reach many more customers than non-bank microfinance institutions.

However, the experts admitted that availability of banking was limited for some disadvantaged groups and in some local areas. The examples presented and the market studies [19] show that gaps in the market persist [20]. Therefore, public intervention can be justified to overcome failures in the market. For the socially excluded in particular, the market has not been functioning for years in most European countries. This situation might become even worse as a result of the financial and economic crisis.

However, examples in the past have shown the negative effects of public intervention in markets. For example, supported soft loan policies can lead to a crowding-out of market products and, when support was withdrawn, no loans were available at all, as one Spanish expert pointed out.

The coexistence between supported and unsupported entities could become distortive, in particular if higher loan amounts were involved. Some banks considered the EUR 25 000 limit too high. Cooperative banks pointed out that in France the average loan for craftsmen was EUR 30 000. So according to the European definition, a major part of their business would be affected by any unfair competition. Therefore, in France the legislator drew the line at a loan amount of EUR 6 000 for certain target groups, the unemployed and people living on a minimum social allowance, where non-banks such as ADIE are allowed to operate.

While any definition of target groups should be wide enough, there was some discussion on where to draw the line between bank and non-bank business. Some participants felt that the EU definition did not take into account important factors, such as target group, loan amount in relation to GDP, institutional delivery model and the objectives of the loan provision (social, local development and commercial), which help better differentiate between market segments.

Furthermore, market distortions could also arise from the perspective of regulation, e.g. Basel II rules or taxation, as banks pointed out [21].

In consequence, it is essential that public support should not distort the market. For the same business, the same risk and the same rules should apply. Therefore, support mechanisms should remain neutral towards credit suppliers.

Interest rates

In the document 'European initiative for the development of microcredit in support of growth and employment' [22] adopted in November 2007, one of four ways to improve the environment for microcredit is to streamline the legislative framework for non-bank microcredit providers, in particular by making lending possible for non-banks throughout the EU and relaxing interest rate caps.

When discussing ways to make microcredit more profitable or sustainable, for example by charging higher interest rates, banks noted that they were not aiming to lend at higher or lower rates without taking into account the capacity of the individual to pay back the loan in the case of small and short-term loans.

The banks also recognised that imposing higher rates on marginal groups would damage their reputation. In their view, too narrow a segmentation of the microcredit market would result in creating banks only for the poor. Microcredit should be tailor-made, i.e. developed within schemes that involve different partners, and include close follow-up of

'Do not focus on the false question of the interest rate by using the European Social Fund to subsidise it. This risks destroying most microfinance lenders. Start-ups can pay relatively high interest rates (up to 20 %) on small sums for short periods. These rates are low compared to what some parts of the market are charging in some Member States (loan shark rates in the UK exceed 200 % annual percentage rate). The problem for most start-ups is access to finance, not its cost.'

Conclusions of the workshop on microfinance at the 2007 Regional Policy Open Days [23]

(19) See European Investment Fund market evaluation studies for Jeremie and European Microfinance Network and EIF market study 'Microlending: Capacity building needs and policy recommendations', Paris/Hamburg, 2009.

(20) See also European Commission, 'Micro-credit for small businesses and business creation: bridging a market gap', 2003.

(21) Banks which adopted the advanced IRB approach faced serious difficulties making loans without collateral.

(22) COM(2007) 708 final.

(23) Held in Brussels on 8 to 11 October 2007 (see http://ec.europa.eu/regional_policy/conferences/od2007/documentation.cfm).

beneficiaries and certain safeguards. Therefore, demand should be carefully managed and any large-scale introduction of microcredit products could lead to problems.

Another more general issue linked with the interest rate is the sustainability of microcredit in Europe. The possibility to charge the client a price that reflects the cost of the loan, including all factors (e.g. refinancing, risk and organisational structure), is a way to make microcredit more sustainable. In particular, the small sums and short maturity of microloans make the payback burden relatively easier than for larger loans. Organisations such as ADIE point out that clients are willing to accept higher interest rates because it is the possibility to have access to credit which counts for them.

However, the resulting financial burden, if not calibrated carefully, could be too heavy for the customer. Participants also clearly pointed out that any form of predatory lending, for business loans as well, should be kept at bay.

The workshop concluded:

Banks disputed claims that they are not serving potential businesses, though evidence of gaps was presented.

Banks and microfinance institutions should have a level playing field on which to offer microcredit products. Subsidised products, in particular soft loans or even more so grants, can lead to the crowding-out of viable lending products from the market.

The definition of target groups for microcredit should not be too narrow but the question was raised as to what non-bank MFIs should do and how broad their remit should be.

Banks saw that microloans could be provided on favourable terms as a means of integrating the borrowers into the banking markets. For their part, microfinance institutions saw interest rates that were so low that they made sustainable operations impossible. Cooperative banks indicated that providing loans at low rates was also an expression of solidarity with their members.

The workshop recommended:

- Any support for microcredit should not lead to market distortions. Support mechanisms should be neutral towards providers. Unfair competition between publicly funded MFIs and banks working on purely commercial terms should be avoided.

On the interest rate:

- Policymakers should find the right equilibrium between the protection of vulnerable groups and sustainable microlending because some legislative measures, such as too low interest rate caps, make covering loan costs impossible and have a certain grant dependency as a consequence.

- Knowledge on the determinants of interest rates should be improved. Interest rates increase because of increased risk and higher handling costs, but also due to better conditions such as flexible repayment schedules, longer maturities and/or longer terms of fixed interest rates.

The trends

Here the question was how microcredit in Europe has developed so far and what the biggest challenges are, taking into account the financial crisis.

To serve the 91.8 % of the 20 million enterprises in Europe that have fewer than 10 employees, two institutional strategies have developed in the past for banks and non-bank institutions (see Graphic 10).

Different motivations (developing new market segments and reintegration into the labour market) and policy objectives (fostering entrepreneurship and social inclusion) have also led to different market exploitation strategies. According to these objectives one can link channels with respective target groups. While credit institutions mostly do 'micro-enterprise lending', MFIs focus more on 'inclusion lending'.

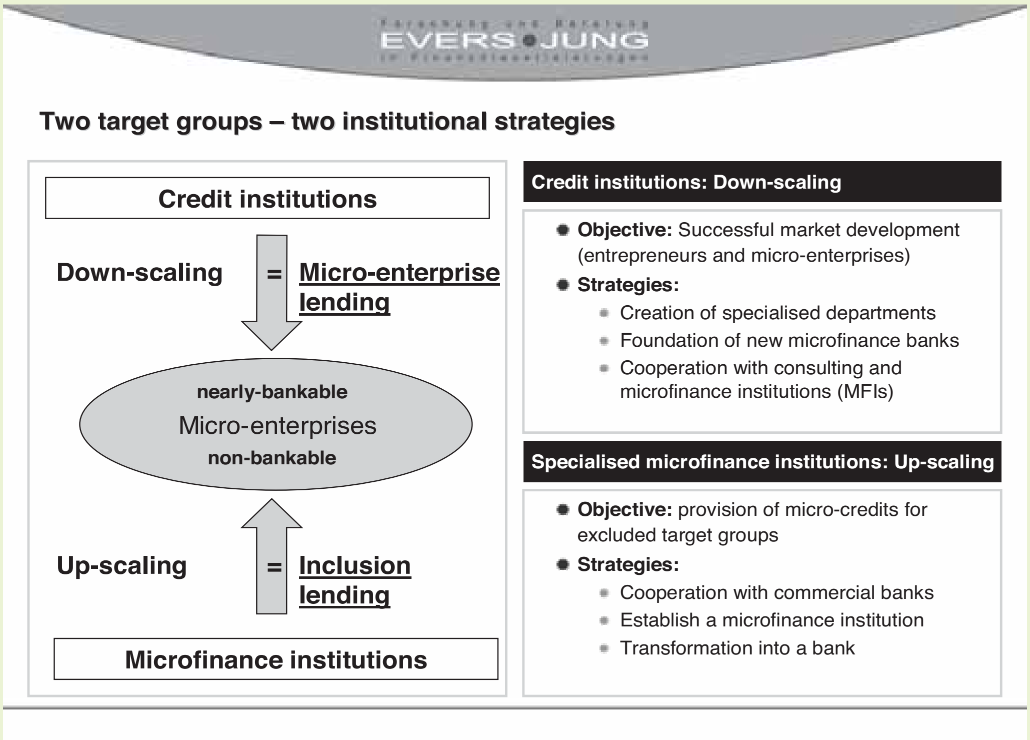
Banks can increase their outreach, especially into the segment of the 'nearly bankable', which includes start-ups, the self-employed and micro-enterprises. These need only small loans but for different reasons (collateral, track record, etc.) are not attractive customers for banks.

Clients with negative factors such as no regular income, a bad private credit history, illiteracy, etc. will face serious difficulty getting a normal bank loan, also because they usually need more support when starting a business. Therefore, microfinance institutions provide loans to this group. Supply by non-bank actors is still fragmented in many European countries and there are many different organisational models in place. But even here loans to 'normal' (commercially viable) micro-enterprises and start-ups are the dominant products in the market.

A case study on how to build up the sector for non-bank lenders in the UK was presented (see Graphic 11). In the UK the community development finance institutions (CDFIs) are considered the chief microcredit lender. There is a variety of CDFIs but the majority are non-profit and non-bank institutions. Their purpose is to give credit to entrepreneurs who cannot get it from the British banking system, which underwent dramatic changes in terms of consolidation and centralisation of credit approval decisions in the early 1990s. The CDFIs are the outcome of a political process, where government support via the Phoenix fund combined with tax relief on investment was essential.

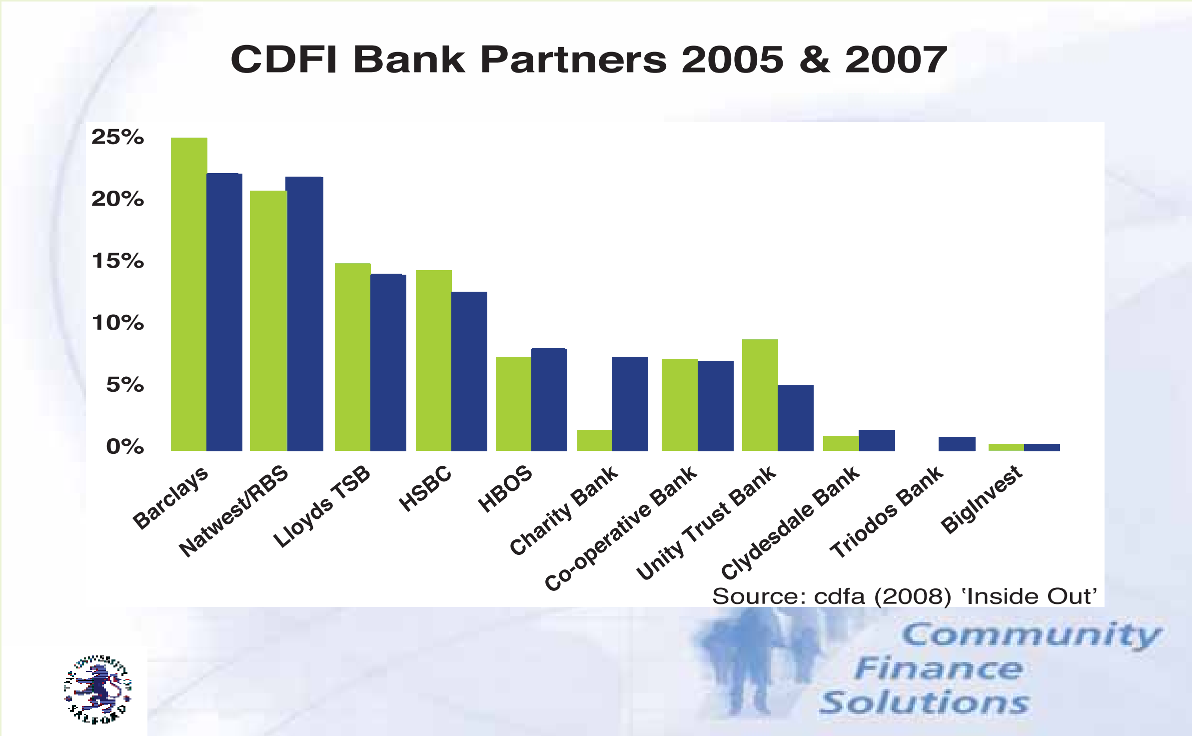
In 2007, for every GBP 1 received for on-lending in grants, CDFIs raised GBP 1.27 in investments and funds under management. The most significant source of capital was funds under management, followed by support by the

Graphic 10 — Institutional strategies according to target groups



Source: Presentation by Martin Jung, Evers & Jung.

Graphic 11 — UK CDFIs' funding partnerships with banks



Source: Presentation by Karl Dayson, Community Finance Solutions.

regional development agencies (RDAs). A mere 7 % of capital came from banks. Partnerships between CDFIs and banks even slightly declined between 2005 and 2007.

With default rates on average around 16 %, CDFIs have proved to be more cost-effective than the soft-loan funds of the 1970s and 1980s, which had loss rates of 30 %. Nevertheless, several lessons can be learned from the British experience. The government's pump-priming support was crucial. However, the timescale for self-sustainability was unrealistic. Until now, although most UK CDFIs are driven by a social mission, very few also meet financial performance standards in terms of management and credit collection systems, and only one has managed to reach sustainability.

The challenge now is how to channel funding to the most promising CDFIs, those which can deliver both social and financial performance. Another lesson was that any political strategy should be prepared in connection with business advisors and banks. For non-bank actors the goal of achieving operational efficiency while maintaining their social mission has been the biggest challenge.

Concerning institutional capacity levels of MFIs in Europe (see Graphic 12), a recent study on behalf of the EIF ([24]) has identified a clear lack of institutional capacity in building and maintaining adequate funding models for growth in microfinance operations. Additionally there is a clear need for sustained funding to cover start-up and operating costs and funding for on-lending to high-risk target groups. Moreover, a culture of transparency and reporting is often missing in non-bank MFIs, especially in western Europe. This is connected to lack of awareness about the importance of this issue and a failure to transfer social visions for microfinance into viable business approaches. In eastern Europe, capacity levels in this regard are higher, but are often too limited to fulfilling reporting requirements of funding/donor organisations.

Over the last 10 years, major changes have taken place in the microcredit market thanks to the development of new actors, the non-bank MFIs. However, the commercial banks also found new ways to reach down into the microcredit market. Credit institutions down-scaled their mainstream products by creating specialised departments, cooperating with business support services and MFIs, and even establishing new microfinance banks. Many MFIs moved upwards into the market by cooperating with banks or even becoming banks. Actions of MFIs may in some cases have led to a rethinking of strategies by banks.

([24]) See European Microfinance Network and EIF market study 'Microlending: Capacity building needs and policy recommendations', Paris/Hamburg, 2009.

Graphic 12 — Challenges of MFI capacity-building

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Capacity-building – A challenging task for microfinance in the EU

Constraints and challenges	Strategies and success factors
Microfinance projects instead of institutions	Support for capacity-building **before** extensive loan funding: • Focus on institution-building • Flexible funding instruments
Periodic funding cycles instead of sustainable business models	• Long-term commitment of donors/investors • Clear Costing & Pricing of financial and non-financial services provided
Lack of • vision and strategy • transparency and accountability • outreach, efficiency and scale	• Perfomance-based funding • Clear performance indicators (social & financial) • Foster installation of professional management information systems
Deficits in • human resource management • system/infrastructure	• Build a market for technical assistance and training • Improve technical, financial and organisational expertise in MFIs and donor institutions

Source: Presentation by Michael Unterberg, Evers & Jung.

The workshop concluded:

Banks have options in their strategic approach to microcredit, depending on their objectives: micro-enterprise lending or inclusion lending based on corporate social responsibility.

For microfinance institutions, the key questions are:

- Where does the capital come from?
- Who should do the lending?
- Can it be sustainable?

The workshop recommended:

- If banks want to develop the market for microcredit, building cooperation with microfinance institutions can help both parties. Various models of cooperation could be explored further.
- Achieving a balance between financial sustainability and social performance would help the non-bank sector to keep its focus on its original tasks and help to avoid competition with the banking sector. For this, the gradual inclusion of microcredit customers in the banking sector is important.
- Internationally, the microfinance industry is increasingly using capital markets to finance its operations. This model could also be more widely used in Europe and the cooperation between banks and microfinance institutions under the Jasmine scheme could help.

The financial crisis and recession

The financial crisis and recession have had an impact on the lending capacity of banks. The higher cost of funding, higher capital requirements and fewer alternatives have already led to a slowing of the pace of growth in credit operations in many countries. This is also likely to have an impact on non-bank microcredit providers and their refinancing costs.

The impact of the recession is being felt by all enterprises, including micro-enterprises. Bankruptcies are increasing as demand shrinks and banks are hesitating to finance the riskiest market segments, reducing unsecured lending and applying stricter credit conditions.

Non-bank MFIs will also be affected by the crisis. As interest rates for commercial loans increase, the question is whether more loan applicants will turn to MFIs, or on the contrary refrain from borrowing altogether. The crisis will also be a stress test for the performance of MFIs´ loan portfolios, if late or default payments increase. It remains to be seen if they react in the same way as banks do: focusing on risk management, more rigorous control of lending procedures, adapted loan characteristics and more public and private partnerships.

On the other hand, the recession could increase business creation, although this effect is likely to manifest itself only as the upturn is in sight. This could encourage the use of microcredit. However, to increase the sustainability of such new enterprises, monitoring and follow-up through business development services should be strengthened.

The workshop concluded:

The financial crisis is likely to lead to a rethinking of banking strategies, which could provide opportunities for developing more microcredit products.

The recession could lead to higher rates of business start-up, which could lead to higher demand for microloan products.

The question was: if non-bank MFIs could step in, would banks lend less?

The workshop recommended:

- The situation of the microcredit market should be closely monitored. Banks and MFIs could use the crisis as an opportunity to cut costs and increase efficiency, improve risk management, set up partnerships and develop new services.

List of participants

Name	Organisation	Country
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GAINING SCALE IN **MICROCREDIT**

Can banks make it happen?

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