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Banks and Microfinance in Europe

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"Microfinance Europe" is the bi-annual EMN magazine. It provides clear insights into European microfinance programmes, with a specific focus on policy measures that could support the development of the sector. Its in-depth articles offer an up-to-date commentary on what is happening in the different European countries, how policies and practices are implemented and evolving and what recommendations can be made by practitioners, researchers and academics to promote microfinance and microenterprise development in the European Union.

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INDEX

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MICROFINANCE Europe

From the editors

Europe is characterised by a dense network of banks with over 8 300 financial institutions. Despite this reality, microfinance provided by non banking institutions has emerged in the last twenty years as a genuine alternative for thousands of micro entrepreneurs, who have been refused access to credit by the mainstream banks.

The special links created between the non banking institutions and the banks have been a key factor in the growth of this sector. The banks entered this new market with a range of different models and approaches. While most banks prefer to provide support to MFIs, some are also starting to offer microfinance directly. As the sector becomes more visible and more mature, relationships between the actors are evolving.

New initiatives (particularly from the EU) will provide further funding for the sector but it is not clear if this will be channelled through the banks, the non financial institutions or both. Some national governments are putting pressure on the banks to downscale their activities in this area.

In this context EMN requested a series of articles which aim to answer a number of questions including: What should be the role of banks in European microfinance? Should banks provide microcredit directly? Or through partnerships with non financial organisations? What opportunities exist? What are the threats? And what challenges lie ahead?

This debate drew contributions from two different institutions, the Millennium bcp bank in Portugal, one of the rare commercial bank in Europe which offers microcredit directly, and Mikrofond in Bulgaria, an NGO transformed into a financial institution.

An article from the European Commission also presents an overview of the question in Europe including the findings of two workshops for banking and non-banking experts organised by the Enterprise and Industry Directorate-General.

Another article outlines the German experience underlining the most recent changes in the microfinance environment including the establishment of a new fund based on a public – private partnership, which marks a critical moment for the future development of the German sector.

The role that should be played by the banks in Europe is then analysed in a further article based on the Spanish experience and especially through the involvement of the savings banks.

New regulations and government pressures on banks to get directly involved in professional microcredit in France provide an opportunity for an article analysing the links between the banks and the microfinance institutions in one of the most mature microfinance market in Europe.

The final article shares the UK experience of social, ethical banks with a European perspective which offer a challenging alternative banking model to reach out on a massive scale to those excluded from the mainstream banks.

Lastly, we also requested visitors to the EMN online forum to give their views, and their reactions reflect the importance of the debate on such issues.

Philippe Guichandut
On behalf of the editorial committee

The Debate

For the present article, EMN asked the representatives of two well-known organisations active in the field of microfinance to answer questions regarding the role that should be played by banks in Europe.

Helena Mena has been responsible for Millennium bcp's microcredit unit since October 2007. She holds a degree in Business Administration from ISCTE (Lisbon) and received further training in Strategic Management at AESE-PADE (Lisbon). Previously, in Banco Pinto e Sottomayor, she held a Senior Management position in the Credit Card Business, Corporate Banking and Marketing and was also a member of the Board of Telesotto (the home banking unit) and SE&o (a private label credit card). Following **Millennium bcp**'s acquisition of Banco Sottomayor, she was named coordinator of the Marketing Unit of the acquired bank, and at the same time, became part of the Working Group responsible for the transformation and integration of the Sottomayor Network into **Millennium bcp**. She also was advisor to Banco Millennium Angola's Executive Committee, Responsible for the Related Clients Unit and for creating and managing the Credit Products Unit.

Millennium bcp is the largest private financial institution in Portugal. Incorporated in 1985, it has grown via a combination of organic growth, through segmentation and cross-selling, and selected acquisitions. **Millennium bcp** is a retail-oriented universal bank with 23% average domestic market share in retail banking, commercial banking, corporate & investment banking and private banking & asset management.

Georgi Breskovski has been the director of Mikrofond since 2003, after being the program coordinator of the Open Society Foundation in Bulgaria. He is also the project director of Consortium **Mikrofond**, which aims at improving the situation and inclusion of disadvantaged ethnic minorities with a special focus on Roma projects. He holds an MBA from the University of Applied Science, Bremen, Germany.

Mikrofond is a lending institution in Bulgaria. Its mission is to provide loans to micro entrepreneurs and to fund low-income or underserved families' life-cycle financial plans (home improvement, education, health care, etc.) and to maintain good financial results in order to serve its clients in the long-term. Currently **Mikrofond** is operating through 11 offices and has disbursed so far over 7500 loans for the amount of 25 million EUR.

What should be the role of the banks in developing microfinance in Europe?

Helena Mena: From my point of view and as a business reference, banks must play a social role in society and, since microcredit is directly connected to banks' business activity, this is a field where banks should render a special service to the community. The banking sector should take an active position, either through the creation and the implementation of appropriate financial instruments themselves, or by acting as financial intermediaries. It is my belief that the service provided by banks, through microcredit, is almost an obligation. Banks have an increased obligation in this area, and the development of microfinance in Europe is clearly something that stems from the general banking business.

Georgi Breskovski: Banks should continue to be the main financial intermediary. They should analyze the market segments and respond to the specific need of each segment. I do not believe that banks should be the main player in microfinance.

Should the banks act directly in providing microcredits or go through non-banking microfinance institutions?

HM. Regarding this matter, banks may act in two ways: either by taking direct action in providing microcredit and, in addition, providing the necessary monitoring and advice to microentrepreneurs, based on the philosophy inherent to these types of funding. Or, if they are unable or prefer not to act directly, they should do it through the various microfinance institutions as financial intermediaries.

This is a socially relevant subject, and in this circumstance, banks must find a way to intervene within their means to ensure support for projects and families who don't have access to credit or are otherwise excluded socially. The overall goal, of course, is to help them access microfinance and microcredit and ultimately achieve self-employment and improved self-esteem. So, in short, banks should act as follows:

- Together with non financial microfinance organisations as intermediary;
- Or, directly with customers while also maintaining the intermediary role through established financial mechanisms;
- And develop an outreach work with NGOs and the Social Services , whose play a crucial role through their intervention within the socially excluded population.

The main difficulty facing the banks is to identify potential customers and reach a large number of people.

GB. The banks should take a two way approach. They should be active in lending to small businesses themselves but also should either invest or lend to microfinance institutions that lend to microbusinesses, self employed and income generating activities. The reason for that is that part of the microfinance market is very hard to serve efficiently through the conventional banking approach. In this area the microfinance institutions are much more efficient and flexible and quickly adapt to market changes and needs. Furthermore I believe that the goal of microfinance is to provide access in a sustainable way not the most profitable one. This conflicts with the purpose of the banks since they have to be efficient intermediaries and maximize profits and therefore cannot allow themselves to serve segments of the markets that are much more expensive to manage.

Is it realistic to believe that banks in Europe will enter the market with a sustainable business model or do they just do it for their RSE?

HM. It is realistic to believe that banks want to enter the market with a sustainable model and not just for their RSE. Microfinance is still in an early stage of development and it would be desirable to find the balance between sustainability and profit. Everything depends on the policy followed by the Banks' Board and here strategies can vary - but the ultimate path will always be to achieve both sustainability and RSE.

GB. As I have said before we should not look at the microfinance market as a whole but analyse the market segments. I believe that banks can build a sustainable model to serve the upper end of the microfinance market through their own operations.

Can the banks reach really socially excluded people?

HM. Most definitely. We see this everyday at Millennium bcp. The key thing is that the banks are willing to make the effort to reach out and find these people, and then make the effort to support them and their projects. For banks this can be a difficult process, because it requires changing traditional banking procedures as well as the mindset. Breaking with these traditional assumptions often means going against all the credit regulation determinations at any bank. Moreover, the difficulty also stems from the fact that close monitoring is essential for the success of the projects in which banks act as a true business partner.

GB. They can do so if they are willing to invest in learning from the experience of the microfinance sector and adopt its methodology. However I believe that the best solution to do so is to create partnerships with microfinance organizations that have better exposure to the excluded people.

Is the involvement of the banks in the sector not too risky – they might attract all the funds but use it for refinancing SMEs or put people into over-indebtedness without the provision of non-financial services?

HM. The involvement of banks in the field of microfinance and microcredit does not imply too much risk, since this sector, as a percentage of the total business of any banks, is not material. It is true that, seen as an isolated operation, microcredit is, in fact, a high risk business. But this risk is mitigated through diversification, microcredit involves small amounts and the projects are continuously monitored from the beginning to the end of the loan. In my opinion, funds allocated to microcredit or microfinance projects should not be used to refinance SMEs, or to finance families that already have high levels of debt. And by definition those people have access to credit; they aren't socially excluded. Microcredit should focus on viable projects and credit for those who have no other way to get a loan or form a banking relationship.

GB. I fully agree that these two challenges are really important that they can have a real negative effect on the microfinance sector. However, as the biggest financial intermediaries the banks bear the responsibility to really use the microfinance funds appropriately and to avoid over-indebtedness of clients.

So far in Europe two NGOS (one in Poland and one in Romania) are in the process of transforming into a bank. What do you think about it?

HM. It is my conviction that this will not be possible. It is necessary to separate things. For any bank, profitability is the main issue. A bank can't become an NGO, or function as such, and NGOs can't provide the services that bank offer. Their skills are different. In the context of microfinance, these entities should act according their own skills. The roles assumed by each of the actors involved -- the NGOs, the microfinance providers, the Social Service institutions and the banks -- are all crucial to the success of microfinance and microcredit ; they walk together hand in hand, fighting poverty and social exclusion. Taking advantage of these natural synergies will allow for the formation of partnerships, based on the expertise and knowledge of local populations with whom the institutions interact very closely. I believe that the big step is the professionalization of NGOs - but they should not become banks, there's no need for that given the natural interest and expertise of the banks.

GB. Transformation is part of the development of the microfinance institutions. **Mikrofond** has also transformed successfully to a regulated financial institution which helped us to attract new funds and to become more efficient. However it is not the guarantee for success, since other factors affect the institution: national regulation, economics, demographic specifics, etc.

What are the main challenges faced by the sector with the involvement of the banks?

HM. The main challenge is to reach as many people as possible. Banks have the critical size dimension, the resources and the financial experience, but there is a lack of presence on the ground, the intrinsic knowledge of the populations they want to reach and how to reach them. This aspect is essential, because, in general, it is the people who come to the banks and not the reverse. Microcredit calls for even greater relationships and involvement than traditional financial products. The aim of this involvement is to ensure a better understanding of the profile of micro-entrepreneurs and their needs, and also ensure their own self-sustainability. This role could be undertaken by NGOs and public entities that are active in social intervention and which are closer to this customer segment.

It is extremly important that banks work together with those entities. It is also very important to reach a common platform of understanding, to the extent that this process contributes to build a model of sustainable development, based on perception and on real response to the challenges presented

GB. The challenges have already been discussed – over-indebtness, use of microfinance funds to finance SMEs not micro businesses, targeting the right market segments, establishing good funding and equity partnerships with microfinance institutions, supporting the outreach of the microfinance institutions, etc.

Gaining scale in microcredit

can banks make it happen?

By Cindy Fökehrer – Enterprise and Industry Directorate-General

Cindy Fökehrer is a national expert at the Enterprise and Industry Directorate-General. She is responsible for helping to improve the financial environment for SMEs, especially in the field of microcredit, where she has been working with two expert groups on reports concerning microcredit and the role of banks and a Code of Good Conduct for microfinance institutions.

The **Enterprise and Industry Directorate-General** of the European Commission works to ensure that EU policies contribute to the sustainable competitiveness of EU enterprises and facilitate job creation and sustainable economic growth. It has the task of ensuring that the internal market for goods runs smoothly and is a major contributor to the implementation of the Lisbon strategy for growth and jobs.

Introduction

Over the last few years the Commission has been working on developing the supply of microcredit as a way to help several policy objectives: it encourages new businesses, stimulates economic growth, facilitates social inclusion and can help counteract the effects of the financial and economic crisis.

The development of the sector can also be demonstrated with some figures. In Europe the microfinance sector has been growing at a rate of over 10% since 2003. In 2007, a total of 42 750 microcredits were granted by the members of the European Microfinance Network, amounting to EUR 394 million.

Despite these encouraging figures, in its "European initiative for the development of microcredit in support of growth and employment", the Commission estimated that there was untapped demand for microloans. The question is how this gap can be filled and by whom? Furthermore, we need to consider how microcredit is defined. Contrary to the more commonly known uses 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. Microcredit may be supplied by any institution whose purpose includes lending smaller amounts to businesses.

This means that the banking system can be an important channel for providing loans to small enterprises and individuals who want to start a business. We cannot overlook the fact that there are around 8 300 financial institutions with over 233 500 branches in Europe. So banks can and should play an important role in the microfinance sector.

Challenges for the sector

Differences in the motivations between banks and non-banks (developing new market segments / reintegration into the labour market) and in policy objectives (fostering entrepreneurship / social inclusion) have led to different market exploitation strategies. Depending on the objective, channels can be linked with respective target groups. While credit institutions mostly do "micro-enterprise lending", microfinance institutions (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. On the other hand, MFIs have been up-scaling their activities towards more financial sustainability in co-operation with banks. Even here, loans to "normal" (commercially viable) micro-enterprises and start-ups are the dominant products in the market.

Start-ups, the self-employed and micro-enterprises that often only need a small loan may be regarded as unattractive customers for banks for various reasons: lack of collateral, limited or no track record, low profitability, etc.

The bank's core business is to assess risk and this analysis can result in the need for collateral or a guarantee. The risk assessment criteria of a bank generally leave little margin for manoeuvre for the loan officer. Having no collateral, or not enough, may also lead to higher pricing of the loan. In addition, dealing with collateral is expensive and can even be uneconomic for smaller loans.

Clients with negative factors such as no regular income, a bad credit history, illiteracy, etc. will face serious difficulty getting a normal bank loan, also because they usually need more support when starting a business.

Problems in business proposals themselves, ranging from basic activities to innovative ones, may also contribute to the financing problems. Clearly, when managing their day-to-day business, bank employees have limited time to help improve their customers' loan applications.

Several factors – no collateral or guarantees or inadequately prepared entrepreneurs or business plans – may limit banks in their capacity to reach the full group of entrepreneurs that is serviceable in a population of 18 million micro-enterprises, i.e. enterprises with less than 10 employees.

Different co-operation models

To overcome these problems, banks and microfinance institutions can cooperate, either by sharing back office (processing) functions, by refinancing MFI activities or by providing supplementary products, such as current or savings accounts.

Approaches to co-operation vary across Europe. Owing to the differing environments in the Member States, various models have evolved. 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 more than 40% in the business loan segment, almost half of them cooperate with business development services (46%), and almost one-third with 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 best to meet the demand. 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, France Initiative or France Active. In the same line, Crédit Agricole's 39 regional banks are engaged in partnerships with the major specialised micro-credit networks.

In Italy, a unit of Intesa Sanpaolo, seeks solutions by partnering with foundations such as Ethnoland and Lombardy Anti-usury to reach the financially excluded. These partners not only contribute to a guarantee fund but they also select the best proposals before sending them to the bank for credit risk evaluation and pricing.

In Spain the "La Caixa" savings bank group decided to establish a strategic venture for micro-credit activity, MicroBank. La Caixa is not only the third largest financial institution in Spain but also strongly promotes social objectives: €500m of its profits were invested in welfare projects in 2008. MicroBank was set up to channel La Caixa`s micro-credit business through its network of over 5 000 branches but within a wholly-owned subsidiary

with a starting capital of €75.5m. It specialises in granting micro-credits and small personal loans and is aimed at persons and families who, owing to their limited resources or lack of collateral, have difficulty in accessing the traditional banking system.

All these examples show that partnerships between banks and non-banks, including business development services, can help with the preparation and follow-up activities that may make all the difference. For example, the survival rate of companies supported by France Initiative was 86% after three years` business activity, which is considerably higher than the national average.

However, for most of the schemes, public support, in particular guarantees, continues to play an important role in the provision of microcredit. Risk-sharing instruments are a well proven tool to overcome lack of collateral and (perceived) riskiness of clients and to stimulate microloan provision from banks.

Cooperation with business support services or microfinance institutions may also be a way to reduce banks' transaction costs. However, this only transfers the cost problem from one entity to another. Where the credit decision is taken by the bank, the problem is then how to ensure proper pre-screening by the partner (who does not bear any risk).

Availability of banking is also limited for some disadvantaged groups and in some local areas. For the socially excluded in particular, the market has not been functioning for years in most European countries. Here public intervention can be justified in order to overcome these failures, although the line between positive support for and undesired negative effects in the market is very thin, as experience in the past has shown. For example, supported soft loan policies may lead to a crowding-out of market products and, when support was withdrawn in the past, no loans were available at all.

Another way to make microcredit more profitable or sustainable - charging higher interest rates - is met with reluctance by banks, in particular for marginal groups. The danger of damage to their reputation is one of the arguments for not considering this option. For some banks, providing microloans on favourable terms can be a means of integrating the borrowers into the banking markets.

The cost sharing and thereby increasing the client base approach might not help to create a sustainable microcredit sector in Europe. The possibility to charge the client a price that fully reflects the cost of the loan, including all factors (e.g. refinancing, risk and organisational structure), could be a way to make microfinance 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 have also pointed out that clients are willing to accept higher interest rates because it is the opportunity to have access to credit which counts for them.

EU INITIATIVES

The EU already has tools to increase the availability of microcredit, especially with the loan guarantees available under the Competitiveness and Innovation Framework Programme (CIP) and through guarantees based on the structural funds, in particular the "Joint European Resources for Micro- to Medium Enterprises" (JEREMIE) programme.

In November 2007 the Commission launched the "European initiative for the development of micro-credit in support of growth and employment", which is currently being implemented by DG 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) improving 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 micro-credit 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.

The facility launched under the fourth strand of the initiative and called "Joint Action to Support Microfinance Institutions in Europe" (JASMINE) is managed by the European Investment Bank Group (EIB and EIF) and seeks to support non-bank microfinance institutions by providing funding (co-financing facility) and technical assistance to microfinance institutions and microcredit providers. The objective of JASMINE is to help build and maintain adequate funding models for growth in microfinance operations of non-bank MFIs.
In order to alleviate the social impact of the crisis, the new European Progress Microfinance Facility, with a starting budget of EUR 100 million, will help deepen the outreach of microfinance to particular at-risk groups which face barriers in access to credit in a context of reduced credit supply. The impact of the recession is being felt by all enterprises but it could also lead to increased business creation, which could encourage the use of microcredit. However, to increase the sustainability of such new enterprises, monitoring and follow-up services should be strengthened. Those helped under the facility will also be able to benefit from mentoring, training and coaching as well as assistance in preparing a business plan, in close cooperation with the existing European Social Fund.

CONCLUSIONS

Banks can play a significant role in bringing scale, professionalism and operational efficiency to the microcredit sector. They should see microcredit as an innovative and profitable way of participating in economic and social development and should develop their cooperation with business support providers. Complementary work can be a key factor for success and lead to more access to finance, not only for final beneficiaries but also microfinance institutions. Only with the banks' involvement can the development of the sector be further accelerated.

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, and to avoid creating a second-tier banking system, the gradual inclusion of microcredit customers in the banking sector is important.

For the MFIs, competence, high operational standards and quality of service facilitate cooperation with banks. This is linked to the question of where they can source capital and how independent they can be from public funding in the longer term.

In general any support for microcredit should not lead to market distortions. Therefore, support mechanisms should be neutral towards suppliers.

The examples presented and market studies show that there is a great diversity in approaches, development level and performance as regards the provision of micro-credit in the EU. There is no "one size fits all" approach for microcredit. Owing to the differing environments in the Member States, various successful models have evolved. Any policy should respect this diversity.

These findings were made by banking and non-banking experts in two workshops in November 2008 and March 2009.

Banks in microfinance
The German experience

By Michael Unterberg & Boris Civieta – EVERS&JUNG
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The German microfinance sector - young and diverse

Over the past decade, a growing interest in microlending, a proliferation of practical microcredit provision and, thus, significant changes in terms of products and institutions could be continuously observed in Germany. Several microfinance institutions have entered the market; others have exited the market or changed their products and operations during this period. Three main institutional types of microfinance programmes can be identified based on their underlying mission. First, there are several private providers in the market, represented by start-up centres, local microfinance institutions and other support organisations accredited by the Deutsches Mikrofinanz Institut (DMI), which was established in 2004 to function as a nationwide umbrella organization. These organizations offer either microlending products or inclusion lending primarily to business founders and solo and micro-entrepreneurs.

Second, there are several promotional banks, including KfW with its microfinance programmes, which also focus to a certain extent on microenterprise lending, and which refer to 'bankable' and 'nearly bankable' persons as target groups, namely growth-oriented start-ups and existing enterprises. Typically they deliver these loans via the German 'Hausbankprinzip'[1]. Even though these are microloans in terms of their size, the applied methods resemble those used for small business loans. Moreover, as bad experiences with commercial banks are a major access barrier to external finance for microenterprises in Germany, the approach via the 'Hausbank' has a limited outreach. In some regions, like Berlin and Saxony, regional promotional banks are already sidestepping the so called 'Hausbankprinzip' of the public German banking system and are giving out microloans directly to clients. Finally, public-transfer bodies (governmental or semi-governmental), such as ARGEs[2], are active in inclusion lending targeting financially and socially marginalised groups such as migrants and long-term unemployed persons, the so called 'non-bankables'.

The commercial banks in Germany were, until now, only active in channelling existing public microlending programmes to clients. They are not serving this market segment themselves with specific micro loan products. There are a few regional savings banks that are working in co-operation with dedicated private providers but are in no way as active as the Spanish or French savings banks.

The role of banks in the German microfinance sector – between denial and co-operation

Regarding the role of German banks in the micro-segment there is no available quantified data - either from the banks or from the German National bank - about the microloans supplied by the banking sector to microenterprises. This situation is especially unsatisfactory since several studies have indicated that the potential demand for microloans in Germany may be substantial. For instance, the KfW-Gründungsmonitor revealed that 84% of all start-ups in need of external finance requested less than 25,000 Euros and the demand by microenterprises for external finance has increased by nearly 50% since 2004. The most specific attempt in assessing the demand for microcredit in Germany was proposed by Kritikos, et al. (2009). They come to the conclusion that around 17% of all young entrepreneurs who started their business during the past five years are interested in microloans and represent a defined target group in Germany[3]. Additionally, within the group of existing micro-entrepreneurs, the demand for microloans may be estimated at around 40% of all businesses with external financial needs[4].

Taking into consideration the dense coverage of bank branches in Germany (around 2,000 inhabitants per branch), it seems only logical, that private and savings banks need to be included in some form into the German microlending system to step up the number of loans disbursed to German entrepreneurs. However, banks themselves are either not interested in entering this market at all, due to cost and risk considerations or, as in the case of the German savings banks, they claim that they are already serving the market for microlending by providing loans up to 25,000 Euro to MSMEs with mostly good ratings and well established businesses. The relatively good performance of savings banks in financing SMEs in international comparisons hinders them from identifying the necessity to adapt their products and processes to the very specific needs of microenterprises. Moreover, the potential market for microfinance banks, which would be the overall segment of MSMEs, is thus limited in scope to the smallest loans only. To put it bluntly, it is the specific strength of the traditional German banking sector, cited in a World Bank study as "small banks finance small firms", that is hindering the banks from serving microenterprises adequately.

Because of this and because of the inflexible German regulation of financial service providers it seems unlikely that a greenfield micro finance bank will be set up in Germany in the near future. Therefore, co-operation seems to be the only way to include banks in sustainable and inclusive microlending activities in

1 The ‚Hausbankprinzip' ascertains that promotional loans and grants are available only through the commercial house bank of the beneficiary.

2 In Germany, ARGEs are the co-operation between the Federal Employment Agency and local municipalities, which are in charge of social welfare services.

3 See Kritikos, Alexander; Kneiding, Christoph and Germelmann, Claas Christian (2009): Demand Side Analysis of Microlending Markets in Germany, Journal of Economics and Statistics 229, 523-543..

4 See Kritikos, et al. (2009).

Germany. The literature on microfinance practice provides a number of approaches towards co-operation models between banks and microfinance institutions that allow for a combination of the outreach strength of innovative front office strategies from dedicated Microfinance organisations with the cost-effective and reliable back office organisation of commercial banks. The best known approach in this vein is the so called "service model" of ACCION, which is characterized by setting small, flexible front office units as interfaces with the client.

First steps in co-operation - the experience of GLS bank and DMI

In Germany a modified service model was adapted already in the early 1990s by the GLS bank, a social bank focusing on sustainable investments. The bank served for a series of pilot projects that all featured a combination of public funds (recently in the form of a risk sharing fund), back office organization by the GLS bank and front office provision by local organizations engaged in start-up support5. These organizations were screened and accredited by the DMI, which established a federal accreditation mechanism and as of last year had built up a member base of 11 organizations.

These pilot projects can be described as sophisticated and in some aspects complicated constructions of risk and cost sharing between the fund, the GLS bank and the local microloan providers. The latest was the so called 'Mikrofinanzfonds Deutschland', funded by the GLS bank, the federal ministries of economic and labor affairs and the KfW. The projects were successful in establishing an operational work-flow between the local financial intermediary and the bank to monitor the loans' repayments and if necessary enable interventions. They were not successful in building strong organizations that would have been able to provide microloans in high numbers. The incentives for giving out many loans were obviously not set in the right way. The chosen combination of risk and cost sharing was badly adjusted so that the financial intermediaries were not actively addressing their target groups. As a result, the total number of loans disbursed by the GLS bank remained low.

The 'Mikrokreditfonds Deutschland' – a public-private-partnership that works?

The lessons learned from these model projects, especially from the 'Mikrofinanzfonds Deutschland', were taken up in late 2009 by the federal Ministry of Labor Affairs. It developed a new instrument for the provision of microloans, the 'Mikrokreditfonds Deutschland'. The aim of the fund is to provide the impetus for a nationwide provision of microloans to business founders and existing micro entrepreneurs. The fund itself is a 100 million Euro guarantee fund (60 million Euro ESF money and 40 million Euro national funds) acting as a risk sharing instrument for loans that the GLS bank is giving out through the intermediation of local microfinance organizations (interest rate of 7.5% and maximum loan volume 20,000 Euro). The operational co-operation between the GLS bank and the organizations 'in-the-field' is based on an online IT-system, which will be further developed during this year. Further co-operation with private banks e.g. for client referral or technical assistance in front-office organization is not part of the model, but may evolve in the future.

The central progress of the model with regard to the incentive structure is that for each successful credit approval the intermediate organization receives a lump sum payment of 800 EUR. Additionally, the organization is paid a share of the repayment rate (10 %) of the loan. Thanks to this it is possible for the first time in the history of the GLS-DMI model to build a business model for pure microlending activities.

The new fund has stirred quite a lot of interest in microcredit provision from a broad range of actors. During the first four months of 2010, eight new organizations were accredited by the DMI and by the end of the year the number of DMI-members is expected to rise to 40 organizations. In the first four months, 250 loans were disbursed with a total volume of about 2 million EUR. The aim is to disburse 15,000 microloans by the end of 2015.

Outlook – a crucial time for microfinance in Germany

In summary, Germany is moving in microfinance. The establishment of the new fund marks a critical moment for the future development of the sector. If the fund is successful in building a number of capable organizations that are able to provide microloans in an efficient and sustainable way, the German landscape for microfinance will be changed profoundly. Banks will have to cooperate more often with these organizations to stay in contact with future clients from the microenterprise segment. Two critical factors remain to be observed and analyzed. Will efficiency be reached through high outreach numbers? For that goal standardized products of high quality combined with a Germany-wide marketing approach and a co-operation of local hubs to share high overhead costs will be a way forward in the system.

This leads to the second point: will sustainable structures be developed so that actors can survive even after the foreseeable decrease of the lump sum subsidy per loan? The crucial point in that regard will be the separation of support and finance services within the organizations, or the development of specialized and professional microlending institutions.

5 *In Germany, there exist a large number of business start-up centers at the local level. They are independent private organizations dedicated to support would-be entrepreneurs. Public subsidies and fees for services they provide to entrepreneurs finance them. Those services include administrative support, business advice, support for loan applications, trainings and so on.*

By Marcelo Abbad Sort – Marcel Abbad Consultoria Social

The role of banks in European microfinance the Spanish experience

Marcelo Abbad Sort was born in Barcelona in 1957 and holds a Master's Degree in Solidarity Economics. He led the implementation of the Microcredit Programme of Obra Social «la Caixa» in 2003. He was a member of the Board of Directors of EMN for two years. He currently heads his own consulting firm, specialising in microcredit. He is the author of the book "Microcredit: loans for dignity", published by Icaria.

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To understand, and then analyse the role of banks in European microfinance, we must look back and review briefly the history of this young industry.

A bit of history

In the seventies, and in places as distant and different as Bolivia and Bangladesh, microcredit was born in order to: 1) combat extreme poverty (the case in Bangladesh with the Grameen model) and 2) provide financial services and the start of small economic activities to people excluded from the system, invisible until then to the so-called traditional banks (the case of Bolivia with the Prodem, Bancosol models).

Although the two goals are somewhat different, they complement each other and share the key element of the nature of microfinance: the focus of the activity on people. Let's say that, for the first time, there were a number of institutions from the formal sector that redirected their mission towards this objective, moving away from an exclusive focus on profit without giving up on it.

Time passed. Microcredit activity was improving. And, as we know, awards, visibility, recognition, together with a clear institutional commitment to «import» this tool to developed countries also followed. In a small and global world such as ours, information travelled quickly from one side of the planet to the other. Banks were not immune to this movement, and voices from various economic sectors also came out clearly in favour of the new model. The political class, with more caution than decision, also joined the trend.

We could say that «genuine» microcredit (recognised by the Nobel Prize) «adapted» to an environment in which, officially, the circumstances of poverty and scarcity typical of the countries that witnessed its birth did not exist. And this adaptation altered two key aspects of the early forms of microcredit. First, it replaced the poor with people living in situations of exclusion, or at risk of suffering from it, and secondly, it redefined the goal of microcredit, from being a tool in the fight against poverty, to becoming a loan to create SMEs.

Changing the nature, of course, also changed the role of the sponsor of the activity, i.e. the bank, because it altered the key elements of any loan: recipient, amount, purpose and guarantee.

Europe relegated the Washington 1997 definition[1] to a historical anecdote and designed a new banking product, which took from microcredit not only its name but also some of its methodologies. It also combined poverty, exclusion, marginalisation, immigration, unemployment, disability and even lack of training, into one segment of the population susceptible to benefit from microfinance.

1 *"Microcredits are programmes providing small loans to the poorest of the poor to enable them start small businesses that generate revenues to improve their lives and those of their families" Washington, 1997.*

Banks watched this metamorphosis, puzzled. On the one hand, adaptation caused the new loan to be better adjusted to the banking tradition, and that was good news. On the other hand, microcredit also opened the door to a new type of risk, previously unknown, and for which the role and utility of guarantees was not clear.

The five types of microcredit

Thus, the role of banks will vary depending on the type of microcredit to which we refer. In my view, there are five types of microcredit. Each one of them involves a different role for its practitioners, and the bank is without doubt one of them.

Any kind of microcredit can fit into some of these groups. And the distinction between «genuine» and «adapted» does not make some better than others. All the funds described below are very necessary, whatever the type of microcredit, particularly in these difficult times.

To simplify this paper, I have limited myself to differentiating them exclusively based on their objective and their target audience, although to be complete, the distinction should be accompanied by a deeper explanation, especially concerning the different methodologies of each group.

Basically (described from the greatest degree of poverty to the least) they are:

- **Microcredits against extreme poverty**: Usually these are provided in developing countries. The clients live on less than a dollar a day or eat only once a day.
- **Development microcredits**: We have gone up a level in the pyramid of poverty. Typically found in developing countries, where the income is greater than a dollar per day. There is enough training although it should be improved.
- **Microcredits for inclusion**: This has nothing to do with poverty. Recipients are people experiencing evident social exclusion and also, therefore, proven financial exclusion.
- **Microcredits for business creation**: The objective here is the establishment of a small economic activity that in most cases will complement other already existing economic activities. Its beneficiaries are usually people who already work, formally or informally, and who seek to improve their income.
- **Microcredits for employment**: Or for the creation of small businesses. These are those that have less to do with the «genuine» microcredit, owing to their clientele, purpose and amount. The beneficiaries receive a good level of training, which may also be specialised.

What should be the role of banks within each of these types of microcredit?

Let's start by differentiating between banks and savings banks, and to simplify this distinction, simply remember that banks are committed only to their shareholders, who expect dividends resulting from the profits of the bank, whereas savings banks, which do not have shareholders, devote a major part of their annual profits to so-called "social objectives".

Let's talk first about the banks.

Reflexion 1)

Engraved in the DNA of the banking business is the management of credit risk based on the traditional risk/guarantee binomial. Solvency, stability, economic strength, financial independence, the capacity for growth and the positioning to compete in the proper conditions, force us to pay attention to these two elements, risk and guarantee. Any other approach is unacceptable. This reflexion can be extended to both banks and savings banks.

Reflexion 2)

Banks were not created to do social work. While progress and development come from their banking activity, the essence of their function is not directly linked to improving people's living conditions. In any case, this situation may be a further effect of this activity. Or it may not. There are opinions for every taste, in both directions, that I will not assess. In any case, what can be agreed on is that they were not created for that purpose.

However, the savings banks were, and social objectives are part of their genesis.

Reflexion 3)

A bank must appear strong to its clients, both current and potential, and to society in general, stating in a clear and transparent way that it is able to generate profits by managing others' resources effectively (customers' deposits) and by lending resources rigorously (i.e. without abandoning the risk/guarantee binomial). It is a message of strength, security and rigour. Any other data can complement this position; but never replace it.

Savings banks must display the same strength, based on exactly the same premises. But they must also explain to society what their contribution in the field of social work is.

The role of the bank differentiated by type of microcredit

Therefore, let us start with the most "banking" and traditional, to move on to the "least banking" and most innovative.

- **Group 5)** Employment and SMEs. Given these operations, both banks and savings banks have only to act on their traditional risk assessment premises, i.e. to respect the binomial. They can do this protected by employment or entrepreneurial programmes specifically designed for that purpose, or on their own. But these are loans "known" by the system. Usually the financial institution is not required to either create specific software or hire external specialists to manage this portfolio, because the characteristics of these loans, as has been said, are traditionally associated with banking, although they are called microcredits.

- **Group 4)** Entrepreneurship. These operations deviate significantly from the bank's origins. Therefore, financial institutions will need either external specialists or professional entities in the management of this type of microcredit. Although it retains a certain business vision, we should mention that this diminishes considerably because managing these portfolios costs more than the traditional administration of other portfolios. In addition, banks need to establish criteria for selecting such support organisations, and base them on trust, complicity and reciprocity of goals and values, an aspect that can cause confusion within the financial institutions themselves. This is more typical of the savings banks.

- **Groups 1, 2 and 3)** Poverty, development and inclusion. These microcredits deviate completely from the traditional banking spirit, although not entirely so in the case of savings banks.

Despite this, in the case of banks, their role may develop in three different areas:

- Participation in or creation of funds investing in microfinance portfolios, with the help of external entities to the bank, highly specialised in their design and management. This model is well known and has supporters and detractors in equal shares. It is not discussed in this article.

- Provision of sufficient capital to a promoter to participate at decision-making levels and manage its microcredit policies in a manner consistent with the objectives and priorities of the participating bank.

- Implementation of investments/donations within the scope of altruism or philanthropy. Usually this is not a "policy" of the bank, but rather a specific commitment to a particular programme, or a country, or a promoter.

Finally, in the case of savings banks, its role related to these three types of microcredit can be twofold:

- To participate in microcredit programmes by including economic items in the budget under the scope of international cooperation, social development and inclusion, always under the protection of its social work. Spain is a positive example of how savings banks can be professionalised in this area and also in far-reaching and high-impact accredited programmes.

- To agree on lending operations "in accordance" with social institutions that manage from the base the described objectives that are shared from the corresponding savings banks. They are special operations, whose repayment is flexible and tailored to the requirements of this special partnership.

Take the example of Spain

The Bank: The country is affected more than average by the consequences of the European crisis. The bank has left thousands of small businesses to fend for themselves, closing credit positions or cutting them to levels never seen before. Therefore, if the bank does not grant credits, it is illusory to think that it will be interested in creating a microcredit policy.

The Savings Banks: This sector is undergoing a complete restructuring as a result of the crisis and of the conditions of strength that the Bank of Spain and the European Central Bank require when seeking access to FROB (Banking Aid Fund). Therefore, at the time of writing this article, all kinds of mergers, acquisitions, agreements and arrangements are being signed between savings banks. Spain had 45 savings banks in the year 2009, and will likely end up with less than half that number before the end of 2010.

However, before starting this maelstrom of mergers within the sector, the savings banks had already decided to leave the microfinance industry. The reasons are many and the explanations are too long for this article.

In Spain, two out of the former 45 savings banks are active in the microcredit field corresponding to groups 1, 2 and 3. And one bank is active in the microcredit field of group 5 and some of group 4. There are no more. Unfortunately in Spain discouragement has spread and the crisis has helped each one to define itself in society. We can now identify those who acted in the microcredit field because they carry it in their genes and believe deeply in this tool, and those who did it for other reasons which have been shattered by the crisis.

Short conclusion

In my opinion, there is still much to be done since the sector is very young and the possibilities for involvement of the financial system are very high and in my opinion are still underused at present. Savings banks can lead the way because social responsibility and commitment to direct development are part of their nature and it is not at all a strange road for them. On the contrary, many of them are examples of specialisation and professionalism in this field. But at the same time, if banks assume ownership of the implicit values in this development, while not losing sight of the existing business potential, they could become a very significant second driving force for microfinance. They could do it without sacrificing rigour and without attempting to change their nature, which is something no one asks for.

All those working in microfinance must accept a portion of the responsibility; the future is ours and we build it every day. Therefore, the role of banks in our industry depends not only on financial institutions. It also depends on the professionalism and efficiency with which the industry behaves. Everyone must act with responsibility in their field of operation. And that concerns us all.

By Benoit Granger – Advancia

France: Involve banks in microcredit online, or through specialised organisations? The issue is not resolved.

Benoît Granger is a professor at Advancia, a business school on entrepreneurship at the Paris Chamber of Commerce. A former journalist, he founded and directed the Société d'investissement France Active, the first venture capital company in France specialising in social enterprises. He also worked as a European Commission expert on the development of fair finance.

Yet another new French law on credit adopted in May 2010 deals primarily with the control of consumer credit. In addition, the government is exerting pressure on banks to become directly involved in professional microcredit. But is this a profitable business for banks? Certainly not if they also provide counselling to microentrepreneurs, which is essential. Hence the questions that arise concerning the coordination between microfinance networks and banks.

Business creation in France deeply moved by recent reforms.

Microcredits continue to grow in France despite the economic crisis. Since 2007 this growth is probably best explained by a kind of 'dumping' effect. First, the threat to salaried employment contributes to the creation of new businesses by the unemployed, but it also has deeper effects. In 2003 and 2005, the Dutreil Laws simplified many of the procedures for creating a business. Then in 2009, the newly launched "auto-entrepreneur" category dramatically altered the business creation landscape. In fact, the number of new businesses in France increased from 215,000 in 2001 to over 300,000 in 2008, most of these being very small businesses. In 2009, more than 580,000 new businesses were registered (+75% in one year). This is mainly attributable to the auto-entrepreneur category because other categories of businesses declined.

The profiles of these newcomers are not very different from those of traditional businesses; yet it is a radical innovation. The formalities for starting a business are made very simple (you can register online in ten minutes and immediately start invoicing). Business rules are minimal, provided that the activity remains on a small scale with a maximum turnover of €32,000 per year for a service activity and €80,000 for a commercial activity. Even though reliable data are not yet available, the significance of this initiative is still relatively modest since only one quarter of self-entrepreneurs carry on a fully-fledged business and an even smaller number succeed in generating an income comparable to the minimum wage.

Microcredit in France: the figures.

France is the most active Western European country with respect to professional microcredit. This is due to the overwhelming success of Adie, which has been promoting microcredit through the media for more than 20 years, and to the more discreet and stubborn field work of France Initiative. The two microfinance networks are quite different in their structures, their philosophies and their targets, even though they share the common feature of being not-for-profit associations.

In 2009, some 40,000 newly created businesses were financed from outside the banking networks. The large majority of these credits can be divided into two roughly equal parts between Adie, on one hand, with an average loan of €2,800 for small projects presented by persons in difficulty, and the local platforms of France Initiative, on the other hand, with an average loan of €7,800 for larger projects. Other operators, such as the France Active Network and some regional networks, have lower trading volumes.

It is likely that there is a much higher latent demand, which has been estimated by studies (Adie in 2008, the EIF[1] in 2009) to be in the range of 100,000 loans per year. This is significant as consistent estimates[2] show that only 15 to 30% of entrepreneurs consider taking on debt in order to start their business. The remainder are reluctant to take such risks, or feel they do not need a loan.

However, this demand is simply an expression of the available supply. Much of Adie's success is related to this phenomenon. For many years, people with problems would not consider setting up a business for many reasons, including the fact these people were convinced that a bank would never trust them and lend them the necessary funds. Thus, it is this supply policy that over the last 20 years has shown that many people have both the will and capacity "to start their own business" and to develop sustainable projects, even when they are constrained to survive on the minimum social income.

Two kinds of cooperation with banks

Two other developments are also changing the landscape. On the one hand, banks no longer content themselves with leaving microcredit networks to do what they either do not want, cannot or do not know how to do directly, that is to say provide small business loans. On the other hand, the combined pressure of the French government and European authorities led the banks to get involved directly in a field of which they were generally ignorant.

Traditionally, for over 20 years, banks in France have outsourced small business loans to microcredit networks. With Adie, the agreement in principle was clear. Adie did all the upstream work (candidate selection, project validation and various aids to entrepreneurs) as well as the downstream work (double tracking of the customers with respect to both reimbursements and business management), with the loan actually being sourced from the bank. Then recently, Adie changed its policy in order to provide loans from its own funds. For the local platforms of France Initiative, the pattern is different and remains unchanged. The 500 local committees (the ones making lending decisions) are partly composed of local bankers. Hence, the unsecured loans are decided in an informal arrangement with the banks, making it easier for entrepreneurs to access additional loans from one of the mainstream local banks.

Thus, a dual system was established, which was highly effective for both partners:

- The bank avoids the costs of production that it considers disproportionate to the amount of the loans and its standards of production. It leaves this work to the associations, which receive grants to do it, but the bank then gains good quality customers.
- The associations, Adie and France Initiative, are able to show the government (which still remains their main source of grants) that they have contributed to the creation of many healthy businesses capable of development, whereas the banks have shown that they are unable to do this work alone.

The policies of these banks have been more or less explicit over the last twenty years. Some prefer to adopt the attitude of sponsors (BNP Paribas), whereas others, such as Crédit Coopératif, and more widely the Popular Banks (Banques Populaires), which federate the decentralised banks that have built real professional partnerships with the SME world and are heavily involved in supporting microfinance. They have long supported Adie initiatives, and are heavily involved in the provision of loans for the France Initiative platforms.

Two very different types of microcredit

Adie and France Initiative differ not only in their targets and the amounts of their loans. The two networks base their activity on very different philosophical grounds. Adie addresses people in difficulty who have a micro project. Its main loan is the Solidarity Credit (Crédit Solidaire), which is a loan of an average of €2,800 for a term of 18 months, and with an overall interest rate between 10 and 12%; and Adie asks its customers for a guarantee for half of the loan amount. The France Initiative loan is aimed at people who are not particularly socially excluded, but who are unable on their own to have their projects financed directly by a bank. The average loan amount is much higher (€7,800) and is for projects which are much larger than those of Adie's clients. The France Initiative loan is an unsecured loan,

1 *Helmut Kraemer-Eis, Alessio Conforti : "Microfinance in Europe, a market overview", EIF working paper, Nov 2009*

2 *See the ILO studies for the years 2000, e.g. the synthesis by Isabelle Guerin (IRD): "Microfinance in northern countries. Review of a comparative study ", 2007 http://www.univ-orleans.fr/deg/GDRecomofi/Activ/doclyon/guerin.pdfSee : Alexander S. Kritikos GfA, Berlin, Christoph Kneiding, Claas Christian Germelmann: "Is there a Market for Micro-Lending in Industrialized Countries? – Evidence from Germany" - GfA Discussion Paper No. 02 (2006) http://www.gfa-kritikos.de/media/Discpaper-No2.pdf*

that is to say without any guarantee or collateral (the borrower agrees to repay "on his/her honour"). In addition, it is a free loan, without interest. Its main attribute is to increase significantly the business creator's capacity for additional indebtedness, since this unsecured loan would be the final one to be reimbursed in case of a problem.

The question arises whether this unsecured loan falls within the definition of microcredit. Indeed, Adie's goal is to achieve a financial balance by covering its costs and risks out of the profit on its loans. This is a goal consistent with the vast majority of microfinance institutions, even though studies show that such a balance is unlikely to be achieved in Western Europe (EVERS & JUNG). France Initiative depends entirely on grants and patronage as its operation remains, by definition, in deficit and will always remain so. In addition, France Initiative funds projects that may be considered too large to match the definition of microcredit. According to the EU definition, confirmed in 2007, this includes business loans to a maximum of €25,000, which corresponds with the unsecured loans of France Initiative. However, their considerable leverage effect on the entrepreneur's additional bank debt leaves this open for debate.

The attitude of banks: disappointing from a strategic point of view

Since the recent financial crisis, banks in France, responding to government pressure, have made commitments towards the VSE (Very Small Enterprises) in order to support them in a difficult situation. At the request of the government, the banks had announced their level of commitment in 2007. Within the category of "VSEs younger than 5 years", it is not possible to distinguish those that would be considered as microcredit. But it is notable that of the €400 billion of outstanding loans granted to SMEs-VSEs, the outstanding loans related to VSEs (with a turnover of less than €1.5 million) younger than 5 years, which includes business creators, amounted to €78 billion at the end of 2007. Following the reduction in credits due to the depression of 2008 - 2009, the Government obtained formal commitments from the five major banking groups to increase their commitments in 2010. But it is likely that this increase will mainly benefit well-established clients of the banks, and not primarily the microentrepreneurs.

Banks have two traditional arguments to explain the weakness of their direct engagements. On the one hand, entrepreneurs are inherently risky customers because "one out of two will fail" according to conventional wisdom. In fact, recent studies (INSEE - APCE, Agency for entrepreneurship) show that the rate of "failure" is much lower (almost half of this group stops voluntarily)

On the other hand, banks have long advanced another argument, namely the disproportionate production costs of small business loans. If it takes the same amount of time to make a loan of €5,000 as €50,000, the explanation is simple. But it also shows that, beyond their traditional clientele of retailers and artisans, banks have invested little in getting to know entrepreneurs. The argument of "asymmetries of information" is weak, especially because recently they have been able to adjust credit interest rates following the recent removal of usury rules in France. However, it does not seem that the opportunity to charge higher interest rates[3] has greatly changed their production methods.

Review the terms of coordination: amounts and profitability; risks of competition

Thus, the situation in France is now unstable. For over 20 years, the two main networks, Adie and France Initiative, have provided convincing evidence of their effectiveness, each network according to its model. But they are only able to develop by obtaining the cooperation of banks. Discussion has taken place concerning the fact that the ceiling of €25,000 is not a good definition. Indeed, the implicit consequence would be to free banks from their direct responsibilities towards the majority of small start-ups, which would be left to the microfinance networks. So the discussion concerns the amount. Banks should commit themselves to implementing loans above €10,000 which they could grant directly while microfinance networks would focus on microcredit loans under €10,000.

3 See: Laurence Attuel-Mendes and Pr. Arvind Ashta (ESC Dijon Bourgogne) : « La législation française en matière d'usure et le développement de l'accès au crédit des microentreprises », Cahiers du CEREN 21(2007) pages 87-100

Is such a division sustainable? Some bankers specialized in VSEs are willing to make efforts to improve productivity and thus lower the minimum amount of their loans. But they add that if Adie, in particular, increases the average amount of its loans, they will come very close to some regular loans from the bank to its own customers, artisans or retailers. In this event, bank support for Adie is less justified. Both operators are potentially in competition while Adie is subsidised to provide its loans. Moreover, Adie would possibly find itself in trouble since it is unable to offer the additional services offered by the bank (current account, financial services, overdrafts, credit cards ...). The debate remains open concerning what is still a small proportion of Adie's "best" customers.

Ideally, collaboration between banks and microfinance networks develops through mutual learning. Banks learn under what conditions some network customers could become profitable customers for them, and microcredit networks learn from banks about the technology they need (computer systems, scoring, recovery techniques ...). But limits quickly appear if one or the other feels that they are losing customers!

Two risks for the future: to abandon the logic of the professional loan; and the trend towards the virtualisation of the relationships between lenders and borrowers

The limits of cooperation between banks and microfinance networks are also defined by other external pressures. The pressure on the profitability of banks' equity capital, which is greater under the Basel Agreements, since small business loans are undoubtedly the least profitable loans for banks. Also the competition between banks and specialised financial institutions, which changes the nature of business loans.

By definition, business loans are based on a strong relationship between lender and borrower, each party needing to "understand" the plan of the other. So this requires a dialogue which implies high production costs. Whereas the techniques of personal loans (consumer loans, revolving credit, etc..) come down to a very quick benchmark between a personal profile and a database, this allows specialised financial institutions to make revolving credit loans of very small amounts, up to €100 or €200, which are very profitable.

So the temptation is great to move from one technique to the other, especially as, in the case of micro projects, the boundaries are blurred between the person of the borrower and his/her project. This is what has happened in some Latin American countries since the late 1990s. The banks have built a range of personal loans in direct competition with those of microcredit NGOs which offered professional microcredit, often based on peer groups. The result is an oversupply and a severe indebtedness phenomenon that was previously unknown[4].

This is a risk already present in some European countries, especially in the East, and which raises questions concerning the very logic of microcredit. There are no physical meetings where the project can be discussed, no more dialogue or assessment, whereas, by definition, clients are people who need advice and counselling. Moreover, the European definition of microcredit includes advice and counselling.

This "debt by a click" trend also converges with another trend towards the virtualisation of business creation procedures. In France, since 2010, a mere 10 minutes on the internet are required to become a self-entrepreneur and start one's activity. So there is no longer any physical encounter, either with a lender, or with a counsellor.

These products are successful because they fulfil a need for an impersonal credit relationship, which avoids the feeling of anxiety or guilt of a personal relationship with the traditional banker, credit sociologists and historians believe. The result, however, is that risks are transferred to one side only, i.e. But as a result, risks are transferred from to only one side: from to the side, in case of a problem, of the one that the person who has "made a mistake" of in borrowing, and not from the side of while there is no risk for the credit supplier. It is in this that lies here that we can identify one of the sources of the risk of new forms of over indebtedness.

4 See CGAP Occasional Paper - "Marketing and excesses of the MFI's mission - the transformation of microfinance in Latin America", March 2001 (downloadable from the CGAP website). See Benoit Granger: "Evaluating microfinance after the scandal of Compartamos " on Moral report on the money in the world 2009. Ed Association d'économie financière, 2009 - http://www.lamicrofinance.org/content/article/detail/24332?PHPSESSID=168869

By Malcolm Hayday, Charity Bank

Microfinance in Europe at a crossroads

Malcolm Hayday is the co-founder and chief executive of The Charity Bank, the world's first general registered charity to be authorised and regulated as a bank. Charity Bank provides a growing range of financial services for the common good. It is a different bank for people who want a different world. In just 7 years, the work of Charity Bank has touched the lives of over 3 million people in the UK and, increasingly, in the wider Europe. It sees its growth through partnership with like minded people and organisations.

More and more banks and other external investment funds have become involved in microfinance in Europe. There had been a feeling that microfinance institutions (MFIs) would be insulated from the shocks in the 'real economy'. There are growing concerns about problems of credit risk which may raise concerns about liquidity and the prospects for refinancing funding requirements, leaving weak MFIs with poor funding and inefficient management that had been buoyed by benign economic conditions and over abundant funding, exposed to a higher risk of failure. But is this a sign of fundamental weakness in the MFI business models or the deeper malaise in the mainstream market and the knock on effect into the investment market?

A European history of trust

For many of us microfinance and Grameen are virtually synonymous. Few are aware of its European history. Access to credit is one of the most useful financial tools available to the poor and marginalised. Credit permits human capital to be leveraged with financial capital in order to increase income. This is what attracts Government policy makers. But as we have seen recently, credit raises problems of moral hazard which requires that the lender must be able to trust the borrower and, perhaps even more importantly, vice versa. Too often this hindered poor people, particularly women who had limited or no access to assets, from accessing credit. With banks unwilling to engage in this market, it was left to the generosity of people like Dean Jonathan Swift in Ireland to develop loan funds. Out of his own pocket, Swift set up a revolving loan fund of £500 which made loans to tradesmen who had fallen on hard times but whose standing was such that they could present guarantees from two neighbours. Swift was drawing upon social capital much as group lending schemes operate today. Swift's lending charity died with him but it encouraged replication. By the 1840s they had become the principal 'formal sector' source of credit for the poorer two thirds of the population. The Irish Famine hit the loan funds hard but some persisted until 1961. It was only as banks put managers into communities that they began to win back the trust of customers - only to lose it again some twenty years later.

Moving to scale

In the latter days of the last century, microfinance was thought of as a small-scale philanthropic movement to provide credit to the neediest. Where banks did engage it was through their foundations. Citigroup Foundation supported microfinance because it saw the stabilising effect on society that economic activity funded in this way could achieve: and Citi wanted 'good governments' as customers.

Fast forward to 2010 and the work of people like the late CK Prahalad who had identified the fortune at the bottom of the pyramid, and we find microfinance established as a major supplier of a wide range of financial services to millions of people. Its success has attracted substantial inflows of external investment, fuelling rapid expansion. MFIs are one of the few recognised impact investing asset classes. This is leading to profound structural change and a blurring of the lines not just between philanthropic loan funds and MFIs but also between the latter and formal banks, as MFIs grow in size and product range and commercial banks enter the market. While these trends have helped shine the spotlight on the sector, they have also created new pressures of competition and mission and have heightened expectations. These trends were at work before the recent global credit crunch but are likely now to have been exacerbated.

A changing risk landscape

The CSFI Microfinance Banana Skins 2009 Report found that the economic crisis had transformed perceptions of the risk landscape. Three clusters of vulnerability were identified for MFIs: the worsening business environment; threats to funding and liquidity; and potential reputational damage. The Report went on to posit that microfinance is at a crossroads and that it might be helpful if it could call a time out to reassess its role. The trouble is that poverty and economic development needs know no such thing as a time out, nor, it seems, do Government programmes. But there are some fundamental challenges ahead. Should MFIs shift from their essential social role towards a possibly more sustainable profit-seeking (I hesitated from writing 'maximising') model? Are subventions endemic to the Western European business model? Should they continue to develop into more or less full service financial institutions, and become part of the formal financial sector? How will the increasing weight of regulation impact them?

In Europe, microfinance institutions are defined as institutions providing loans of up to €25,000 to micro enterprises. They are operated principally to contribute to enterprise development, although some may argue for the growing number providing personal financial services and consumption credit. This seems to raise an important policy issue about the role of savings in financial inclusion. MFIs can play a fundamental role in harnessing for local investment, small scale savings, much more effectively than big banks. Specifically, microfinance is linked to two EU policy objectives: to improve access to finance for SMEs as part of the regional development agenda; and, micro enterprise as a means to promote social cohesion. Until recently the most notable initiative by the EU was the JASMINE pilot programme, led by the European Investment Fund (EIF) to provide effective support to MFIs to offer sustainable microcredit within the EU. This is now being overtaken by the Progresso Facility, targeted at enterprise promotion and social cohesion through greater access to finance. While the EIF has shown itself to be innovative and fleet of foot, is it really the most empathetic partner for such programmes? It seems to an external observer that were Progresso to be allied to an incentive to save it could lead to greater sustainability in those MFIs capable of being regulated to accept deposits.

Microfinance in Europe

In 2007 the expanded EU microfinance sector made over 42,000 loans to a value of around €400 million and had in excess of 120,000 clients (Jayo et al, 2008). The sector was dominated by three large MFIs created before 1996. Together, ADIE, France; Finnvera (Finland); and Fundusz Mikro (Poland) accounted for 70% of the loans activity. Yet the model was not homogeneous. The Central and Eastern European model appears to be focussing on sustainability, profitability and scale whereas some commentators have observed that the Western European sector has a strong focus on social inclusion and pays less or almost no attention to its profitability (Evers and Jung, 2007). The European Commission expert panel on microcredit noted that non-bank MFIs in the narrower EU were to a large extent reliant on grant funding. Indeed, many of the practices, such as offering extensive technical support in addition to finance and of graduating clients on to mainstream banks, may run counter to reaching sustainability. Repeat clients can be an important driver of sustainability (Dayson et al, 2008). The regulatory framework may also limit the possibility of closing the gap between delivery costs and income.

Banana Skins 2009 found similar perceptions of the MFI risk landscape in Western Europe and the CEE. In Western Europe, respondents had equal concerns about the impact of the crisis on MFIs .e.g. credit risk, the macro economy and liquidity, and the implications of this for investors in foreign currency exposures, refinancing and funding difficulties. CEE respondents saw credit risk and its impact on profitability as the biggest risks facing MFIs. In both markets, greater political interference and inappropriate regulation were concerns at a time when the pressures of competition from other MFIs and commercial banks were beginning to hit profitability.

The regulatory environment

Microfinance is not just about lending. The Basel Committee has recently launched an initiative on microfinance activities and the Core principles for effective banking supervision, which acknowledges the importance of microfinance as a key vehicle to build inclusive banking markets. Earlier, the World Savings Bank Institute (WSBI) had outlined a vision of an environment conducive to financial inclusion that allows MFIs to efficiently provide small financial services, while maintaining high levels of risk prevention and consumer protection. The WSBI's views are interesting because many of its members are involved in microfinance. A number, particularly in Europe, provide microcredit services to micro entrepreneurs or to socially vulnerable individuals. These tend to form part of the social interest commitments of the banks, as in Spain, or CSR activities. Although they gain the bank wider public recognition, they are minute in the scale of overall balance sheet activity and have a negligible impact on the bank's overall financial risk: which raises the question of whether it is profitability that is stopping them doing more. Die Zweite Sparkasse is a new model of savings bank in Austria, initiated in 2006 by Erste Foundation with Caritas and a debt counselling service to bank the unbanked. It is run entirely by volunteers (often retired Erste Bank staff) and is in effect a low cost nursery for that bank. In France the finances et pedagogie and Parcours confiance programmes have been instrumental in providing training and support for excluded people together with guaranteed microloans.

Other WSBI members, especially beyond Europe, offer microfinance as part of their mainstream business through their ability to collect low value savings and to grant small loans, or have opened specialised (and subsidised?) windows, such as Banco Estado Microempresas in Chile. Then there are other deposit taking institutions such as postal financial services which may operate under different regulatory rules. Here, the new UK Government's interest in a Post Office Bank providing basic banking services may be one to watch and its impact on the fledgling CDFI market. WSBI's view is that all microfinance activities should be governed by the principle same business, same risks, same rules. It is not clear how this will sit with the Basel Committee's current thinking that amounts to a lighter touch regime for smaller institutions given the limited systemic risk they pose to the financial system. In the UK, we have seen an increasingly one size fits all approach to regulation which does not augur well for micro institutions. However, microfinance clients, by definition, come from the most vulnerable and low income segments of the population where the social impact of any default of an MFI could be substantial.

Mission driven sustainability

So, it seems that we have very different models that may become subject to similar, if not the same regulation. Trust banking is not easy for regulators to score. If any financial institution can exhibit financial sustainability both now and in the stress tests that regulators require of it, then all is likely to be well albeit at a financial cost. Complying with regulation does not come cheap. But if MFIs are largely market based but social models delivering government inclusion agendas at EU or local level, then this may be at the cost of their sustainability. The question then arises as to who should pick up the cost of subsidy or capital. If these MFIs are in fact providing a proving ground or nursery for mainstream financial services, having taken out much of the risk, should not the commercial banks be required to pay for this? Given that it is to achieve public policy they should benefit from tax credits for so doing. But then their support may last only as long as the incentive or while the CSR budget endures.

Significant inward investors have been foundation and impact investment funds, albeit not as significantly in Europe as elsewhere. But as profitability and sustainability come under closer scrutiny and other investment opportunities begin to appear in the impact investment space will these investors begin to look to diversify their portfolios away from microfinance? Is there a role for the social banks? Some, such as Triodos, Oikocredit, Banca Etica, and funds such as SIDI have established programmes of working with MFIs around the world.

Charity Bank needs to do the same. Recently, FEBEA has launched the Active Europe project to create a coalition between social banks and those organisations, including MFIs working for social integration through economic activity. At their heart social banks and MFIs share a common vision of a people centred economy based upon real economic rather than synthetic activity. If we are to offer people, governments and regulators an alternative banking model, it can be one that embraces social banks, many of whom need to be substantially larger than they are today, and MFIs reaching not only the marginalised communities they reach successfully already but also those they do not yet serve as comprehensively: often the immigrant communities, the Roma, the dispossessed who have needs that embrace savings and insurance as well as loans. Together we can offer stakeholders a compelling case and a long term solution.

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Perhaps the new wave of establishing "green banks" as a response to the image crisis of traditional commercial banks following the financial crisis may also provide an opportunity to create a specialised microfinance bank. *(Boris C. – Germany)*

It is necessary to give all social classes the opportunity to save and invest. This means that microfinance has to exist and differentiate itself from big banks. European banks should sponsor the creation of microfinance institutions and keep them separate from the traditional financial system so that MFIs have exclusive charge of microfinance services. *(N - Italy)*

This potential clientele has low entrepreneurial knowledge - this is one of the reasons why commercial banks can not finance them - so lending to them requires special care. It must be linked with the provision of information, advice and mentoring. Financial and technical services can not be separated in space or time. *(Istvan K – Hungary)*

If we want to arrive at sustainable structures, we need sustainable incentives for involvement. Consequently, the question is not what should the bank do (to add value to the sector), but what might the bank want to do (that benefits the sector). *(Boris C – Germany)*

In the present European context of globalization and crisis, economic change will accelerate the emergence of important new groups of micro-entrepreneurs. […] Micro-entrepreneurs are microfinance clients whom the banks have great difficulty in serving. Working with micro-entrepreneurs requires specialised know-how that banks do not have. *(François L. - France)*

Banks must understand that poor people have needs just like everyone else. They also need to understand that providing them with the means to improve themselves and their future is not only an effective strategy but one that could also open up international capital markets to a diverse clientele with an acceptable profit margin. *(Louisette R. - Madagascar)*

I think that the banking systems […] have increased their interference into the microfinance market, and as result the competition in this market has increased a lot. We would prefer market division, since MFI specialization in this market is more fruitful. *(Robert L. - Albania)*

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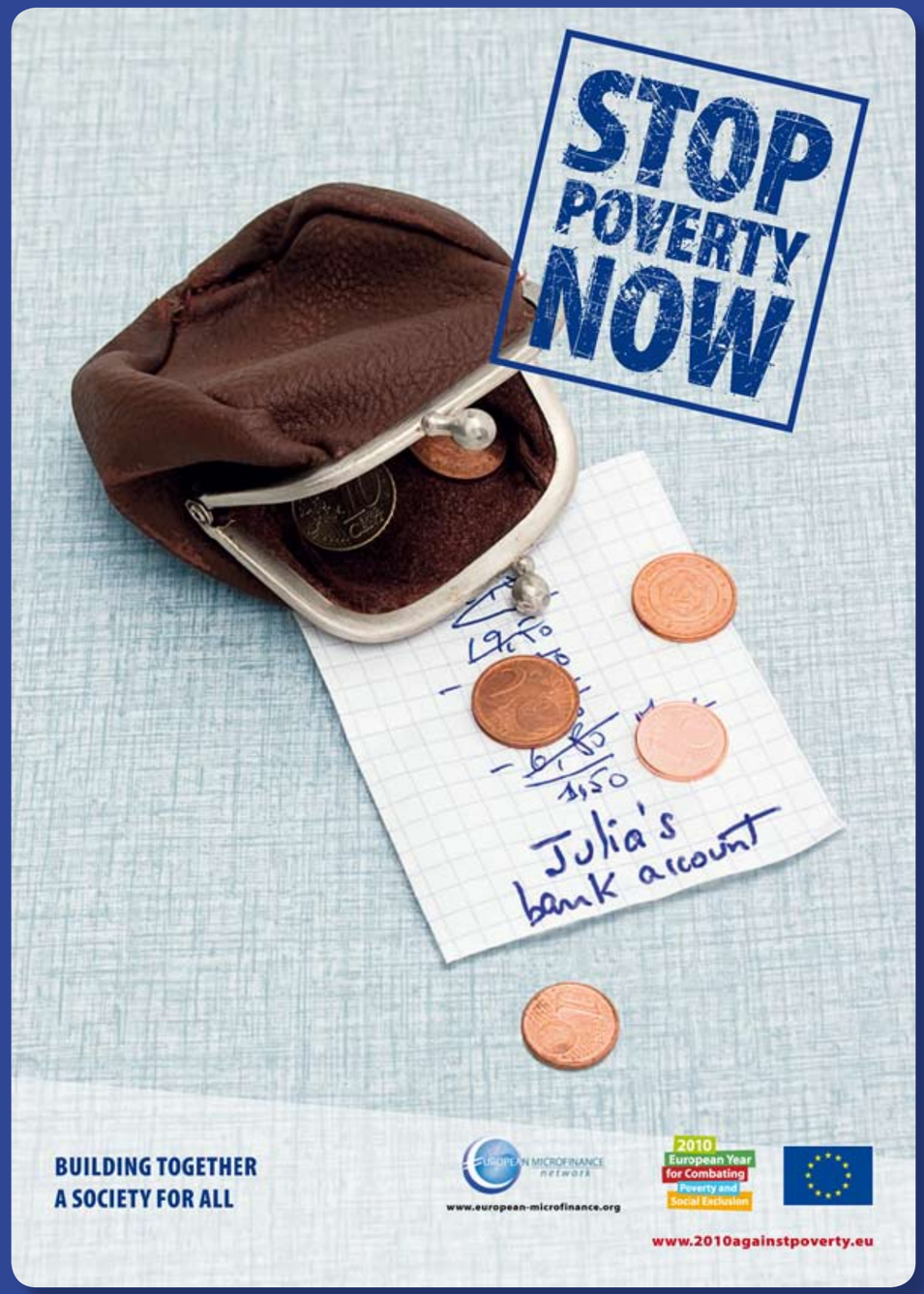

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