

# The Legal Framework for Microlending in Germany and its Implications for the Lending Design

Alexander S. Kritikos

*GfA, Berlin*  
*e-mail: kritikos@gfa--kritikos.de*

Christoph Kneiding

*GfA, Berlin & CGAP World Bank*  
*e-mail: kneiding@gfa--kritikos.de*

## Key Words

Microlending, Small Business Finance, Legal Framework

## Abstract

In this paper we investigate the status quo of regulation for Microfinance Institutions (MFIs) in Germany. A short presentation of the legal framework is followed by a detailed account of the practical implications for the lending design that MFIs face. Five different models of loan extension are presented: the credit flow model, the trust model, the hybrids, the fund model, and the outsourcing model. These models are illustrated by case studies which emphasize the organisational consequences for lending operations that MFIs face. The article concludes with several policy recommendations that might serve as a first step towards better integrating microlending into the German banking system.

# **The Legal Framework for Microlending in Germany and its Implications for the Lending Design**

Christoph Kneiding and Alexander Kritikos<sup>\*</sup>

## **Abstract**

In this paper we investigate the status quo of regulation for Microfinance Institutions (MFIs) in Germany. A short presentation of the legal framework is followed by a detailed account of the practical implications for the lending design that MFIs face. Five different models of loan extension are presented: the credit flow model, the trust model, the hybrids, the fund model, and the outsourcing model. These models are illustrated by case studies which emphasize the organisational consequences for lending operations that MFIs face. The article concludes with several policy recommendations that might serve as a first step towards better integrating microlending into the German banking system.

---

<sup>\*</sup> The authors thank Christoph Höltermann and Maike Classen for very helpful comments.

## **1. Introduction**

Compared to other European countries, the history of microlending in Germany has been relatively short. In 2000, a couple of locally confined projects started to extend loans to micro businesses. In order to assist business owners displaced by corporate restructuring, many regional governments also set up their own loan funds—most of them outside the formal banking system. Despite the existence of such programs, only about 2,000 loans were actually approved by 30 different regional or local institutions in 2006 (Evers and Lahn, 2007).

One possible hindrance to the success of microfinance in Germany might have been the legal framework that regulates banking activities. A comparative study of institutional frameworks for microlending that has been funded by the European Commission showed that the legal framework is clearly a bottleneck for a more favourable microfinance environment in Germany (DG Employment, 2007). The case of ADIE, a French micro-lender who started operations in 1989, supports this view. It was only after ADIE executives managed to open a special window in the banking act that loan numbers jumped up to a significant extent. Since the creation of this special window, ADIE is allowed to borrow for on-lending which makes the organisation much more efficient because it does not need to pass through a bank for its operations. In 2006, ADIE extended 7,500 loans, and reported to have more than 13,000 active clients.<sup>1</sup>

The objective of this paper is twofold: on the one hand, it depicts the status quo of microlending regulation in Germany. Unlike previous studies (cf. Bornemann, 2000), though, it does not aim at analysing the legal details and intricacies of German banking law. Its objective is rather to picture the economic and organisational consequences that arise for Microfinance Institutions (MFIs) that plan to set up operations in Germany. On the other hand, this study will offer a first assessment of the microlending models that have so far been developed in Germany. When possible, short case studies will be presented that exemplify how these models work in reality.

---

<sup>1</sup> Similar developments, namely low Microlending activities under the old bank regulation and increasing activities under a new regulation are not only reported from other Western European countries such as Norway but also from the home country of microloans, namely Bangladesh. Mohammad Yunus reported that the reform of banking regulations towards microfinance institutions was the most important prerequisite to start Microlending at a large scale.

The remainder of the paper is structured as follows: Section 2 offers a brief overview of the microfinance sector in Germany. Section 3 presents the regulations of the German Banking Act (KWG) and EU laws that are relevant for MFIs. Section 4 describes the microlending models that have been developed on the basis of these regulations and exhibits case studies of organisations that employ these models. Section 5 formulates policy recommendations how the extension of microloans in Germany could be facilitated. Section 6 concludes.

## **2. The Microfinance Approach and Markets for Microlending in Germany**

### *Microfinance Approach*

Microlending is defined as the extension of micro loans to persons who mostly do not have access to the formal banking system. Commercial banks perceive microlending as a high risk and low return activity as micro businesses exhibit relatively high failure rates during their first years of operations. Furthermore, lending very small amounts entails high transaction costs which can usually not be covered by according interest rates due to federal usury laws (cf. EMN, 2006).

Generally, the definition of microloans encompasses all loans ranging up to €25,000 (European Commission, 2003). Usually, persons require microloans to finance short term investments or cash flow requirements. Moreover, businesses considered eligible for such a loan type are micro-businesses where the business owner is a solo-entrepreneur or employs not more than 5 persons in the business and has a turnover below € 1 million per year. One may expect, however, that persons who are interested into these kinds of loans are typically business owners with a yearly turnover of less than € 100,000.

However, micro-lending is not only just lending very small amounts of money to business owners but also a technology which is applied to the complete loan process. In this process, financial statement analysis is substituted by an assessment of the personality and the local surrounding of the micro entrepreneurs. More specifically, lenders assess i) the personality characteristics, ii) the entrepreneurial abilities and iii) the entrepreneurial knowledge of the applicants, iv) while applicants are (mostly

but not always) asked to provide new forms of collateral and where v) the gathered information is put together into a new kind of credit scoring.

### *Market Size*

Concerning the potential market size, the German SME sector comprises of 4.2 million businesses in 2007. Around 90% of them achieve a yearly turnover of less than 1 million Euros, 70% of them of less than 100,000 Euros and 56% are run by the self-employed persons alone (see Piorkowsky and Fleißig, 2008). The average year-to-year survival rate of all businesses in recent years has been 92.5% (Constant and Zimmermann, 2005). As to new businesses, the number of start-ups was around 500,000 in the last years with a relatively strong drop to 425,000 in 2007 and it is estimated that about every second firm was created out of unemployment.

### *Actors*

Inside and outside the formal banking system, there are various funding alternatives for small and micro-business owners. As the main provider inside the system, the *Kreditanstalt für Wiederaufbau* (KfW) offers three loan products aimed at small and micro-businesses in their start-up phase, with two of the three allowing customers to apply for a loan up to three years after founding the business. Maximum maturities vary between five and ten years, and maximum loan amounts range between €10,000 and €50,000. Slightly more than 4,500 loans have been extended in 2004. In this context, another public support scheme should be mentioned: the ‘Gründungszuschuss’ (*start-up grant*), which is granted (i.e. it does not have to be repaid) to previously unemployed business founders for a maximum period of 15 months. Within the first 9 months it is nearly equal to the unemployment benefit the entrepreneur would have received had he or she remained jobless; during the following 6 months, the payment is reduced to a lump-sum of €300 per month. In July 2007, more than 200.000 persons received the ‘Gründungszuschuss’ (BA, 2007).<sup>2</sup>

Relatively little is known about alternative forms of finance, including family lending, bootstrapping strategies, and credit card finance. Anecdotal evidence from interviews with entrepreneurs suggests that these can be useful non-standard sources

---

<sup>2</sup> This number includes 115.000 people who received the so called ‘Existenzgründungszuschuss’, a measure that is no longer granted.

of funds that can help bypass financing bottlenecks. Presently, there is no German data set that could help to measure directly the extent to which this is the case.<sup>3</sup> Kneiding and Kritikos (2006) therefore use data on household income and consumption in order to measure transfers of funds between the household and the business of entrepreneurs. Their results indicate that personal overdraft facilities are used for business purposes in entrepreneurial households. This is especially likely when the household is credit constrained, which indicates the use of a strategy to bypass commercial banks.

Outside the formal banking system, a variety of projects has emerged during recent years that aim at distributing small loans to microenterprises. As a rule, these projects are carried out by start-up centers (also called business development centers) that cooperate with banks which take care of the loan extensions (a detailed description of these models will be delivered in Section 4). Their success has been relatively limited so far. As already stated in the introduction, 30 of these local or regional institutions have extended about 2,000 loans altogether. Therefore, although there are several financing alternatives through both commercial banks and other sources, only a very small minority of start-ups are actually making use of these services at present.

### **3. Legal Regulations affecting Microlending in Germany<sup>4</sup>**

MFIs occupy a market that is (or at least should be) served by commercial banks. It is therefore important to clarify if the regime of German bank regulation also applies to microlenders. In this context, two regulatory frameworks will have to be analyzed. First, the German Banking Act, which regulates banking activity in Germany and second, EU Bank Law, which constitutes its counterpart on the European level.

#### **3.1. The German Banking Act**

The central provisions on credit extension by commercial banks are contained in the German Banking Act (*Kreditwesengesetz, KWG*). The Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin*) supervises the compliance with these regulations. 2,300 credit institutions, 800 financial service

---

<sup>3</sup> In the US and the UK, in contrast, two detailed surveys on small business finance have delivered interesting insights into this topic.

<sup>4</sup> The content of this section is largely geared to the analysis of Bornemann (2004).

institutions, 630 insurance undertakings and 6,200 investment funds are currently subject to its supervision.<sup>5</sup> Breaches of the Banking Act are sanctioned both under administrative as well as penal law.

MFI's are subject to KWG regulation as soon as they conduct banking business. According to §1I(1) KWG, relevant potential banking transactions can be (i) deposit-taking business, (ii) credit transactions and (iii) guarantee business. The MFI might also act as an intermediary between the borrower and the bank (e.g. by handling the loan application or monitoring the loan repayments). In this case, the question arises if the out-sourcing of these activities falls in line with KWG regulations.

In his analysis of the KWG, Bornemann (2004) comes to the conclusion that MFI's

- **conduct credit business** if they issue loans on their own account or issue transmitted credit to credit institutions, which in turn issue credit to end-borrowers;
- **possibly conduct credit** business if they issue credit by bank transmission by way of fiduciary loans;
- **conduct guarantee business** if they, in order to provide credit to individual borrowers, take over guarantees or similar securities.

In order to qualify as a credit institution, the banking business has to be conducted commercially (i.e. profit-oriented) or on a scale which requires a commercially organised business undertaking (s. §1(1) KWG). According to Bornemann (2004), this commercial dimension is reached when the overall credit volume exceeds €500,000 (composed of at least 20 loans), or more than 100 loans have been extended by the institution.

While the former criterion does probably not apply to German MFI's (at least not at their current state of development), the latter could possibly be affirmed, but will still be subject to examination. Taking over possible acquisition and management activities from the bank, on the other hand, (provided it is clear that the bank is the creditor), at least in the context of permissible out-sourcing under §25aII KWG, does

---

<sup>5</sup> Source: [www.bafin.de](http://www.bafin.de).

not amount to bank business. MFIs can therefore exert credit application handling or loan monitoring activities without being legally treated as a credit institution.

Qualifying as a credit institutions entails a series of legal consequences. In order to conduct banking business, a banking license is needed that is issued by the BaFin. This license is only issued if certain legal requirements are met, inter alia (cf. §32 KWG):

- A minimum initial capital of €5m is required (§33(1) Nr. 1d KWG);
- At least two professionally qualified directors must be nominated (§33(2)1 KWG). This qualification comprises the demonstration of theoretical and practical knowledge with regard to the relevant business sector, as well as management experience. Such competence is presumed if the relevant persons have held a management role for a period of at least three years in an institution of comparable size operating in a comparable business sector.
- There are comprehensive reporting, notification and information provision requirements, which are laid out in §§24, 25 and 45 KWG.

According to an anonymous insider, the BaFin is currently considering a special approval for microlenders in terms of a “microlending window” which is comparable to the French solution. This step would mitigate the legal requirements in one central respect: the minimum initial capital requirements and the resulting Basle II regulations would not apply to microlenders. There are some preconditions, though, that would have to be fulfilled:

- 1) The MFI’s main business must be training and consulting; financing has to be a secondary activity that merely accompanies the consulting process.
- 2) MFIs are not allowed to offer investment products to their clients. This right is reserved to credit institutions defined by the KWG.
- 3) The legal requirements concerning the qualification of the directors as well as reporting, notification, and information provision still apply.

It is questionable, though, if such a special approval would spur the creation of MFIs that extend loans independently from banks. First, the compulsory packet solution of consulting and financing will arguably deter numerous potential clients from

applying for a loan. Even though many of them might be in need of external advice, the experience has shown that only a minority is also willing to pay for this service. Second, in order to make a business case of the lending activity, profitability projections demand a minimum of around 2,000 loans per year. This is an illusive number, given the scarce capital available for lending to this market segment. These considerations cast serious doubt on the necessity of a special lending window for German MFIs, at least for the short term.

### **3.2. EU Banking Regulations<sup>6</sup>**

So far, the European Union has not passed regulations that specifically regulate microlending activities by non-banks. Basically, two legal frameworks have to be taken into account: first, the *Bank Supervisory Directives*, which were aimed at credit institutions and were not relevant for the investment funds of microlending institutions. Second, the *Consumer Credit Directive* contains provisions which do not explicitly address the issue of credit for productive purposes, often an important feature of microloans. Hence, one can only rely on the interpretation of the Bank Supervisory Directives. According to them, microlending by non-banks is permissible, provided (i) MFIs do not take deposits when refinancing through bank credits; (ii) own capital; (iii) issue microloans guaranteed through collateral. European law has granted exceptions to some states, and credit unions and cooperative banks in particular have taken advantage of them.

### **4. Implications for the Institutional Design of German MFIs<sup>7</sup>**

German MFIs are not comparable to MFIs in developing or transformation countries. Usually, their core business consists of start-up counseling and professional advice for young entrepreneurs. Each of these institutions receives public funds in some way or the other (either as direct subsidies or in terms of governmental assignments). Microlending has just recently become part of their activities, and is therefore still practised with rather low numbers. It is no wonder, thus, that none of these institutions will open up a fully-fledged bank soon, even not in the medium term. This raises the question how German MFIs have designed their loan processes and what are the experiences they have made so far. These topics will be covered in the following.

---

<sup>6</sup> This section is based on the analysis of Reifner (2002).

<sup>7</sup> Most of the models presented in this paragraph have been proposed by Bornemann (2004).

#### 4.1. Direct Loan Extensions by Microlenders

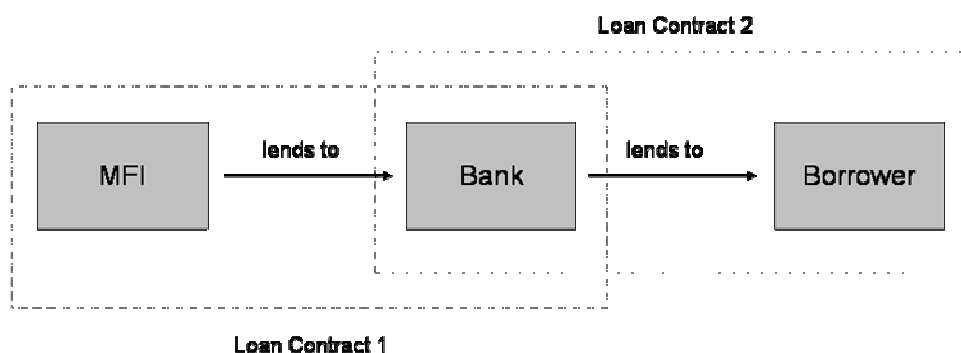
The simplest way of financing entrepreneurs would be the direct extension of microloans by MFIs to each specific entrepreneur. This, in turn, requires the MFI to hold a bank license, which appears to be quite an unlikely scenario given the requirements posed by German banking law (s. Chapter 3.1). For this reason, MFIs will have to partner with banks in order to reach their clients.

#### 4.2. Loan Extension via a Bank as Intermediary

A variety of different lending models has been tested in the German market during the past years. In the following, we will consider the different conceivable designs of these models, and provide some real-world examples how these models have been implemented in practice.

##### *Credit Flow Model*

In the case of the credit flow model, the bank only acts as an agent that transmits funds which had previously been loaned by the MFI. As Figure 1 shows, there are two separate loan contracts, one between MFI and bank, the other one between bank and borrower. Therefore, this model can also be described as credit transmission. The MFI does in no way participate in the credit risk of the borrower as there is no contractual relation between these two parties. Thus, the bank bears the full risk of loan default.



*Figure 1: Credit Flow Model.*

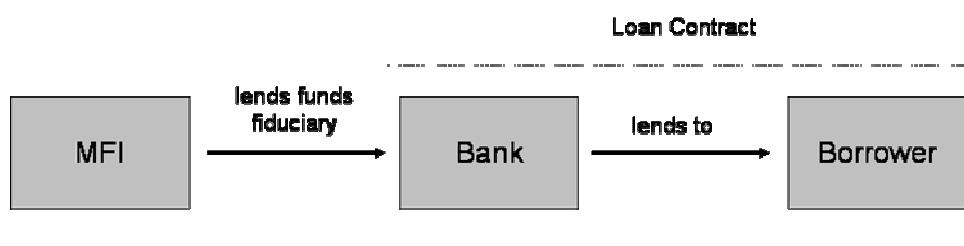
It is questionable why banks should be interested in such a lending model. As Bornemann (2004) stated, possible incentives to banks might be the margin between interest on the investment in the venture (active interest) and the interest on re-

finance borrowings (passive interest). If this spread is sufficiently high to cover the costs and risks associated with the provision of credit (and additionally includes a profit margin) banks might opt for this model for reasons of profitability. In addition, they may seek a (one-off) payment for administrative as well as risk costs.

So far, this model has not been practised in Germany, the reason most probably lying in a lack of incentives as well for the MFI as for the bank. First, the MFI might as well consider to lend directly to the borrower without choosing the bank as an intermediary. Taking into account that the special relationship between borrower and MFI is one of the defining elements of microlending, there is no plausible explanation why MFIs would opt to out-source this core competence. Second, given the low capital endowments of MFIs in Germany, it is unlikely that MFIs could offer an interest spread high enough for banks to get into microlending. Third and most importantly, MFIs would require a bank license for this type of lending, as they would commercially conduct a credit business (s. Chapter 3.1). As has already been discussed above, this is illusory given the early stage of development of German MFIs.

#### *Trust Model*

A way to mitigate the incentive problems that are associated to the model above has been proposed by advocates of the trust model. In this case, the bank obtains the funds for on-lending from the MFI as a trustee under a procurement agreement. The bank acts solely as an intermediary and is therefore entirely freed from lending risk. This, in turn, raises the chances that the bank will take part in a microlending project. Under the trust agreement, the bank provides credit to the borrower in accordance with instructions and manages the arrangement as appropriate. In the event of default, the bank is not obliged to reimburse the loan funds to the MFI. So far, this model has not been applied in the German context.



*Figure 2: Trust Model.*

### *Hybrids*

In between the pure credit transmission model where the intermediary bank bears the credit risk for the whole of the sum loaned, and the trustee model, where the bank bears no risk at all, there are hybrids in which the credit risk is distributed among the parties involved. Under civil law, such an outcome can only be achieved by means of an agreement providing exemption from liability or a term in the credit transmission agreement making repayment in part conditional upon recovery of the loan fund provided by the bank from the end borrower.

#### **Case 1: The KfW Mikrodarlehen**

The Kreditanstalt für Wiederaufbau (KfW) is the largest government bank in Germany and describes itself as the major supplier of start-up finance to small and micro-enterprises. Applying the ‘Hausbankprinzip’, commercial banks are used as a distribution channel for KfW products, as e.g. is the case for the ‘Mikrodarlehen’ (Microloan). This product is especially apt for small enterprises in their start-up phase that need to finance expenditures of up to €25,000.

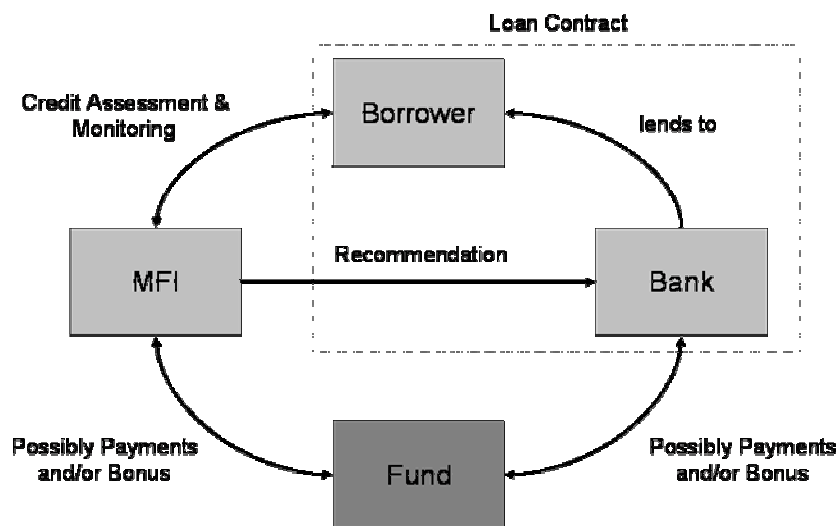
The loan application is first checked by the Hausbank and then forwarded to the KfW. If both approve, the KfW extends the loan. Should the borrower default, the Hausbank carries 20% of the losses (even after liquidation of all collateral), while the bulk of 80% is covered by the KfW by means of an indemnification clause. At the same time, KfW’s risk is fully covered by the Federal Government. These features make the credit business a riskless activity for KfW, and incentivise the bank to collateralise the loan at 100%, thereby blurring the borders between classical credit business and microlending.

Each Hausbank receives a fixed processing fee of currently €1,000 that renders possible the financing of small amounts typical for microenterprises. The intention is to motivate commercial banks to extend small loans to young entrepreneurs by covering the main costs – namely risk costs and processing costs – that are associated to this business. The Hausbank does not participate in the profits generated through interest, though.

In 2006, 1,300 ‘Mikrodarlehen’ have been disbursed by the KfW, amounting to a total value of €21m. Anecdotal evidence from interviews with loan officers suggests that the reason for this rather low number may lie in the fixed processing fee: it might be too low for the business being at least a zero-sum game for commercial banks. Therefore, the KfW has recently decided to raise this fee in order to boost loan numbers. Another reason are the low repayment rates that are typical for this market segment, which don’t make the case for a profitable business model.

### *Fund Model*

A different solution for the incentive problems that concern MFIs and banks is offered by the Fund Model. Here, the bank enters into a loan agreement with the borrower, while the MFI provides the credit assessment and/or monitoring of loan repayments for the bank (this is described in more detail in the next section). Loan defaults are covered by a security fund that has previously been designated for this case. There are different ways where this fund can draw its monies from, as the case studies below will show. As in the case of the Trust Model, there are infinite possibilities of how the risk can be shared between bank, fund and MFI.



*Figure 3: Fund Model*

## Case 2: Early ‘Lighthouse’ Models

The first microlending attempts in Germany were mainly funded by corporate actors, most notably the Ministry of Economics and Labor. Most of these projects were initiated around the year 2000, the intended message being that corporations were delivering their contribution to solving Germany’s most pressing problem, namely unemployment. The projects were spread all over Germany and, inter alia, included:

- The **Siebte Säule** (‘Seventh Pillar’), a microlender in Hamburg, was founded in 2000 by the start-up center Enigma and stopped operating in 2004. Until then, about 76 loans had been extended to small business owners via a local commercial bank. A revolving security fund was established and endowed with €100,000 that were provided by the Deutsche Bank Alfred Herrhausen Foundation. One of their preconditions was that loan recipients should not be older than 30 years. 50% of the loan sum were supposed to be covered by a credit guarantee taken over by a primary obligor; the other half through a transfer by way of security. Additionally, a credit coaching was offered that includes crisis interventions in case of difficult business circumstances.
- A similar approach was taken by the **KIZ Auf Geht’s Darlehen**. As in the Enigma model, a rolling over security fund was established (volume: €75,000), by the Deutsche Bank Alfred Herrhausen Foundation. When possible, securities were pledged from the borrowers with a focus on credit guarantees by friends and family. The project started in 2001, and was phased out in 2006. All in all, 20 loans had been extended by then.
- **MONEX** also started operations in 2001 and followed a similar approach as the models represented above. In contrast to them, several funds were set up that were financed by different actors, e.g. corporate foundations, local foundations or public bodies. About 20 loans were extended via a partner bank until the project ended in 2006.

All in all, these projects obviously should rather be understood as ‘lighthouse models’ rather than MFIs that strive for sustainability. None of them reached significant outreach, and portfolio at risk and loan defaults proved to be quite high. Consequently, their achievement should be seen in raising public awareness for microlending in Germany rather than providing examples of an efficient lending model.

### Case 3: The German Microfinance Institute (DMI)

The DMI is an umbrella organisation of German microlenders. It provides training and resources for its member MFIs, aiming at the long-term overall availability of microlending services in Germany. The DMI offers trainings in product development, assistance in building up a finance organisation or benchmarking of its member organisations.

The loan disbursement process involves the participation of four different actors (it is also called the ‘Cooperation Model’): the borrower, the MFI, the bank and the fund (see also Figure 4). First, the MFI checks the borrower’s loan appraisal (step 1) and recommends it to the bank provided that it has been assessed positively. The bank then extends the loan to the borrower by closing a standard contract (step 3). Part of the interest payments are transferred to the bank to cover administrative expenses. Subsequently, the MFI supports the borrower by providing training and advice, as well as by monitoring loan repayments.

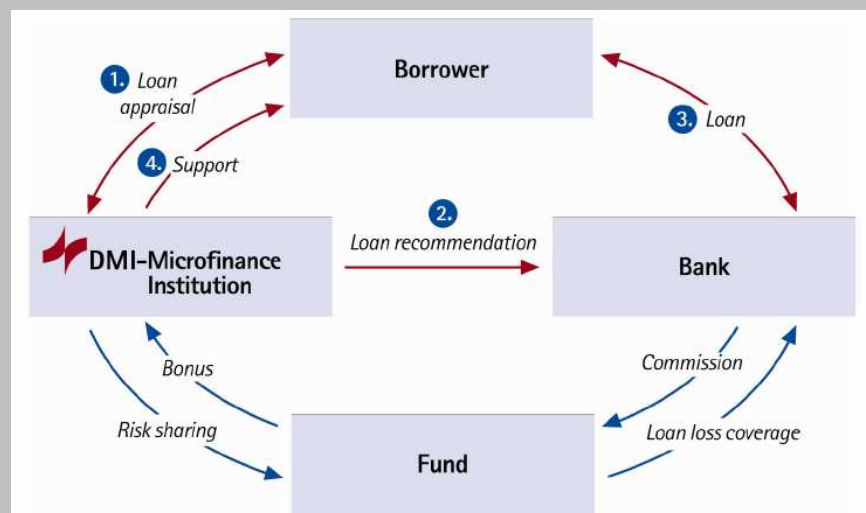


Figure 4: DMI's Cooperation Model.

But what happens if the borrower defaults with the repayment of his loan? In this case, the fund comes into play. It covers 80% of the defaults, while the remaining 20% have to be carried by the MFIs as part of its first loss liability. This means that any losses amounting to up to 20% of the annual loan volume have to be carried by the MFI. For example, an MFI that has extended €100,000 in 2007 and had two write off two loans amounting to €25,000 in the same period, will have to carry €20,000 of these losses (20% of €100,000), while the remaining €5,000 are covered by the fund.

Through this measure, it is ensured that MFIs carefully choose their borrowers. As long as loan defaults do not exceed 10% of principal payments, the MFI receives a bonus from the fund. The fund that is financed cooperatively by the GLS bank, the KfW as well as the Federal Ministry for Labour, receives part of the interest payments as a compensation for securing the loans.

### *Outsourcing Model*

Instead of extending loans themselves, MFIs can also act as intermediaries between bank and borrower by selecting suitable clients and taking over the credit assessment for the bank. In 2005, Germany's state-owned KfW bank published a handbook called 'cooperation guidelines between credit institutions and business development services' (KfW, 2005). Its declared aim was to 'show ways of how existing funding and consulting activities can be pooled in German regions'. The logic behind this idea is based on a typical win-win proposition: while credit institutions can focus the bulk of their resources on projects yielding higher profitability expectations, MFIs get the chance to establish a client base of young and promising enterprises. Evers et al. (2002) propose three main ways of cooperation between banks and MFIs. First, banks could set up a specialist branch and outsource all their microlending activities to it. Second, banks can cooperate with MFIs in a variety of ways, which would increase their capacity and effectiveness. Third, banks could copy the techniques used by MFIs in order to enter the microlending business themselves. The last option, though, is not a cooperative solution, as implied by Evers et al. (2002).

Outsourcing the costs of credit assessment could provide an incentive to banks of becoming involved in microlending. Naturally, this mode of cooperation is only acceptable to banks if MFIs are able to signal the quality of their processes: all outsourced activities, like credit assessments, business practices and monitoring must be considered acceptable by the credit institution concerned. A quality assurance model should include regular reviews of cooperation aims and quality standards, variance analyses (including its causes), as well as error reporting and documentation (KfW, 2005). But even then, as Bornemann (2004) conjectures, banks might insist on further risk reductions by pledging indemnity or other forms of guarantees from the MFI, in case the bank provides the loan funds.

#### **Case 4: MONEX Baden-Wuerttemberg**

MONEX is a microlending project from Baden-Wuerttemberg, a province in Southern Germany. In 2005, its executives were negotiating with local banks on a cooperation treaty. The idea was that MONEX would scan the market for promising entrepreneurs needing small loans, conduct the credit assessment and forward all successful applications to the bank, which could then extend a loan based on MONEX's recommendations. This would have allowed for interlinking start-up assistance with funding – a missing link for many young entrepreneurs.

Two banks entered into negotiations, and one of them was already close to signing a contract with MONEX. But proceedings came to a sudden halt, when the banks realized that this model would demand a change in their internal business processes. In the end, none of them adapted the model. “Our aim was to cooperate with several banks at the same time in order to secure a wide array of funding alternatives for our clients”, says the project manager who conducted the negotiations for MONEX. “Their unwillingness to cooperate has shown us that we have to find different approaches when financing entrepreneurs in the region.”

### Case 5: Hans Lindner Institut

Since 2003, the Hans Lindner Institut has been cooperating with the local savings bank on the promotion of small and micro enterprises in the region. The cooperation model is depicted in Figure 5 below.

The institute offers start-up counselling free of charge for young entrepreneurs. After the business plan has been compiled, founder and institute jointly decide on the amount of counseling during the first three years after foundation. The savings bank can realise many advantages from this cooperation: founders are better prepared, have more background knowledge, and – above all – can already provide well elaborated calculations of their project. The ongoing accompaniment after the loan extension facilitates risk monitoring and controlling. With growing experience, the cooperation will steadily be improved. Both actors meet for yearly feedback talks and discuss possible changes that could be made to the existing system.

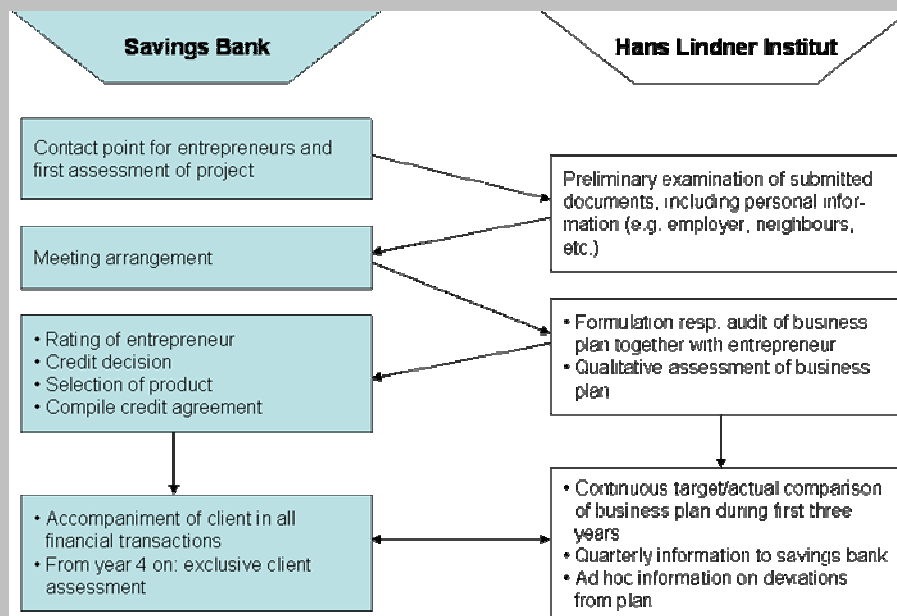


Figure 5: Cooperation Model of Hans Lindner Institut.

## 5. Policy Recommendations

The analysis has shown that the main actors on the German microlending market clearly center their activities on the fund model and/or the outsourcing model. The question that arises is: What policy measures could be taken in order to further support the development of German MFIs? In the following, three recommendations will be presented that might serve as a base for further discussion:

- Obviously, funding has been a major problem for MFIs that wanted to set up operations in a low-yield market like microlending. Limited sources of finance have prevented them from extending their business model to a significant scale that could serve as a test for their business model. Therefore, public policy should focus on providing more public funds to MFIs and give them the chance to experiment with different organisational structures. This will eventually lead to a ‘survival of the fittest’, and sort out non-sustainable models. The German Microfinance Institute (DMI) formulated three essential funding demands that need to be covered by third parties if microlending is to be pursued further in Germany:
  - *Start-up costs* for MFIs amount to around €40-50,000. This includes particularly the setting up of an organisational structure, the development of internal lending processes, as well as building networks with potential distributors like local development agencies or labour offices.
  - *Process costs* of loan distribution lie around €800 per loan. This number has been extrapolated through (i) estimations by those MFIs that have already made first experiences in the German market; (ii) a comparison to the lump-sums that governmental banks normally pay to subsidise process costs of publicly funded loan schemes.
  - Microlending in Western European countries is a risky business, as historical default rates are much higher than in any developing country (EMN, 2006). Considering the low numbers of loans extended by MFIs in Germany so far, their pioneering efforts should be supported by a *first loss risk coverage* of around 20%.
  
- In the past, policy makers tended to prescribe which target groups a certain microlending program should focus on (e.g. young people under 35, migrants from certain countries, or unemployed women). This severely limited the outreach of these programs and forced them to search for ‘fundable’ clients, not for the best clients in the market. Public policy therefore should let MFIs decide which market segments they can serve best; monetary incentives could then be used in order to put a slant on specific target groups.

- The outsourcing model has so far been practised on a rather limited scale. Efforts like the KfW's cooperation guide show that there is a genuine interest from banks to improve this cooperation. MFIs cultivate highly specialised knowledge on their target communities and could therefore be integrated in a bank's credit assessment process. For this to happen, public policy should provide monetary incentives for banks to outsource credit assessment procedures in underserved markets and/or deprived communities to these specialised agents. This could be done through a lump-sum that is paid to the MFI for each credit assessment, which again would lower the overall cost for the bank.

These recommendations show that the main lever for improving the situation of MFIs in Germany is not a major change in the legal framework. Obviously, it is in its current form rather apt to accommodate the different types of organisational forms that have been created throughout the last years. Assertions of several DMI members support this view: according to them, the current framework is satisfactory in the medium term; changes comparable to the French model are not on their agenda. Thus, policy measures should rather focus on fostering the development of this niche market and see how it develops; should it be successful, changes in the legal framework could follow.

## References

Bornemann, A. (2000). ‚Micro-lending: Banking Law and European Regulation’, in: Micro-lending - A Case for Regulation in Europe, Schriften des Instituts für Finanzdienstleistungen e.V., Vol. 5, Baden-Baden.

Bundesagentur für Arbeit (BA) (2007). ‚Der Arbeits- und Ausbildungsmarkt in Deutschland – Monatsbericht Juli 2007’, Nürnberg.

Constant, A., Zimmermann, K. (2005). ‚Self-Employment Dynamics Across the Business Cycle: Migrants Versus Natives.’, *IZA Discussion Paper* 1386.

DG Employment (2007). ‚eScorecard – Favorable Microfinance Environments in Europe’, 2007.

European Microfinance Network (EMN) (2006). ‚Overview of the Microcredit Sector in Europe 2004-2005’, EMN Working Paper No. 4, Paris.

European Commission (2003). ‚Mikrokredite für Existenzgründer und Kleinstbetriebe: Ausgleich einer Marktlücke’. Brussels.

Evers, J., Jack, S., Loeff, A. and Siewertsen, H. (2000). ‚Banks and Micro-lending. Support, cooperation and learning’, Personal Finance Research Centre in cooperation with Institute for Financial Services, April 2000. ‚Reducing Cost and managing Risk in Lending to Micro Enterprises. Handbook for Micro-lending in Europe’, February 2000.

Evers, J. and Lahn, S. (2007). ‚Status of Microlending in Germany: An empirical Survey of Programmes in 2006, in KfW (ed.): ‚Microfinance in Germany and Europe’, Frankfurt.

KfW (2005). ‚Existenzgründer und Junge Unternehmen gemeinsam stärken. Ein Leitfaden für Regionale Kooperationen zwischen Kreditinstituten, Beratungs- und Wirtschaftsförderungseinrichtungen.’, Frankfurt am Main.

Kneding, C. and Kritikos, A.S. (2006). ‚Funding Self-Employment - the Role of Consumer Credit’, GfA Disc. Paper No. 6 (2007).

Kritikos, A.S. and Wiessner, F. (2000). ‚Ein zweiter Kreditmarkt für eine zweite Chance’, *Perspektiven der Wirtschaftspolitik*, Vol. 1, pp. 357-78.

Gesetz über das Kreditwesen (KWG) (2005), URL: <http://www.bafin.de/gesetze/kwg.htm>, Deutsche Bundesbank, Frankfurt a.M.

Piorkowsky, M.-B. and Fleißig, S. (2008). ‚Existenzgründungen im Kontext der Arbeits- und Lebensverhältnisse in Deutschland – Eine Strukturanalyse von Mikrozensusergebnissen – Aktualisierung der Sonderauswertung der Mikrozensen 1985 bis 2001 für die Jahre 2002 bis 2004’, Statistisches Bundesamt, Bonn.

Reifner, U. (2000). ‚Micro-Lending: A Case for Regulation’, in: Micro-lending - A Case for Regulation in Europe, Schriften des Instituts für Finanzdienstleistungen e.V., Vol. 5, Baden-Baden.