

**Microfinance within the EU banking industry:
policy and practice**

This report has been written by the European Banking Federation's Working Group of experts in the financing of Small and Medium-sized Enterprises (SMEs).

Credits

Responsible Editor: Guido Ravoet, Secretary General

Editorial Team

Editor: Elena Letemendía, Senior Adviser, Economic & Monetary Affairs

Sub-editor: Alison Bell, Coordinator, Economic & Monetary Affairs

Design and layout: Sanàa Rouiha

Terms & Conditions:

Please mention source when quoting. This EBF publication does not necessarily reflect the views of the individual member associations of the Federation.

EBF©2010

Brussels (Belgium)
European Banking Federation (EBF) a.i.s.b.l
10, Rue Montoyer, B-1000 Brussels
For enquiries
ebf-communications@ebf-fbe.eu

I. Introduction

Private banks are among the main providers of microfinance within the European Union (EU). They supply microfinance both independently for their own account, and in partnership with other providers, such as public bodies, notably the European Investment Bank (EIB), and specialised Microfinance Institutions (MFIs). Normally, private banks provide microfinance lending to “bankable” borrowers, who are deemed to have a viable business with a relatively high probability of being able to repay debt. Other MFIs and public bodies are more likely to provide microfinance to “non-bankable” borrowers; generally those individuals or very small companies that do not have a credit history or the ability to provide adequate collateral.

While a good deal of microfinance provided by EU banks is destined for low-income borrowers in developing countries, the focus of this paper is exclusively on the **microfinance which EU banks are making available to borrowers within EU borders.**

The EBF represents, through its member associations, some 5000 European banks, of all sizes, wholesale and retail, local and cross-border. It reports here on the nature of the microfinance services being offered by these banks around the EU to their domestic clients. It points to the challenges in developing the market for microfinance in the EU, particularly at a time of recession. On the basis of observations on the commercial market for microfinance, it draws conclusions on the appropriate framework at EU level to accommodate the different approaches to microfinance, and to allow public and private supply to co-exist in a healthy way. The following main conclusions are drawn:

- public support should be carefully targeted at non-bankable borrowers, and carefully monitored to ensure that it adds to the financial possibilities of sections of the population which would not otherwise benefit;
- microfinance within the EU banking industry is based on a different concept from the microfinance usually seen in the developing world, and generally involves the supply of small loans to bankable borrowers;
- the regulation governing the microfinance activities of banks in the EU is well developed. It is important to ensure a level playing field between all providers according to the “same business, same risks, same rules” principle;
- the success of this type of finance can be significantly enhanced if the different providers (bank and non-bank, public and private) cooperate, and exchange information and good practice.

The EBF hopes that these comments will contribute to the understanding of the many facets of microfinance activity in the EU, and feed the continuing discussion on how best to stimulate economic activity and promote social inclusion in the EU.

II. *The nature of microfinance*

There is no single definition of microfinance. It presents heterogeneous characteristics, and has specific reference targets that vary according to the different contexts in which it is applied. Microfinance can be about more than lending: it can be seen by a bank as an opportunity to develop a full commercial banking relationship, which may consist of a broad range of banking services, such as credit services, savings products, current accounts, payment services, and funds transfer. Microfinance within the EU banking industry normally refers to small loans (“microcredit” or “micro-loans”) and to small commercial customers (“micro-entities”). It is commonly associated with other financial services: advisory or involving funding.

The loan element of microfinance is in many cases indistinguishable from a “plain vanilla” corporate loan, although loan sizes are at the lower end of the scale. The average **size of microcredits** appears to be around €10-15,000 in the older Member States of the EU (“EU-15”), and lower in the newer Member States (“EU-12”). The European Commission considers microcredit in the EU to be loans under €25,000 for business initiatives, and has observed that, typically, the average is €10,000 for the EU-15 and €3,800 for the EU-12.¹

Enquiries among the EBF’s Member Associations have identified two broad **approaches to the supply of microfinance** by private banks to borrowers in the EU. These approaches tend to characterise entire national markets.

- 1) **The concept of microfinance is unfamiliar, but small loans to micro-enterprises are being provided by the banks in that country.** Because these loans are not classified as microfinance, there is little or no data available on them. They may be reported as consumer loans (for example, in the case of a loan secured by a mortgage that is used to finance a start-up) or as corporate, possibly Small and Medium-sized Enterprise (SME), finance. This is the case, for example, in Austria (where such loans are usually not supported by a mortgage), Luxembourg, Poland, Sweden and Denmark. In the case of Poland and Sweden, much small-scale lending is undertaken through the consumer credit and corporate credit channels, respectively. In the UK, the EU definition is not used for measurement of the size of a small business. All firms with an annual turnover of £1 million or less are defined as SMEs. It is not therefore currently possible to compile data limited to microfinance as defined in the EU.
- 2) **Microfinance is an established product,** although not all microfinance is identified as such (for example, Italy, Germany and Norway).

The lack of a consistent and commonly used definition of microfinance for banks’ internal reporting impedes the collection of information about the activity. Reliable facts and figures for the **volume of microcredit and related services**, particularly for the EU as a whole, are elusive. Nonetheless some country-level data is available, and this serves to illustrate the diversity of national practices.

¹ http://ec.europa.eu/regional_policy/funds/2007/iji/micro_en.htm

In some markets, efforts are being made to revise and improve the framework of reference for microfinance. For example, in **Italy**, the Italian Banking Association (ABI) undertook an exercise in 2007 to “map out” current banking services. This broadened the concept of microfinance to encompass **financial inclusion** as a “range of methodologies, instruments, innovative practices that, corresponding to the inexpensiveness criteria, facilitate the financial inclusion of low-income people and/or those who are in social disadvantage”.² Examples of these practices included microfinance services; domestic selling practices; financial educational projects, and partnerships with non-banking entities. Recently, ABI and the Italian Ministry of Welfare began working with different stakeholders to provide banks and relevant players with a definition of microfinance, which relies on a common understanding of the issue, and is relevant for institutions and stakeholders working in microfinance. A recent survey by ABI shows that microfinance services, including the broad range of services mentioned in the first paragraph of this section, are offered by banks representing 69% of the total industry³. The survey indicates that at the end of 2006, the impact of microfinance on total services income was 3% (in 95% of cases), and sometimes reached 5%. The microfinance label covers a multitude of products and services. The main categories are current accounts and payment services (49%), followed by financing (31%), and savings services (20%). In Italy, the banks work alongside numerous specialised MFIs, which by end-2006 had disbursed an estimated €75 million in favour of 8000 projects.

In **Germany**, microfinance means small loans of up to €25,000 provided by banks and savings institutions to business customers. Microcredit for SMEs and start-up entrepreneurs *via* the banking sector reached an amount of approximately 661,000 loans in 2006. This corresponded to a total volume of €5.28 billion (0.8% of new business). The average micro-loan amount in 2006 was €10,300 for SMEs and just €4,300 for start-ups. However, owing to the availability of highly subsidised development loans, the scope that banks and savings institutions have for supplying microfinance is limited. The activities of the *German Microfinance Institute (DMI)*, aimed at servicing the non-bankable segment of the German microfinance market, have played only a minor role to date. The DMI provides approximately 300 loans each year, with an average amount per loan of about €6,800.

In **Austria**, microcredits (up to €30,000 *per* enterprise, *per* calendar year) to micro- or small enterprises for investments and/or working capital needs may be secured by a 80% payment guarantee, which is given by AWS (a specialised bank fully owned by the Austrian State) in favour of commercial banks providing microcredits to micro- or small enterprises.

² ABI's strategy with respect to microcredit: “Microcredit is a social business and, as such, should be developed as a market; therefore, it requires appropriate business, regulatory and transparency mechanisms; as microcredit is developing also in Italy, its underlying products and processes must be cost effective, meaning that the investment should be able to cover at least the direct and indirect costs associated with the operation; in the course of creating a market infrastructure, it would be opportune for banks to develop extensive types of pre-competitive cooperation, specifically with reference to sharing statistics able to represent trends and performance of the loans disbursed; with respect to public intervention, we believe that the priority should be to create a national guarantee fund, able to foster market growth in the first few years.” Source: ABI Executive Committee, June 2009.

³ Regarding the representativeness of the sample, banks participating in the survey on microfinance are equal to 69.4% of the entire banking industry in terms of total assets. Within the sample the banks that declared that they provide microfinance services represent 69% of the total industry. In terms of numbers of bank counters, the banks that participated in this survey correspond to 73.7% of the total industry; the representative amount of banks that participated in the survey providing microfinance services and products are equal to 72.9%. Source: Banks and financial inclusion: survey on Italian territory, ABI's study on financial inclusion activities undertaken by Italian banks (II edition 2007).

In **France**, the *Microfinance Observatory* established in 2006 by the *Banque de France* collects and analyses data on microfinance and the development of its practices. Its first report, for 2008, was published in June 2009.⁴ This report observes a wide range of actors in the market place, including both private banks and public bodies. Among the non-banking institutions providing finance, *Oseo* occupies a special place in the financing of credit in favour of business start-ups through direct loans and guarantees, while the *Caisse des Dépôts*, which manages the *Social Cohesion Fund (FCS)* on behalf of the State, is active in providing financial guarantees to banks and approved institutions, alongside other services. The report notes that the intervention of the FCS in the field of professional microcredit represents a guarantee total of €51.2 million. Its rapidly growing activity contributed €12 million in 2008. The average microcredit loan to professionals is estimated to be of about €5000, for a duration of 2-3 years.

As well as these mature markets for microfinance, in some EU countries, such as the **Netherlands**, microfinance as an identifiable business line is at an early stage, but developing quickly. Here, the *Microfinance Council*, set up in 2007, is working on increasing the knowledge of, and support for initiatives towards micro-lending to small and start-up entrepreneurs in the Netherlands. The Council's task is to bring together government bodies, financial institutions, centres of expertise, and other organisations active in the field of small and start-up entrepreneurship and engaging in microfinance in the Netherlands. The Council also aims at facilitating access to, and increasing knowledge of, existing and new initiatives for small and start-up entrepreneurs. Finally, the Council is to advise members of government on how to improve policy implementation in respect of micro-lending to small and start-up entrepreneurs. Besides the new advisory council, there will also be a centre of expertise for microfinance in order to make expertise more accessible.

The Dutch Ministry of Economic Affairs has set up a project whereby business support services are offered locally but the credit facilities are managed centrally to create larger volumes at lower costs. This project, started in 2009, is financed with a public-private partnership, whereby a public subsidy of €800,000 is complemented by an injection of €1.2 million in working capital from three Dutch banks: ING, Rabobank, and Fortis. To refinance lending, the Dutch Ministry has provided an interest-free loan of €15 million.

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

A fresh approach is also being taken in **Poland**. A new bank, *FM Bank SA*, will make its debut in February 2010, offering banking services dedicated to micro-firms. It is believed that by the end of 2010 it will have opened 62 branches and acquired 40,000 clients. It is expected that the average value of credit amounts could reach PLN 20,000. The maximum credit amount granted to a particular micro-firm will be PLN 300,000. The *FM Bank SA* will base itself on the experience of *Fundusz Mikro*, a microfinance institution established in 1994 by the *Polish American Enterprise Fund (PAEF)* to promote the development of micro-enterprises in Poland. The International Finance Corporation (member of the World Bank Group) is one of the shareholders of *FM Bank SA*.

⁴ <http://www.banquedefrance.fr/fr/instit/telechar/services/microfinance.pdf>

In the **United Kingdom**, as outlined above, businesses which have a turnover of £1million or less *per annum*, are defined as SMEs. These will include but are not limited to micro-enterprises. The main high street banks provide services for microfinance businesses, such as business current accounts, deposit accounts and commercial loans.⁵ Since January 2009, the British government has supported SME businesses *via* the *Enterprise Finance Guarantee (EFG)* that allows banks to provide credit to small businesses whose risk profile may make them inappropriate for traditional lending. The government guarantees the first 75% of a loan made under the EFG.

Other sources of finance are also available to micro-enterprises in the UK. For instance *Community Development Finance Institutions (CDFIs)* provide finance to businesses that cannot access mainstream finance⁶.

As with figures for the size of the market, estimates of the unmet **demand for microcredit** must be tentative. The European Commission recently estimated, on the basis of Eurostat data, that “an additional 700,000 micro-loans could be disbursed in Europe if we had the intermediaries, the capital and an improved environment.”⁷ It judged that this potential demand could be worth approximately €6.1 billion in the short term.

Currently, the recession could be depressing the normal rate of business start-ups, and reducing demand for micro-loan products, but the EU institutions are now proposing to supplement the existing supply further, in an effort to counter the ill effects of the crisis. This increased availability could possibly stimulate demand.

⁵ The British Bankers' Association collects and publishes monthly statistics on SME banking which can be accessed at <http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=467>

⁶ <http://www.cdfa.org.uk/index.htm>

⁷ European Commissioner responsible for regional policy, Danuta Hübner, speech on “Microfinance: Tool for growth and employment in Europe”, Nice, 10 September 2008
<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/416&format=HTML&aged=0&language=EN&guiLanguage=en>.

III. *The risks and returns of EU bank microfinance*

a) **The incentives**

Around the EU, banks' strategic approach to microfinance is diverse. One of the main points of difference is the extent to which the business is seen to be driven by economic and/or social objectives.

Even after setting aside developmental lending to non-EU economies, much microfinance from EU banks is undertaken in the context of Corporate Social Responsibility (CSR) policies.⁸ Where CSR policies are embedded in the business model, attention is given on the one hand to innovation within the business lines so as to improve economic sustainability; and on the other hand, to the creation of value for stakeholders and society as a whole. For a bank aiming at promoting financial inclusion, this may mean identifying and developing new business opportunities, such as planning and providing appropriate products and services according to the different types of customers.

This is the case for Italy, for example, where the development of "sustainable" business, and social inclusion, is an important strategic objective for banks, representing more than a philanthropic activity. Here it forms, in many cases, the context for their microfinance business. The most recent work has focused on promoting microcredit as a way to lend money with a view to including non-bankable individuals. The establishment and management of *partnerships* between banking and non-banking subjects is one of the innovative methods through which several financial inclusion projects are developing. The subjects involved could be service industry organisations, bank foundations and banks. Service industry organisations have a crucial role to play in retrieving the data necessary to evaluate each case. They primarily carry out an informal screening of the applicants for financing and then offer them support after credit has been granted. Through the management of guarantee funds, banking foundations perform their function by means of practical intervention in social issues. The banks likewise provide their services, collecting information on trustworthy subjects, which are instrumental in their intervention in the chosen community.

Around the EU, banks are participating in, and channelling small business finance on behalf of, public entities such as the EIB. This activity offers a range of benefits to the bank: the fulfilment of the broader policy goals of the public institutions (their regional, enterprise, and employment policies in particular); as well as the strictly commercial gains from the activity.

Mainly economic reasons are cited by private banks for offering micro-lending in Germany, where it is highly subsidised by the government and channelled through bodies outside the private banking industry. The *German Promotional Bank (KfW)* offers subsidised micro-loans to SMEs and start-up entrepreneurs. As a result, a large part of the micro-lending market has not been profitable enough for it to be in the commercial interest of private banks to become involved in this business segment. At present, cross-selling - the banks' ability to offer other services to the borrower - plays an important role in enabling micro-loans to be profitable.

Within the EU, the volume of business motivated by "non-commercial" factors is greater than it may appear. Even in countries where the main incentive for banks to offer micro-lending is economic, government support may be helping to make the activity commercially viable. This is the case for the micro-lending activities of private banks in Germany, Austria, and Spain, for example, although in the latter case the beneficiaries are largely situated in developing countries.

⁸ See EBF 2008 report on "Corporate Social Responsibility", available on the EBF website: www.ebf-fbe.eu.

For the lending bank, commercial and broad socio-economic objectives are likely to overlap, to some extent at least, as successful micro-lending will tend to create new business ventures and clients for the future. Indeed, where CSR policies have helped to generate a particular business line, such as microfinance in Italy, it may not be appropriate to make a strict division between CSR and commercial motives.

Last but not least, the practice of corporate social responsibility may lead a bank to withhold finance from a business that it does not consider to be viable. This could occur even in cases where public support, such as a guarantee, would be available.

b) The cost/earnings conundrum

At the best of times, young and small enterprises often face special problems when they need small amounts of finance from external capital providers for their investment projects. The loan amounts may be too small to offset the higher risk and higher operating costs of the business, owing to borrower group specifics, such as difficulties in assessing the credit standing of start-up or small entrepreneurs, and the high risk of default. This could result in earnings for a commercial bank being insufficient. The adverse cost/earnings ratio may mean that a microcredit is unprofitable for banks in the “conventional” way of lending business.

Recently, the financial and economic crisis has made the assessment of risk more hazardous. The need for banks to rethink their strategies, restructure balance sheets and improve profitability has reduced their appetite for risk. It can be expected that this will have an impact on the availability of microcredit products.

The special risk elements of microcredit compared to traditional small business lending - in particular the absence of a borrower track record and the uncertainties connected to a start-up - are responsible for the fact that it is very often backed by collateral or guarantees provided by public or non-profit entities.

A feature of the Italian CSR-based model of microfinance is the introduction of alternative criteria in relation to public or private guarantees (in well over a third of the sample considered in the recent survey conducted by ABI). Here, private, trade, and national associations play an important role in providing both assessments and guarantees. The innovation from the standard CSR is the fact that a partnership is formed. This is judged to allow market access times to be reduced, and network strategies to be enhanced, because it effectively connects civil society and microcredit organisations to the financial circuits of traditional banking operators.

Such an approach builds into the lending relationship a high degree of monitoring and advice, often in partnership with other organisations. Indeed, in most mature markets where banks offer microfinance products, advisory services (*e.g.* business support, mentoring) usually accompany the financing. This is seen as an important safeguard, helping to ensure that new start-ups and small enterprises receiving funding can benefit from the experience of others, and are more likely to survive.

In some countries, credit information-sharing for example through borrower databases, is used to mitigate the uncertainties over risk. But there are limits to the usefulness of such databases. One difficulty identified is that owing to the different rating systems applied by credit institutions, ratings are not easily comparable, and therefore the information on ratings is of limited value. Ultimately the banks themselves have the responsibility of evaluating the risk of doing the business, and its likely effect on their profitability.

IV. The role of the public sector

Only a part of the microfinancing activity of banks is apparent, owing to the lack of reliable data. There is a blurring of the border between small scale lending to smaller companies, and “microfinance”, which is likely to continue for the foreseeable future. Despite the difficulty of measuring the size of the commercial market, it seems clear that because of the risks and uncertainties associated with this type of lending, the most influential single provider of microfinance within the EU is likely to be the public sector.

In recent years, microfinance has been prominent among the financial products supported by EU regional and enterprise policies for stimulating small enterprises and start-ups. EU policy has rightly given high priority to micro- and small enterprises, which are the vast majority of start-up enterprises. In this way, they support candidates on the cusp of business creation, with all the benefits that this implies for the economy and employment. Public support is generally aimed at helping non-bankable businesses to become bankable, not at helping unprofitable enterprises to remain afloat.

The financial instruments of the EU’s *Competitiveness and Innovation Framework Programme (CIP)*, in particular the microcredit guarantee window of the *SME Guarantee Facility (SMEG)*, offer substantial resources to support microcredit.⁹ This is supplemented by the *JEREMIE (Joint European Resources for Micro to Medium Enterprises)* initiative, launched jointly by the European Commission and the EIB in 2006, which enables the Member States and regions of the EU to use part of their Structural Fund allocations for financial products designed for SMEs.¹⁰ More recently, the *JASMINE (Joint Action to Support Microfinance Institutions in Europe)* initiative, announced in November 2007, is targeted at the institutions serving the non-bankable segment of the market.¹¹

With the advent of the financial and economic crisis, European governments have seen the need to provide much greater financial support to the micro-loan sector. On 2nd July 2009, the EU announced a proposal for a new *European Microfinance Facility for Employment and Social Inclusion* (amounting to €100 million, with a possible leverage to €500 million) to be managed jointly with international financial institutions, in particular the EIB. This facility, due to run from 2010, represents a significant increase in the resources for microfinance within the EU.¹²

Alongside these initiatives, the European Commission has enhanced its dialogue with private sector providers, including banks, to ensure that lessons learned from the available experience of microcredit can be shared. In November 2008 and March 2009, two workshops, organised by the Commission’s Directorate General for Enterprise and Industry, addressed the topic: “Gaining scale in microcredit – can banks make it happen?”. In concluding these workshops, it was noted that in seeking to stimulate the microfinance market in the EU, public authorities should avoid competition between publicly funded MFIs and banks.

⁹ http://ec.europa.eu/enterprise/entrepreneurship/financing/financial_instruments.htm

¹⁰ <http://www.eif.org/jeremie/>

¹¹ November 2007 “Commission proposes new options to reinforce development of micro-credit in Europe” <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1713>

¹² <http://ec.europa.eu/social/main.jsp?langId=en&catId=89&newsId=547&furtherNews=yes>

V. Conclusions

Public support needs careful targeting and monitoring

In theory, the activities of public and private providers should be complementary and mutually enhancing, with public support targeted at non-bankable borrowers to ensure that needier sections of the population, who would not otherwise obtain financial services, are served. In practice, a difficult balance must be struck. Public schemes will need to identify areas of market failure so as to avoid squeezing out commercial lenders or damaging competition. At the same time, the authorities will wish to ensure that their financing supports, and helps to create - to the highest degree possible - enterprises that will be successful in the longer run. These considerations will be all the more difficult to address in a time of recession, when many companies are having difficulty in obtaining finance, and surviving.

The latest initiative for public funding, the proposed €100 million loan facility, is intended for “those who would usually have difficulty accessing the necessary funds to set up a business or micro-enterprise”. As with other EU-level programmes, it will be important to monitor results and assess the additional impact of this measure as efficiently as possible. A continuing and deepening dialogue with other providers of microfinance should facilitate this task.

The wide dissemination of information on the opportunities for public support, and the publicising of cases that have received support, should improve awareness among potential beneficiaries of the assistance available, and also enhance the transparency of public intervention.

If public support cannot clearly be shown to be additional to that which the commercial market would have provided, public investment may be a *zero sum game*, or even harmful to the market.

Microfinance within the EU has special characteristics

The microfinance being provided in the industrialised world differs from the original concept of microfinance as applied in the developing world. Within the EU, there should be as clear as possible a separation between small loans that can be supplied by a bank to bankable borrowers, and those cases that should indeed be handled by a MFI or development bank (the non-bankable segment of the market).

Nevertheless, it should be recognised that in some markets banks are providing, or supporting, microfinance services to the non-bankable sector as well. In these cases, their activities are motivated by their own CSR or financial inclusion objectives, and/or by the benefit of collaborating with public bodies through public-private partnerships. In the longer run, these activities may allow some borrowers to migrate from the non-bankable to the bankable.

Whatever the pattern of the microfinance business in a market, it is important to avoid confusion between the bankable and non-bankable kinds of business. Each type has its distinct objectives, risk profiles, and rewards, which should be as transparent as possible.

There is no need for a dedicated regulatory framework

With microfinance, the level of regulation of bank providers is already highly sophisticated, and built into an international framework of rules for liquidity, capital and risk management.

As was noted during the recent Commission-organised microfinance workshops, a level playing field for lenders, according to the "same business, same risks, same rules" principle, is necessary in order to avoid distortions of competition and excessive risk-taking. There may be scope for special conduct of business rules applicable to microfinance. However, these would not be relevant for the banks - given the existing regulatory framework - but rather for the unregulated providers.

Cooperation and dialogue between providers is essential

A greater understanding is needed of the nature of the microfinance activity in the 27 Member States, and of the role played by the different actors in the national markets. The dialogue and exchange of good practice that is already taking place between the different players is clearly helpful. This could usefully be developed, particularly at EU level, where much public funding originates. The DG Enterprise workshops made a good start towards developing understanding of the different models of microfinance within the EU.

The EBF's study of the variety of approaches among its members, reported here, shows that private and other providers are working together in many instances. This collaboration, and the sharing of experience, is likely to be advantageous to all sides, lenders and borrowers included. Start-ups benefit from a network of supporting institutions, including banks, community bodies, and foundations. Banks have a central role as sources of funding and related services, such as payments, but other institutions provide an invaluable complement to them. The proposed *European Microfinance Facility for Employment and Social Inclusion* offers an opportunity for all actors in the microfinance business to bring their different skills and experience to bear, and to implement public policy objectives, as efficiently and effectively as possible.