

Weekly Report

revised version

Microcredit: Is there Demand for this Type of Loan in Germany?

A lack of financial access to financial means is viewed as a key reason why small businesses fail. Therefore, also in Germany several institutions tried to establish microloans as a financing tool. A first empirical approach, building a benchmark for similar studies in Western Europe, shows that about 15 percent of all self-employed individuals would be interested in getting access to microloans. The study also demonstrates that these financial needs exist in target groups different from what was previously expected, at least in Germany. Rather than proposing microloans to people who plan to start an own business, they should be offered to existing small business owners in specific sectors. In addition, in order to be accepted by entrepreneurs, access to microloans must be available rapidly, with short repayment periods.

Support for small and micro businesses has been a core component of European economic policy for many years. At the same time, it is assumed that small businesses encounter in Europe but in particular in Germany obstacles when accessing capital markets which are not faced by large businesses. For this reason, in the late 1990s several local Microfinance Institutions (MFIs) came up with the idea of introducing “Microlending” in Germany. While there have been first successes in the implementation of microlending in such countries as the US, France, and England, the introduction of this financial innovation in Germany failed so far on a large scale. Indeed, over the past ten years, a range of government-financed local initiatives have been launched with high expectations. However, the expected demand for microloans did not emerge.

The main problem of these microfinance initiatives was that initially only business founders were allowed to apply for microloans. This means that microloans were only offered to individuals who had not actively started to run their business, many of whom had no demand for loans at all or were afraid of running into debts. Thus, these microfinance initiatives failed to address the needs of the marketplace. It was not until the creation of the German Microfinance Institute (DMI) and a first microfinance fund that both together formed an umbrella structure which made risk capital available for microfinance institutions (MFIs) free of any prerequisites (see box).

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Text Box

Microloans

Microloans have become widely known due to their great success in a number of Asian, Latin American, and East European countries. By providing access to such loans, more than 100 million people have been enabled to make investments, hence, to improve their income situation and life circumstances.

In accord with EU guidelines, this study defines loans of more than 25,000 Euros as financing for small to medium sized businesses (SMBs). Loans below this amount, by contrast, are classified as microlending. Microloans are differentiated from conventional SMB loans not only based upon the size of the loan but also by their repayment periods, requirements for proving creditworthiness, and target groups. In microfinance, one is dealing with short term loans to micro businesses (solo entrepreneurs and businesses with fewer than five employees and annual sales of usually less than 100,000 euros). Microloans are predominantly granted based on the character of the individual entrepreneur. By contrast, SMB loans involve longer-term commitments by somewhat larger enterprises that typically employ a number of workers and show sales of up to one million euros. In this segment, creditworthiness is typically verified based on documentary evidence and on traditional collateral requirements.

Loans offered by professional microfinancing organizations (MFIs) are also characterized by an unbureaucratic application procedure and the rapid access to capital, as well as by collateral requirements being different from bank loans. Because of the small loan amounts, these institutions charge interest rates for their credit products that are far higher than prevailing interest rates for traditional loans in the banking sector, typically over 20 percent.

Germany is considered to be the birthplace of the microloan, as local rural credit cooperatives—so-called Raiffeisen banks—engaged in similar small-scale lending in Germany some 150 years ago. About 10 years ago,

the idea of microlending returned to Germany, when the Deutsche Bank Foundation launched a nationwide working group that led in following years to the establishment of the first local pilot projects. Co-founders and promoters of these projects were the German Federal Employment Agency and the Federal Ministry of Labor and Social Affairs. Together with the Deutsche Bank Foundation, they created start-up centers for five pilot projects with start-up financing and risk capital to back loans for individuals starting new businesses. In the course of the ongoing development of local microfinance initiatives, the German Microfinance Institute (DMI) was established in 2004 to function as a nationwide umbrella organization. The DMI created an initial Microfinance Fund, which was jointly funded by the German Federal Ministry of Economics and Technology, the Federal Ministry of Labor and Social Affairs, KfW (a government-owned development bank), and GLS Bank, along with private investors. In 2010, the Federal Ministry of Labor and Social Affairs increased the fund by 100 Million Euros.

The main aim of the DMI is the authorization and training of microfinance institutions (MFIs) for the granting of access to the German Microfinance Fund (Mikrofinanzfonds Deutschland). At regular intervals, the DMI evaluates the activities of MFIs and decides on this basis about the renewal of their authorization. To date, the DMI has accredited about twenty MFIs. At this time, access to the Microfinance Fund enables MFIs to extend microloans not only to individuals starting new businesses, but also to existing small business owners. In order to ensure that the loan approval in accord with the regulations set by the German Credit Services Act (Kreditwesengesetz), the following procedure has been agreed upon:

Regional MFIs counsel potential borrowers and analyze their loan applications. On the basis of a credit recommendation from the MFI, the cooperating banks (to date, the GLS Bank and a few local savings banks) compile and

Overview of Microloans

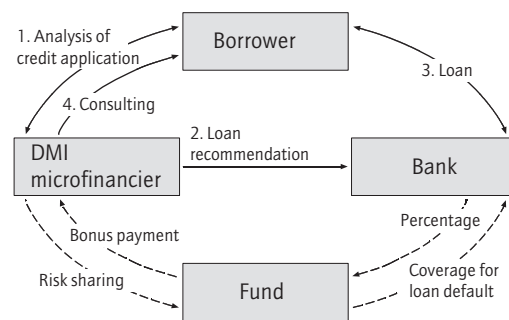
Greatest prevalence		Loan amounts	Number of borrowers	Status	Goals
Developing countries	South America, Asia, Africa	50–500 euros	>2 million in large institutions	In part (highly) profitable In part subsidized	Fighting poverty and promoting self-employment
Transitional countries	Eastern Europe	500–10,000 euros	>20,000 in large institutions	In part (highly) profitable In part subsidized	Financing for new self-employment
Industrialized countries	USA, UK, France	1,000–25,000 euros	USA: 50,000 Europe: 5,000	Highly subsidized Maximum cost coverage of 50% at this time	Growth financing for micro enterprises Financing for new self-employment

process the loan applications, functioning as an automated clearing house. The Microfinance Fund backs the credit risks that are incurred. In cases of loan default, the Microfinance Fund assumes all losses once the local MFI has covered the first 20 percent of the loan default in the form of "first loss risk." In the case of losses that fall below ten percent, the fund pays out a bonus payment to the MFIs.

Meanwhile, the European Commission is also ready to provide institutional support for private MFIs. With its JASMINE ("Joint action to support microfinance institutions in Europe) pilot initiative, the Commission has created a broad program that enables revolving capital to be invested in microfinance funds and grants technical help to microfinance institutions. The encouragement of microlending by the EU could prove to be of relevance for the development of the microloan segment in Germany and other European countries.

Alongside these private MFIs, there are numerous government development loans that operate under the banner of microloan products. These include microloans issued by

Microfinancing Flow Chart



Source: German Microfinance Institute. DIW Berlin 2010

KfW, a government-owned development bank, and by a number of state investment banks. The term "microloan" is used to refer to this government lending (only) due to the small loan amounts involved. Otherwise, almost none of the typical characteristics of microlending apply to these highly subsidized loans, which are generally accessible only to entrepreneurs seeking start-up financing.

In a pilot study the results of which are presented here, two key questions were investigated: First, who needs microloans? Second, how should microloan products be developed in order to increase their outreach in the market? Specifically, the study addressed the following questions:

- How do Micro and Small Enterprises (MSEs) finance themselves in Germany and to what extent do they face restrictions when raising capital?
- How many MSEs need outside capital, and which types of MSEs would need microloans?

Most Self-Employed Individuals Finance their Business with their Own Funds

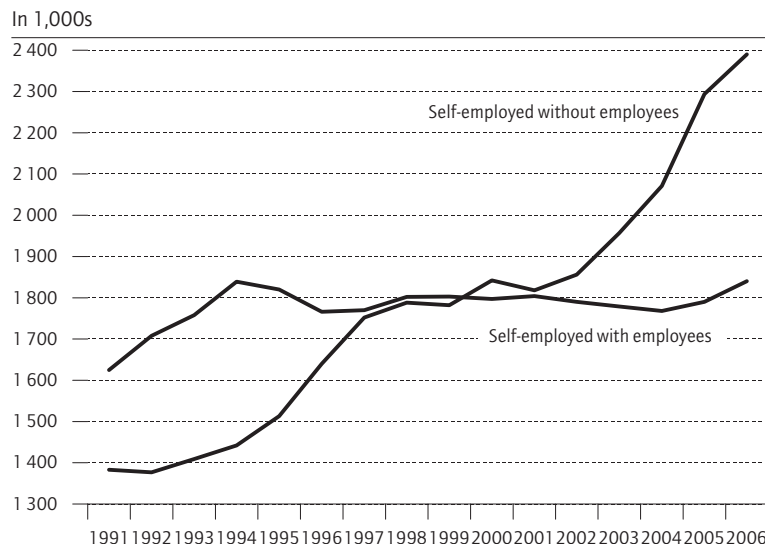
We start with some basic facts about Self-Employment in Germany: The German Microcensus, a representative household survey conducted by the Federal Statistical Office, reveals that between 1991 and 2006, the number of self-employed people rose by 40 percent to 4.2 million. Most of this growth occurred in the category of solo entrepreneurs (Figure 1). While the number of self-employed people with employees rose during this time period from about 1.6 to 1.8 million, the number of solo entrepreneurs increased from 1.4 million to 2.4 million. Around 90

percent of self-employed people had annual business revenues of less than one Million Euros, and about 70 percent reported business revenues of less than 100,000 Euros.¹

¹ See Piorkowsky, M.B., Fleißig, S.: Existenzgründungen im Kontext der Arbeits- und Lebensverhältnisse in Deutschland—Sonderauswertung des Mikrozensus für die Jahre 1991 bis 2006. Statistisches Bundesamt, Bonn,

Figure 1

Number of Self-Employed People in Germany



Source: German Microcensus; Calculations by DIW Berlin.

DIW Berlin 2010

A first overview of the financing methods used by micro and small businesses was provided by the 2008 KfW Small Business Monitor.² According to the report, in 2006 some 75 percent of MSEs in Germany had not taken out a loan of any kind. The remaining 25 percent had made investments using outside financing. Of this latter group, about 50% had taken loans of less than 25,000 Euros. Based on data from the 2006 KfW Small Business Monitor, we calculated that 60 percent of all MSEs used own funds to start their business—the remaining 40 percent had applied for loans, but one third of these had been declined. Moreover, we reveal that there was a positive correlation between the loan amount requested and the probability of approval. In the microloan segment of less than 10,000 Euros, the fraction of rejected applications was as high as 65 percent. The percentage of denied loan requests decreased to as low as 25 percent for sums above 25,000 Euros.

Small Business Survey

In order to identify groups of potential customers for microloans—especially in relation to conventional small- and medium-sized business loans (SMB loans)—interviews were conducted with more than 300 randomly chosen active and former self-employed people from different regions of Germany. Using a standardized questionnaire, participants were asked retrospectively about their needs for

Wallau, F.: Mittelständische Unternehmen in Deutschland, in Schauf, M.: Unternehmensführung im Mittelstand, Hampp Verlag, Munich 2006.

² KfW-Bankengruppe: Der Markt für Mikrofinanzierung in Deutschland: Marktgröße, Instrumente, und Finanzierungsschwierigkeiten. KfW Research 35, Frankfurt a. M. 2008.

business financing during the first three to five years they were in operation.³

Equity Financing Dominant

In the survey, just over 60 percent of the interviewed persons stated that they had been able to conduct their business activities to date entirely without outside capital (Figure 2). The 2008 KfW MittelstandsMonitor reported similar findings. On the one hand, many small entrepreneurs have no need for outside financing since they are involved in service sectors or professions that are not capital intensive (e.g. lawyers, journalists, artists). On the other hand, small and micro business owners in Germany are to a certain extent afraid of indebtedness. One contributing factor to this attitude is that the design of existing credit products is poorly tuned to their special market needs.

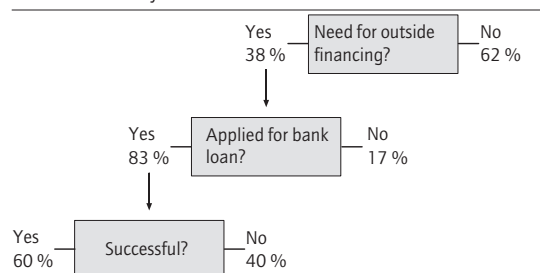
This also means that two-fifths of those interviewed were self-employed business owners with a need for outside capital. It is important to note that this study used a very broad definition of outside capital to encompass all sources of financing aside from equity capital, including personal loans extended by friends or family. Among all individuals with a need for outside capital, 83 percent applied for a loan from conventional banks, while the remaining 17 percent preferred friends and family as a capital source. The latter group reported that they had no contact with any bank for a loan application. Among the 83 percent of enterprises with a need for outside financing that applied for a bank loan, approximately 60 percent had their application approved. Other studies have arrived at a similar figure.

In addition, this survey showed that there is a linear relationship between the loan amount requested and the probability of approval. The percentage of successful loan applications for amounts up to 5,000 euros was 30 percent. The approval rate rose to 50 and 60 percent for loans between 5,000 and 25,000 Euros, and reached 75 percent for loan requests larger than 25,000 Euros (Figure 3).⁴ The survey also followed up on the activities of the loan applicants who were declined funding. About half of them faced liquidity problems being forced to close their business or reduced their overall investment

Figure 2

Need for Outside Financing

Data from Surveyed Small Businesses



Total sample: N = 314

Source: Kritikos, A.S., Kneiding, C., Germelmann, C.C.: Demand Side Analysis of Microlending Markets in Germany. DIW Discussion Paper No. 903, 2009. DIW Berlin 2010

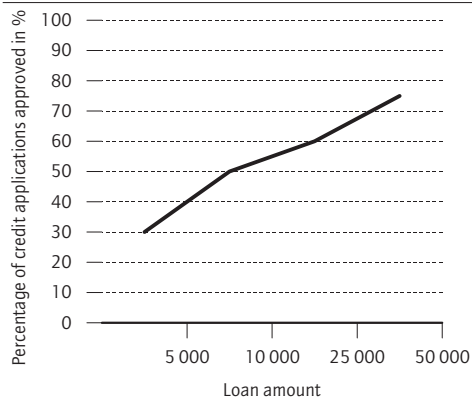
³ Regarding the database, methodology as well as detailed survey findings, see also Kritikos, A.S., Kneiding, C., Germelmann, C.C., Demand Side Analysis of Microlending Markets in Germany, DIW Berlin Discussion Paper 903, 2009.

⁴ It should be noted that in this study and the KfW MittelstandsMonitor report, it is not possible to draw conclusions regarding the degree to which loan requests were rejected due to the small size of the loans (and thus to the low interest payments that would be received by the bank) or due to low quality loan proposals on part of the entrepreneur.

Figure 3

Success Rate of Loan Applications According to Loan Amount

Data from Surveyed Small Businesses



Source: Kritikos, A.S., Kneiding, C., Germelmann, C.C.: Demand Side Analysis of Microlending Markets in Germany. DIW Discussion Paper No. 903, 2009. DIW Berlin 2010

volume. The other half acquired financing by turning to friends and family.

Other obstacles also came to light regarding access to bank loans. Among the interviewed business owners who took out a bank loan, not all of them were able to obtain a loan right away. Instead, two-thirds of the applications were rejected by the first bank and had to submit multiple loan applications before receiving access to credit. This indicates that greater efforts are required on the part of small businesses to raise funds when compared to larger businesses.

Microloans Most Suitable for Established Entrepreneurs

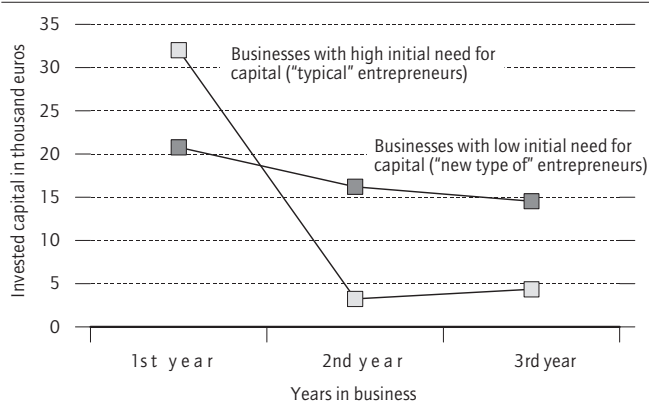
In order to estimate the potential demand for microloans, all entrepreneurs who had a need for outside financing were presented a typical microloan in comparison to a traditional SMB loan. The questionnaire explicitly noted the high interest rates for microloans. Among all persons with a need for outside financing, 40 percent expressed interest in a microloan, while the other 60 percent were more interested in an SMB loan.

The surveyed entrepreneurs' financing histories in the first years, when their businesses were in operation, provides important information about potential SMB and microloan customers. Figure 4 reveals that there are two different types of entrepreneurs with respect to their investment behavior and accordingly with respect to their financial needs. On the one hand, there were entrepreneurs who experienced right from the beginning of their operations

Figure 4

Investment and Financing Behavior during the First Three Years of Business Operations

Data from Surveyed Small Businesses



Source: Kritikos, A.S., Kneiding, C., Germelmann, C.C.: Demand Side Analysis of Microlending Markets in Germany. DIW Discussion Paper No. 903, 2009. DIW Berlin 2010

a need for larger sums of capital. These "typical" entrepreneurs were more likely to be successful in obtaining traditional bank or government loans. Over the longer term, banks mostly provided these businesses with lines of credit which could be used to cover their relatively low further capital needs once they had started their operations. Such entrepreneurs belong to the typical target group for SMB loans. On the other hand, there were small and micro business owners with lower initial investment needs. This second type of entrepreneur was more likely to need access to outside financing in later stages, once they started operations. Among this group, loans with appropriately matched repayment periods for instance for the short-term pre-financing of orders or for specific projects were most often needed. For these entrepreneurs, accessing conventional bank loans is more difficult. Microloans are the more suitable form of financing for this target group.

Entrepreneurs Want Rapid Access to Credit

The central aim of the study was to identify product features that could augment the attractiveness of microloans in the marketplace. Our research shows that potential customers are most interested in microloans when: (1) rapid access to capital is offered, with repayment periods adapted to the needs of the borrower; (2) lenders take the business needs of these small and micro business owners seriously; and (3) the probability of being approved for a loan is sufficiently high upon application. The study further reveals that in order to access such high-quality

credit products these business owners are prepared to pay higher interest rates. The study also makes clear that microfinance institutions will be most likely to experience demand from entrepreneurs who have previously obtained private loans from friends or family, or who have had poor prior experiences with banks due to low quality services or due to rejected loan applications. In addition, there are particular sectors—such as retail or parts of the service sector—that could be especially well served by microloans. According to the study's results, immigrants represent an additional important potential customer group.⁵

Microfinancing organizations in Germany should address these potential customer groups with a targeted marketing strategy and with products that clearly and unambiguously state who can qualify for a loan. Transparency regarding the criteria for loan approval and professional authorization procedures which facilitate rapid loan processing, while also guaranteeing high repayment rates, are, thus, core requirements for dynamic growth in the microloan segment.

Conclusion

In recent years efforts have been made in Germany to develop microloan products for small and micro business owners. Previously, business *founders* were the primary customer group targeted by such efforts. Experience has shown that there is little demand for microloans on the part of this target group. For this reason, the overall need for microloans was investigated in the present pilot study.

With respect to the market size for microloans, we revealed that 40 percent of the small and micro business owners surveyed who required outside financing would be interested in a microloan. Projected onto the entire survey sample, this would lead to a potential demand for microloans by 15 percent of the self-employed individuals.

This study identified a new borrower profile. It includes retailers, and non-capital-intensive service businesses which have a recurrent need for financing, most often below 10,000 Euros—a need that could be specifically met through short-term microloans. Furthermore a potential demand exists among established entrepreneurs whose activities had been financed by friends and family to date and who had negative prior experiences with banks. However, these are precisely the potential target

groups that had been excluded from previous microloan programs.

For existing and future microfinance organizations, this means that a better market outreach of microloans will only become possible when product development and marketing strategies are directed at the appropriate target groups. Concentrating on individuals who are just starting up a business will continue to be unsuccessful in the future. At the same time, it is also clear that potential customers for microloans in Germany are not necessarily excluded from obtaining conventional loans; but instead, do have partial access to alternative methods of financing. As a consequence, microfinance organizations have to develop loan products of high quality.

This means that access to microloan products must be quick and easy, with flexible repayment contracts and flexible collateral requirements. MFIs can offer such products if they develop specialized software systems and train loan officers in their use. For such loan products, they will then also be in the position to charge higher interest rates.

This study also has consequences for government programs. The strategy pursued to date of offering microloans to start-ups at heavily subsidized interest rates via development banks at the national or local level has not been very beneficial. These programs create unrealistic expectations about the price and quality of microloans, as they provide credit at low rates but also come with significant barriers to access. Yet perhaps more importantly, they have been directed at the wrong target groups, and are thus a waste of tax money. If microloans are a legitimate tool for providing small and micro businesses with a similar level of access to credit markets as large companies (and this makes sense from the perspective of promoting competition), then government institutions should pull back from developing and marketing their own credit products. Instead, they should encourage the development of the market by extending support to private-sector microlending organizations who address credit needs which are not adequately served by the traditional banking sector. Such financial support of local MFIs should be linked to the achievement of specific milestones. Numerous successful microfinance organizations in the US, England, and France have already demonstrated how this can be done.

(First published as "Mikrokredite: Bedarf auch in Deutschland", in: Wochenbericht des DIW Berlin Nr. 27-28/2009.)

⁵ For details on the survey's findings, see also Kritikos et al. (2009).

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