

Pilot Project Microfinance in Brandenburg

Background

In Brandenburg as elsewhere, micro and small enterprises (MSE) and start-ups encounter severe problems assessing sources to finance their working capital and capital investment requirements. Even though the supply of financial services and products is theoretically available in the market, practically micro and small entrepreneurs experience that financial institutions are hesitant and often negligent to finance them. The reasons are manifold: they are perceived as being too risky, they lack the documents required for the credit application or do not provide sufficient bankable collateral. In addition to that, the loan amounts are often too small to cover the cost of lenders to appraise and monitor the borrower. Hence, MSE and start-ups depend largely on government programmes, own resources or contributions of their respective families and friends which - if not sufficiently available - hamper their growth and future perspectives. Entrepreneurs, on the other hand, perceive financial institutions not as partners solving (financial) problems together with them albeit they would prefer such a relationship.

This mismatch of supply and demand for microcredits will be addressed by the pilot project 'Microfinance in Brandenburg'. It virtually started in October 2008 after signing the agency contracts between the Ministry of Economy (MoE), the Loan Guarantee Bank Brandenburg (BB) and FIDES Financial Systems Development Services (FIDES) S.A.. In addition the German Technical Cooperation (gtz) supports the pilot project through funding and its international expertise in microfinance. The duration of the pilot project is 12 months. During this period the newly founded FIDES subsidiary 'FIDES Unternehmensförderungs GmbH' (in short: FIDES GmbH) will develop and implement an

innovative credit appraisal mechanism facilitating access of MSE as well as start-ups to micro credits.

Objectives during the pilot phase and lending mechanism

The overall objective is to design a profitable lending mechanism that after initial promotion is able to sustainably serve the demand of a significant portion of those micro and small enterprises having difficulties in accessing financial services offered by conventional banks. This long-term objective reaches beyond the pilot phase of just 12 months. The pilot phase is conducted in order to design and test a business model for a market-oriented microfinance approach in Brandenburg and thus supports the long-term objective.

The innovative credit appraisal process to be developed and pilot tested contrasts the traditional approach of financial institutions in appraising loans (so-called documentary-based approach since it relies mostly on ex-post analysis of balance sheets and profit and loss statements). FIDES GmbH will pay more attention to the character, the personal entrepreneurial competencies, the social context of the entrepreneur without overlooking the financial creditworthiness of the business appraised.

It is envisaged to first test this approach in two regions of Brandenburg, namely the capital Potsdam and the neighbouring county of Potsdam-Mittelmark. By concentrating on two regions, the business case can be developed in a pilot phase even with a small number of loans without causing prohibitively high transaction costs (e.g. travelling time to the applicant) due to long distances encountered within the large-area state of Brandenburg. However, financing of enterprises



outside the key regions even during the pilot phase will be possible.

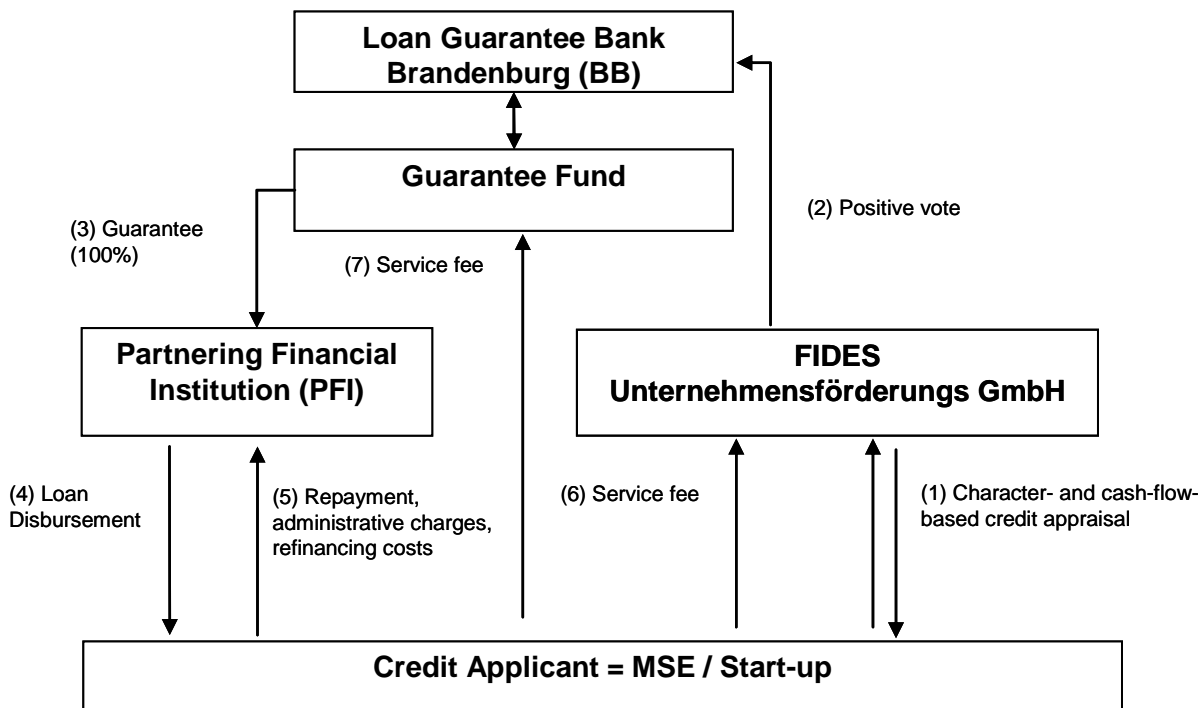
Up to 40 loans could be financed with a maximum amount of EUR 12,500 for the first loan. For that purpose a loan guarantee fund of EUR 500,000 has been established with funds from the MoE and FIDES S.A. In implementing this project FIDES cooperates with BB as administrator of the fund as well as a partnering financial institution for the on-lending process. The lending mechanism is described below. Like the credit appraisal process, these institutional arrangements, too, will be tested during the pilot phase.

(4) The PFI signs together with the applicant the loan contract, opens the loan account and disburses the loan amount. The PFI does not conduct its own credit appraisal of the applicant.

(5) The borrower repays the loan amount directly to the partnering financial institution as well as the interest rate consisting of refinancing costs and administrative charges.

(6) The borrower pays a service fee to FIDES GmbH.

(7) The borrower pays a service fee to BB.



(1) FIDES GmbH carries out a character- and cash-flow-based credit appraisal of the credit applicant (i.e. outsourcing of credit appraisal to a specialised service agency).

(2) In case of a positive decision the Loan Guarantee Bank Brandenburg (BB) is informed.

(3) BB issues a 100% guarantee in favour of the partnering financial institution (PFI). BB does not conduct its own credit appraisal of the applicant.

It is important to take note of the fact that the total amount paid by the borrower in terms of interest, fees and service charges will be comparable with effective interest rates prevailing in the market. It is neither the idea to overcharge the borrower with excessive interest rates nor to push a subsidised loan programme into the market. Interest rates and fees charged should be sufficient to allow a commercial approach aiming at financial self-sustainability of the service agency.



Project activities so far

As of mid January 2009 the pilot project operates for almost four months. This phase can be regarded as the 'development phase' of the project. Major activities within this phase have been:

- The establishment of the FIDES subsidiary 'FIDES Unternehmensförderungs GmbH' as the implementing service agency. This activity is related to the foundation and registration of the service agency, set up of technical infrastructure as well as elaborating the company's business plan.
- An update of the market survey carried out in 2007 (please refer to the chapter "Analysis of the demand for microcredit in Brandenburg"). For this update 14 entrepreneurs have been interviewed to find out about their views on financial institutions, access to financial services and their current demand for financing. The results of the survey update supported the development of demand-oriented loan products.
- The selection of a partnering financial institution. Several institutions have been contacted; at this stage the Mittelbrandenburgische Sparkasse (MBS) seems interested in cooperating with the service agency, however, negotiations are ongoing.
- The development of a credit appraisal mechanism. Based on the experiences made in other FIDES partner countries (such as Algeria, Mali, etc.) and benefiting from institutions like AIRDIE (France) the FIDES GmbH in Brandenburg developed the credit appraisal mechanism including procedures, formats and templates how to appraise the creditworthiness of MSEs and start-ups.
- The development of demand-oriented loan products. Based on the market survey of 2007 and the update of 2008 the service agency substantiated the initial outlines of lending products to be offered. Assumingly, the highest demand is for a loan with regular repayments to be utilised for working capital and small capital investments.

- Establishing contact to potential multipliers (networking). The FIDES GmbH has been engaged in contacting people and institutions (such as business promotion agencies, chambers, etc.) on the one hand to create awareness of the microcredit project in Brandenburg and on the other hand to support at a later stage the identification of potential borrowers. This activity forms part of the marketing strategy.

The way forward

In the months to come until end of September 2009 these activities will continue. Special attention will be paid to successfully finalise the negotiations with the Mittelbrandenburgische Sparkasse (MBS), addressing all legal and organisational issues related to the on-lending process and, most importantly, starting with credit appraisals of interested entrepreneurs.

Towards the end of the pilot phase FIDES GmbH will establish the lessons learned and will provide recommendations on how the lending mechanism, the credit appraisal process and other issues surface during the implementation of the pilot project need to be amended to achieve the long-term goal of improved access to financial services of MSE and start-ups.

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