

# MICROFINANCE AND START-UPS IN THE EU

German country profile

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## Abbreviations

Business Development Agency	<b>BDA</b>
Business Development Centre	<b>BDC</b>
Chamber of Industry and Commerce	<b>IHK</b>
Deutsches Mikrofinanz Institut	<b>MFI</b>
Development Bank	<b>DB</b>
Federal Development Bank	<b>FDB</b>
Kreditanstalt für Wiederaufbau	<b>KfW</b>
Mikrokreditfond Deutschland	<b>MKF Deutschland</b>
Ministry of Labour and Social Affairs	<b>MLSA</b>
Trust-based-partnership model	<b>TBP model</b>

# INTRODUCTION

This report maps the German start-up scene and the relationship between microfinance and the non-tech start-up ecosystem in Germany. Section 1 of the report presents the big picture and explains the start-up landscape in Germany more generally. Moreover, it analyses the surrounding ecosystem and summarizes government support, entrepreneurship education and other

supporting organisations, while also explaining the current needs and challenges of German entrepreneurs. Section 2 discusses the most important microfinance initiatives and emphasizes non-tech businesses. Section 3 delivers policy recommendations to support current microfinance initiatives in their work.



# 1. THE BIG PICTURE

According to the “Deutscher Startup Monitor 2016” (DSM 2016), which publishes an annual study about the start-up scene in Germany, there are three major trends in the German start-up scene: First, the share of female entrepreneurs is growing at a slow, but consistent speed. Second, German start-ups are becoming more international with respect to employees and/or market strategies. Third, the need for investment continues to expand.

The KfW-Gründungsmonitor from (2016) states that the high employment level in Germany has an influence on annual business creation; the founder ratio dropped from 1.5% to 1.3% between the years 2015 and 2016. Importantly, there

has never been less business creation out of necessity (i.e. unemployment) than during 2016. Yet, start-ups dominate the business creation scene and play an increasingly important role.

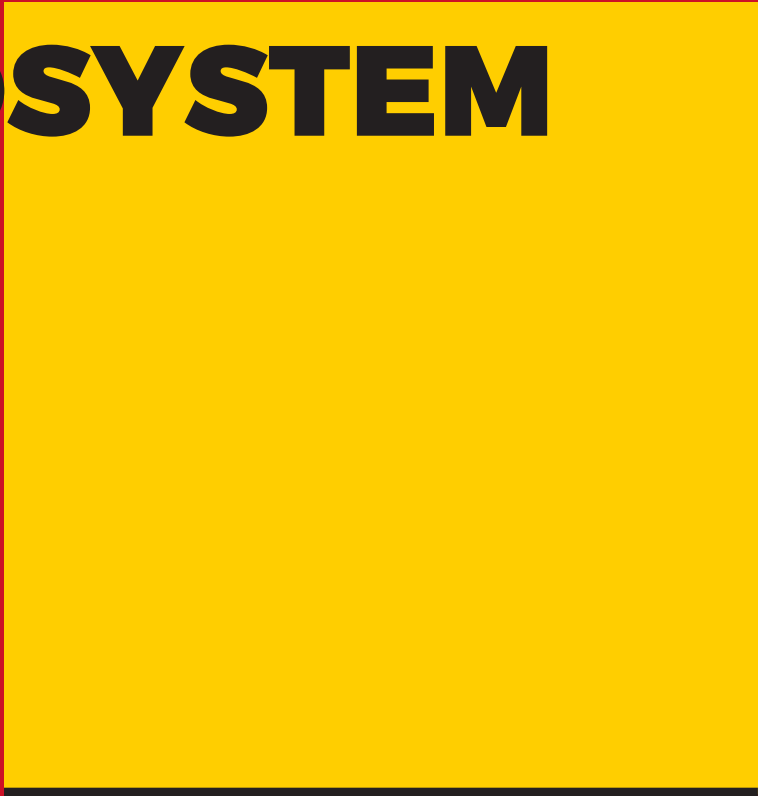
Small and medium-sized enterprises (SME) are an economic powerhouse in Germany and business creation is essential for German economic growth. There are several national and regional programmes to support entrepreneurs both financially and non-financially, although there is still a substantial lack of entrepreneurial education and awareness to present self-employment as an alternative career.

# 2. START-UP BUSINESS LANDSCAPE

According to the KfW-Gründungsmonitor (2016), Hamburg established itself in 2016 as the new capital of business creation (Gründungshauptstadt). From 2014-2016, 253 per 10.000 employed people started their own business in Hamburg. Berlin, which is ranked second, reported 238 new businesses per 10.000 employed people. In third place, Hessian reported 182 new businesses per 10.000 employed people. Many metropolitan areas in Germany report higher numbers of self-employed people since they more populated and the communication is better. Figure 1 - Capitals of business creation - in the Appendix shows the areas with the strongest entrepreneurial development per 10.000 employed people in more detail.

Ockenfels (2016) suggests four sectors where German start-ups have been successful. The first is the FinTech sector, which is not part of this report. The second sector is AdTech, which includes big data, data analytics and activities such as small and mid-cap M&A activity. eCommerce is another strongly growing sector in the German start-up scene, especially start-ups focused on fashion, auctions and food delivery. The last start-up sector emphasized by Ockenfels is the leisure sector, which includes e-sports, gaming, travel and music. This sector is strongly connected to German culture where traveling is very important, and as a result, targets a large captive audience.

# **3. THE SURROUNDING ECOSYSTEM**



# Government support

## The national strategy for business development, main objectives, implementation and programmes

The coalition agreement between the ruling German parties SPD, CDU and CSU in the 18th legislative period set the main framework and goals for a national strategy in terms of business development, SME support, entrepreneurship and business creation, which should be implemented and achieved in the current legislative period (2013-2017). The main objectives of the national strategy are to strengthen SMEs in Germany and to support business creation, including all entrepreneurial target groups (i.e. Fin-tech, unemployed, etc.). The coalition agreement specifically underlines the importance of small and medium sized businesses in Germany as “innovative companies” and the “employment powerhouse.” The connection between regional attachment and internationalisation

is described as an important factor to guarantee the German value-added chain. SMEs, especially the craft sector, fulfil a central role in the apprenticeship of young people in Germany and create employment. In this context, the promotion of SMEs (Mittelstandförderung) can be found as a national strategy in the coalition agreement. Programmes that are to be implemented within this context include the “Enterprise Region” (Unternehmen Region). This programme has already been successfully implemented in East Germany and is currently embarking on a national expansion. “Unternehmen Region” is an initiative that establishes innovative and competitive regions within Germany. The “Centralised Support Programme for innovative SMEs” (Zentrale Innovationsförderprogramm

Mittelstand (ZIM)) is another programme that supports innovative SMEs on a national level. In addition, the coalition agreement promises a continuation of support for start-up coaching, especially for people who want to start their business out of unemployment.

Another concept, “Time to start a business” (Gründungszeit) hasn’t been established yet. This idea targets people who want to start a business out of employment but cannot afford to lose their job/wage in the meantime. Based on the concept of “Family care time” (Familienpflegezeit), a programme that supports individuals to arrange work, family and nursing at the same time, the “Time to start a business” should similarly promote the arrangement of family, self-employment and work at the same time.

## Labour market instruments and self-employed programmes for the unemployed

Despite addition to the national strategy and various supporting programmes, there are a number of labour market instruments to support entrepreneurs. To help people start a business, there are numerous “supporting programmes” (Förderprogramme) at the national and regional levels. These supporting programmes include access to finance, technical know-how and business contests. A complete

overview of the existing support programmes can be found on the website of the Ministry of Economics and Energy<sup>1</sup>, which distinguishes between funding authorities, federal states, eligible persons, funding areas and the kind of support.

People who want to start a business out of unemployment can apply for two different types of financial support depending on the legal framework of their unemployment. Usually, in

the first year of unemployment, the employment agency is responsible. They offer the so-called “business grant” (Gründungszuschuss). The business grant is paid for six months in the amount of the unemployment benefit. Furthermore, there is a monthly payment of € 300 for the social security contribution, which can be paid up to 15 months. The business grant is a payment in the framework of German unemployment

1 <http://www.foerderdatenbank.de/>

insurance (Social Security Code III). If unemployment exceeds twelve months, the responsibility usually shifts to a job centre. Job centres offer

the “jobstart grant“ (Einstiegsgeld), which can be used to start a business. The amount paid and the payment duration depend on the specific case

and are not granted by every job centre. The jobstart grant is a payment in the frame of the “basic financial protection“ (Social Security Code II).

## Effectiveness of the programmes in terms of scale and impact

In order to evaluate the programmes mentioned above in terms of scale and impact, we need to review the developments of the past 20 years. In 2000, a time where Germany was struggling with high unemployment rates and low economic growth, the strategy of “self-employment“ was introduced. Self-employment aimed to fight high levels of unemployment by increasing the number of entrepreneurs. This topic hadn’t been embraced by government by this point in time but quickly became an important labour market instrument. The two primary instruments introduced during this time were a start-up subsidy called “Me Inc.“ (Ich-AG) and the “bridging allowance“ (Überbrückungsgeld). Both instruments complimented each other and helped unemployed individuals become an entrepreneur. Most of the self-employment strategy was implemented by the Ministry of Labour and studies report an overall success story: The study by Caliendo, Künn and Wießner (2009) shows that 50-60% of unemployed people who used Me Inc. from 2003-2006 were still full-/part time self-employed in 2008. Similarly, 53-67% of unemployed people who used the bridging allowance from 2003-2006 were still full-/part time self-employed in 2008. Both instruments funded more than 1.000.000 million unemployed people from 2003-2006. In terms of market integration, both instruments were deemed to be effective, although Me Inc. and the bridging allowance were phased out in 2006 and merged

together into the business grant described above.

The study by Caliendo, Hogenacker, Künn and Wießner (2012) also compares the effectiveness of the business grant to its predecessors. The study suggests that the business grant is an important labour market policy instrument and achieves, as far as analysed, similar results to the Me Inc. and bridging allowance. In terms of self-employment, the business survival rates are higher in comparison to the Me Inc. and the bridging allowance. Moreover, the majority of business grant recipients reach a living income. In addition, one-third of them have created additional jobs. On average, each founder has created 1.6-2.8 jobs. Nevertheless, there is still some desire to improve social security. Most of the business grant recipients have health insurance but do not invest into any retirement programme.

In 2010, Germany implemented a major strategic policy change since the labour market was no longer characterised by high levels of unemployment. The new challenge in the labour market, which still exists today, is the shortage of specialists. Due to the shortage of specialists, the Ministry of Labour and Social Affairs (MLSA), which was previously the primary institution supporting business creation, ceased its work in this area. Budgets were shortened and application rules became more prohibitive.

For example, in 2010, more than 146.000 business grant applications

were approved. By 2015, only 35.000 business grant applications were approved, representing a decrease of nearly 76%. Similar trends occurred in the Microcredit sector: The MLSA was managing the “Microcredit Germany Fund“ (Mikrokreditfonds Deutschland), which provided some 5.900 credits in 2012. By 2016, the number of credit provided dropped by nearly 66% to 2.000 credits. Interestingly, the MLSA always highlights the success of these programmes (see above). Nevertheless, they do not support self-employment anymore due to low levels of unemployment and a shortage of specialists. The MLSA clearly states that the Ministry of Economics is in charge of start-up support and self-employment and, as a result, the Ministry of Economics has recently lent support in this area. However, the resources available are a fraction of the former promotion by the MLSA.

In general, the satisfaction of German entrepreneurs with policy support at the national is consistently lower than the average across the 16 federal states. Figure 2 - Satisfaction of German entrepreneurs with the policy support - in the Appendix shows the results for each federal state. Contentment of national support is shown in purple; federal support is shown in pink. 1 is the best and 6 is the worst rank. On average, the 2016 national entrepreneurial policy was ranked with a grade of 3.9.



## Start-up definition in Germany

Germany hasn't yet introduced legislation that defines the term "start-up." This can be attributed to German Federalism where regional politics are strong and nation-wide definitions are rare.

Currently, many definitions of start-ups exist in parallel, although a key definition has been introduced by the DSM 2016. They define start-

ups as an enterprise younger than 10 years, and that is based on an innovative technology or business model could embrace significant staff or profit growth. Another definition by the "Chamber of Commerce Berlin" (Industrie- und Handelskammer Berlin) captures the general understanding of a start-up in Germany: It is innovative, young

and shows a high growth potential. The definition of the German development bank (KfW Kreditanstalt für Wiederaufbau) defines start-ups as "more digital, innovative and capital-intensive." This very broad definition of start-ups could be expected to become a common definition in Germany in the coming years.

# Entrepreneurship education

## Entrepreneurial education at schools

Entrepreneurship education at schools is still not incorporated into the normal curriculum and is not a widely available topic for young people. However, there are initiatives and governmental efforts to increase the awareness of young people at school and strengthen entrepreneurial skills among students.

There is no national strategy for entrepreneurship education in terms of school curriculums, grades and courses at German schools, but there is a national strategy in the form of initiatives, which should help to promote this topic among young students. This is a first attempt to improve the lack of entrepreneurial education in Germany, which is still a weakness compared to other countries. According to the Federal Ministry of Economics and Technology, the most crucial phase

of life to influence attitudes towards entrepreneurship is during young adulthood. Moreover, the best age group to establish entrepreneurial competences is between 15-19 years. As a result, the Federal Ministry of Economics and Energy has started the initiative "Entrepreneurial spirit at schools" (Unternehmergeist in Schulen). This initiative brings together eleven supra-regional and a number of private initiatives that work together to present entrepreneurship as an alternative career choice and to strengthen the start-up culture in Germany.

The member organisations within the "Entrepreneurial spirit at schools" programme promote the combination of academic theoretical concepts and the practical experience of enterprises. The results show that the students are highly motivated

and develop an understanding of the entrepreneurial landscape and acquire many entrepreneurial skills. The initiative includes various offers, which are addressed to teachers to help them implement entrepreneurial activities in their courses. The offers include options such as business games, online-tools or real business creation. Apart from the online and offline tools to teach entrepreneurial skills, there are also a number of start-up competitions for young people. The competition "Youth is starting a business" (Jugend gründet) is a two-stage competition. In the first step, participants develop a business plan for an innovative idea. In the second step, they run this "virtual" business and ensure successful growth. First prize is awarded a trip to Silicon Valley in the USA.

## Entrepreneurial education at universities

The topics “start-up” and “self-employment” have seen a huge increase in interest among university graduates in Germany within the last years, particularly with respect to the creative sector, liberal professions (freie Berufe), information and communication technology and life science (medicine, biotech).

Universities in Germany also try to help their graduates with their business creation. For example, they offer seminars and lectures to transmit entrepreneurial know-how or provide coaching sessions. According to the Federal Ministry for Economics and Energy, there are currently around 130 entrepreneurship professorships in Germany, with plans to add more in

the coming years.

Graduates are experts in their field of studies but often lack entrepreneurial know-how and entrepreneurial skills. Moreover, they don't have a well-established network and face difficulties to obtain financing. Since they often cannot provide collateral, they are not attractive for traditional bank loans. To help graduates start their business, both public and private funding support programmes can be found across Germany to help entrepreneurs start, grow and sustain their business idea.

For example, “EXIST” is a support programme funded by the Federal Ministry of Economics and Energy and co-financed by the ESF. This support

programme is targeted towards graduates and young scientists with technology-oriented and knowledge-based business ideas. They can receive financial support for up to one year as a form of personal income, plus coaching and material expenses. This programme tries to close the financial gap for young entrepreneurs. Another support programme that is funded by private partners is “Youth Business Germany.” This programme provides free scholarships to young people between 18 and 35 years where they are taught entrepreneurial know-how. Moreover, they get to know other young entrepreneurs and establish a sound network.

## Entrepreneurial education for adults

If an adult decides to quit his current job and become self-employed, he might face similar problems to the graduate student: He is an expert in his particular career field but might lack entrepreneurial know-how. Due to this gap in entrepreneurial know-how, there are several

programmes/institutions that provide entrepreneurial training to adults. Examples include the regional IHKs (Chamber of Commerce), start-up centres or business development centres, which provide coaching, training and workshops to people who want to develop their entrepreneurial

skills. Until 2014, there was also the possibility to receive grants from the Ministry of Economics to provide trainings and courses. However, this was cancelled due to budget limitations.

## Other support organisations

### Financial support to start-ups

A general overview of different ways of entrepreneurial funding can be seen in Figure 3 - Sources of funding in Germany - in the Appendix. The figure, from the DSM 2016, shows the popularity of various funding sources among German start-ups from 2014-2016. Importantly, this survey mainly considers start-ups, with a focus on well-spoken youths and highly innovative enterprises. The funding sources for SMEs or necessity businesses may look different.

Figure 3 reflects the German culture in terms of risk and credit taking, with 84.1% providing funding from their own savings (Eigene Ersparnisse); this was the most popular way for German entrepreneurs to finance their business activities in the year 2016. An additional 35.5% of start-ups report government grants as a funding source.

Development banks (DB) (Förderbanken) are also essential institutions in Germany when it comes to the financing of enterprises. DBs are special banks that provide credits, investments, mezzanine capital or guarantees. They have a governmental mandate for a respective topic or federal state to implement and manage funding measures in policy areas like economic or living space.

The Kreditanstalt für Wiederaufbau (KfW) and the Landwirtschaftliche Rentenbank (agricultural sector) are two institutions that work on a national level. Every federal state in Germany has its own "federal development bank" (FDB). Therefore, in total, there are 18 development banks in Germany. For example,

"WIBank" is the FDB of Hessen, "NRW. Bank" of North Rhine-Westphalia and "LfA Förderbank Bayern" of Bavaria. Each FDB has different products and conditions. At first glance this might seem confusing but it follows a logical pattern: FDBs in Germany do not develop their own strategies, they support the political strategies of their respective federal states. The KfW supports the policy of the government.

The DBs are not in competition with the traditional German banking sector. This is achieved through the "Principal Bank Rule" (Hausbankprinzip). This rule states that clients are not allowed to stay in direct contact with the DB. All credit applications and credit contracts with DBs need to be handled via the principal bank of the client.

Nevertheless, these credits are not very popular among principal banks. The margins and fees of the product transmission to DBs are normally not very high. In this case, the "delivery channel" of the promotional product is blocked. Additionally, many exceptions to the Principal Bank Rule have been introduced. An illustration can be made with the microloans in Hesse or the "Guarantees without a bank" (Bürgschaft ohne Bank), where the application needs to be sent to the guarantee bank and only after this can the principal bank become involved. Interestingly, within this context, Grenke-Bank (a small private bank, specialising in SME-financing) uses the blocked delivery channels for their services. They provide applications for KfW-start-up credits on a national level and work together with regional

consulting partners (start-up centres, business development services, consultants). Finally, it is important to note that guarantees and investments are not primarily issued through DBs, but through separate legal identities (investment companies, guarantee banks). Nevertheless, these separate legal identities work closely together with the respective DB.

Additional funding sources include Family and friends, which provide 30.2 % of funding to start-ups. Family and friends are especially important for enterprises with a small financial requirement; the lower the financial requirement, the higher the percentage of family and friends funding.

Apart from private resources, governmental grants and family and

friends, start-ups also use Business Angels (22.6%) and Venture Capital (18.8%) as sources of finance in Germany. Business angels provide financing as well as business know-how to innovative start-ups and ask in return for a participation in the profits or shareholding. The Business Angel Network Germany (BAND) accredits German Business Angels and lists them on their website. Currently, they have 54 members and start-ups can filter them by federal state.

According to Bauer and Metzger (2015), venture capital is especially important for start-ups in Germany. Start-ups using new technologies and that have a high financing need are often difficult to predict in terms of success rate and growth opportunities. As a result, they are

a typical target group for venture capitalists. Nevertheless, in 2014, only € 560 million was invested by German venture capitalists, which is a relatively low amount in an international context.

From an historical point of view, traditional financing has been a central source of financing for SMEs in Germany. Due to changes in the financial markets, the financing of German enterprises is also changing, but the standard banking loan (Bankdarlehen) is still a popular financing instrument for SMEs and start-ups. 14.6% of German start-ups used this source of financing in 2016. Internal Financing (Innenfinanzierung) - 19.4% - is another traditional way of business financing that is also used by the start-up scene in Germany.

## Other financial support schemes for start-ups

There are two important programmes in Germany which help early stage start-ups to grow and succeed:

Accelerators which help entrepreneurs to develop their business idea and Incubators which establish a very

close relationship between a sponsor and start-up to help them develop a business idea.

## Accelerator

Nearly every month, a new Accelerator programme is opened in Germany. According to the "Gründerszene" article, "42 Acceleratoren, die Start-Ups fördern wollen (2016)" there are already more than 40 Accelerators in Germany that provide support to more than 600 start-ups every year<sup>2</sup>. German accelerators cover almost

every business sector. Moreover, there are six social impact labs that provide support to social entrepreneurs. There are also programmes for very specific topics such as eye-relevant innovations, foodtech or music-oriented business models. Similar to the variety in accelerator programmes, there is variation

in the services offered and the accompanying programme conditions. On average, a start-up receives € 25.000 in exchange for 5% of company shares<sup>3</sup>. By far, the region with the most accelerators is Berlin (21 out of 48 accelerators are located in Berlin), followed by München (7), Stuttgart (6), and the Rhein-Main (5).

<sup>2</sup> <https://www.gruenderszene.de/allgemein/uebersicht-accelatoren-deutschland>  
<sup>3</sup> <https://www.gruenderszene.de/allgemein/uebersicht-accelatoren-deutschland>

## Incubator

The number of Incubators in Germany is increasing on a weekly basis. Cooperatives in particular use this concept to connect to the start-up world and improve their own product or service portfolio. However, the incubator programmes of

cooperatives can differ substantially. Two of the most well known incubator programmes in Germany are MainCubator and DvH Ventures. MainCubator is a Commerzbank Incubator and supports FinTech start-ups with infrastructure, know-how

and customer access. DvH Ventures is an incubator of the media companies of DvH Media and supports start-ups with capital, contacts and access to a large, well-read public.

## Non- financial support to start-ups

An important form of non-financial support for entrepreneurs is the programme “Encouragement of entrepreneurial know-how” (Förderung unternehmerischen Know-hows). Self-employed individuals are provided with a grant for consultancy that covers between 50-80% of the costs (depending on the region). The consultancy services cannot exceed € 4.000 Euro (grant element of € 2.000-3.200) for each of

the first two years, and are limited to € 3.000 in the third year (grant element of € 1.500- 2.400). Businesses who are struggling (independent of their age) receive a 90% coverage grant for consultancy (grant € 2.700). The application for this grant can be done through registered contacts that are normally organised on a regional level (Chamber of Commerce) or in sector associations. Additionally, a number of providers

offer free initial consulting, including the Chamber of Industry and Commerce (IHK), start-up centres, incubators or business development centres (BDC). In some regions, consultancy or training for unemployed people is provided by the employment agency or job centres. Until 2010, this support was a national wide approach, whereas today it is rarely practiced.

# 4. NEEDS OF ENTREPRENEURS

According to the DSM (2016), the four biggest challenges for German start-ups in 2016 were sales/customer acquisition (20.2%), product development (18.2%), growth (15.5%) and capital procurement (12.4%). Figure 4 - Challenges 2016 - in the Appendix lists all the mentioned start-up challenges in Germany up and values their respective importance as a percentage.

Moreover, regarding public policy, German start-ups expect a degradation of bureaucratic and regulatory obstacles (20.3%), tax reduction (13.5%) and support in capital procurement (13.5%). A more detailed listing of policy expectations can be found in Figure 5 - Policy expectations 2016 - in the Appendix.

# 5. CURRENT MICROFINANCE INITIATIVES

To present the range of current microfinance, the following sections are dedicated to the pillars of microfinance in Germany:

- Deutsches Mikrofinanz Institut (DMI) and Regional MFIs
- Mikrokreditfonds Deutschland (MKF Deutschland)
- Federal development bank (FDB)
  - Digression: The role of the IHK (Chamber of Commerce)
- Municipal business development agencies (Kommunale Wirtschaftsförderungen)
- Job centres

### Deutsches Mikrofinanz Institut (DMI) and regional MFIs

Established in 2004, the DMI accredits German microfinance institutions (MFIs) to create a national microfinance network. These MFIs agree to a code of conduct and provide microcredits (€ 500-25.000) to entrepreneurs in Germany.

Until 2014, there was a consistent microcredit framework among the members of the DMI where the DMI accredits German MFIs and in cooperation with Mikrokreditfond Deutschland (MKF Deutschland) and GLS Bank provides the credits. However, in 2015, the financial environment of participating MFIs worsened. Currently, only a few MFIs are still active in the programme. Some MFIs started working together with the federal programmes; others ceased operations. As a result, the market is in a large transitional phase. This section summarises interviews with MFIs and reflects on the work, outcomes, needs and challenges of this first microfinance alternative within the German market.

The general consensus within the microfinance sector is that there is no standard definition of a “start-up.” The interviewed partners suggest that there is a murky understanding of start-ups, which typically includes a young enterprise (younger than five years). Apart from this, no concrete definition has been established.

Whereas no common definition of start-ups exists for MFIs, the sectors supported by MFIs can vary significantly. Some of them support nearly all sectors while others exclude risky industries like gastronomy or cosmetic studies. In terms of business size, all MFIs support small sized business, normally sole-enterprises or sometimes with up to 2 or 3 employees.

Most enterprises served by MFIs require investment rather than working capital. In terms of financial needs, clients get a microloan to invest in their business activities. One MFI that was interviewed mentioned that microcredit is often used as co-financing tool in combination with a grant or a client's own savings.

Other financing sources vary substantially across the range of business ideas and sector. Some MFIs mentioned that they are often the last resort of financing. In some cases, MFIs finance high potential business ideas, which later move to other forms of investment such as business angels or private investors. In general, most microloans are accompanied by private savings and/or family and friends support.

There are no differences between the provided products offered by MFIs. For instance, there are no differentiated products for start-ups or established businesses. However, one MFI is thinking to differentiate by business sector and another currently provides advantages for clients who are active within the network.

All MFIs refer to most of their clients as “start-ups” since most of the businesses they support have not yet started operations. Again, “start-up” in the microfinance context refers to young enterprises rather than highly innovative or high-growth businesses. No average financial need could be established from the interviews or data. MFIs report that the financing need depends heavily upon the business idea, sector and savings of the particular entrepreneur.

The youth segment is an important target group for MFIs. Most MFIs work with younger people but there are no special products for different age groups. Some MFIs



note differences between younger and older entrepreneurs. The differences mentioned are not based on qualification, motivation or openness, but rather on experience and collateral. Moreover, youth entrepreneurs' business ideas tend to be more innovative and operate through alternative channels like Facebook or Twitter. In addition, youth entrepreneurs are more open to newer financing sources such as Crowdfunding.

In terms of Business Development Services (BDS), some MFIs offer additional consultancy hours for financing and provide options for professional exchange. Non-financial services typically entail one-on-one coaching, consultancy hours or seminars.

Offering non-financial services together with microloans is a common offering, but not the standard in every MFI. The typical offer is a combination of consultancy and financing. Often,

there is an introductory conversation before the credit is distributed. Moreover, there is intensive support during the repayment period. Once a month, the borrower receives an email with three questions:

- How are you?
- How is your business going?
- Are you able to pay the next instalment?

Crisis intervention is also important. If clients do not answer or respond that they are facing problems, the next step would be a telephone call or a personal meeting. Some MFIs report that a close, personal relationship is the key to success and leads to low default rates. In this scenario, there is a visit to the entrepreneur's workplace at the beginning of the credit process to strengthen the relationship and obtain a better idea of the business.

Since most businesses are defined as "young businesses," there is no differentiation between the default rates of different business-age groups.

Monitoring after loan repayment is not part of any MFI's standard operations. Nevertheless, some MFIs organise networking events or "entrepreneurial breakfasts" (Gründerfrühstück) to keep contact with former clients. Others just inform borrowers about potential follow up programmes and support options.

In general, MFIs have a positive attitude towards EU instruments, although not all of respondent MFIs were able to obtain EU funding. Among the EU instruments mentioned were the ESF fund, which is currently supporting some German MFIs. Others reported applying several times for funding but eventually being rejected.

Unfortunately, most German MFIs are also facing high bureaucratic obstacles to obtain financing. There is a desire from the MFIs to establish an easier and less bureaucratic application process.

### **Mikrokreditfonds Deutschland (MKF Deutschland)**

The MKF Deutschland was established in 2010 using the "cooperative model of microfinancing" (TBP-model - trust-based-partnership-model), which was created by the DMI, regional MFIs and GLS bank from 2002-2009. Until 2012, only this particular structure had been used and reached its plateau in 2012, when 54 MFIs distributed some 6.000 credits with a total loan volume of € 33 million.

By 2011, the uncoupling of MKF Deutschland from the TBP-model

had started. Also in 2011, quality criteria were introduced. By 2012, MKF Deutschland was working together with MFIs that hadn't been accredited by the DMI, and hence, weren't members of this organisation.

In 2015, the system was re-established. The new strategy was to work together with a few of the more facilitating MFIs. Credit screening should be done via a scoring procedure so that most of the process could be automated. According to MFIs, which

also have worked in the "old system", the new system causes MFIs to lose their individuality in the credit lending process. The differentiation of credits from the FDBs is also difficult. Unfortunately, today there are no available credit numbers from MKF Deutschland. However, according to MFIs, the number is likely under 2.000 credits. The credit processing is done via the Grenke Bank.

## Federal development bank (FDB)

As previously mentioned, there are 16 FDBs in Germany providing entrepreneurs with financial support. Most of them include special microfinance programmes in their product portfolio, with particular attention to help necessity business entrepreneurs to flourish and succeed.

An example of this alternative German microfinancing is the Hessian “WIBank.” The summary of the “WIBank” interview reflects the work and the outcomes in Hesse and is indicative of the German development bank in general.

Among the WIBank’s several programmes, one provides loans to SMEs at a subsidised interest rate. The programme, “Foundation and Growth Financing Hessian” (Gründungs- und Wachstumsfinanzierung Hessen (GüW)), was established in

cooperation with KfW. In addition, the WIBank administers federal programmes that affect business development. The programme, “Hessian Microloans” (Hessen-Mikrodarlehen), provides loans to young businesses and is presented in detail below with information from the WIBank interview.

The Hessian Microloan was created for natural persons, as well as members of liberal professions, who are planning to start/take-over a business or strengthen their business (within 5 years of business operation). Applicants need to show adequate business understanding and professional know-how, as well as demonstrate experience in their particular field of interest. This definition also includes a natural person who takes part in the operation of a business, if this

participation allows enough time for self-employment and entrepreneurial decision-making. The target group are people who face difficulty accessing capital, but have an entrepreneurial business idea that guarantees profits or, at least, the coverage of household living expenses.

The Hessian Microloan programme started in November 2013. Applicants request €18.000 on average although the maximum loan amount is €25.000. On average, the programme provides 70 loans per year (245 loans have been distributed since 2013).

In addition to the loans, WIBank provides free consultancy to its clients. Moreover, clients have access to a large network if needed. The network includes 23 partners from the IHK, Chambers of Craft (Handwerkskammern (HWKs)) or business development agencies.

## Digression: The role of the IHK (Chamber of Commerce)

IHKs are regional organised and cross-sectoral business associations. In Germany, there are currently 79 IHKs in charge of specific regions. They are not allowed to provide credits themselves, but in the last years they have gained importance in the microfinance sector. As described above, there are a number of DBs, which do not provide credits via principal banks, but rather provide the microcredits directly to clients. Since the DBs do not have a point of contact in some regions, they use IHKs as a local contact party. The IHK informs prospective clients about the programme, helping clients with the application and making recommendations to the DBs.

In this context, an interview was conducted with a representative of the IHK Offenbach, one of the 79 members, and is summarised below.

To date, no official definition of a start-up exists within the IHK circle. Nevertheless, the meaning of start-up is somehow already established: start-ups are young, innovative companies with a high growth potential. It is expected that this “unofficial” definition will achieve a legal status in the coming years.

The IHK provides different forms of consultancy to entrepreneurs. First, there is an entrance consultancy for entrepreneurs, and then there are different levels of support depending on the knowledge and skills of the entrepreneur. There are individual consultancy programmes and workshops in various topics such as financing, marketing or legal issues. Importantly, the IHK only provides a basic business consultancy; more comprehensive consultancy services are not offered. Moreover, there are

informational events, fairs and online tools.

Each year, the IHK Offenbach has around 2.000 consultancy queries. The business target group is very broad: the IHK supports almost every industry area with the exception of crafts. Crafts businesses receive special support from HWK. Moreover, liberal professions like architects, lawyers or tax advisers are not included since they also have their own professional chambers.

The sources of financing and the amount of financing for IHK clients vary strongly between the different industries. In general, service sector businesses ask for less capital than the production sector. There is a tendency for entrepreneurs to use their own savings or ask family/friends for money to finance business investments or working capital, which

is echoed in Figure 3 of the Appendix where client savings are reported as the most funding source in 2016.

The IHK consults young entrepreneurs between 18 and 35 years, but the average age of clients is between 30 and 40 years. Older people tend to have more experience and savings (or collateral), which helps them to

obtain a loan. However, younger entrepreneurs are, according to the experience of the IHK in Offenbach, often better prepared for consultancy and more open in the sessions. On average, younger entrepreneurs are more willing to take risk and their ideas are more innovative. Moreover, they use alternative channels to

promote their goods or services. For instance, engaging on social media such as Facebook or Twitter is a normal part of business activity for young entrepreneurs. Nevertheless, the products do not differ for younger or older clients.

### **Municipal business development agencies (kommunale Wirtschaftsförderungen)**

Municipal business development agencies play an important role in the support and promotion of entrepreneurs. Similar to the IHK, they consult entrepreneurs on business and finance related topics. Some of the agencies have partnerships and cooperate with banks and other institutions to provide microcredits for entrepreneurs.

An example of this kind of entrepreneurial support is the “Frankfurter Gründerfond” in Hesse. Established in 2009, the Frankfurter Gründerfond began issuing loans one year later. The fund is a project of the Frankfurt “Business Development Agency” (BDA) (Wirtschaftsförderung Frankfurt) in cooperation with the Frankfurt School of Finance Services GmbH, the Bürgschaftsbank Hessen, eight partner banks, the Frankfurt School of Finance and other local partners.

The Frankfurt BDA is in charge of operational activities for the fund and is the project lead. Before the fund was established in 2010, the Frankfurt School of Finance, which has more than 20 years’ experience in the field of microfinance, conducted research about the needs and the expectations of the banks and entrepreneurs within the microfinance context. The fund was designed based on the

study results. The Frankfurt School of Finance Services GmbH is involved in the financial due diligence and has contracts with eight partner banks that provide the loans. Moreover, the Bürgschaftsbank Hessen guarantees the bank loans.

The target group of the Frankfurter Gründerfonds are small businesses in Frankfurt. Clients can receive a loan (€2.500–50.000) and guarantee from the Bürgschaftsbank. The Gründerfonds is open to all business sectors, with the exception of the liberal professions (lawyers, tax consultants etc.). Services sectors represent the majority of clients. Sectors such as gastronomy, retail, craft, IT and the publishing industry are often supported with a loan.

Between July 2010 and July 2017, the average loan amount was €37.600 with a total of 100 loans issued during the period (14 per year on average). The credit approval process takes 4-6 weeks. Apart from the Frankfurter Gründerfonds, family and friends are the most common source of financing for these clients.

In general, the age group applying for a credit is between 35-50 years. This age group is seen as looking for a second career, after having a previous professional career. They often look for new challenges and want to become

self-employed. The second most represented age group is between 25-35 years, comprised mostly of people who have finished university and are planning to become self-employed in the fin-tech sector. Youth applicants between 18 and 25 years are rare.

There are no differences in products by age group, although there are different behaviours by age. Younger clients tend to have more fin-tech/ IT related business ideas and regularly use social media to reach (potential) clients. Most clients have an academic background.

The USP of the Frankfurter Gründerfonds is its neutral financial consultancy. In general, every entrepreneur receives an entry consultancy where the eight partner banks are presented. The Frankfurter Gründerfonds treats each partner bank equally and the entrepreneur decides which bank fits him or her the best. There is intensive supervision throughout the credit period. Borrowers need to give frequent feedback about their business and credit repayment. Moreover, during the loan period, the Frankfurter Wirtschaftsförderung provides free consultancy hours and one-on-one coaching for the entrepreneurs.

## The Job Centres

Self-employed individuals who are eligible for a basic income from the job centre (Social Security Code II), are also able to receive a loan, although most of the job centres do not offer them. There is no existing survey or evaluation on this topic. As a result, we give a short review here based on interviews with consultants who frequently work together with the job centres.

Typically, the credit amount is between €2.000-5.000, although in special cases the amount can reach up to €10.000. The target group are Social Security Code II recipients. Sector, age and other client characteristics are not relevant. A requirement to apply is typically an audit and recommendation from an external and neutral consultant.

Some job centres work together with MFIs. For example, the job centre Offenbach created, in collaboration with the MFI KIZ Finanzkontor, a special microcredit (ostpol-Kredit) that worked within the framework of the Mikrokreditfond Deutschland. By 2014, the project had provided 50 credits with a volume of €240k. Importantly, the default rate was less than 2% (!), which is extraordinary for the target group. According to the job centre Offenbach and KIZ, this is due to a close collaboration during the repayment period.

Below we summarize the opinions of the microfinance initiatives about the usefulness of various financial instruments for start-ups:

➤ Grants: Grants face differing

opinions. Some microfinance initiatives argue that this is a good way to boost and support business, especially for entrepreneurs who don't have enough experience to get a bank loan. Others do not see it as an efficient financial tool since grants do not encourage effort by the borrower.

- Micro Equity: Equity is seen as a useful and effective tool.
- Guarantees: Guarantees are seen as a useful tool and very important in the German Microfinance sector.
- Peer-to-Peer lending: P2P lending, especially Crowdfunding is seen as an effective tool in terms of a first market test. Unfortunately, it is time intensive and not convenient for every business.

## Conclusions about German microfinance initiatives

Below, we present some key take-aways from the interviews with the various microfinance initiatives in Germany:

- There is no precise definition of a start-up. There is a broad understanding of start-ups that is related to a young, innovative and high growth business. As a result, there is a low share of start-ups compared to the total number of clients.
- Nearly all business sectors are represented although liberal professions are excluded.

- Most clients also use their own savings or financing via friends and family.
- Microfinance initiatives in Germany serve young people (18-35 years), although young entrepreneurs tend to have less experience/savings. Their ideas tend to be more innovative and they use alternative communication channels (i.e. social media).
- In general, there are no product differentiations between start-ups and mature business or between younger and older people.

- Non-financial support is an important feature of German microfinance. Often, non-financial support comes in the form of advice and consultation before clients take a credit. Moreover, there is intensive support in the credit period. Typically, there is no business performance tracking after loan repayment.
- "Guarantees" and "micro-equity" are seen as important financial tools in the microfinance sector.

# 6. POLICY RECOMMENDATIONS

In this section, we present policy recommendations that would help national MFIs to serve more start-ups and do it more effectively. The following recommendations are suggestions and ideas from the interviews with the respective microfinance initiatives in Germany.

## Reactivation of the know-how from DMI and the MFIs

From 2002-2012, more than €2 million from the ESF-fund was used to develop and strengthen microcredit know-how. Structures were established to improve and smoothen the credit provision. The programme reached a plateau in 2012 when 54 MFIs provided 5.853 credits with a total volume of €33,7 million. The main knowledge developed during this period includes:

- How to reach target groups.
- How to behave in the credit lending process and structure crisis intervention to maintain a low default rate.
- How to build and maintain an IT based risk management system for individual loans and at the portfolio level.
- How to structure an Incentive-Liability-Model to involve private partners into the microcredit lending process.
- How a regional microcredit fund can be established in cooperation with regional partners.

Currently, this know-how is not widespread since the DBs are not currently interested in changing their existing system. However, there is the call for the establishment of a European product that is also accessible for certain MFIs.

## Financing non-financial support

Microfinance is more than just the provision of money. A close companionship during the credit period significantly reduces the default rate. For example, the MFI KIZ Finanzkontor was able to reduce the default rate to less than 6% through intensive support of its clients. Seeing

credit default through the eyes of the client is an important feature of microfinance. Each default impacts a family that is not able to repay their debts, and that may worry at breakfast and faces desperation at dinner time. Especially with the goal of social inclusion, microfinance cannot be

used to be just another chapter in a book of failures. Microfinance means social responsibility. Microcredit provision that prepares clients and accompanies them in crisis has a huge social impact.

## Provision of handling fees

In a continuation of policy recommendation two, we need to take into account that the cost of microcredits cannot be fully covered by the interest rate. In 2012, a detailed survey among German MFIs suggested that the interest rate would need to

be around 25% p.a. on average to cover all MFI costs. This interest rate is not feasible in Germany and would violate applicable law. The average shortfall of credits under €10.000 is approximately €450 per credit using an interest rate of 8,9% p.a.

Note: The microcredits in the context of the FDB are working since the administrative costs are mostly covered by the respective federal state.

## European legal framework for MFIs

Only banks can provide credits in Germany. This means that MFIs need a cooperative banking partner to provide credits, which is difficult to implement and increases the cost

of lending. In other countries, such as the UK, the MFI lending process is structured differently. In some countries, the legal framework is similar but there are exceptions for

the microcredit sector or certain MFIs. A simple European Regulation for the microfinance sector could increase the number of microcredits in Germany significantly.

### **A reduction in the minimum size of the EU funds**

Support at the European level for microfinance is highly welcome, but the relatively high minimum funding amount is a large handicap for German MFIs. In Germany, only a few MFIs can overcome this hurdle. As a result, the FDB is the main recipient of these products, but does not have a real interest to scale up the microfinance sector within Germany. This can be related to policy point three: more credits result in higher subsidies from the federal state, but social inclusion and access to finance for micro-entrepreneurs may not be able to be achieved in this manner.

### **Start an initiative for “Open European Microfinance Funds“**

The primary cost in the provision of microcredit are default costs. MFIs to date have relied upon the willingness of foundations, municipals or even private investors to invest into the microfinance sector. Nevertheless, establishing and administering a fund is very expensive. There is some support to examine the concept of an “Open European Microfinance Fund“ that would deliver equity for regional microcredit programmes.

### **Microfinance and Crowdfunding**

Crowdfunding has become indispensable in today’s microfinance sector. However, these two phenomena remain largely separate. The development of products that directly connect both sectors is desirable.

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# Interviews

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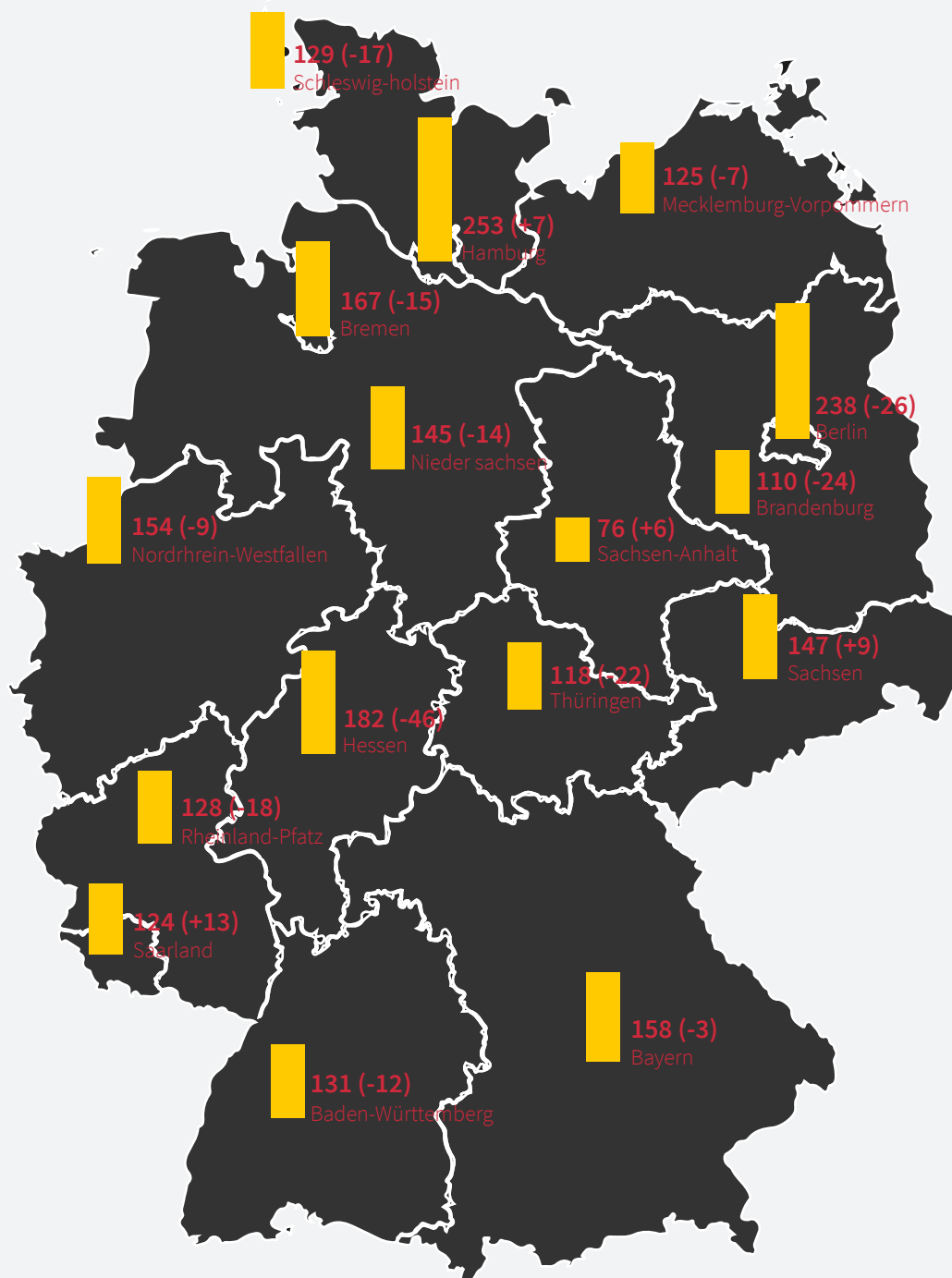
## **ELISABETH NEUMANN**

Hessischer Gründerpreis, KIZ Sinnova gGmbH

# Appendix

## Figure 1 - Capitals of business creation

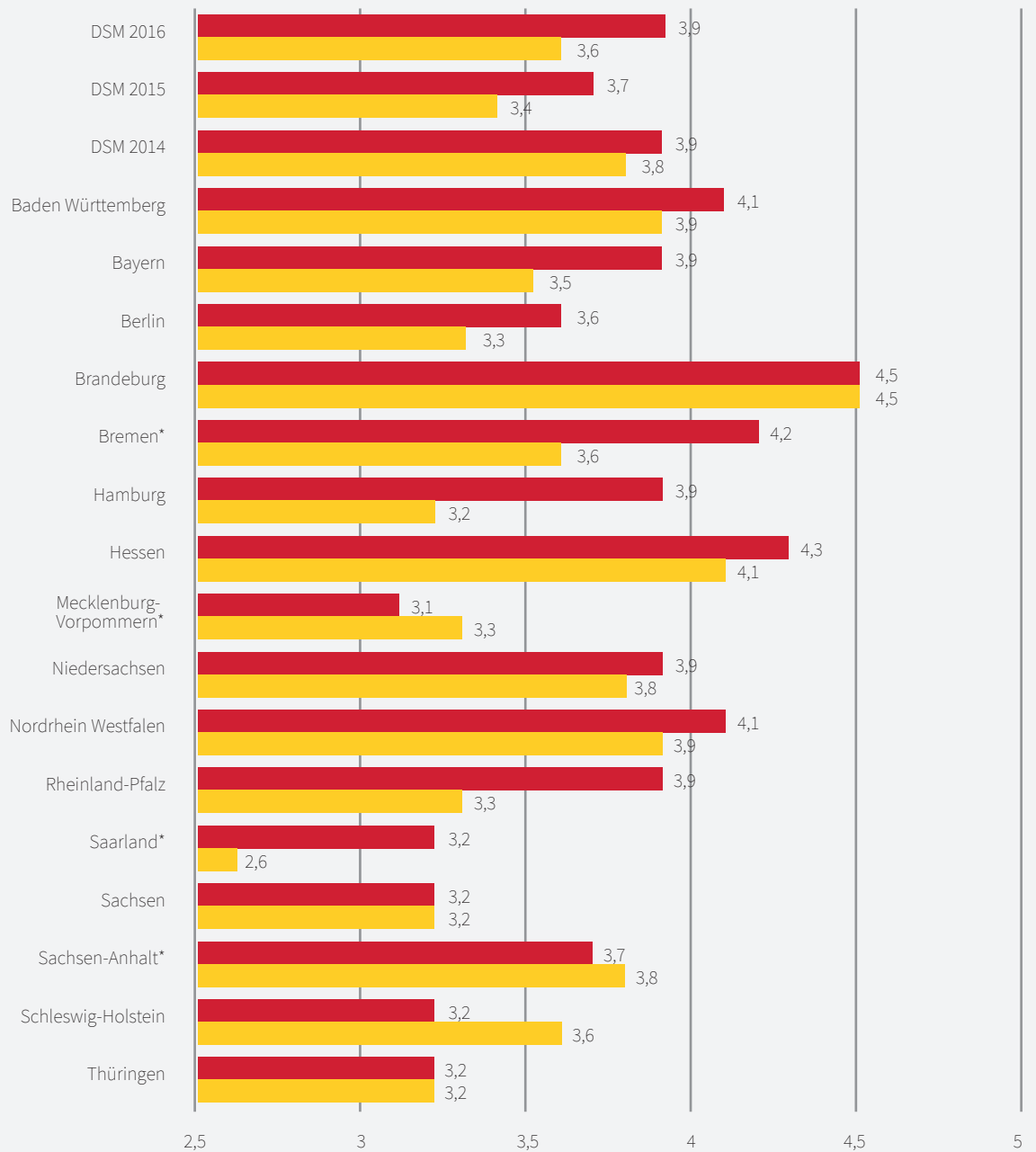
Number of entrepreneurs per 10.000 employed people between 18-64 years from 2014-2016 p.a. Values in brackets are the changes to the period 2013-2015.



## Figure 2 - Satisfaction of German entrepreneurs with policy support

Contentment of the 16 federal states with policy support  
(Ranking from 1-6. 1 is the best ranking, 6 is the worst ranking)

\*Deviation from original version: Legend was translated into English



● Level of satisfaction with the national entrepreneurial support

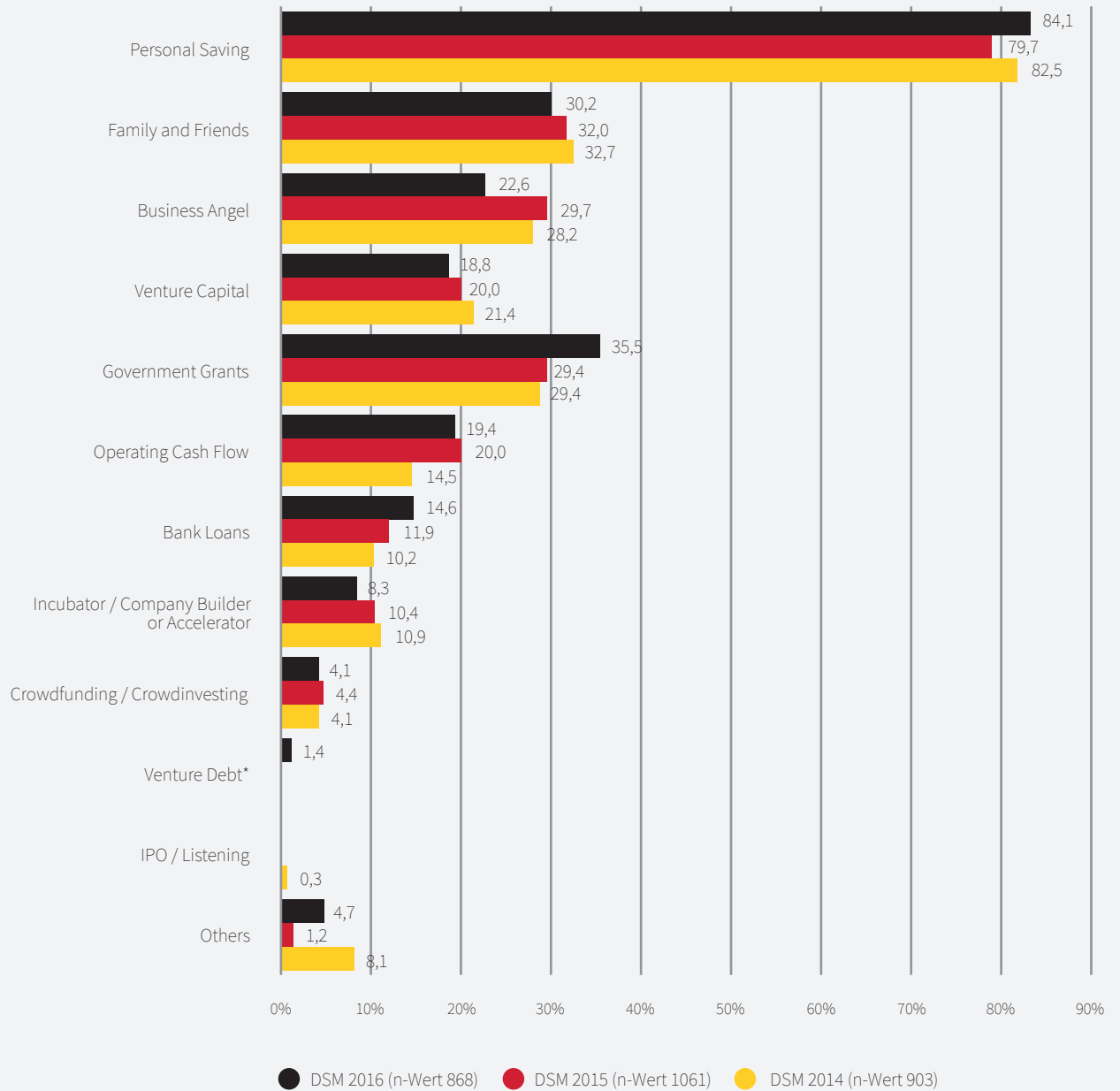
● Level of satisfaction with the federal entrepreneurial support

\*School grades for the support in the founding location

Source: Deutscher Startup Monitor 2016

### Figure 3 - Sources of Funding in Germany

\*Deviation from original version: Legend was translated into English

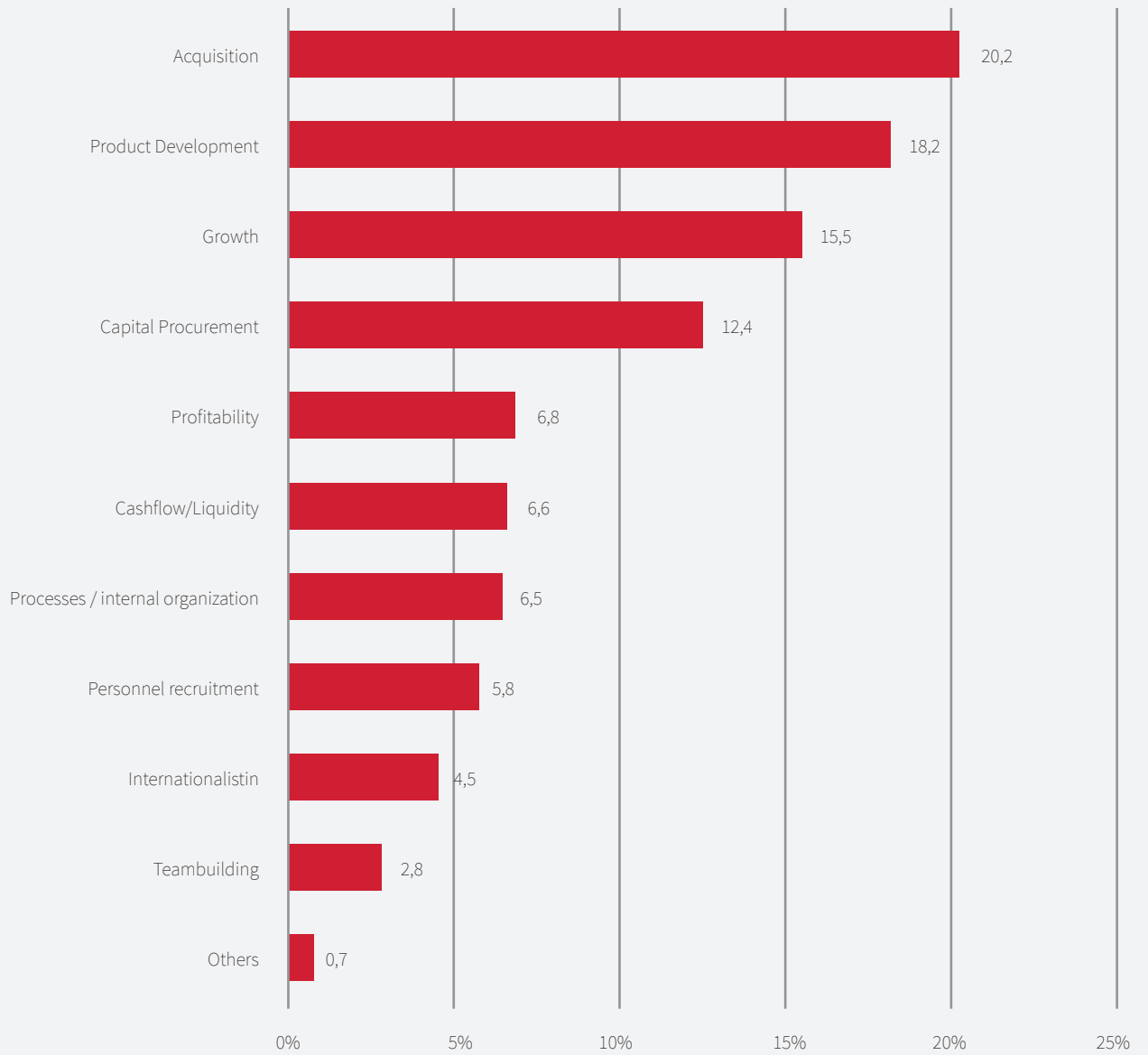


\* The Source of Funding VC was initially asked in the DSM in 2016. Therefore there exist no previous year values.

Source: Deutscher Startup Monitor 2016

## Figure 4 - Challenges 2016

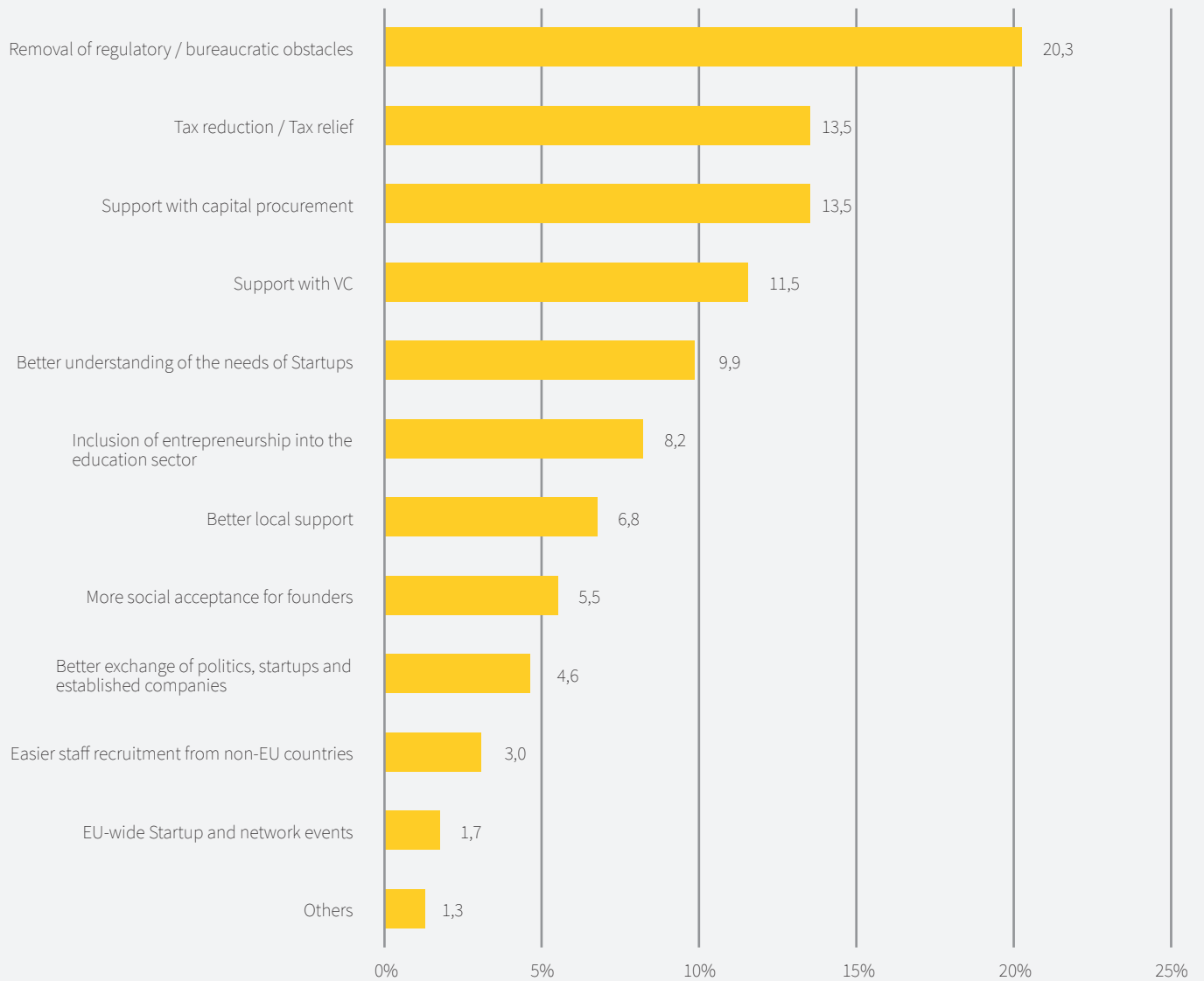
\*Deviation from original version: Legend was translated into English



Source: Deutscher Startup Monitor 2016

## Figure 5 - Policy Expectations 2016

\*Deviation from original version: Legend was translated into English



Source: Deutscher Startup Monitor 2016





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