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LENDING TO MICROENTERPRISES

DIRECT ASSISTANCE TO THE SMALLEST ECONOMIC ACTIVITIES OF THE POOR

Testimony

**presented to: The House Banking Committee
The House Select Committee
on Hunger**

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SUMMARY

This statement responds to the inquiry of the House Banking Committee and the House Select Committee on Hunger as to the usefulness of delivering credit and other assistance to the "micro-scale" economic initiatives of the poor, thereby generating much needed employment and income. It draws on ACCION International's current projects with local foundations assisting more than 12,000 microenterprises throughout Latin America, the author's directorship of the PISCES Project¹, an AID sponsored, worldwide study of programs directly reaching the smallest economic activities of the poor and his recent work with the rural banks of Ghana.

¹The PISCES Project (Program for Investment in the Small Capital Enterprise Sector) was carried out by ACCION International, Partnership for Productivity and the Development Group for Alternative Policies. For more information see: Local Efforts in Microenterprise Development, volumes I & II, Jeffrey Ashe, USAID, 1985.

2

INTRODUCTION

Recent research and project experience has shown that the smallest economic activities of the poor can be reached effectively and efficiently; businesses such as:

- o the seamstress with her sewing machine who makes clothing to sell to her neighbors;
- o the street food seller who cooks inexpensive meals for those too poor to buy firewood or to own a pot;
- o the trader who purchases the produce of a few farmers to sell on the street in a neighboring town; or
- o the market vendor, the sandal maker, the toolmaker;

the list is infinite.

Simple inputs - most notably, almost inconceivably small amounts of credit - from \$10 to \$500, extended for one month to a year - can lead to significant increases in income, production and employment, and importantly, an upsurge of hope for the future. Using innovative approaches - combining the quick access to credit of moneylenders, the good management techniques of the best of the private sector, and the vision of social agencies - these projects can cover much or all of their operating costs when they charge a commercial or premium interest rate and are strict about loan repayment.

Existing initiatives are generally small and scattered, but methodologies are emerging based on a number of successful projects in Asia, Latin America and Africa, suggesting guidelines for increased lending to efforts reaching these smallest "microentrepreneurs". At the smallest level, one microenterprise can be assisted with each \$100 to \$200 added to the revolving loan fund of a local institution creating twice that or more in new income every year; a little money can go a long

way. Microenterprise development represents perhaps the most cost effective way of alleviating poverty.

MICROENTERPRISE SECTOR

The businesses of the poor - what are coming to be called "microenterprises" because of their extremely small size and minimal capital investment - are too important an economic force to be ignored. Representing from 30% to 70% of the labor force - the largest and fastest growing part of the private sector - these businesses:

- o will generate a majority of the 120,000 jobs a day needed in the developing world between now and the year 2000 and
- o will represent an even larger percentage of the jobs needed for women, recent immigrants from rural areas, the uneducated, youth and the poorest.

In addition, they:

- o provide goods and services to the poor in small quantities - half an onion, inexpensive shoes and school uniforms - at low cost and often on credit;
- o provide skills and entrepreneurial training - the typical shoemaker has a decade of experience as an apprentice and master craftsman before opening a tiny shop;
- o represent an appropriate low capital, labor intensive, energy saving mode of production - in Nairobi, the investment in tools and equipment of tinsmiths, mattress makers and cobblers averages \$15 and
- o provide a vital link to modern enterprises distributing their products and producing finished goods for resale and export.

4

This microenterprise sector is growing in importance in most countries, but it is growing in the face of obstacles that affect the growth, profitability and even the sustainability of these smallest economic initiatives, namely:

- o an almost total lack of access to institutional credit from banks and other lending institutions;
- o a dependence on traditional moneylenders, middlemen and suppliers who charge rates ranging from 20% a month to 20% a day in most countries;
- o a hostile policy environment that considers most of these enterprises as outside the law, and
- o a lack of access to the raw materials and other advantages of large businesses.

The best microenterprise projects have creatively dealt with these obstacles, demonstrating that what is lacking is not ability or good ideas, but access to simple inputs.

WHAT DOESN'T WORK

Assisting microenterprises is not easy. The legacy of underutilized communal workshops, craft outlets laden with unsold goods and non-viable enterprises capitalized through seemingly endless subsidies, is evidence enough of that. Crippling default rates, soaring administrative costs and distressing delays in the delivery of services give little encouragement to practitioners starting such ventures. Poor performance is not random; analyzing these failed efforts a common pattern emerges. They simply do not reflect the realities and needs of this street backyard and front porch economy.

When direct assistance effort are run by banks and other financial institutions, they typically:

- o present obstacles - legal registration, guarantees, co-signers, property titles, collateral requirements,

etc. - that effectively bar most of the potential borrowers at the smallest level;

- o intimidate poor people, many of whom have never stepped inside a bank;

- o are expensive to microbusiness owners because of the excessive documentation, repeated visits and endless waits, and expensive to banks because the criteria for larger loans are applied to tiny ones;

- o provide credit ill-suited to the needs of business owners at this level, generally too much money loaned for too long; default and late payments often emerge as problems later.

Unless banks have a department with simplified procedures, trained staff and a sense of mission to reach the poor to attend to the microenterprise sector, they are generally unable to reach these businesses efficiently.

On the other hand, when projects are run by social agencies, another set of problems tend to emerge:

- o staff have good outreach in poor communities, but little business experience;

- o there is little capacity to manage revolving loan funds; welfare and business goals are often mixed;

- o projects are often too complex - involving international marketing and collective production, for example - overwhelming the poor people they are reaching.

Projects run by social agencies tend to be expensive, highly subsidized and reach very few, unless they are business-like, with clear goals and well-defined performance standards.

6

WHAT DOES WORK

Effective and efficient projects are possible and do-able, and properly designed projects will almost predictably result in significant increases in income, employment and empowerment. These projects work remarkably well; the services needed are delivered in a timely fashion and clients actively participate because the services provided reflect their needs.

Generally speaking, staff of the more successful projects assume:

- o business owners are capable people who have shown initiative in putting together their economic activity, no matter how small, and that running such a business requires considerable skill, motivation and hard work. The ability to run very small businesses is common in poor societies.
- o their enterprises provide a vital source of income, training and goods and services oriented to the needs of the poor.
- o projects exist to put the clients plans into effect, not vice versa.

The staff of successful projects ask themselves, who are these microentrepreneurs, what do they need, and how can the project address these needs? Project services are geared towards the very poor - often recent immigrants who have little education, heavy family responsibilities, little experience with institutions and none of the traditional guarantees banks require. On the other hand, the staff recognizes their clients as experts in doing business within the context of the street economy. Their businesses are viable, they are highly motivated, they have considerable skills and, above all, they have good ideas on how to make their businesses grow.

**MICROBUSINESS OWNERS
CONSTRAINTS AND OPPORTUNITIES**

<u>Constraints</u>	<u>Opportunities</u>
o very poor	o have a viable business or are actively interested in starting one
o often recent	
o little or no education	o highly motivated
o heads of households with little time	o business is generally a full-time activity generating 50% of family income or more
o little experience with institutions	o production/selling skills adequate
o not training in business	o are a part of a network of relationships
o no traditional guarantees	o have good plans

Reflecting these constraints and opportunities, successful projects:

- o work directly in the poor community
 - "banks" may be no more than a wooden plank, two calculators and record books;
- o simplify applications to the maximum
 - one or two pages/no literacy required;
- o extend credit quickly
 - less than two weeks for first loans and less than two days for subsequent loans;
- o do not require books or record keeping initially
 - a demand for record keeping emerges as businesses start to grow;
- o do not require co-signers, legal registration or property titles
 - loans are guaranteed through mechanisms such as credit guarantee groups where three to eight tiny business owners are

8

mutually responsible for the payback of loans

- o work with existing businesses, no matter how small
 - or encourage the creation of new businesses at the micro-scale, that are common in a community,
- o focus on the local market
 - niches can be found in local markets where an outsider thought none existed,
- o base credit extended on the owner's plans, which experience has shown are generally realistic;
 - \$100 for three months to purchase a second hand machine,
 - \$20 for two weeks to purchase vegetables,
 - \$200 for one year to purchase a tricycle cart;
- o extend small short-term loans initially, mainly for working capital,
 - receiving the next loan is contingent on paying back the previous loan on time,
- o charge interest rates at the market rate or higher,
 - from the perspective of clients quick credit is more important than a low interest rate. An interest rate that covers all costs is still one-fifth to one-tenth the rate charged by moneylenders,
- o assume the beneficiaries through their network of friendships will:
 - promote the program,
 - form their own groups,
 - collect their own loan payments,
 - provide each other advice, and
 - help if one member cannot make a payment, thereby reducing operational costs significantly

and making project self-sufficiency a distinct possibility.

THE RURAL BANKS OF GHANA: AN AFRICAN CASE STUDY

There are many examples of projects incorporating these basic principles - with the Grameen Bank in Bangladesh and the BKK in Indonesia providing loans to over 150,000 of the poorest business owners - but can the same principles be applied to Africa? Apparently so, as demonstrated by the Rural Banks of Ghana.

July 1986 marks the tenth anniversary of the creation of the first rural bank in Ghana. Now there are 106 independent, community-run, financial institutions whose mandate is to provide a place to save and to make loans, principally, to small farmers and also to the owners of cottage industries and commerces. Rural Banks are located in areas not serviced by other financial institutions. Most of these banks are making a profit.

Growth has been extremely rapid. Locally mobilized deposits of 147,639 cedis in 1977 grew to 861,989,982 cedis by June 1985. The 802 savings accounts holders in 1977 grew to 220,653 by the end of 1984. This demonstrates that rural, often illiterate, peasants and village dwellers will save if they have confidence in the bank, find it convenient and have ready access to their savings. Since the Rural Banks started, 553,861,280 cedis have been loaned, virtually all from funds saved locally, most loans averaging 12,000 to 18,000 cedis (\$200 to \$300 at the 1985 exchange rate). The total number of loan beneficiaries through December 1984 was 31,924. Showing the spreading enthusiasm for the Rural Banks idea, by the end of 1984 there were 213 applications to the Bank of Ghana for the creation of new banks.

Why have the Rural Banks been successful, while traditional agricultural credit programs, often funded with millions of dollars from donor agencies, have reached only 5% of

African farmers - mostly the largest most sophisticated producers?

These are some of the principal lessons learned:

- 1) Catalyzing local initiative is vital. The directors of the banks are local leaders who are committed to their community's development.
- 2) The basic principal must be that funds mobilized locally are used locally.
- 3) There is far greater potential for savings in the rural areas of Ghana than was thought possible.
- 4) Loan selection is based on the producers reputation in the community, not abstract formula and collateral requirements that eliminate most potential borrowers.
- 5) Administrative costs can be kept low if procedures are simple and standardized and when the local staff is recruited locally and resides in the community.
- 6) The owners of the smallest farms and smallest businesses are good candidates for productive loans.

This is not to say that there have not been problems. Loan payback, averaging 95% in the first years, had slipped to 38% by 1985. The system expanded faster than staff and local boards could be adequately trained and a major restructuring and recovery effort is needed.

Despite the problems, what has been demonstrated is an African model of decentralized, locally responsive banking. It can no longer be said that large-scale, cost-effective approaches are only possible in Asia and Latin America. A network of banks such as these in other African countries, could have a powerful effect through capitalizing the micro-scale economic sector and thereby helping alleviate endemic poverty.

RECOMMENDATIONS

There is a rapidly accumulating body of knowledge demonstrating that high-volume, comparatively low-cost, local savings utilizing institutions serving the smallest economic enterprises of the poor can be viable. Systems are adaptable to organizations ranging from local Private and Voluntary Organizations to networks of specialized banks in rural and urban areas. To encourage the spread of this highly effective, direct assistance methodology and to help finance such efforts, Congress might consider the following:

- 1) Encourage the major donor agencies to:
 - a. Make microenterprise projects a priority. This is a private sector initiative, but necessitates a radical redefinition of what is currently conceived of as the private sector;
 - b. Sponsor further learning about how to assist microenterprises and support effective projects;
 - c. Train donor agency staff so they can respond to the type of efforts that are going to make a difference.

- 2) Help governments make policy changes that favor small enterprises, such as:
 - a. Simplifying the legalization of informal sector businesses;
 - b. Requiring financial institutions to invest part of their portfolio in this sector.
 - c. Raise the interest rates so that loaning to small scale farmers and microbusinesses becomes profitable.

- 3) Propose legislation that will creatively use blocked currencies and remonetize P.L. 480 funds to finance microenterprise programs.

12

Finally, the Congress should consider what the lessons learned abroad tell us about enterprise development in this country. We have a Small Business Administration that does not serve truly small businesses and a banking system which virtually ignores the smaller end of the enterprise scale. Yet there are hundreds of job creating and income generating, small-scale businesses in every county languishing because of lack of credit and encouragement - a situation parallel to microentrepreneurs in developing countries. What might a rural and urban bank network of America accomplish if the ceiling on initial business loans was \$5,000 and businesses were graduated to traditional banks when their loan requirements increased to \$50,000? The impact on job creation, urban and rural poverty and the development of grassroots entrepreneurship would be significant.

ACCION INTERNATIONAL'S MICRO-LENDING EXPERIENCE

ACCION International is a non-profit development agency established in 1961 and based in Cambridge, Massachusetts. Beginning in Recife, Brazil in 1973, ACCION has helped local organizations start micro-lending projects throughout the Americas. Currently, the fourteen projects assisted by ACCION are loaning to more than 12,000 microentrepreneurs.

ACCION offers:

- o a complete package of assistance to local organizations, including feasibility studies, developing proposals, setting up projects, staff training and evaluation;
- o knowledge of micro-lending projects throughout the world, through our directorship of the PISCES Project in collaboration with Partnership for Productivity and Development Group for Alternative Policies. PISCES was funded by AID to study methodologies appropriate for assisting the smallest economic activities of the poor;
- o the organization of several international workshops on micro-lending;
- o experience in developing training manuals and administrative procedures for local projects.

ACCION hopes to collaborate with the House Banking Committee and the House Select Committee on Hunger in this pioneering legislative initiative.