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Financial Services for Microenterprises: Programs or Markets?

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FINANCIAL SERVICES FOR MICROENTERPRISES: PROGRAMS OR MARKETS

INTRODUCTION

For more than two decades, government agencies and donors have pumped billions of dollars into agricultural credit programs in developing countries. Broadly speaking, the objective has been to expand the supply and reduce the cost of loans, especially for small farmers. It was expected that through this "supply-leading" approach to rural finance, technological change would accelerate, agricultural output would expand and small farmer incomes would rise.

The great concern today for microenterprise credit is reminiscent of this earlier preoccupation with agricultural credit. The rationale, the approach, the earmarking of funds, the targeting of beneficiaries, the rationalization of poor performance are similar to that earlier period. Small business programs, of course, have as long and checkered a history as does agricultural credit, but most advocates cast aside that experience in their zeal for microenterprise development. It is appropriate, therefore, to review the now abundant analysis of the small farmer credit experience. That experience can provide a framework for looking at issues related to microenterprise financing. The lessons learned should help prevent a repetition of past errors and reduce some private costs to the individuals directly affected and social costs for the society as a whole.

SMALL FARMS AND NONFARM ENTERPRISES

A useful point of departure is to identify the similarities and differences between small farm and nonfarm enterprises. The similarities are significant. They both are small by definition whether measured in terms of scale of production, capital invested or persons employed. Most employ only family labor. The technology utilized is traditional and may be several generations behind the most modern enterprises of the same type in the country. Incomes and wages are low, frequently below wage rates in the modern sector; therefore, they are often viewed as subsistence operations. Some may sell only a fraction of their total production and are not well integrated into factor and product markets. Likewise, they have limited access to government programs and escape many laws and government regulations. In fact, many nonfarm enterprises can survive only by avoiding laws and regulations that apply to larger enterprises.

Both types of enterprises receive little credit from formal institutions although they may have deposit and saving accounts. They self-finance most of their working capital. Loans from friends and relatives furnish much of their start-up capital. Informal lenders provide them with short-term loans frequently at interest rates much higher than regular bank rates. The entrepreneurs participate in a variety of self-help groups, many of which have savings and loan programs. Rotating credit societies (ROSCAs) frequently provide a means of savings, and access to loans for emergencies or selected investments.

Although they aren't well integrated into formal financial institutions, small enterprises have a rich mosaic of financial transactions. They are frequently small scale lenders and borrowers at the same time, making loans to friends or relatives while taking a loan from a trader. They build up borrowing capacity through voluntary savings, through participation in traditional social groups, and through linking themselves with others who do borrow from formal institutions - landlords, traders, suppliers of inputs, richer entrepreneurs. They value and preserve these relationships because with their limited cash and capital reserves they need the insurance of being able to borrow in cases of emergency or unusual opportunity. To preserve good relations with informal sources of loans, they repay informal loans before formal ones when they experience cash constraints.

There are important differences between the two types of enterprises. It is a well known fact that the relative importance of agriculture declines with economic growth while the industrial and service sectors increase. Therefore many small farmers will eventually disappear but the number of small nonfarm enterprises will rise. Farmers produce largely homogeneous goods and cannot easily differentiate their products. Nonfarm enterprises often thrive precisely because they successfully develop a product that finds a market niche. Farm enterprises suffer the risk of natural disasters weather [illegible] but nonfarm enterprises also have their share of risks such as interruptions in supplies of water, electricity, and other key production inputs. They also risk the heavy hand of government if they are discovered to operate without an appropriate license, or are disobeying labor laws, or are found to be robbing electricity.

Although small scale enterprises face innumerable obstacles that threaten their survival, policymakers especially note the few formal loans, the lack of long term loans and the high interest rates paid on informal loans, and immediately conclude that credit is the real bottleneck (or at least it is the one problem they think they can do something about in the short term). Furthermore, existing financial institutions, especially banks, are "bad". They are perceived as being overly cautious, risk averse and unimaginative with respect to small enterprise lending. Instead, they prefer to lend to their friends in larger enterprises, industry, commerce and trade. No consideration is given to the value that banks provide in supplying safe, dependable deposit and savings services. The "need" of small enterprises is diagnosed as cheap loans.

SUPPLY-LEADING FINANCE[2]

This perception of unsatisfied demand for loans and assumed inadequacies in supply of funds from the banking system has led policymakers, often in conjunction with donors, to develop a strategy in which increasing the supply of funds was expected to "lead" economic activities. The following summary characterizes many of the policies and programs designed for agricultural credit, and many of these features are also found in small or microenterprise programs.

1. Increase the supply of funds available for lending to the priority sector (small farm or nonfarm enterprises) through:
   a. portfolio quotas or targets for existing lenders,
   b. the creation of specialized financial institutions to work only with the priority sector(s),
   c. grants and subsidies for non-financial institutions (ministries, departments, institutes, NGOs, PVOs),
   d. central bank rediscount programs, often funded by donors.
   e. mandatory placement of bank and/or public sector deposits in specialized lending institutions,
   f. nationalization of banks that fail to meet social objectives.
2. Reduce the interest rate on loans made to the priority sector through:
   a. interest rate ceilings on loans which set the lowest rates for the smallest/poorest borrowers,
   b. low interest rates charged by the central bank on refinance funds,
   c. encouraging banks to cross-subsidize by charging higher rates to non-priority borrowers in compensation for low rates to priority borrowers,
   d. direct government interest subsidies to lenders.

3. Reduce lending risks and costs through:

   a. detailed targeting of loans including requirements about production practices and input use required of borrowers,

   b. crop and loan guarantee programs,

   c. creation of joint liability through lending to groups of borrowers,

   d. technical assistance to lenders to help improve institutional efficiency.

These financial measures are often taken in conjunction with programs to provide technical assistance, modern inputs, marketing, business management support and other services. These services are linked to finance when extension agents are required to authorize farm loans made by banks. Alternatively, they may be included in an integrated package of inputs and services provided by a government agency or an NGO.

The supply-leading financial strategy has succeeded in expanding lending, at least temporarily, to target groups in some countries. Some financial institutions have gained experience in lending to a new clientele, and some have introduced innovations to more efficiently serve their customers. The failures of the strategy are more numerous, however. They have been extensively documented elsewhere[3] and will only be summarized here.

1. Lending quotas and targets have been ignored or evaded by lenders through creative loan documentation and multiple small loans to large borrowers.

2. Lenders employ the alternatives offered to increased lending such as investing in low interest government securities.
3. Rural deposit mobilization is discouraged.
4. Interest rate controls result in non-interest rationing of loans that raises borrower transaction costs and concentrates loans among wealthier borrowers.
5. Cheap loans are diverted from targeted purposes into higher return uses of funds, and borrowed funds substitute for own capital.
6. Heavy reporting and documentation costs create high lender transaction costs.
7. Political intervention directs subsidized loans to favored clients and protects delinquent borrowers.
8. Lenders experience high loan delinquency and default.
9. The viability of lending institutions is undermined because of their failure to cover costs, recover loans, and mobilize deposits.
10. Lenders are unreliable for their customers because they are prisoners to the ebbs and flows of government and donor funds.

In summary, a few select borrowers have enjoyed a one-shot increase in liquidity but viable institutions have not been built. A viable rural financial institution is one that is self-sustaining, that covers its costs, that provides services valued by rural households and businesses, that serves an ever increasing number of customers, that is dynamic in providing new financial products and services, and that actively [illegible] ways to reduce transaction costs for itself and/or its customers. By implication, it operates over a long time horizon and becomes a reliable rural institution for its clientele.

PROGRAMS OR MARKETS?

The negative experience of small farmer credit provides insights into the alternative strategies to develop financial services for microenterprises. At one end of the continuum of possibilities is the "financial markets approach" that has the objective of developing viable financial institutions competing to serve a large number of customers with a variety of financial products. At the other end is the "program approach" that has the objective of meeting credit needs of a specific target population usually with subsidies for the borrower and the lending institution. The institutional form in the first case is usually a financial institution, frequently some type(s) of bank. Although many credit programs are implemented through banks, the emphasis in the second case is on a wide variety of nonbank institutions whose primary or exclusive role is to provide loans: government agencies, institutes, associations, NGOs and PVOs. A comparative analysis of the two broad alternatives of programs versus markets follows.

<u>Access</u>

The "need" for credit is widely debated (Hunt), but it is probably true that loans draw clients to small enterprise projects (Ashe). Our fundamental concern should be the extent to which small enterprises have access to financial services. The market approach is criticized because banks don't serve a large enough number of target clients, yet frequently the credit programs of banks serve many more low-income customers than nonbank programs. Some of the biggest programs are found in Asia. Timberg reports that the Indian IRDP (Interest Rate Differential Program) reached over 15 million families in the period 1980-85. Indonesia has several bank programs, and the BKK (Badan Kredit Kecamatan) program from 1972-1983 provided 2.7 million loans totaling over $55 million (Goldmark and Rosengard). Likewise, the Bangladesh Grameen Bank is reported to currently have about 70,000 groups with 350,000 members operating in over 7,500 villages. Furthermore, it is likely that statistics reporting participation in bank programs underestimate total small enterprise access because they usually do not count the number of small, but untargeted, loans provided out of regular bank funds. By comparison, many nonbank programs operate in only one or a handful of locations and access is limited to several dozen or a few hundred participants. One NGO program I recently visited in the Philippines had eight loans! Moreover, it is not the case that bank programs cannot reach the poorest with the smallest loans. Many of the bank loans made in India, Indonesia, and Bangladesh are quite small.

Access is directly related to proximity. Banks with a widespread branch network or a nationwide system of unit banks reduce borrower transaction costs through their [illegible] entrepreneurs[4]. A PVO or a cooperative working in a few villages or a government program with only one office for the entire country located in the capital city cannot provide access to many people, particularly for small loans where noninterest costs (including travel time and expense) represent a large share of total borrowing costs.

Interest rates also have an important impact on access. A policy of charging interest rates high enough to cover costs is frequently rejected by advocates of lending to the poor. Yet the choice may be serving fewer people with lower-cost loans versus serving more with unsubsidized loans. Programs that require subsidies deny their services to nonparticipants when they fail to recover costs through interest income from participants. Furthermore, interest rate ceilings on banks are self-defeating and raise the cost of credit to the very sector that the government intends to support. The transaction costs and risks of lending to small enterprises is perceived as being greater than lending larger loans to other sectors so banks either will not lend to the small scale sector or will pass on to borrowers a greater share of the risks and costs through noninterest charges (Bhatt). Low interest ceilings and fixed interest spreads have tended to benefit larger borrowers with collateral in Asia at the expense of smaller borrowers with little collateral but profitable projects (Hiemenz and Bruch).

Low loan rates also imply low rates paid on deposits; this thwarts an institution's ability to mobilize deposits. Without deposits, a lender is dependent on donor and/or government funds. These sources have proven to be quite uncertain; at times, the institution has funds to expand lending while at other times it does not.

Inflation erodes the real value of a loan portfolio. If interest rates are too low to cover inflation, the real value of new loans made will decline even if the institution achieves 100 percent loan recovery.

There are obvious limits to the level of interest rates that borrowers can pay. Theory suggests that if little capital is used in an enterprise, the marginal return on its use must be high. This implies that the marginal return from borrowing should also be high, at least for small, incremental loans. Although small entrepreneurs frequently report that one of their chief problems is lack of credit, they often do not consider the interest rate to be an important factor. They put higher priority on speed of loan disbursement, availability of second loans and simplicity of procedures (Ashe). The large amount of lending to poor people that occurs in the Indonesian BKK program with rates of 5 to 10 percent per month, in the Grameen Bank with effective rates approaching 25 percent per year, and in a Bangladesh Rural Finance Experimental Project with rates up to 36 percent per year support this observation.

Credit guarantee schemes have been used in se[illegible]es to overcome lender resistance to small enterprise lending. These schemes aim to encourage financial institutions to lend to small businesses that have viable projects but that are unable to provide adequate collateral or cannot prove they are creditworthy. These schemes have frequently not lived up to expectations. The are costly, complex to design and manage, and it is not clear that they have really contributed to much additionality in lending (Hiemenz and Bruch; Levitsky and Prasad).

Viability

Institutional viability is closely related to access. If an institution cannot achieve viability and support itself, the expansion of its services to new participants will be controlled by the amount of subsidies it can extract from governments and donors. By definition, poor countries cannot afford large subsidies, yet since the poor are so numerous, large subsidies are required if many are to be reached. Donors cannot be relied upon to provide an increasing flow of new resources to keep an institution expanding.

The level of interest rate charged on loans and the spread between that rate and the cost of funds is crucial to determining institutional viability. Although interest expense is usually a small component of a borrower's total operating expense, interest income is the most important source of revenue for a bank and may also be important for a nonbank program. Interest rate regulations must be relaxed so the operating spread is more favorable. Cheap government and donor funds aren't necessarily a substitute because of the costs of reporting and documenting their use and impact. For example, Cuevas and Graham found that lender transaction costs for lending through a government-owned and a privately-owned bank in Honduras far exceeded the 3-4 percent margin allowed with donor funds. Lending costs for the private bank using donor funds were nearly five times the cost of lending its own money for farmers. Likewise, Ahmed and Adams found that the Agricultural Bank of Sudan was limited to charging 7-9 percent per year on loans when its administration costs average 10-15 percent of the value of loans.

The subsidization of costs can have an insidious impact on nonbanking institutions, and especially NGOs that function in a relatively resource rich environment. When resources are abundant, survival becomes unlinked from performance and self-evaluation is not a priority (Sen)[5]. Administration is lax, costs are not controlled, and there is relative indifference to loan recovery. Commercial organizations working in a competitive environment face relatively greater pressure to perform. This gives them an entirely different orientation to lending operations and can increase their chances of long-term survival. This observation is relevant for many, but not all, banking operations. Nationalized banks are often a key exception.

Subsidies also invite political intervention and corruption. Subsidized interest rates create an excess demand for funds so implicit rationing must occur. Political connections [illegible] influence those who are the lucky few to get a loan. Rent-seeking employees of the financial institutions exploit their opportunity to extract gifts or "tea money" for granting subsidized loans. Leaders of cooperatives and credit unions use their positions to gain disproportionate access to loans. Borrowers with political leverage can avoid loan repayment while borrowers who "bought" their loans see little reason to repay. High loan delinquency is a logical outcome in these situations and this can severely weaken an institution. Incentives to repay decline even more when borrowers perceive that an institution is weak and they may not get a new loan after repaying a current one.

Multiple Financial Services

Entrepreneurs need financial services, not just loans. A program that offers only loans forces a borrower to obtain deposit, savings, and checking services elsewhere. A bank can offer these services in addition to the loan, along with other services such as the international transfer of funds that is important in labor exporting countries. Furthermore, depositors reveal important aspects about their financial management abilities by the way they conduct their deposit and savings operations. This information is useful when lenders process loan applications. Banks recognize the value of this information and often require that an enterprise maintain an account for several months before considering a loan (McLeod). The Grameen Bank requires an established record of weekly savings before a group is considered for a loan (Hossain), and other programs have similar requirements.

Accepting deposits also imposes discipline on an institution's lending because management realizes to keep itself credible it must have funds to meet depositor demand. By using its own funds for lending rather than relying solely on government targeted programs, an institution can escape some political intervention over deciding who gets a loan and who must repay. This may also have a salutary effect on repayment when borrowers recognize they are stealing their neighbor's rather than the government's money when they default on loans. It is frequent in the Philippines, for example, to hear that a "dole-out" mentality affects repayment on government projects (Sacay, et. al). Cooperatives and credit unions performed well in Latin America in the 1960's. Many deteriorated in the 1970's, however, when they began to accept external funds (Marion).

Graduation

Many special programs propose to graduate participants once they reach a level where they can obtain loans from regular financial institutions. The rationale for this idea recognizes that as enterprises grow, they pass through different stages of financial sophistication and the financing options widen as they build up their assets and their reputation (McLeod). It has also been recognized that programs should disburse small amounts as a first loan to a client. This will test repayment ability, but it will also avoid overburdening the business with more [illegible] it can invest wisely (Farbman). Traditional agricultural lenders have been criticized for being inflexible in determining amounts to be lent and have encouraged borrowers to accept more than really needed (Tendler, 1982).

The data on graduation rates are sparse, however, and most program evaluations, if they mention the concept at all, fail to provide much evidence. The fact that data are not readily available suggests it may not really be that important a performance indicator in actual practice. Clearly there are real disincentives for both program and borrower to graduate. If the loan is highly subsidized, a borrower will face higher costs when graduating to another source. The increase in size of loan obtained must be large if the cost differences are large. For the program, graduation implies losing an established good performing participant and substituting another with all the costs and learning that implies. Far better and cheaper if funds are tight to extend another loan to the established client.

The graduation problem suggests that a better approach may be for the program not to directly lend but become an advocate to help the participant obtain loans from financial institutions. Graduation to larger loans will then occur naturally as repeat loans are made to valued customers. Important performance incentives can be given to the program by providing operating subsidies in direct proportion to the number of participants it successfully helps obtain loans. The programs are also relieved of the costs of developing expertise to efficiently manage loan accounts and can concentrate resources instead on providing those nonfinancial services they can best provide.[6]

CONCLUSIONS

Supply-leading rural finance has been an integral part of development policy in many developing countries during the past two decades. It has also been a vehicle through which donors have pumped billions of dollars of foreign assistance into developing countries. The results have been disappointing. Although there have been temporary increases in loans for a relatively few lucky borrowers, financial systems have not been created to provide on-going financial services. The amount of funds available to the rural sector, and especially small farm and nonfarm enterprises, has actually shrunk in many countries in the past few years after rising during the 1970s.

The emphasis of the supply-leading strategy has been misplaced. Policymakers have addressed the supposed need for cheap loans by low income entrepreneurs and have ignored how the policies and programs they created undermined the viability of the financial institutions induced or created to make the loans. Evidence of the failure of the strategy can be seen by the multitude of failed and struggling banks, and dependent NGOs and PVOs that survive only through government and donor aid. Unviable institutions cannot hope to meet the financial needs of small enterprises. They can assist a few participants up to the limits of their subsidies, but they cannot hope to expand their services to a broader number of equal deserving clients. This issue frequently boils down to serving fewer clients with lower cost loans versus reaching many through unsubsidized loans.

Finance is important; a sound financial system is necessary for economic development. The development challenge is to create competitive, viable rural financial markets in which entrepreneurs of all income levels with appropriate projects will find loans, and all entrepreneurs and households will find suppliers for their checking, deposit and savings needs. Subsidizing a few entrepreneurs with cheap loans can contribute little to developing a viable financial market.

Strong financial institutions find it hard to operate in the unfavorable economic environment that exists in many developing countries. Likewise, entrepreneurs cannot prosper in such an environment, and a few subsidized loans will not resolve their fundamental problems. As we struggle to find ways to assist the development of microenterprises, we must be alert to the fact that by tinkering with financial policies, we may just be addressing symptoms of the problem, not the problem itself.

FOOTNOTES

1. The characteristics of farm enterprises are well known and their financial patterns and problems are described in publications included in footnote number 3. Similar information on small nonfarm enterprises can be found in Anderson and Leiserson, and the considerable work done on the subject at Michigan State University, an example of which is the paper by Liedholm and Mead.

2. The term supply-leading finance has been attributed to Patrick.

3. This section summarizes a large literature discussing the supply-leading strategy and the results that have been obtained. Key readings include Adams and Graham; Adams, Graham and Von Pischke; Adams and Vogel; Chew; Donald; Howell; Lieberson; Schmidt and Kropp; Von Pischke; Von Pischke, Adams and Donald.

4. Khalily et. al analyzed the impact of the expanded bank branching network on rural deposits in Bangladesh.

5. Tendler (1983) came to the surprising conclusion that a small NGO specializing in credit in Brazil failed to develop a low-cost model because of its <u>small</u> budget and limited horizon.

6. It is beyond the scope of this paper to discuss the services that programs can effectively provide. An example of an attempt to analyze this question can be found in Kilby and D'Zmura.

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