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A Financial Systems Approach to Microenterprises

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A Financial Systems Approach to Microenterprises

by

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ABSTRACT

The paper argues that microenterprise finance should be treated as part of financial system development, in order to reach large numbers of people without continuing large subsidies. The financial systems approach treats microenterprises as a market — offering a product with attributes clients want at a price that covers costs. The approach aims for financial viability of lending institutions, and it stresses that savings are equal in importance to credit. The report describes principles of credit delivery that have proved effective with poor clients. It also examines the prospects for financial viability among the nongovernmental and financial institutions providing microenterprise finance. Suggestions are made on institutional support requirements, the role of donor organizations, and government policies to support growth of financial services for microenterprises.

SECTION ONE

A NEW VIEW OF MICROENTERPRISE FINANCE

This paper addresses a goal shared by many who work in the field of microenterprise development. That goal is to enable the majority of poor entrepreneurs throughout the Third World to have access to financial services provided from locally generated funds, without external subsidies. While presently elusive, we believe this vision can be achieved with the sustained commitment of the institutions that play a role in microenterprise credit. In particular, institutions that adopt certain key principles of credit delivery and savings services constitute a promising strategy for realizing the goal of access to financial services.

Before this can happen, however, these actors must begin to approach microenterprise credit not through isolated, donor-dependent programs and projects, but as part of the development of the financial system itself. The institutions involved must demonstrate the capacity to function as, or with, financial intermediaries to capture and transfer resources to large numbers of poor people. The institutions and policy makers of the financial system, in turn, must support these transformations. This paper explains why it is crucial to think of microenterprise credit as financial system development, and attempts to provide a framework for such thinking.

The dominant view historically of microenterprise credit presumed that lending to very small enterprises could not be commercially viable. Commercial lenders, it was believed, could not overcome the high transaction costs and risks associated with small loans to small and informal enterprises (World Bank, 1990:65). Therefore, governments, donors, and nongovernmental organizations (NGOs), driven by the importance of microenterprises to the economic well-being of the poor and by the perception that microenterprises need credit, created special microenterprise credit programs. For the most part, these programs have been financed through grants, because high operating costs, loan losses, and expensive accompanying services could not be covered by interest rates that were typically below commercial rates. Because of the large infusions of grant funding required, and for many other reasons, such programs necessarily remained small.

During the 1980s, new lending technologies were developed that challenge the initial premise about lack of commercial viability. Rather than attempting to scale down lending methods developed for large businesses to fit microenterprises, these technologies borrowed from informal financial systems, which have been serving the poor for many years (Christen, 1989). These new technologies proliferated during the 1980s under such names as minimalist credit, solidarity group lending, savings and credit societies, village banking, and others.

The new technological approaches share certain characteristics that enable the institutions concerned to deal effectively with the host of transaction costs standing in the way of reaching the microenterprise sector (Meyer et al., 1990). The programs rely on character, group dynamics, and the prospect of repeat loans to motivate repayments. This tactic removes the need for costly loan appraisals and collateral certification. The new approaches assume that entrepreneurs require little or no training to become qualified as borrowers. The programs recognize that the most important financial services for microenterprises are not term loans for fixed assets, but working capital credit and savings/depository services. And, finally, recognizing that the poor pay dearly for informal sources of finance, these new programs charge interest rates at or above prevailing commercial rates.[1] These techniques have been applied successfully by institutions like the Grameen Bank in Bangladesh, the Badan Kredit Kecamatan (BKK) in Indonesia, ACCION International in Latin America, the affiliates of the World Council of Credit Unions in many countries, as well as a growing host of other institutions.

The advent and experience of these savings and lending technologies make it possible, and indeed necessary, to begin to think of microenterprise credit and financial systems development in the same breath. If techniques exist to serve microenterprises on a basis that approaches commercial viability, it is important to foster conditions in which those techniques can be widely applied, without large external subsidies. Such conditions will involve the policies and the institutions of the financial system and require significant changes in approach by microenterprise credit programs themselves. Given the vast numbers of the poor who lack access to financial services, it is incumbent on microenterprise programs to view their own program objectives in relation to the enormous potential demand and to embrace the new approach.

The desire to achieve increased scale in lending will drive the evolution of microenterprise credit programs toward a financial systems approach. There is little hope for reaching the numbers of poor entrepreneurs who are potential borrowers without self-sufficient financial institutions. Some hypothetical but not unrealistic numbers will illustrate. A typical grant-funded microenterprise program reaching 1,000 borrowers may require $200,000 per year to cover operations and loan funds. In a country with 1 million microentrepreneurs, half of whom wish to borrow in any given year, it would require $100 million per year to fully serve the target group. Such amounts are far beyond the capacity of donors and governments. This kind of calculation reveals how inadequate microenterprise programs will be as long as they rely on grants. The scale needed to reach a substantial fraction of the target population can be reached only when microenterprise credit programs operate as financial institutions (in other words, self-sufficiently), and raise funds from both clients and local commercial sources.

This paper reviews the thinking, developed largely by Ohio State University and by now widely accepted, on the role of financial systems and principles of sound financial systems development. It also discusses the well-documented gap between the financial needs of microenterprises and the ability of the formal system to supply those needs. These discussions set the context for the more important portions of the paper outlining the potential for specialized operations using proven principles of lending to the poor to bridge much of the gap, the agenda facing these institutions on the issues of commercial viability and fund raising, and the policy steps needed to support the growth of these operations.

[1] Among the first writers to identify these traits were Goldmark and Rosengard (1983).

SECTION TWO

ADOPTING A FINANCIAL SYSTEMS DEVELOPMENT PERSPECTIVE

A financial systems perspective involves the following elements:

- A market perspective that understands the preferences of the target group and designs products to meet them;
- Recognition that savings cam be as important as credit for microenterprises, financial institutions, and the economy;
- Insistence that financially viable institutions provide financial services. This requires that the institution develop the ability to break even or turn a profit in its financial operations and gain access to funds from nonsubsidized sources.

Adopting a financial systems approach to microenterprise implies a subtle yet profound reordering of goals and expected achievements. In particular, it means relaxing the insistence on measuring success by a direct connection between impact-level indicators of change, focusing instead on measures of increased access to financial services. The financial systems approach suggested here sets as its primary objective reaching poor entrepreneurs with financial services and thereby improving their lives. Microenterprise programs variously define the purpose of their work as alleviating poverty, improving income, enabling a productive activity to grow, or sustaining jobs. These objectives define the motivation for providing financial services, and the expectation, in general terms, of what such services will help accomplish. They also provide a reason for maintaining a focus on the selected client group.

For the poor, financial services provide access to resources that allow them to take advantage of economic opportunities. The poor obtain increased participation in the economy and more effective use of their own resources. Access to finance may yield a substantial effect, and this hope stands behind the desire to increase access to poorer populations. However, the effect of increased access to finance on both economic growth and the alleviation of poverty will be determined primarily by the (often quite limited) nature of economic opportunities facing the poor and by the individuals' own choices of investment versus consumption.[2] Because the intervening factors are so important, financial systems or institutions should not be held directly accountable for effects on poverty or growth, but primarily for how well they provide access to financial services. A healthy financial system in which loans are demanded and repaid indicates that financial resources are contributing in some way to economic growth and, if the poor have access, to poverty reduction.

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[2] The importance of real sector constraints points out that financial services alone are not the solution to microenterprise growth or poverty reduction. They are one part of a broader context involving economic policy, regulatory reform, market development, training, and the like.

MICROENTERPRISES AS FINANCIAL SERVICE CLIENTS

Before reviewing the services available to microenterprises, let us consider the kinds of financial services microenterprises need or request, as well as the characteristics of microenterprises relevant for financial institutions.[3]

Microenterprises usually have very small start-up capital requirements. Liedholm and Mead's (1987:38) review of the available evidence in several countries found initial capital requirements ranging from $49 in Sierra Leone to $1,104 in Jamaica. It appears that relative to their small asset bases, the requirements for working capital are likely to be large, to cover raw material purchases and inventory. Most urban microenterprises operate on short-term planning cycles, often daily or weekly. In rural locations, business often varies with agricultural seasons. The life of many microenterprises is short. The population of microenterprises is in constant flux, with large percentages of enterprises starting and ending in any given year (Liedholm, 1990:30).

Many, if not most, microenterprises are not autonomous economic units, but are part of larger family or household units. The cash associated with one microenterprise is frequently mingled with that of other household activities. Thus, the financial needs of the families, or at least of individual entrepreneurs, are often not separable from the financial needs of the enterprises themselves. This is particularly true for enterprises owned and operated by women. The families that operate microenterprises typically lack assets, especially marketable assets. Family members who operate microenterprises, especially women, have serious time constraints because of household responsibilities. Families engage in several economic activities at once, making it difficult to match financing offered to its real use. The family has needs beyond those of the firm, for consumption, financial security, and human capital investment (such as education and health care).

The characteristics of microenterprises and their families determine the financial services they are likely to demand. It is possible to classify the financial service needs into three groups.

- Microenterprises need short-term working capital to cover current transaction requirements and purchases of supplies and inventories.
- The need for term capital is far smaller, though it is probably important for microenterprises that are growing.
- Both for family financial security and for enterprise growth, microenterprises need a secure place to store the assets they accumulate that will at least maintain the value of those assets.

Surprisingly, many of the financial needs outlined above can be met through savings services as well as through credit. It may be well understood that the ability to save money securely is important for the long-term financial health of households, as protection against illness, periods of unemployment,

[3] The definition of microenterprise is always somewhat arbitrary. For the purposes of this paper, we adopt the definition of enterprises with up to 10 employees. This definition spans the size range from part-time income generating activities of individuals, through family-operated businesses, to very small enterprises employing hired labor. The majority of the enterprises in most developing countries fall in the lower end of this spectrum. On another continuum, the term microenterprise encompasses all types of urban and nonfarm rural activities, from manufacturing to commerce to transport.

and the like. Savings are equally important for enterprise growth, for it is from savings that most investment in enterprises comes (Liedholm and Mead, 1987:38). Moreover, savings can serve the same functions as credit. Through savings, investments are paid for in advance, while through credit they are paid for after the fact. The former is certainly preferable. Use of savings creates equity while use of credit creates debt. Entrepreneurs save in nonfinancial investments as well as financial ones. Well-crafted savings services can encourage a move into financial savings, which can have the advantages for entrepreneurs of safety and liquidity and for society of providing funds for investment by others. A recognition of the importance of savings argues strongly that it should be given equal weight in microenterprise programs.

WHY FORMAL AND INFORMAL FINANCIAL SYSTEMS FALL SHORT

The characteristics of microenterprises make it difficult for mainstream financial institutions to serve them. Banks must be able to process loans at a cost that can be covered by interest charges, and to have confidence in the borrower's intent and ability to repay. In commercial banking, the methods used to meet these banking needs do not fit with the characteristics of microenterprises. The practices that most banks use to gain confidence in the quality of loans are expensive and can only be used if loans are large. They involve (1) credit checks to gain information about the client's character; (2) project appraisal to assess the client's business prospects; and (3) formal collateral, which serves both to motivate repayment by making default costly to the client and to reduce the cost of default to the bank.

These techniques cannot be used in microenterprise lending. Project appraisal is too expensive, and microenterprises do not keep proper records. Microenterprises have no established credit record. They lack marketable collateral. These problems have kept commercial banks out of microenterprise lending.

In the past, donor-funded programs for microenterprises tended to adapt commercial bank methods that emphasize project appraisal. However, they relaxed collateral requirements, and offered low interest rates. As a result of their high subsidies, their reach was small. Moreover, they rarely reached the lower tier of microenterprises. Such programs long constituted the major response of formal institutions to microenterprise credit needs.

On the savings and deposit side, the picture is not so bleak. A large number of financial institutions provide savings and deposit services to the poor. Commercial banks, government-owned post office banks, and other institutions take small savings deposits. Few of these institutions return those deposits in the form of loans to the communities or client groups from which they draw them. In Kenya, for example, commercial banks, with an extensive branch network, gather savings in remote areas, lending them mainly in Nairobi and other major cities. The Malawi Post Office Savings Bank uses its small deposits to finance government-owned corporations. Thus, an imbalance often exists in which the poor and microenterprises have greater access to savings than to credit services. A financial sector approach to microenterprises would right that imbalance.

A strong current of informed opinion regarding increasing financial services for microenterprises holds that the best path lies in general financial sector deepening, through financial market liberalization, regulatory changes, and institutional development. This is the path advocated by most financial sector policy experts (Meyer et al., 1988). Under these scenarios, progress is made toward extending financial services to microenterprises first by removal of legal barriers and refinement of commercial banking techniques, and second by a general strengthening of the formal financial system, which leads to increased liquidity in the economy, and reaches microenterprises through informal financial systems, including trade credit.

The Popular Mortgage concept advocated by Hernando de Soto assumes that secure land titles that can be used as collateral will open bank doors to the informals. Similarly, attempts to reform the legal status of women will have some effect on their attractiveness as commercial bank clients. Although these steps are needed, neither removing legal barriers nor strengthening the financial system necessarily will have the desired payoff for microenterprises. The problem concerns banking technologies. As long as commercial lenders use lending technologies based on project appraisal and formal collateral, unit costs will be prohibitive for all but the very upper end of the microenterprise spectrum, and microenterprises will still not have access to financial services.

An alternative source of both savings and credit for microenterprises is the informal financial sector, an area receiving increased academic attention. Informal systems are agreed to be available to more microenterprises than are formal systems, but are regarded as inadequate for many reasons, such as their lack of depth of intermediation. Informal financial flows that channel increased liquidity into the microenterprise sector could serve as a vehicle to achieve general financial deepening. However, that effect depends on interaction between the formal and informal sectors. Although some such flows can be documented, one of the most commonly cited shortcomings of the informal financial sector is its segmentation — its separation from the financial mainstream.

Another means to provide credit to microenterprises is through flows of trade and supplier credit that would reach microenterprises. However, the limited evidence from a variety of countries suggests that the linkages between microenterprises and larger businesses are weak, accounting for only a small fraction of microenterprise sales (Liedholm and Mead, 1987:48). Segmentation in both the informal financial system and in the economy itself prevents the benefits of financial liberalization in the formal sector from reaching down into the informal markets. While some researchers advocate building greater links from informal to formal markets, methods for doing so have not developed.

From these observations, one can conclude that neither the formal financial system nor the informal financial system, as they are presently constituted, are likely to increase greatly the availability of financial services to microenterprises. This paper offers an alternative: specialized financial services based on proven principles for credit delivery of credit and savings services to the poor.

SECTION THREE

PRINCIPLES FOR FINANCIAL SERVICE DELIVERY TO THE POOR

CREDIT PRINCIPLES

The technology for lending to microenterprises has improved greatly during the past decade, with the creation and evolution of the Grameen Bank, Badan Kredit Kecamatan, Bank Rakyat Indonesia (BRI) Unit Desa System, and ACCION International, among others. All these programs have adopted a set of techniques representing proven principles of lending to the poor.

The programs mentioned above, and others that fall in the same general category, look different depending on target group, local context, and other factors. However, underlying these differences is a common thread that makes the programs qualify as effective credit delivery systems. Some have implied that the common element is the focus on the very poor (Biggs, et al.). Others explain that these programs do not have formal training or extension as prerequisites or accompaniments to credit. Still others emphasize that these programs strip themselves of all activity except lending and as such become "minimal" in their approach. None of these attributes reaches the heart of the matter, however.

What, then, are the common threads among effective credit delivery programs for microenterprises? All have found ways to streamline their activities to such a degree that the costs of lending are commensurate with the size of loans being made. Loan applications, approvals, disbursements, and collections have been stripped down to the bare minimum required to effect the transactions. Simplified loan processing techniques are made possible by the nontraditional mechanisms these programs use to secure repayment. The techniques employed resemble, often by conscious adaptation, those that have developed in the informal financial sector over many years. The following three principles represent the core of the new techniques.

- **Know the market -- the poor are willing to pay for access and convenience.** The major service need among the poor is credit for liquidity and working capital, with loan terms of one year or less, and little attempt to direct credit to specific uses. Transactions costs for borrowers are lowered by locating lending outlets near the client, providing simple application processes, and disbursing quickly. Interest rates are high relative to prevailing rates in the formal financial system, though low compared to typical informal system rates.

- **Special techniques reduce administrative costs** to a level commensurate with loan size. The simplest procedures are used for the smallest loans. Loan applications are often no more than one page. Approvals are decentralized and are not normally based on business appraisal, but rather on readily verifiable eligibility criteria. Borrower groups often handle much of the loan processing activity.

- **Special techniques motivate repayment.** Lenders use other techniques to fill the roles usually assigned to security and loan appraisal: (1) group guarantees or pressure from social networks, (2) the promise of repeat loans in increasing amounts, and (3) savings requirements. Although some of the most successful of these programs, such as the BRI Unit Desa system in Indonesia, require tangible collateral, most do not.

Application of these principles is the foundation for financial viability of a lending operation that serves poor microenterprises. It is important to recognize the essence of the difference between these techniques and commercial banking practice. The substitution of a repayment incentive structure in lieu of costly information gathering enables lenders to serve microenterprises at a reasonable cost.

Each lender adapts these principles in different ways to suit local conditions, so that no two credit programs look exactly alike. For example, the village banks that the Foundation for International Community Assistance (FINCA) and other U.S. private voluntary organizations promote share with credit unions affiliated with the World Council of Credit Unions the attribute of client ownership and management. But the village banks lend through groups while credit unions lend through individuals.

Group formation is among the most successful features of many such programs, particularly for the poorest clientele, as demonstrated in Grameen Bank, FINCA, and ACCION International programs. The group plays a role in reducing the cost of gathering information about the borrower, but its more important role is in motivating repayment through shared liability for default.[4] On the information side, lenders can shift some of the loan processing and loan approval tasks onto groups because the groups have better access to information on the character and creditworthiness of potential borrowers. The Grameen Bank, for example, uses a two-tiered group structure in which client groups determine not only eligibility for loans, but loan timing and size. This system externalizes many of the tasks that would otherwise be borne by paid staff, and takes advantage of the fact that borrowers can carry them out cheaply by virtue of their relationships with each other.

The development and spread of the principles outlined above for lending to the poor are significant achievements in the field of microenterprise development. The success of institutions and programs that have used these principles during the past decade provides the basis from which to build financial services to microenterprises into the financial system.[5] Although the number of successful examples grows each year, very few countries can boast that the market for financial services to microenterprises is largely satisfied. These programs should still be regarded as immature. Their full potential to grow, spread, and achieve greater financial self-sufficiency has not yet been reached.

SAVINGS: AS IMPORTANT AS CREDIT

The financial systems approach to microenterprises emphasizes that savings is:

- As important a service for the poor as credit; and
- Crucial in building self-sufficient financial institutions.

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[4] Groups also provide the opportunity in many instances for achieving nonfinancial objectives, ranging from social consciousness raising to nutrition education. The relationship between the individual clients, the groups, and the credit project can involve complex relationships that involve information asymmetries and the principal-agent problem. Huppi and Feder (1989) have made a start at examining such questions.

[5] For a listing of some of the largest such programs and their achievements, see Holt and Ribe (1990).

To date, only the credit union movement and scattered programs (like BRI in Indonesia) have embraced savings as equal in importance to credit. Many other programs have incorporated savings elements, and voluntary savings belongs as an integral partner to the lending principles outlined above. Just as there are proven principles of lending to the poor, principles of savings are beginning to emerge from limited experience. Indications are that when savings is approached using these principles, clients respond enthusiastically. These principles include:

- Lending to microenterprises can be financed to a significant extent by savings from the same communities, provided that savings is treated as a service and designed with customer needs in mind;
- The most widely desired savings instruments offer safety, convenience, ease of deposit, ready access to money, and a positive real return;
- More people want a good place to save than want loans. Thus, savings services can reach deeper into the community. The opportunity to save should not be limited to those who borrow; and
- Systems that provide both savings and borrowing are more self-sufficient and reach a larger proportion of the communities they serve.

One of the unresolved issues in this field is whether the microenterprise sector and its associated households are in fact net savers or net borrowers, at least in financial terms. Although credit unions have shown that it is possible to serve that client group solely on the basis of savings, other programs have not been able to do so. This issue will require more investigation in the coming years. Additionally, the prudential and regulatory environment, as well as the inflation rate in a country, influence a program's capacity to capture savings. The first creates a legal barrier, the second a financial one. The macroeconomic setting for capturing deposits is more complex than for lending activities.

It is incumbent upon donors and governments to encourage microenterprise finance institutions to offer savings services, by refusing to establish themselves as long-term sources of funds. Moreover, they must assist governments to establish a policy and supervisory framework that allows these programs to take deposits and helps them manage them safely.

To summarize, a number of institutions have developed and honed techniques for providing savings and credit services to microenterprises on a large scale and on a financially viable basis. The following challenges must be taken up next: to expand the reach of such services based on the principles outlined here beyond their current spotty distribution, and to develop strong institutions that can continue to exist without external dependency. Financial self-sufficiency is the key to meeting these challenges.

SECTION FOUR

INSTITUTIONAL REQUIREMENTS

A HARD LOOK AT FINANCIAL SELF-SUFFICIENCY

Financial self-sufficiency is the essential prerequisite for making financial services widely available to microenterprises. Yet debate remains on whether it is a feasible goal for most institutions. The microenterprise programs referred to in this paper have come far closer to financial self-sufficiency than the previous generation of programs, yet few have achieved complete self-sufficiency. The question of self-sufficiency must be treated thoroughly, but delicately — thoroughly because so many different definitions of self-sufficiency are used that key issues are often obscured under claims of achievement, and delicately because expectations set for these programs must balance between realism and stringency.

A financially self-sufficient credit program must cover the following costs through fees and interest charges: operating costs, including loan loss reserves; the cost of funds; and inflation, to maintain the real value of loan capital. To achieve genuine commercial viability, an operation must also yield a profit, or return, to its owners.

It is helpful to analyze institutional performance in terms of four distinct levels of self-sufficiency. For many programs, achievement of self-sufficiency involves moving through progressively more stringent levels of cost recovery. Individual programs should be judged not on the basis of their current level of achievement, but on the basis of their past and future progress from lower to higher levels. Programs that have stopped short of financial self-sufficiency and are not in motion toward it, should not be candidates for expansion.

The lowest level of self-sufficiency, **Level One**, is associated with traditional, highly subsidized programs. At that level, grants or soft loans cover operating expenses and the establishment of a revolving loan fund from which loans are disbursed and into which principal repayments and interest payments are placed. However, when programs are heavily subsidized and performing poorly, the value of the loan fund is eroded quickly by delinquency and inflation. Revenues do not even cover a portion of operating expenses and, as a result, grants are continually required. A large number of microenterprise credit programs can be found at this level.

Most programs that use the proven principles we described, and that are working smoothly, can attain the second level of self-sufficiency. At **Level Two**, programs begin to raise funds by borrowing on terms closer to, but still below, market rates. Interest income covers the cost of funds, as well as a portion of operating expenses, but grants are still required to finance some aspects of operations. Programs at this level often claim greater self-sufficiency by excluding some grant-funded items, such as expatriate staff salaries, from their calculations. Most programs at this level are proud of their breakthrough, as they should be, because the level of subsidy required is significantly smaller than at the earlier level. However, they should not be satisfied to remain at this level.

At **Level Three**, most subsidy is eliminated, but programs find it difficult to eradicate a persistent dependence on some element of subsidy. This is the level associated with most of the well-known credit programs, and it is probably necessary to reach at least this point in order to achieve large-scale operations. Programs at this level are rarely required to take the next step, because both they and their sources of support are pleased with performance at this level. The Grameen Bank, for example, retains two kinds of subsidy: its cost of capital is several points below market, and it receives income from soft loan funds placed on deposit. However, it uses much of that support to finance expansion in its operations, so that the subsidy element in its ongoing program is not large. The BKK program has eliminated subsidy from its branch network, but requires some grant support for branch supervision. ACCION programs in several countries have reached this level, but face the problem of maintaining the value of loan funds in the face of high inflation and distorted prevailing interest rate structures.

The final level of self-sufficiency, **Level Four**, is reached when the program is fully financed from the savings of its clients and funds raised at commercial rates from formal financial institutions. Subsidy is fully eliminated — fee and interest income cover the real cost of funds, loan loss reserves, operations, and inflation. The only major microenterprise programs to have reached this level are those of the credit union movement in certain countries, and the BRI Unit Desa system in Indonesia.

STRATEGIES FOR MOVING TOWARD SELF-SUFFICIENCY

The following discussion outlines the structure of costs faced and income enjoyed by credit programs at each of the four levels of self-sufficiency. By analyzing each type of cost as well as fee and interest income, we can determine how credit programs can move from one level to the next.

Operating Costs

Traditional credit programs at Level One typically have very high operating costs. It is not uncommon for programs to spend a dollar to lend a dollar, particularly at the smaller end of the microenterprise spectrum.[6] Programs at higher levels of self-sufficiency achieve most of their movement toward viability by using methods that cost far less, that is, by adopting the techniques outlined in Section Three, which bring them to Level Two. Once these methods are adopted, however, changes come incrementally from increasing efficiency and from achieving scale economies in operations as programs expand. Efficiencies may come from marginal improvements in processes, computerization of management information, improved financial management, and the like. Staffing and physical overhead are major cost elements that can be addressed only on a case-by-case basis. Therefore, continued streamlining is not the primary strategy for programs to move into the higher levels of self-sufficiency.

When NGOs move toward becoming financial institutions, differentiating between financial and nonfinancial services becomes an important consideration. Most observers of microenterprise programs agree that the provision of financial services to the poor requires different inputs than financial intermediation targeted at higher income groups. Most microenterprise programs, at all levels of self-sufficiency, provide nonfinancial support services in a nontraditional form. These support services include preparing the borrower to manage and use credit, assisting in the formation of guarantee groups, additional training in areas related to production, special meetings, and others. These inputs prepare poor entrepreneurs to operate with financial institutions as well as to meet the requirements for lending.

One position argues that these inputs are a social investment in a poor population with a corresponding social cost. This cost, the argument goes, should be subsidized since no provision of

[6] See Kilby (1985) and Tendler (1983) for examples.

financial services, however efficient, can cover these costs. The counter position on this topic argues that these inputs are costs associated with lending to this population. Without this kind of support, borrowers would not be able to borrow. Therefore, the argument goes, these costs should be understood as real program costs and should be built into full-cost pricing.

Loan Losses

Programs that have adopted the principles outlined here have achieved substantially better repayment rates than traditional programs, often reaching levels that compare favorably with commercial bank operations. One can observe many programs, particularly at Levels Two and Three, that claim losses at or below 3 percent of principal. Delinquency and default cannot be eliminated entirely, but can be maintained at a level that does not threaten the financial integrity of the institution.

Cost of Funds

Lending operations must pay to raise funds, either by borrowing or by generating savings. Programs operating on grants and very soft loans are spared this cost: donors bear it. Dependence on soft sources of funds is a limiting factor, as soft sources are in short supply. Institutions at Level Two may still use them, but by Level Three the transition to commercial or nearly commercial sources (for example, those provided through IDB global discount lines) should have been made. This is one of the key distinctions between the two levels.

Inflation

All programs bear the consequences of inflation, whether they recognize those costs or not. In an appropriately functioning financial system, the inflation factor is built into the interest rate paid on funds raised (or offered to depositors for self-generated funds). This practice returns the real value of the funds to the suppliers, and therefore maintains that value in the financial system. However, when programs use concessional funds they are not charged this inflation factor. In any given year, therefore, they may appear self-sufficient, but over time the real value of their loan fund dwindles, and they are able to serve fewer clients adequately. If hyperinflation sets in, all progress toward self-sufficiency is destroyed. Microenterprise programs have a good chance of reaching Levels Three and Four only if they operate in countries where inflation is kept to moderate levels.

Fee and Interest Income

Traditional loan programs have been reluctant to charge full-cost interest rates to microenterprises on the belief that the poor cannot pay. In many Level One programs, the rate charged is negative in real terms.

In most countries there is a large difference between commercial rates of interest and rates charged in the informal financial sector. Microenterprise programs, therefore, can charge much more than formal financial institutions and still underprice informal sector alternatives. Moreover, studies have shown that microenterprise borrowers are far more sensitive to the availability and convenience of credit than to the interest rate. The nonfinancial transaction costs borrowers normally face in obtaining credit dwarf interest costs. Recognizing this fact, most Level Two and Three programs charge what they consider to be commercial rates, or more.

To make the transition from Levels Two and Three to full self-sufficiency at Level Four, programs must maintain full-cost pricing policies: charge interest rates and fees that cover all cost elements. If full-cost pricing is adopted, the resulting rates will be well above what are generally regarded as commercial market rates, in other words, those charged by commercial banks.

Despite indications that full-cost pricing would not inhibit demand, few institutions have been willing, or able, to adopt it. In more and more countries, interest rate ceilings in the mainstream financial system are being removed, or at least raised to positive real levels. Even in countries with fully deregulated interest rate regimes, however, microenterprise programs have been reluctant to charge full cost, either because they believe higher-than-commercial rates to be unfair to poor clients, or because they wish to avoid being regarded by others as having exploitative interest rates. These attitudes may prove as difficult to break as the earlier regulatory constraints.

The presentation of these levels as a series in a progression is not meant to imply that programs should begin at the bottom and work up. Programs may be able to begin toward the top. Beginning in such a way is far preferable to starting at Level One, because fewer bad habits have to be shed. Few programs at Level One will ever move to Level Four, and even moving from Levels Two to Four may appear impossible to many organizations.

Complicating this picture is the need microenterprise programs face to raise funds for rapid expansion. As noted in the case of Grameen, initiating services in new areas will require a greater degree of subsidy than providing ongoing services. Operating costs associated with starting new branches are high, and cannot be internally generated. The same is true for funds for lending. Programs undergoing expansion, except those that are fully funded by savings, will need to raise increasing amounts of funds. These funds are likely to come dearer than the grants and soft loans available on a smaller scale. Expanding programs must often struggle with using more costly funds at the same time as they engage in high-cost start-up activities. Therefore, programs that are expanding rapidly may look less financially self-sufficient than they would at a steady state.

The achievement of complete financial viability by an increasing number of microenterprise programs depends on both the inherent ability of the techniques behind the principles of lending to the poor to yield a break-even operation and on the incentives facing the institutions running such programs. We do not know whether these techniques can consistently support Level Four operations. On the basis of current experience it seems safe to say that well-designed and operated programs can yield Level Three operations in any situation in which the cultural, economic, and institutional conditions of the country are reasonably favorable. We do not know about Level Four operations largely because so few programs have been willing or able to charge the higher interest rates that Level Four would require. Therefore, the effect of the higher rates on client demand and loan performance has been given only limited testing. The next few years' experience should provide a better answer to this question.

In principle, donors and governments should wish to see microenterprise programs reduce dependence on subsidy, and should encourage programs to move toward sustainability. In practice, donors and governments all too often are content with lower levels of performance. Donors have money to move quickly and governments often view microenterprise programs as political — a means to give something to the poor without spending excessive amounts.

The problem with this practice by governments and donors is that it results in small programs because it does not foster independence. The massive amounts required to respond to the potential demand for financial services among the poor can be found only through savings and through commercial sources. Thus, if the goal stated at the outset of this paper is to be realized, it is incumbent upon governments and donors who are the current supporters of microenterprise programs to demand movement toward viability. This will require that program supporters fashion assistance in ways that complement that move rather than provide alibis for it. For example, donors can require increasing percentages of funds raised from savings, or can guarantee loans from commercial sources or provide equity capital. At a minimum, grant funds should be limited to supporting operating costs, so that programs are forced to use borrowed or deposited loan capital. Donors should use the subsidies at their disposal to equip organizations to rely on more plentiful nonsubsidized sources of funds. Commercial financial institutions should be brought into partnership with microenterprise programs as early as possible, to bring both the know-how and the resolve for commercial viability. Such a shift in perspective on the parts of donors and governments need not involve rigid requirements. In each case donors should recognize the level at which a program is operating and the issues involved in moving to the next level.

Microenterprise programs, donors, governments, and financial institutions must work together with firm conviction that achieving financial self-sufficiency is a prerequisite to providing financial services to the poor. The commitment of these actors to that principle, and the incentives they create, will be the deciding factor in the success of what this paper advocates.

INSTITUTIONAL ALTERNATIVES FOR PROVIDING FINANCIAL SERVICES TO MICROENTERPRISES

The authors contend that the most effective path to realizing the vision stated at the outset of this paper is the creation and expansion of capacity to deliver specialized financial services to microenterprises, using the principles of credit and savings delivery presented in Section Three. This path can be realized through any number of institutional arrangements, for the determining factor is not the type of institution providing the service per se, but, first, the quality and efficiency of the services themselves; second, the ability of the institution to support the services; and third, the assurance that programs reach the selected client group. This section discusses some of the institutional variations that can fulfill these conditions, and their prospects for expansion. Three models are discussed: linking programs to commercial sources of funds; creating specialized financial institutions, including transforming programs into such institutions; and creating microenterprise operations within mainstream financial institutions.

The first model differs from the other two in its assumptions about the location of savings. If one considers a "complete" financial institution to be one in which funds for lending are raised by the institution itself, primarily through deposits, the first arrangement does not qualify.[7] However, because many commercial financial institutions already collect deposits from microenterprises, the linking of a program that emphasizes lending to such a commercial institution completes the financial loop.

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[7] See Vogel (1984).

Linking Nongovernmental Programs to Sources of Finance

Many of the autonomous microenterprise credit programs run by NGOs are not in a position to become true financial institutions, that is, institutions that finance their lending largely from deposits they take. They may face legal restrictions on deposit taking. Equally important, they may decide that it is not appropriate for them to take on the added prudential responsibilities that come with handling individual deposits. The future for such programs depends on their ability to forge funding relationships with formal financial institutions. This approach is particularly desirable when deposit services offered by formal financial institutions are already widely available to microenterprises. Through links to these institutions, microenterprise lending programs can recirculate the capital raised through deposits back into the microenterprise sector.

The simplest arrangement is for microenterprise programs to finance their lending by borrowing from commercial banks. To be able to borrow in this way, microenterprise programs must meet two stringent criteria. First, they must be able to repay borrowed funds at a rate acceptable to the bank. If a commercial bank regards a loan to a microenterprise program as a commercial transaction, it would charge, at best, the prime lending rate — that is, the rate charged to the most favored customers. Second, they must be able to assure the bank that the program — as borrower — is creditworthy. Few microenterprise programs have as yet been able to meet these tests on their own. A number of programs, including several affiliated with ACCION International, do borrow from commercial banks with support from other sources. To meet the interest rate targets, they blend commercial bank funding with soft loans (or grants) from donors or governments. As they seek to grow, they recognize that they will have to reduce their reliance on these soft sources. They use guarantees to meet creditworthiness standards, such as those supplied through ACCION's Bridge Fund and A.I.D.'s Loan Portfolio Guarantee program. Over time, programs can earn recognition as creditworthy borrowers, which can eventually lead to their receipt of bank loans without external guarantees. Programs can also use the funds of both the program and the borrowers as sources of security for the bank. The success of early efforts along these lines suggests that commercial banks can potentially channel a significant amount of resources through NGOs.

This approach builds on relationships that already exist between many microenterprise programs and commercial banks. Frequently, microenterprise programs that have no funding relationship with banks have arrangements under which banks handle important aspects of lending transactions. In the ADEMI program, an ACCION affiliate in the Dominican Republic, each borrower must open a deposit account with the Banco Popular, a private commercial bank. ADEMI disburses its loans by paying directly into these accounts. This arrangement is desirable for ADEMI because it reduces ADEMI's need to handle cash. The bank likes the arrangement because loan funds remain in bank coffers until borrowers require them. The arrangement is desirable for borrowers because it introduces them to commercial banking and indirectly promotes savings. Such an arrangement provides a foundation from which microenterprise programs can build funding relationships with commercial banks.

In some countries, so-called second-level institutions are being created that relieve credit programs of the necessity of building their own relationships directly with individual banks. These institutions act as brokers or wholesalers between banks and NGO-based programs. They raise funds from commercial, governmental, and donor sources and supply them to individual microenterprise programs. This service is helpful to the microenterprise programs because it gathers funds from a number of sources, and it is helpful to commercial banks because it takes on the burden of supervision of the individual credit programs. The second-level institution must enforce performance standards that permit banks to have confidence in the loans they make. Second-level institutions exist in Colombia through ACCION and the Philippines through Opportunity International, and one is being developed in the Dominican Republic. At present, these institutions broker both commercial and softer sources of funds, and will continue to do so for some time to come. Because they are relatively new, many issues are only beginning to be resolved, including the financial viability of the institutions themselves; the best ways to measure and enforce performance by credit programs; interest rate spread requirements; and the structure of liquidity, credit, and interest rate risks among the various parties to the transactions.

The intent of all types of efforts being undertaken at present is to demonstrate to banks that resource allocation to the poor involved in microenterprise activities need not mean a sacrifice of either income or safety in the name of good deeds. Only when banks are so convinced will significant amounts of resources be forthcoming from them.

Transforming Programs into Specialized Financial Institutions

Microenterprise programs are carried out by a variety of institutions, from NGOs that have worked primarily with subsidies (Level One) to nonprofit organizations such as village banks that start out as financial institutions with a mentality geared towards self-sufficiency (Levels Two or Three). In all cases, these institutions must undergo similar changes to become financial institutions that engage in full financial services of lending and capturing deposits.

At the structural level, these institutions must reorganize in order to provide both savings and credit, and must do it in a manner that will allow expansion to take place. At the first opportunity, the organizational structure must be modified to support the primary activities of the organizations, the capturing of deposits, and the provision of credit. The functions and the make-up of each department, as well as the relationship among these departments must also be reorganized. For example, most microenterprise programs contain a large operations department that provides credit, and a much smaller financial department that engages in accounting functions and tracks the uses of sources from the various grants and soft loans that comprise the program. As these institutions evolve to resemble or become financial institutions, they require fundamental changes, primarily because savings would become an important source for lending. These internal transformations would be more easily absorbed if the organization is close to Level Four, because to reach that level, the organization already would have undertaken some of these changes.

A second structural change required is for the organization to use some form of franchise or branch office system to continue expanding its operations. It could open offices in new areas to increase its outreach. The organizational structure would require information systems adequate for a decentralized operation. Finally, these organizations would plan and project their operations on the basis of full-cost pricing, rather than on the assumption of having subsidies finance their activities.

Another consideration centers on the legal dimensions of an organization transforming itself into a financial institution. For example, the legal framework in a country will determine whether an institution can take deposits. In some countries, the law permits organizations outside the banking system, identified as "non-banking lending entities," to capture savings directly. However, in most countries this is not the case. Institutions may modify themselves in order to fit within the existing law, such as by creating a credit union arm, or forming a cooperative. The legal considerations will be a key factor in defining how these institutions will change internally.

When institutions capture deposits, they also take on the added responsibility of complying with prudential regulations such as those that govern all banks. These regulations are designed to maintain the stability of the financial system, and for the first time these organizations would be required to abide by them. The ability of specialized microenterprise institutions to cope with these requirements is untested, and is therefore a topic for much further exploration.

A final issue in transforming or creating specialized financial institutions is the need to have ownership invested in a body that will take responsibility for the success of the institution, and whose interests are aligned with that success, through their investment of capital. Savings and credit societies and village banking programs solve that problem by making owners out of all their members. This arrangement can provide strong incentives for good management. In a few places more standard private and public forms of ownership are being explored, with combinations of banks, large businesses, government organizations, and individuals forming investor groups.

Specialized Operations within Commercial Financial Institutions

To date only a handful of commercial banks have been interested in taking on the microenterprise client group. Yet it is possible for such an arrangement to succeed, as demonstrated by the tremendous success of the Bank Rakyat Indonesia Unit Desa program, which is run by a large government-owned bank and serves 7 million savers and 2 million borrowers. Major advantages of placing microenterprise operations in commercial banks include infrastructure available to banks through branch networks, access to liquidity, and commercial orientation. However, banks must be educated in the special techniques described above as minimalist principles, for no bank will succeed with this target group by applying its standard operating procedures. At this time banks are generally unaware of these techniques, of the promise the techniques may hold for serving microenterprises commercially, and of the required changes banks would have to make to run minimalist operations. The next steps in this area are to continue moving nonbank lending entities toward financial viability, and to build more links between banks and those operating microenterprise programs.

PROMOTING FINANCIAL SERVICES FOR MICROENTERPRISES: A POLICY DISCUSSION

Governments in many countries are moving toward including informal sector enterprises in their national agendas. Along the way, policies will have to be reformulated, particularly those in the realm of the financial system. The actors that must review their policies include national governments, regional and local governments, financial institutions, and, finally, multilateral and bilateral donor organizations.

Financial system policies should foster the processes of transformation that have been described above. Policies should:

- Make it easier for programs offering specialized financial services to microenterprises to become financially self-sufficient;
- Support the efforts of NGO-based programs to access commercial sources of funds;
- Support the efforts of NGO-based programs to become specialized financial institutions; and
- Encourage mainstream financial institutions to develop specialized microenterprise operations of their own.

In addressing each of these tasks, the first priority should be interest rate deregulation. As shown above, the ability to charge full-cost interest rates is the best strategy microenterprise lending programs have for becoming financially self-sufficient, after they have adopted the lending techniques advocated here. The interest rates that microenterprises will have to face will be substantially higher than those now commonly thought of as "market" or "commercial" rates, because they must cover the high unit costs of administration of very small loans. Even under deregulation, however, self-imposed and political restrictions are likely to remain. Governments, lenders, and donors can lead the way in changing attitudes by making (and following) firm policy determinations to require full-cost pricing policies from any organization that requests finance or special assistance from them. Such policy pronouncements will signal the designers of microenterprise lending programs that higher rates are acceptable. Interest rates on deposits also should be allowed to rise, to provide appropriate incentives for microenterprises to use savings rather than credit to finance lending operations.

Regulations governing acceptance of deposits also must be reviewed, although this will prove to be a thorny issue. In many countries, NGO programs are prevented from accepting deposits by banking laws, which restrict that function to full-fledged financial institutions, subject to all banking legislation. The main purposes of such regulations are to protect individual deposits and secure the health of financial institutions. When depositors know that institutions have met certain conditions, for example, for capital adequacy, and further, that government regularly reviews their adherence to those conditions, they will be willing to deposit their funds in the institution. Continued depositor confidence is the cornerstone of financial market stability. Governments have a responsibility to both depositors and financial institutions to ensure that such confidence is not violated. Therefore, when nonfinancial institutions begin to accept deposits, governments are legitimately concerned.

On the other hand, as this paper has argued, savings services are as important to microenterprises as are credit services, and are also important to the viability of the institutions serving microenterprises, because they are a major source of funds for lending and can be used to motivate repayments. A way must be found to support savings elements in microenterprise programs based on new types of financial institutions. The solution lies in supervisory standards tailored to specialized operations or institutions. In many countries, credit union systems operate according to explicitly designed rules which are promoted worldwide through the World Council of Credit Unions. As increasing numbers of microenterprise credit programs transform themselves into financial institutions, they will have to come together to consider these issues, and to present joint proposals to governments. In countries where second level institutions exist, they can play a major role in developing standards and supervision procedures for the individual programs they serve, and in lobbying for changes in legislation where needed.

It is premature to attempt to prescribe governmental policy toward deposit-taking by microenterprise programs, but possible elements of such a policy can be identified. Programs offering credit for microenterprises would be permitted to take deposits, provided they meet the following provisions: minimum equity investment, adequate loan loss reserves, a limit on the percentage of deposits that could be lent, and maintenance of proper accounting standards. In order to prevent misuse of the provision by individuals wishing to circumvent normal banking regulations, programs might be required to keep loan sizes small.

At the same time, governments should allow banks and other formal institutions to develop microenterprise programs using the new techniques. This may require that standards governing loan collateral, approval, documentation, and the like be adapted for special bank programs.

The success of these efforts to make policy more supportive of financial services for microenterprises will depend to a great degree on the general economic climate in which they take place.

Services being developed in a growing economy have a much better chance of succeeding than those facing economic stagnation: demand for finance will be higher, income is more likely to support repayments, and it will be easier for microenterprises to save. Similarly, if microenterprise finance is to be integrated into the formal financial system, that system should not be laboring under credit constraints that dry up liquidity. It is particularly important for inflation to be controlled, as high inflation plays havoc with interest rate structures and can quickly ruin carefully crafted plans for financial self-sufficiency. These macroeconomic conditions should be taken into account when discussing policy towards microenterprise finance.

Finally, a word about the role of the multilateral and bilateral donor organizations. The forces operating at local levels will tend to argue that financial self-sufficiency is either unattainable or not necessary. Governments and even private organizations have for too long viewed microenterprise programs as at best an income redistribution strategy or, at worst, a means to court political favor among the ranks of the poor. The donor organizations, together with successful microenterprise finance institutions, should take the lead in advocating a financial systems perspective towards microenterprise development by demanding better performance from the programs they fund, by promoting learning across countries, and by encouraging governments to adopt more supportive interest rate and regulatory policies.

Innovations by donors in their funding activities will also emerge as a challenge. Among the most interesting current issues are equity investment to start up financial institutions, recognition of guarantee funds and of their importance in backing up commercial sector credit, and assisting these programs to understand and lobby the legal and regulatory framework in which they operate. The next decade may not see the realization of the goal described at the outset of this paper, but if all parties pursue that goal under the framework outlined here, we may come surprisingly close.

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