'Poverty Lending' and Microenterprise Development:

A Clarification of the Issues

GEMINI Working Paper No. 30

GEMINI

GROWTH and EQUITY through MICROENTERPRISE INVESTMENTS and INSTITUTIONS
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'Poverty Lending' and Microenterprise Development: A Clarification of the Issues

by

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May 1992

This work was supported by the U. S. Agency for International Development, Bureau for Asia and Private Enterprise, Office of Small, Micro, and Informal Enterprise, through core funding to the Growth and Equity through Microenterprise Investments and Institutions (GEMINI) Project, contract number - DHR-5448-C-00-9080-01.

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ACKNOWLEDGMENTS

This paper evolved over animated discussions with Jim Boomgard, Don Henry, Matt Gamser and Jennifer Santer at DAI. I would like to thank them and Elisabeth Rhyne of A.I.D., and Maria Otero of ACCION for their guidance and comments on several earlier versions of this paper. Tom Timberg of Nathan Associates and Osvaldo Feinstein of IFAD provided insightful comments on the final draft. This paper also benefitted from the discussion and suggestions of participants at the GEMINI Small and Microenterprise Regional Conferences in Swaziland and Indonesia, where it was presented, and from discussions with Areiys Gomez and Lawrence Yanovitch of FINCA.

I. 'POVERTY LENDING' AND MICROENTERPRISE DEVELOPMENT: A CLARIFICATION OF THE ISSUES

THIS PAPER'S PURPOSE

This paper is an attempt to demystify the issues in the controversy surrounding 'poverty lending' as an approach to microenterprise development. It explores whether assisting the poorest and achieving financial sustainability are contradictory objectives. Its purpose is to clarify rather than resolve poverty lending issues that are provoking debate and discussion in the microenterprise development field.

In this light, it explores two approaches to microenterprise development: the Poverty Lending (PL) approach and the Financial Systems (FS) approach. The PL approach advocates lending to the 'poorest of the poor.' The FS approach articulates how to better meet the financial needs of the poor through the development of viable financial institutions and through the incorporation of microenterprise lending in the wider context of an improved financial system.

It explores the PL approach in light of the Microenterprise FY91 Report Language passed by Congress, urging A.I.D. to *"make every effort to adopt a 'poverty lending' approach such as that of the Grameen Bank in Bangladesh."* At a time when we are getting used to speaking about 'microenterprise development' and 'financial sustainability' in the same breath, the PL approach and its implications for sustainable programs warrant a reassessment.

THE EARLIER DEBATE AND WHERE WE ARE NOW

Microenterprise lending involves the provision of a range of loan sizes to entrepreneurs who range from the poorest to the poor in developing countries. Several kinds of approaches to address the financial constraints of poor entrepreneurs have been developed and put in practice. Poverty lending refers to an approach that advocates targeting small loans to the poorest of the poor on grounds of equity. Other approaches use a wide angle lens to view the sector in its entirety. These other approaches have also introduced the objective of achieving sustainability in delivering financial services to the poor.

Debate over the types of approaches has been at the heart of long-standing controversies in the microenterprise development community. The controversies revolve around whom to support, how best to do so, and what objectives to accomplish through this type of assistance.

Entwined in the discussion is a web of related issues: whether the focus of assistance should be on the poorest of the poor; whether to assist the poorest to better survive, or jump-start the less poor who can be the propellers of growth; and whether reaching the poorest is a goal in and of itself, or whether it has to be coupled with financial sustainability.

The heart of the controversy initially centered on the who question — who is the appropriate target group. Advocates of PL, whose interests were articulated by a Washington-based lobbying group called RESULTS, eloquently argued for targeting the poorest of the poor on grounds of equity. Their solution to keep the sights on the bottom-two deciles of the income strata was to lobby Congress to mandate that average loan ceilings in A.I.D.-assisted microenterprise programs not exceed $300. They viewed microenterprise development as a way to keep U.S. Foreign Assistance aimed at the truly needy.

Other microenterprise development practitioners, including A.I.D., argued that total microenterprise lending should not be limited only to the poorest, but should also encompass other poor entrepreneurs with demonstrated potential for growth. Benefits of growth and expansion from assisting the less poor would spread to the poorer and poorest enterprises through increased employment opportunities and strengthened backward linkages.

The PL prescription for loan ceilings and other targeting mechanisms was further countered by arguments that a global blanket prescription, such as the $300 average loan ceiling, would not address the complexity of the issues involved in microenterprise assistance, nor would it account for the heterogeneous needs of different sizes of enterprises along the microenterprise continuum, let alone from different country contexts. The Stock-Taking study articulated the need for recognition of differentiated approaches to serve distinct groups within the sector.[1]

The 1989 Microenterprise Bill does not mandate the $300 average loan limit, nor does it mandate any single approach. The debate on whom to target has reached a new threshold without ever closing the earlier debate. Wider recognition of a plethora of approaches has led former debaters to stop debating whom to target. Instead, discussion has evolved to frame a new question — how best to assist microentrepreneurs. Instead of growth versus equity, the new focus is on how best to achieve growth with equity. The Financial Systems approach articulated by Rhyne and Otero has rephrased the who question to ask how best to meet the financial needs of the poor.

It is important to remember that the controversies in microenterprise development are emotional ones — beyond costs and facts, they get to the heart of what development professionals believe development is all about and how best to achieve it. There is no resolution to these issues. The shift in focus from whom to lend to, to how to lend better to the poor represents an important move from ideology-based polarization to pragmatic solution seeking.

DEFINING POVERTY LENDING, POOR, AND THE POOREST

The term "poverty lending" has become misused to represent the targeted lending to the poorest advocated by proponents of the PL approach. By definition, A.I.D.'s lending efforts for microenterprise development represent lending to the poor. The issue here is the degree of poverty. The PL approach advocates lending to the poorest versus lending to the less poor.[2]

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[1] The Stock-Taking study commissioned by A.I.D. identified three approaches to microenterprise assistance -- Formation, Expansion, and Transformation -- each with a different development challenge, different target groups within the microenterprise sector, and different development goals. Formation programs aim to integrate highly disadvantaged groups or individuals into the microenterprise sector. Expansion programs assist microentrepreneurs to expand their operations. Transformation programs seek to graduate enterprises from the microenterprise to the formal sector (Boomgard, 1989).

[2] However, for purposes of consistency, the term 'poverty lending' will be used in this paper.

Speaking of the poor and the poorest forces at least a cursory definition of these terms. The poorest are one or two rungs below the poor on the economic ladder. They do not possess assets or working capital, and they have no reliable source of livelihood. Typically they are casual day laborers or are self-employed. A more adequate and secure subsistence is the immediate goal of economic activity. For this reason, the severely poor have been characterized as operating in the survival economy. The less poor have some assets, working capital and means of livelihood. Although primarily self- and family-employed, they may employ other workers. Above all, they are not on the brink of malnutrition.

Lipton defines the ultra-poor and poor by food adequacy standards. The ultra-poor are those who spend 80 percent or more of their earnings on food yet fulfill less than 80 percent of the average calorie requirements for their age, sex, and activity groups and are undernourished. The poor are defined as those who spend 70 percent or more of income on food, meet 80 to 100 percent of calorie requirements, and are not undernourished (Lipton, 1988:4).

Poverty lending programs in microenterprise development target those in the bottom 20 percent of the income strata, who would correspond to Lipton's ultra-poor.

II. THE DISTINGUISHING CHARACTERISTICS OF THE POVERTY LENDING AND THE FINANCIAL SYSTEMS APPROACHES

This section analyzes the underlying objectives and methodologies of two approaches to microenterprise finance: PL and FS. The section describes the two approaches in simplified form, highlighting the theoretical differences between them. It is important to note, however, that the differences between the programs are not always sharply defined; examples of successful PL programs incorporate many of the principles of sound financial management advocated by the FS approach, and successful FS programs have been able to serve the very poor entrepreneurs which PL programs focus on.

It is incorrect to interpret that the two approaches are being compared with each other. It should be noted that the PL approach is defined largely by the cumulative and evolving experience of microenterprise lending. The FS approach is defined by the ideal financial management principles it advocates programs to aspire to, with admittedly few actual programs reaching the full level of self-sufficiency it aims for.

THE POVERTY LENDING APPROACH

The PL approach argues that only the poorest of the poor should be targeted to provide them with assistance that would otherwise bypass them. It assumes that broad target group definitions fail to extend benefits to the most marginal. The approach is motivated by equity concerns with how best to assist the poor, and in particular, the poorest. Lending is considered only one of many variables that can be used to ameliorate abject poverty. Most PL programs provide more than just financial intermediation. They provide credit and savings services with a big socioeconomic development "plus" (Lassen, 1991:1-2).

There is consensus among the U.S. community dedicated to PL that it is something distinct from microenterprise lending. The definition and criteria put forth in Lassens's paper are described below.

Objectives

PL programs seek to advance individual and community well-being, community growth, and prosperity. PL programs state their objectives and measure their achievements in terms of social benefits that include participating in decision making, overcoming oppressive cultural practices, increasing dignity and enhancing self-worth, obtaining legal rights and freedom from monopolistic money lenders, gaining access to social safety nets to meet emergency requirements, and improving community-based organization for other types of development.

Target Group

PL targets the poorest and most marginalized — typically women and members of lower castes and ethnic minorities.

Methodology

The PL approach seeks to address a host of constraints faced by the poorest through the provision of a variety of services. Programs following this approach have a large socioeconomic development agenda, of which savings and loan services may be a critical, though not the sole, element. PL programs almost always include nutrition, education, training, and other components. These other components are considered as key to enabling the financial services as the latter are to the former. Credit is treated as the catalyst to induce the poor to organize to improve their socioeconomic welfare.

Lassen defines 'poverty loans' as very small, very short-term working capital loans that supply producers with cash flow to carry out subsistence-level economic activities.[3] This series of loans provides a cash flow over a period of two to three years that the very poorest can invest to generate a surplus. Loan periods range from one to six months, and loan sizes range from $10 to $300. Activities supported revolve around frequent marketing such as petty trade, food preparation and vending, and handicraft production. Most PL programs have a loan ceiling to keep lending targeted to the poorest. In the best of systems, they are controlled by participants. PL programs typically graduate clients once they have reached the loan ceiling, in order to keep assistance targeted to the poorest.

Operating Principles

PL vigorously promotes savings, charges positive interest rates, is sensitive to cost control and cost-effectiveness, and has a plan for sustainability based on local earnings (Lassen 1991:14).

This final characterization by Lassen is of the 'ideal' PL program. In reality, PL programs have been characterized by subsidies, a welfare-oriented approach, and greater emphasis on meeting socio-developmental objectives of empowerment and participation than on achieving financial sustainability. Only recently have PL programs begun to emphasize the cost-effectiveness and sustainability aspects that Lassen attributes to them.

In the terminology of the Stock-Taking study, PL programs correspond most closely to the formation approach. This approach is embodied in programs that aim to integrate highly disadvantaged groups or individuals into the sector. They target the poorest of the self- employed and unemployed in areas where they operate. Social benefits are given a high priority. Most programs reach a high proportion of women. The cost per beneficiary was highest in the formation programs, given the remoteness of areas served and the high costs of training and technical assistance delivery. The study concluded that these programs are unable to financially sustain themselves on the basis of internally generated interest and fee income (Boomgard, 1989).

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[3] Perhaps in this respect they are not truly the poorest of the poor, who, as defined by Lipton, are at risk for malnutrition.

THE FINANCIAL SYSTEMS APPROACH

The Financial Systems approach argues that microenterprise finance should be treated as part of financial system development to reach large numbers of people without continuing subsidies.[4] The FS approach treats microenterprises as market-oriented endeavors offering a product with attributes clients want at a price that covers costs. The approach aims for financial viability of lending institutions and stresses that savings are equal in importance to credit.

This approach aims to incorporate microenterprise lending in the wider context of an improved financial system. 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. This approach meets the diverse credit and savings needs of microentrepreneurs and provides financial intermediation by financially viable institutions. Programs following this approach often operate with sufficient profitability to allow them to become financially self-sustaining after a reasonable period (four to six years). This approach is based on covering costs through internally generated earnings, rather than through infusions of grant capital.

Objective

The primary objective of this approach is to reach poor entrepreneurs with financial services and thereby improve their lives. It treats financial self-sufficiency as an essential prerequisite for making financial services widely available to microenterprises. It contends that the most effective path to enabling the majority of poor entrepreneurs to have access to financial services from locally generated funds is through the creation and expansion of capacity to deliver specialized financial services to microenterprises. Because other constraints are so important, financial systems should not be held directly accountable for effects on poverty or growth but primarily for how well they provide access to financial services.

Target Group

Its focus is on developing strong and viable institutions to meet the diversified financial needs of poor entrepreneurs in developing countries.

Methodology

Although it recognizes the multitude of constraints faced by the poor in developing countries, it does not seek to address all of them. It focuses on addressing one of them — lack of access to financial services.

It advocates the development of viable financial intermediaries through the application of sound financial and management practices — streamlining procedures and being cost-effective. It calls for fully

[4] This section is based on Rhyne and Otero, *A Financial Systems Approach to Microenterprises*, GEMINI Working Paper No. 18, April 1991.

accounting for the institution's cost structure — operating costs, loan losses, cost of funds, and inflation — and recovering these costs through fee and interest income. Savings are an integral feature of this approach, which considers savings mobilization as important a service to the poor as credit, and crucial in building self-sufficient financial intermediaries. Admittedly by the authors of this approach, very few programs to date have achieved this level of financial sustainability, or fully embody the features of the approach. Table 1 presents some of the key distinguishing characteristics of both approaches.

TABLE 1

DISTINGUISHING CHARACTERISTICS OF THE POVERTY LENDING AND FINANCIAL SYSTEMS APPROACHES

CHARACTERISTICS	POVERTY LENDING	FINANCIAL SYSTEMS
Objectives	Advance well-being, self-worth, empowerment. Attempts to address multiple constraints through provision of multiple services.	Develop viable sustainable financial institutions to serve financial needs of poor MSEs.
Target Group	The 'poorest of the poor,' the most marginalized operators of the 'survival economy,' those at risk of malnutrition.	The specialized financial institution that serves poor entrepreneurs.
Methodology	Loan ceilings, client graduation.	Financial discipline. Streamline procedures and systems at institutional level.
Services	Credit and nonfinancial assistance.	Financial mediation between savers and borrowers.
Costs	Typically high costs per borrower.	Can be streamlined to a minimum.
Interest Rates	Grappling with issue of full cost-recovery. Moving from charging subsidized to commercial rates.	Advocates full cost-recovery through interest rates to sustain services to the poor.
Subsidies	Social benefits justify subsidy elements.	Subsidies will stunt the possibility to provide sustainable services. Can be justified at start-up and rapid expansion phases.
Sustainability	Community organization sustainability viewed as critical. Financial sustainability not viewed as germane to program success. Is now an increasing concern.	Is THE fundamental objective of the financial institution, without which services and benefits would not continue to clients.

III. EXPERIENCES WITH THE POVERTY LENDING AND FINANCIAL SYSTEMS APPROACHES

This section profiles two widely touted microenterprise development programs, which have come to serve as models. Because substantial literature documenting their experiences is widely available, this section will focus on their prospects for achieving long-term financial sustainability.[5]

The Grameen Bank (GB) of Bangladesh and the Badan Kredit Kecamatan (BKK) of Indonesia are both examples of successful microenterprise finance programs which reach a similar client in their respective countries; the poorest microentrepreneurs. Table 2 summarizes the basic characteristics of the two programs.

THE POVERTY LENDING APPROACH

The Grameen Bank

The GB is a specialized financial institution that uses credit as an impetus to stimulating overall development for the poor.[6] It began as a research project in 1976 and was formed as a bank in 1983 with share capital from the Government of Bangladesh to provide credit and nonfinancial assistance to rural men and women and improve their economic condition. It is jointly owned by its borrower shareholders and by the government, in a 3:1 ratio. By February 1992, Grameen Bank had over 1.1 million shareholder members and had disbursed $421.5 million and mobilized $40 million in savings through its network of 934 bank branches.

Methodology

GB disburses collateral-free small loans averaging $85 and not exceeding $140 to self-organized homogenous groups of five individuals who are all jointly liable for an individual loan. Borrowers may use the credit in any productive activity, as long as it is invested within seven days of receipt. The principal has to be paid back in 50 weekly installments.

Members are required to save a portion of their loans. Each member has to pay one taka (3 cents) per week into a group fund, along with 5 percent of the loan amount. The group fund earns an

[5] Rhyne and Otero identify four levels of self-sufficiency. Level One: Grants or soft loans cover operating expenses and the establishment of a revolving loan fund. Level Two: Programs raise funds by borrowing on terms closer to but still below market rates, and grants are still required to finance some operating costs. Level Three: Most subsidy is eliminated, but programs are dependent on some element of subsidy, such as sources of capital at below-market rates. Level Four: The program is fully financed from clients' savings and funds raised at commercial rates from formal financial institutions (1991:12).

[6] Information was derived from Hossain, 1988.

TABLE 2

PROGRAM CHARACTERISTICS

CHARACTERISTIC	GRAMEEN	BKK
Year of Data	1985-1987	1989
Program Initiation	1976	1972
Target Group	The poorest	Poor MSEs
Services	Credit and non-financial.	Credit and savings.
Annual Interest Rates	16% nominal; 33% effective.	Varies with loan term, 24-60% nominal.
Average Loan Size	$85	$75
Loan Ceilings	$140	$118-$590
Repayment Rates	98%	98%
Women (% loans)	75%	60%
Targeting Mechanism	Land holdings and assets: HH members with less than 0.5 acres of land, or asset values less than 1 acre.	Loan size: Maintains percentage of loan portfolio that lends below $118.
Lending Methodology	Five-member solidarity groups. Group guaranty, weekly meeting attendance, mandatory savings, 16 Principles.	Tiny individual loans and savings services provided through village-level depots. Character reference from village leader, mandatory savings
Client Graduation	Repeat loans until loan ceiling is reached.	Repeat loans. Clients do not graduate from program.
Personnel	University and high school graduates.	Senior technical high school graduates.
Operating Costs	51% deficit covered by income from deposits of concessional funds.	Covered entirely by interest income. Income exceeds expenditures.
Level of Financial Sustainability*	2	3

* Please refer to footnote 5 on Page 9 for definitions of the levels of self-sufficiency.

annual interest of 8.5 percent, the rate in Bangladesh. Members can borrow from this fund for personal reasons and emergencies. Each borrower must also deposit 25 percent of the total interest payment on a loan into an emergency fund, as insurance against death or disability. Whereas the nominal interest rate of 16 percent is calculated on the total loan, these up-front deductions increase the effective interest rate to 33 percent per year.

Borrowers are graduated from the Bank once they reach the loan ceiling of $140. There is a dearth of financial institutions to bridge the chasm between Grameen Bank graduates and larger wealthy borrowers.

Aside from credit, Grameen provides nonfinancial training. Members are encouraged to abide by Grameen's 16 Principles, which advocate child education, use of latrines, elimination of dowry practices, sanitation and hygiene, and the cultivation of fruits and vegetables for consumption. Members are also required to participate in physical training programs at the weekly meetings.

Scale

The cumulative amount disbursed was $421.5 million. Grameen had reached over 1.1 million households by February 1992. The bank's operations have expanded rapidly, with disbursements increasing on average by 33 percent a year. The bank's outstanding portfolio increased by 62 percent a year from 1983 to 1986. It has succeeded in reaching 26,360 villages throughout Bangladesh.

Operating Costs

Given intensive supervision of borrowers and heavy investments in staff training programs and in social development activities, the bank has high operating costs. The cost of loan operations in 1986 was estimated at 21.7 percent of the loans and advances at the actual cost of funds to the bank, which is highly subsidized by concessional loans from IFAD. This cost would have been 26.5 percent if it had to borrow at the same rate as other financial institutions in Bangladesh. In 1986, income from lending activities covered 61 percent of costs, thus requiring a subsidy of 39 percent. If funds had been borrowed at 8.5 percent—the market cost of capital — the subsidy would have risen to 51 percent.

Prospects for Sustainability

Grameen has financed its income deficit with interest income earned from investing a substantial part of concessional loans received from IFAD in fixed- and short-term deposits with other banks. In 1984, this source of income accounted for one-third of the bank's income, in 1986 for 51 percent.

Dependence on these external funds, and on their availability for investment precludes long-term sustainability based on internally generated income. Interest income from deposits cannot be counted on as a long-term source of income. Grameen's high cost may constrain expansion, unless interest rates are increased, costs are reduced by providing larger loans, or the bank embarks on deposit banking on a large scale.

THE FINANCIAL SYSTEMS APPROACH

Badan Kredit Kecamatan (BKK)

The BKK program was established by the Government of Central Java in 1972 as a weapon to combat rural poverty.[7] BKK's primary goal is to supply capital through a convenient mechanism that charges a reasonable interest rate but still earns a profit. This goal is based on the belief that a viable, self-sustaining financial institution provides good long-term assurance that the rural poor in Central Java will continue to have access to its services to develop off-farm income-generating activities. In 1987 BKK initiated a savings mobilization program.

Methodology

BKKs function as a single system owned and operated by the Central Java Provincial Government and receiving technical assistance from the Central Java Regional Development Bank (BPD). The system is composed of over 500 BKK units, each of which is locally administered and financially independent. Consistent system policies, standards, and procedures are applied, and local accountability and incentives are based on local performance. BKKs provide banking services throughout the province at over 3,000 depots, which conduct all credit transactions, usually on the village market day. BKKs serve a market niche not yet served by other formal savings programs — that is, small-scale village savers. Seventy-five percent of the savers are not BKK borrowers.

Average loan sizes are under $75, with 90 percent of the loans under $60. Loan terms vary from 22 days to one year. Interest rates also vary, the highest rates being charged for the shortest-term loans. The nominal monthly interest rate ranges from 2 percent on six-month loans to 4.8 percent on 22-day loans. Mandatory savings has been a key program component. The percentage that borrowers are required to save ranges from 20 percent for the one-year loans to 6.5 percent for the 22-day loans.

The system has developed a five-point scale to gauge the financial health of BKKs, with I signifying the highest level of financial soundness and V signaling financial distress. Technical assistance to rehabilitate the failing BKKs in Class V was successful in reducing the number of Class V BKKs from 184 units in 1981 to six units in 1989. BKK's relationship with the BPD has been a key factor in its rapid growth. It has served as a constant source of loan capital, technical assistance, and supervision.

BKK has set up a simplified risk classification system to set loan ceilings. In 1988, the 18-year-old system was modified to increase loan terms to one year and maximum loan sizes to $590, based on borrower quality and the class of the BKK unit.

To continue serving the poorest as well as larger clients, loans of more than $118 are limited to half of the total loan portfolio of BKK units in the lower three classes. In addition, a borrower's new loan ceiling is restricted to an increase of 50 percent or less of the previous credit limit. To sufficiently diversify its portfolio and maintain its health, BKK is also cofinancing local enterprises with high economic potential.

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[7] Information on BKK is based on Patten & Rosengard, 1991.

In the Indonesian case, graduates from BKK have a plethora of rural and urban financial systems to revert to. BKK clients could, for example, be absorbed by the BRI banking system, which serves larger clients than BKK.

Scale

The number of BKK units has expanded rapidly from 200 in 1972 to 500 in 1989. It has disbursed over 6.6 million loans over this period, with an average of 75 loans per borrower. BKK units serviced 41 percent of the target villages in Central Java by 1989.

Operating Costs

BKK not only sustains itself financially, but it earns a profit. In 1989, BPD also showed profits on its BKK operations. BKK has covered its expenses and generated a profit in all the years from 1985 to 1989, purely on its income from loan operations.

Prospects for Sustainability

BKK has demonstrated its ability to continue on a financially and operationally self-sustaining and even profitable basis. It does require some grant support for branch supervision, although in 1989 BPD also earned a profit on its BKK operations.

IV. CHARACTERISTICS OF SUCCESSFUL POVERTY LENDING AND FINANCIAL SYSTEMS DEVELOPMENT APPROACHES — PRESCRIPTIONS FOR IMPROVED LENDING TO THE POOR

Successful microenterprise financial programs regardless of approach are based on a similar premise: providing cost-effective, sustainable financial services to microentrepreneurs. Success is also measured by the percentage of the target population reached. This section prescribes some general principles for lending to the poor, drawing on the experience of the Grameen Bank and BKK, discussed in the previous chapter.

The successful few have been able to target a niche not served by traditional commercial nders. The successful ones have been able to understand their clients' financial needs — quick access short-term working capital loans and a safe place to store savings that will maintain the value of the sets. Further, the better programs have recognized that services and the pricing of them should be tablished with the recognition that access to rather than the cost of credit is the primary constraint to poor. The better programs mimic the informal money lender's lending techniques but charge more petitive rates.

They have learned to overcome the constraints of working with the traditional five 'c's of credit — character, collateral, capital, capacity, and conditions. Microenterprise lending programs focus on character or "social equity" and capacity to absorb and repay the loan as the most important borrower characteristics.[9]

They have recognized the high transaction costs to both lenders and borrowers in the traditional commercial bank lending methodology, and have devised innovative solutions to reducing these costs. The costs of appraisal, feasibility analysis, reference checks, and collateral-backed lending would be insurmountable to process loans of the size and with the frequency desired by microentrepreneurs. In turn, microentrepreneurs do not keep records, do not have collateral acceptable to banks, are often illiterate and therefore cannot fill bank application forms and other paperwork, and are further constrained by social and class barriers that restrict their access to formal institutions.

In response to these constraints, alternative lending mechanisms that bypass traditional bank lending criteria, issue small loans, incorporate the incentive of access to larger amounts of credit based on successful and timely repayment of previous loans, incorporate a savings feature to instill financial discipline, and reduce borrowers' transactions costs by taking banking to the poor rather than vice versa have been created.

They have streamlined their activities to such a degree that the costs of lending are commensurate with the size of loans being made. Loan application, approval, disbursement, and collection procedures have been pared down to the barest minimum required to effect the transaction successfully. For example, both Grameen's and BKK's loan applications are less than a page, loan approval takes less than a week, and, in the case of BKK, a repeat borrower gets a loan on the same day that it is requested.

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[9] "social equity" is a term used by Biggs et al. (1990) to refer to the borrower's communal identity and social relations.

Several have incorporated group formation as a program feature, particularly for the poorest clientele, such as that targeted by the Grameen Bank. The group plays a role in reducing the cost of gathering information to the borrower and serves in motivating repayment through shared liability for default. 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 uses a two-tiered structure in which groups determine not only loan eligibility but also loan timing and size. This externalizes tasks and costs that would otherwise be borne by lending staff. Groups also serve as a vehicle for consciousness raising, empowerment, and nutrition and social education (Rhyne and Otero, 1991:8).

They have expressed a commitment to the goal of financial sustainability and devised a plan for achieving it. Patten and Rosengard mention that an important factor contributing to the BKK's success is that the system received donor support only after several years of operation; it did not have to be weaned away from dependence on donor funding.

They devote attention to instilling financial discipline in borrowers. Training staff and current and potential members in the operations of the financial institution is necessary to ensure program success. Both BKK and Grameen invest significant resources in staff training.

They no longer view borrowers as beneficiaries but as clients. More market- and marketing-oriented programs are concerned about how best to meet their clients' needs. They view their own survival in the market as dependent on how well they perform in this respect.

They have devised innovative mechanisms to deter leakages outside of the target clientele as well as to keep sights focused on the poor. Stringent requirements such as enforced weekly meetings, small loan sizes, interest rates higher than those charged by commercial banks, and mandatory participation in a larger social development agenda, as stipulated in the 16 Grameen Principles, weed out participation by the non-needy. BKK's policy of establishing loan ceilings for a certain portion of the portfolio ensures that the poorest will continue to be served, and that the lending institution can have a sound, diversified portfolio made up of a range of loan sizes and borrowers.

The successful ones operate in densely populated areas with relatively well-developed physical infrastructure. This has large implications for reducing costs in terms of serving relatively accessible clients.

They operate in relatively favorable policy environments. Both BKK and Grameen have evolved with much support and little interference from the governments of Indonesia and Bangladesh. BKK's program flourished under the Government of Indonesia's policy reform and economic liberalization measures, which led to the removal of interest rate ceilings, liberalization of the financial sector, and support of rural industries.

BKK's strategy is well summarized by Patten and Rosengard (1991):

"Charge interest rates high enough to cover operating expenses, including the cost of funds; rely on character references from local officials for loan eligibility, rather than on availability of collateral or lengthy staff analyses of a proposed enterprise's feasibility; reduce risk by making small initial loans to a new borrower and then gradually raising that client's credit ceiling as repayment record warrants; use repeat loans as the borrower's primary incentive for full and timely repayment; blend local autonomy with overall program quality control by stressing a highly

decentralized organizational structure with villages as the focus of operations, together with central program technical supervision by the Central Java Regional Development Bank."

This strategy embodies the principles of successful lending to the poor. Many of these characteristic are shared by Grameen and other successful lending programs.

V. OPERATIONAL AND POLICY ISSUES IN POVERTY LENDING PROGRAMS

Increased interest in providing financial services to the poor as a means to alleviate world poverty and emphasis on devising ways to make these programs sustainable have forced examination of some key characteristics of PL programs. Many of these issues have been raised by practitioners of various PL programs.

1. The restricted loan sizes limit investments to the most traditional and least profitable or productive activities. The limited growth potential of clients' enterprises restricts the growth potential of the lending institution, which scales up loan sizes to meet clients' expanding credit needs.

2. While the small size of activities financed leads to income increases, it does not generate new employment. Several PL practitioners question whether they should develop complementary programs to lend to larger enterprises with greater employment generating potential (Inter-PVO Session, 1991).

3. Poverty lending programs face a policy dilemma of whether to gradually give larger and longer loans to meet the growing needs of their clientele and diminish focus on the poorest or whether to target the poorest, even if it means that program graduates have no other mechanism to graduate to.

4. The high costs associated with traditional PL programs may not permit a program to be large enough to have a significant impact on poverty; they may restrict it to serving a handful of borrowers.

5. The few successful programs may not be replicable under different conditions. According to Hossain, the replicable parts of Grameen are the formation of small groups for loan supervision and loan guaranty purposes, loan recovery in small regular installments, and collective savings. Grameen's extensive branch network (400 in 1989) and close interaction with borrowers would be impossible or expensive in sparsely populated areas with underdeveloped infrastructure and transportation.

   Patten and Rosengard caution against the "cookie cutter school of economic development." They stress that BKKs have been operating in one of the most densely populated areas of the world, where, unlike Africa, almost every subdistrict has a critical mass of clients capable of supporting the costs of staffing a BKK office. They caution against its replicability in economically stagnant, sparsely populated, and ethnically diverse areas with poor human and physical infrastructure.

6. Microenterprise practitioners differ on whether the costs of nonfinancial support services should be treated as a social investment in a poor population — that is, as a subsidy — because no provision of financial services, however efficient, can cover these costs, or whether these are legitimate costs of lending to this population, without which borrowers couldn't borrow, and therefore should be treated as program costs, factored into full-cost pricing, and paid for by borrowers (Rhyne and Otero, 1991:13).

7. Some question whether financial programs should incorporate nonfinancial support services provided by other development programs, such as education, health, family planning, and nutrition. The provision of multiple services may diffuse program attention and require a more diverse mix of

management and personnel skills, thereby increasing costs. In addition, keeping costs of the financial and nonfinancial components separate and transparent requires more complex accounting.

8. PL programs are often subsidized with the justification of the long-term social and economic benefits to be generated from such assistance. It is questionable whether continued subsidization is a prerequisite to achieving these social benefits, or whether programs such as BKK have demonstrated otherwise.

9. Although PL programs have begun to address program sustainability, most programs do not have adequate systems to assess their financial health. PL programs typically do not maintain transparent financial operations, which differentiate costs of lending and other operations. A clear plan for financing activities and a system of progressive cost recovery should be laid out at the outset.

10. It is not clear that the poorest are best assisted through financial programs. As Lipton suggests, the poorest 10 to 15 percent of people may require initial help to get over food, health, or labor market thresholds before they can respond to policy stimuli that successfully reach less poor people (Lipton, 1988:7).

VI. FINANCIAL SUSTAINABILITY AND TARGETING THE POOREST: A TRADEOFF?

This section examines whether the PL approach can be financially self-sustaining, and whether lending to the poorest can be financially self-sustaining. Not merely a question of semantics, this examination emphasizes that PL represents only one possible approach to lending to the poorest. The term 'poverty lending' has incorrectly become synonymous with lending to the poorest.

POVERTY LENDING AND SUSTAINABILITY

It appears that PL programs cannot be sustainable within the four-to-six-year time frame that FS programs can. Structural features of PL programs — such as high costs of lending to marginalized groups and unwillingness or inability to charge the interest rates necessary to cover costs, client graduation requirements, low loan ceilings, and the provision of multiple services, both financial and nonfinancial — make sustainability a more difficult goal to achieve.

Limiting credit to a particular target group, such as the poorest, limits the number of potential clients or the size of the market that the program can serve. Sustainability at this small volume of lending would require charging excessively high interest rates to borrowers. A program needs to reach a critical mass of borrowers before it can break even. This is even more true for PL programs, which restrict loan sizes and thus increase the number of loans that would have to be disbursed to generate the volume necessary to break even. Costs are further increased when the poor are dispersed, and thus more difficult to reach.

The client graduation feature of most PL programs undermines sustainability. Most programs restrict the time within which borrowers can borrow, before they are moved out of the project and funds are concentrated on new and poorer clients. The method implies enforcing high client turnover, sending away proven clients in order to assume a whole new set of high-risk, unknown clients. It defies principles of risk diversification, loan portfolio management, and increasing market penetration and share.

However, incorporating the principles of sound financial practices and management that are articulated by the FS approach into PL programs would make these programs better managed and more streamlined, thus lowering the cost of capital to borrowers and improving the prospects for sustainability. At a minimum, these programs need to establish a clear plan for progressively increasing cost recovery over a stipulated period. They need to institutionalize the financial discipline that they seek to instill in their clients.

SUSTAINABILITY AND LENDING TO THE POOREST

Lending to the poorest does not necessarily require a tradeoff with sustainability, as demonstrated by BKK. Adhering to adequate financial management principles as outlined in the FS approach, while maintaining sights on the poor permits the marriage of these seemingly incompatible objectives.

The challenge for programs is to continue to maintain focus on the poor and very poor as they evolve and expand. Programs must resist the temptation to take the easy path to sustainability — concentrating resources on low maintenance larger clients who borrow larger amounts for longer periods.

Although the FS approach is a viable one for lending on a large scale to poor entrepreneurs, it does not ensure that the poorest entrepreneurs will always be reached. The BKKs' success may depend on the unique characteristics of Central Java and not be replicable. Moreover, BKK has also fine-tuned its operations during its two decades of experience.

In conclusion, the microenterprise sector is a heterogeneous one, with a range of participants from the poorest to the poor. There are different approaches, each with different target groups or clienteles, different expected benefits, and different program costs, determined by the different development objectives they aim to reach. The prospects and the time frame for becoming sustainable will consequently differ by approach.

VII. THE BROADER OUTSTANDING ISSUES

Several questions on assisting the poorest and the poor through the provision of financial services are raised below for discussion.

1. Are the poorest best served through lending and the provision of financial services or through other types of poverty alleviation programs — such as those which aim at basic needs fulfillment? Or is PL a partial panacea and reaction to the vast majority of poverty alleviation programs which have failed to reach the poorest?

2. Does reaching the poorest require programs that directly target the very poorest, as the PL approach argues?

3. Are PL programs truly reaching the poorest of the poor?

4. Are PL programs assisting participants to break out of poverty?

5. Can PL programs reach the over 400 million producers in developing countries who the 1990 World Bank Development Report estimates are below the poverty line, 200 million of whom are severely poor?

6. Should the poorest be charged the full costs of lending to them? Is it equitable to charge the poor more than the wealthy for the same services, simply because it costs more to lend to them?

7. Should we strive for full financial sustainability in lending to the poorest? Does it conflict with development objectives or further them?

This paper has raised more issues than it has resolved. In this respect, it hopes to have complied with its original mission of articulating and clarifying the issues.

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