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Transformation Lending:

Helping Microenterprises Become Small Businesses

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Transformation Lending: Helping Microenterprises Become Small Businesses

by

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ABSTRACT

This paper examines how small enterprise credit institutions can support the transformation of microenterprises from the micro sector to the small enterprise sector. It first examines the needs of enterprises undergoing this transformation. These enterprises experience changes in markets, personnel, production, and sources of supply. In addition, many of these enterprises face expanding needs for credit, often in amounts larger and for terms longer than those provided by lending programs that provide only short-term working capital loans.

The paper also reviews five lending institutions that provide loans and (in some cases) training to support microenterprise transformation, analyzing their program design, lending methodology, financial performance, and impact. The paper then summarizes the key lessons that come out of this review and suggests areas where additional research could help credit institutions develop programs aimed at encouraging the growth and transformation of microenterprises.

SECTION ONE

AN INTRODUCTION TO TRANSFORMATION LENDING

Pity the successful microentrepreneur. Farisai is one. She has paid back every short-term working capital loan she received and enlarged her business in the process, but her success has disqualified her from receiving more loans from the microenterprise development agency that supported her. Rodrigo is another. He can triple his production and number of employees, but neither the bank nor the nonprofit credit program he borrowed from before will give him a loan for purchasing the equipment he needs to expand.

Farisai and Rodrigo are caught in what economist Hugo Pirela Martínez calls "the gray area of microenterprise development." Too big for credit programs that provide only short-term working capital, yet still too small to meet the minimum loan amounts or collateral requirements of formal financial institutions, these enterprise find their growth curtailed by a lack of credit available in amounts and terms that meet their expanding needs. Growing microenterprises find that "their success has made them too steep a risk for both the informal and formal finance sectors They are lost in the gray area, a true structural gap in which thriving businesses stagnate, their potential for generating further income and employment curtailed" (Pirela Martínez, 1990).

The irony is that growing enterprises like those owned by Farisai and Rodrigo, according to the microenterprise stocktaking report of the U.S. Agency for International Development, ". . . may offer the greatest potential for reaching the poorest of the poor by creating jobs and for generating the greatest developmental impact by transforming marginal enterprises into sustainable businesses" (Boomgard, 1989).

Although A.I.D. and Pirela Martínez recognize the potential of enterprises operating in the gray area, neither can point to successful examples of programs that support the growth of these enterprises. The same A.I.D. stocktaking report states that "The question of how to reach the enterprise whose needs cannot be satisfied by the minimalist strategy remains unanswered" (Boomgard, 1989). Pirela Martínez states:

> The appropriate question to ask nongovernmental organization (NGO) credit programs emulating informal financial institutions is whether or not NGO credit programs ever help `structurally graduate' a microbusiness. Are they able to aid a microenterprise's capitalization, its growth, its productivity, the deepening of its operational reserves, the expansion of its market share, and the achievement of bank credit-worthiness? If so, how do they do it? How effective are they at the task? There are no quantitative, unambiguous answers to these questions anywhere, and the development community should be looking for them (Pirela Martínez, 1990).

This paper seeks to answer those questions by reviewing five programs that successfully do transformation lending — that is, they make loans and provide services to support the transformation of microenterprises into small businesses. These five programs succeed not only at providing loans and other services that have aided microenterprise transformation, but they also cover all or nearly all of their expenses with earned income.

TRANSFORMATION LENDING: A DEFINITION

The A.I.D. microenterprise stocktaking report divided the microenterprise programs it reviewed into three approaches: enterprise formation, enterprise expansion, and enterprise transformation. The key characteristics of these three approaches are:

- Enterprise formation — seeks to move highly disadvantaged groups from the survival economy into the microeconomy. Provides loans (average size of $500 or less) tied to intensive training and technical assistance;
- Enterprise expansion — seeks to improve the performance of small to medium-sized microenterprises. Provides short-term working capital loans with an average size of $700; and
- Enterprise transformation — seeks to graduate larger microenterprises from the microenterprise sector. Provides working capital and fixed asset loans (average size of $3,000) combined with training (Boomgard, 1989).

Using this typology, the transformation referred to in transformation lending is the movement from micro to small enterprise. For this paper a microenterprise has 10 or fewer workers (most of whom are members of the owner's family); produces simple, unsophisticated products based on traditional technology; and faces intense competition as a result of low barriers to entry. Small enterprises have 10 to 50 workers (many hired from outside the family), produce relatively more complex products involving some sort of innovation in technology, and work in a less competitive environment because of higher barriers to entry.

Thus, microenterprise transformation involves:

- Changes in the means of production and increases in productivity;
- Increases in sales income sufficient to support the addition of new employees;
- Changes in the relationship between the business owner and his or her employees;
- Increases in assets; and
- Increases in specialization.

Transformation lending is the provision of a mix of credit and services that assists microenterprises to increase their assets and productivity to a level similar to that of small businesses in the same economic activity, and thereby increasing their sales, income, and number of employees.

This definition of transformation lending does not equate transformation with either graduation into the formal financial sector or legal incorporation. Achieving these standards requires vastly different levels of cost and effort in different countries, which makes them difficult to use as across-the-board measurements. For example, a microenterprise owner in Indonesia can receive a loan from a commercial bank for as little as $13.50. In other countries the commercial banks will provide loans no smaller than $10,000 and require collateral equal to three times the value of the loan. Similarly, in some countries the process of legal incorporation takes only a few hours and provides legal protection worth the

additional cost of paying taxes. In other countries the process of incorporation takes several months and bribes, and subjects the business to tax rates of 50 percent or more.

For this paper, then, transformation will be defined by increases in assets, productivity, and employment rather than the legal status of the enterprise or its source of financing.

HOW MICROENTERPRISES GROW

Surveys of the microenterprise sectors of more than 25 countries carried out by Michigan State University, the Growth and Equity through Microenterprise Investments and Institutions (GEMINI) Project, and others have shed new light on the prevalence and growth patterns of microenterprises.[1] Some key findings from these studies are noted below.

- Micro and small enterprise (MSE) employees make up a large portion of the total labor force. Liedholm and Mead (1987) report that in 13 of 14 countries reviewed, MSEs accounted for more than 50 percent of the industrial workforce. In their 1992 review of surveys conducted in six countries of Southern and Eastern Africa, Liedholm and Mead found that substantially more people work in MSEs than in the formal economy.

- Most MSEs are very small. In the majority of countries surveyed, one-person firms make up more than half the MSEs (in Southern Africa, one-person firms comprise more than two-thirds of the MSE population). Firms with more than five employees range from 3 percent (Zimbabwe) to 16 percent (Bangladesh) of all MSEs (Liedholm and Mead, 1987 and 1992; McPherson, 1991b).

- MSEs appear and disappear rapidly. In Southern and Eastern Africa, about half of all new MSEs disappear before the end of their third year. Bad business conditions cause only about half of these firm closures; better business opportunities, personal reasons and governmental interventions account for the rest (Liedholm and Mead, 1992).

- Most MSEs don't grow, but a small percentage grow rapidly. In the Southern and Eastern Africa surveys, firms that did not grow (in number of employees) or that shrank ranged from 50 to 80 percent of the total MSE population. Average growth rates for those firms that did experience growth exceeded 40 percent per year (McPherson, 1991b; Fisseha, 1991; Fisseha and McPherson, 1991; Liedholm and McPherson, 1991; Parker and Aleke Dondo, 1991; Daniels and Fisseha, 1992).

- MSEs cite the lack of credit as one of their primary problem areas. Lack of credit ranked first or second among problems perceived by MSE owners. Among credit needs, MSE owners cited working capital needs most often. Between 5 percent and 20 percent of MSE owners who reported problems reported the lack of investment credit as a problem (Liedholm

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[1] These surveys have covered all or parts of the following countries: Bangladesh, Indonesia, Sri Lanka, Korea, Pakistan, the Philippines, Thailand, Taiwan, Malaysia, Indonesia, India, Egypt, Sierra Leone, Ghana, Burkina Faso, Kenya, South Africa, Niger, Nigeria, Botswana, Swaziland, Lesotho, Zambia, Zimbabwe, Jamaica, Haiti, Honduras. Fifteen of these studies have used similar survey methodologies developed by Michigan State University. Many of these studies are summarized in Liedholm and Mead, 1987 and 1992.

and Mead, 1987; McPherson, 1991b; Fisseha, 1991; Fisseha and McPherson, 1991; Liedholm and McPherson, 1991; Parker and Aleke Dondo, 1991; Daniels and Fisseha, 1992).

- Only a small percentage of MSEs receive credit. In most countries surveyed, more than 85 percent of MSEs have never received credit in any form. Formal financial institutions provided credit to less than 2 percent of MSEs (Liedholm and Mead, 1987; McPherson, 1991b; Fisseha, 1991; Fisseha and McPherson, 1991; Liedholm and McPherson, 1991; Parker and Aleke Dondo, 1991; Daniels and Fisseha, 1992).

- Credit can play an important part in the growth of MSEs. In Botswana, 22 percent of the growing enterprises received credit from a formal source, but only 5 percent of the firms that did not grow received this type of credit (Daniels and Fisseha, 1992).

- The capital needs of MSEs vary by business activity. Manufacturing firms have higher investment capital needs (Liedholm and Mead, 1987) and would use loans to purchase tools and equipment more often (Daniels and Fisseha, 1992).

These surveys present a picture of a large and fluid microenterprise sector. Firms start up and disappear at a rapid rate. Of those firms that do survive, most don't grow, while the growing firms grow very rapidly. The growth that does take place occurs largely without access to credit. Credit in amounts and terms appropriate to the needs and activities of various types of MSEs may foster more growth in the MSE sector.

THE NEEDS OF A TRANSFORMING MICROENTERPRISE

Most microenterprises start as fully integrated or highly integrated firms. They grow or collect raw materials or purchase unprocessed goods in bulk and sell them to end users (for example, basket makers and vegetable hawkers). Many microenterprises find they can increase their productivity by restricting themselves to a smaller number of activities within the production and distribution system. They may purchase raw materials from a wholesaler instead of growing or collecting it themselves. They may sell to marketers instead of selling directly to end users (Mead, 1992).

With this increased specialization come many other changes in the operation of the business. These include:

- Personnel — the enterprise moves from primarily family labor, with family members functioning in many different roles, to more hired labor with defined roles. Personnel management and labor relations become concerns of the business owner;

- Marketing — transforming businesses must secure stable markets for their increased production. This often entails expanding beyond small neighborhood markets, selling to formal businesses, and clearly defining the enterprise's comparative advantage;

- Technology — new and larger markets often require higher production quantities and more stringent quality standards. To meet these requirements, microenterprises upgrade their technology. Workers in the enterprise will need to acquire skills appropriate to this change in technology (Jean et al., 1990);

- Supply — with new equipment in place and a larger work force, the enterprise cannot afford to have supply disruptions idle the operations. It needs secure, long-term sources of supply;

- Credit — the greater reliance on processed and purchased raw materials creates an increased need for working capital credit. The need for tools and equipment creates an increased need for fixed asset credit; and

- Cash Management — with increased raw material expenses, more hired labor, and higher investment requirements, transforming businesses must be able to make distinctions between business and household funds.

This review of the needs of transforming enterprises has two key implications for credit programs seeking to support microenterprise transformation. First, these programs must provide credit for both working capital and fixed asset needs. Fixed asset loans must be made in amounts large enough to make equipment purchases and over terms long enough to match the payback period of the equipment. The data in Table 1 show the importance of loan terms to a fixed asset loan. This table assumes a microenterprise with monthly sales of $500 and monthly expenses of $450, leaving $50 in net cash flow each month. This enterprise receives a $1,000 loan at 30 percent interest to purchase equipment. If the enterprise has to repay the loan in three months, it will need to make monthly payments of $350; it will also need to increase cash flow from operations 700 percent to repay the loan and still have $50 left over at the end of the month. On the other hand, if the enterprise can repay the loan in 24 months, it will need to make monthly payments of $56, requiring an increase in cash flow from operations of 112 percent.

The second implication is that credit alone will not cause a microenterprise to transform. Along with credit come needs for changes in business management, production processes, marketing channels, and sources of supply. Some microenterprise owners will already have the skills and knowledge necessary to make this transition. Others will be able to locate, on their own, mentors or training courses that will help them improve their skills to the level where they can successfully manage the transition. Still others will need specialized training or other targeted interventions in order to be able to transform their enterprises. The type and amount of services a transformation lending program might provide depend on which of these microenterprises it targets.

REVIEW OF TRANSFORMATION LENDING PROGRAMS

In the next section of this paper, we describe five programs involved in transformation lending and conclude with two tables giving statistical summaries of these programs. The five programs are:

- The Unit Desa system of Bank Rakyat Indonesia (BRI);
- The Association for the Development of Microenterprises (ADEMI), Dominican Republic;
- The Instituto de Desarrollo Hondureño (IDH);
- The National Development Foundation of Jamaica (NDF/J); and
- The Agence de Crédit pour l'Entreprise Privée (ACEP), Senegal.

These program descriptions are based on reviews of published documents and internal reports, rather than field visits.

TABLE 1

THE EFFECT OF LOAN TERMS ON PAYMENTS AND CASH FLOW REQUIREMENTS

Operating Income	$500			
Operating Expenses	$450			
Net Cash Flow	$50			
Loan Amount	$1,000			
Interest Rate	30.0%			
Term in Months	3	6	12	24
Monthly Payment	$350	$182	$97	$56
Monthly Cash Flow Required*	$400	$232	$147	$106
% Change	700%	363%	195%	112%

*Monthly Cash Flow Required is the Monthly Payment plus the previous Net Cash Flow ($50).

SECTION TWO

A REVIEW OF FIVE TRANSFORMATION LENDING PROGRAMS

BANK RAKYAT INDONESIA - UNIT DESA SYSTEM[2]

BRI (Bank Rakyat Indonesia or Indonesia People's Bank) is one of five state-owned banks in Indonesia. It is one of Indonesia's largest banks, with total assets of $6.5 billion and a loan portfolio of more than $4.7 billion. BRI operates a Unit Desa (Village Unit) system that is the world's largest supplier of credit and savings facilities to microenterprises. From 1984 to mid-1990, the BRI Unit Desa system made 7.9 million loans totaling $2.7 billion, with an average loan size of $340 over the life of the program. In June 1990 the Unit Desa system had 1.8 million loans outstanding totaling $614.5 million. The Unit Desa system also operates 6.7 million savings accounts and has $646.8 million in savings on deposit.

Credit Program

Loan Types and Sizes

The Unit Desa system operates a lending program known as KUPEDES. The KUPEDES program provides two type of loans, working capital and investment, which differ only in the length of the loan terms. Working capital loans range between 3 and 24 months. Investment loans can be for up to 36 months. Eighty-five percent of the loans made in the KUPEDES program have been working capital loans. Loan sizes range from $13.50 to $13,500. Only proven clients who have made full and timely payments on previous loans can receive the maximum amount. The average size loan in 1989 was $437.

Loan Appraisal and Security

Loan appraisal involves simplified procedures for assessing the profitability of the business and the value of collateral. Unit Desa loan managers visit business sites and within two hours complete simple cash flow and balance sheet calculations. From these appraisals the loan managers determine the appropriate loan size.

The heart of the KUPEDES credit program is a progressive lending system that rewards timely repayments. Borrowers who make every loan payment on time automatically qualify for a repeat loan of double the previous loan's size. Each late payment reduces the maximum size of the next loan, and borrowers who make their final payment more than two months late cannot qualify for another loan.

All borrowers must demonstrate that they have collateral sufficient to cover the value of their loans. This collateral may be in the form of land, buildings, other property, or the assignment of wages.

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[2]This section draws heavily on Boomgard and Angell, 1990; and Rhyne, 1991. Other sources are noted in the text.

Borrowers receiving small loans need only give proof that they pay taxes to meet the collateral requirements. Those receiving larger loans must turn over to BRI the titles of the items they pledge as collateral.

Interest Rates

BRI has established a two-tiered interest schedule, charging monthly flat interest rates of 1.5 percent on loan amounts of up to Rp. 3 million and 1 percent on loan amounts above that amount. The effective annual rate for a 12-month loan ranges from 31.7 percent on loans under Rp. 3 million to 22.7 percent for the maximum loan of Rp. 25 million. The KUPEDES program also charges a prompt payment incentive fee of 0.5 percent per month, which it refunds to the borrowers who make all their payments on time.

Lending Performance

The Unit Desa system currently makes 115,000 loans totaling $50.3 million each month. Past due loans equal 5 percent and loan losses 1.2 percent of the portfolio.

Savings Program

The Unit Desa system offers three different savings programs paying interest ranging from 9 percent to 15 percent based on the amount deposited. The most popular of these programs, SIMPEDES, allows savers to make unlimited withdrawals. The Unit Desa system has three and a half times more savers than borrowers and at the end of 1989 total savings on deposit exceeded total loans outstanding by $34 million.

Training Program

The BRI Unit Desa system does not include a training component for borrowers or savers.

Organizational Structure

The BRI Unit Desa system is organized around village units, staffed by four people — a general manager, loan officer, cashier, and bookkeeper. As loan volume increases, the Unit Desa adds staff until it reaches 10 employees. After that the Unit Desa is split in two. If there is significant lending activity in outlying areas, the Unit Desa will set up a Village Post consisting of a cashier and a bookkeeper. BRI pays Unit Desa staff on a scale equivalent with other bank employees. Unit Desa employees tend to be better trained than those of other lending programs in Indonesia serving smaller microenterprises. In June 1990, BRI had 2,893 Unit Desa and 735 Village Posts, employing almost 15,000 people. For every four Unit Desa, BRI operates a Branch Office; 15 Regional Offices supervise the activities of the Branch Offices.

The average Unit Desa maintains a portfolio of 475 loans with outstanding balances totaling $185,000.

Finances

Financial Structure

Savings on deposit, loans bearing market rates of interest, and a grant from the government of Indonesia[3] make up the $535 million loan fund of the Unit Des systema. Since 1989, savings on deposit have exceeded outstanding loans. The Unit Desa system pays an average cost of capital of approximately 12 percent.

Profitability

Prior to the introduction of the KUPEDES lending system, BRI suffered large losses in the Unit Desa system. The KUPEDES program broke even 18 months after its introduction, and has been making money ever since. Profits from the Unit Desa system have quadrupled since 1985, reaching Rp. 36.9 billion ($20.3 million) in 1989.

Impact

A 1988 study for BRI on the impact of the Unit Desa system on its borrowers found that:

- Profits grew in real terms at an average annual rate of 24.6 percent;
- Total household income grew in real terms at an average annual rate of 20.7 percent;
- Workers per enterprise grew from 3.4 to 5.6 (18.2 percent per year) and labor hours per enterprise grew from 5,590 to 10,080 (22.5 percent per year);
- Wage rates grew in real terms at an average annual rate of 2.9 percent; and
- Enterprise employment and household income grew most rapidly with loans above Rp. 1,000,000 ($539) (Sutoro, 1990).

The percentage of women receiving KUPEDES loans (25 percent) is high by Indonesian banking standards, but low when compared to programs that target smaller microenterprises (for example, the BKK program in Indonesia, with an average outstanding loan of $25, makes more than 60 percent of its loans to women).

The BRI Unit Desa System and Transformation Lending

The rural credit system offered by the Unit Desa system of BRI is primarily an enterprise expansion program. The Unit Desa make primarily short-term working capital loans. However, even with only 15 percent its loans in the investment category, the Unit Desa system ranks as one of the world's largest suppliers of fixed asset credit to microenterprises.

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[3] The grant from the government came in 1984 and makes up only 4 percent of the current loan portfolio.

Four key aspects of the KUPEDES lending program make it useful to enterprises undergoing transformation.

1. The practice of providing loans of increasing size to borrowers with good repayment records allows businesses in the KUPEDES loan program to increase the size of their businesses with each successive loan.

2. KUPEDES allows loans for investment or the purchase of fixed assets.

3. KUPEDES provides these loans in amounts sufficient for the purchase of fixed assets. KUPEDES' maximum loan amount of $13,500 is the third highest of the five programs reviewed in this paper.

4. KUPEDES provides these loans with repayment schedules of up to three years, giving the borrower sufficient time to recoup his or her investment in new equipment.

BRI has found that these larger-sized loans both increase the profitability of the Unit Desa system and also support enterprises that have a large impact on enterprise employment and household income.

Because the Unit Desa system does not offer training to its borrowers, it limits investment loans to those borrowers who do not need training or who are able to receive training elsewhere. With the Unit Desa system making 200,000 investment loans per year at present, it is still reaching a large number of enterprises beginning to move from microenterprise to small business status.

It is possible to look at the vast number of short-term working capital loans made by the Unit Desa as a huge screening system for transformation loans. Almost 9 out of 10 borrowers cannot make the transformation without additional assistance. But for those entrepreneurs who have the drive, skills, and know-how needed to turn their microenterprises into small businesses, the Unit Desa system has a credit vehicle to support that transformation.

ADEMI[4]

The Association for the Development of Microenterprises (ADEMI), located in Santo Domingo, Dominican Republic, began operations in 1983 with support from ACCION International, a U.S.-based private voluntary organization. From the beginning ADEMI has aimed to create jobs and increase incomes in the informal sector by providing credit to microenterprises. From 1983 until the end of 1991, ADEMI made 36,377 loans for a total value of $20 million.

Credit Methodology

Loan Types and Sizes

When ADEMI first started it provided only working capital loans to both individual microenterprises and solidarity groups. It now provides both working capital and fixed asset loans, but only to individual microenterprises (which it defines as businesses operating for at least one year, with six or fewer employees and less than US$1,600 in fixed assets). Loans for working capital have terms of 1 to 12 months, while fixed asset loans can have terms of up to 24 months. Loans for working capital range from US$50 to US$500, and for fixed asset purchases from US$800 to US$5,000.

Loan Appraisal and Security

Loan advisers visit potential applicants several time before assisting them to complete a three-page application form. Loans are approved first by the loan adviser, then by his or her Operations Manager and finally by the Finance Manager. Clients receive small (average $135), short-term (1-3 months) loans initially. Loan amounts and terms increase as the borrower successfully repays previous loans (average loan size for repeat loans is US$508). Successful borrowers can stay with ADEMI indefinitely and many have received more than 20 loans from the organization.

ADEMI provides fixed asset loans only for borrowers who have been with the program for several loan cycles and demonstrated their creditworthiness. ADEMI provides more scrutiny to loans of this type to ensure that adding fixed assets is the most appropriate means of increasing the productivity of the enterprise.

All clients receive regular visits from loan officers who monitor the progress of the business and the use of the loan funds.

Interest Rates

ADEMI charges a commission of 8 percent on the loan, paid in advance. It also charges a flat rate of 2.8 percent per month which combines charges for interest and advisory services. ADEMI's effective annual rate equals 74 percent.

[4] This section draws heavily on Lewin, 1991; Poyo et al., 1989; ACCION, 1992; and ADEMI documents.

Lending Performance

At the end of 1991 ADEMI had 8,930 loans outstanding totalling RD $57 million (US$4.5 million), with an arrears rate of 6 percent. ADEMI made 60 percent of these loans to manufacturing businesses, 24 percent to trade, and 16 percent to services and others.

Savings Program

ADEMI does not operate a savings program but does encourage its borrowers to open savings accounts with commercial banks.

Training

ADEMI provides demand-driven technical assistance, responding to needs expressed by borrowers to their loan advisers. If the loan adviser cannot solve the problem, he or she will bring in outside consultants to address it. Technical assistance from ADEMI has covered problem areas in production, marketing, and accounting. In 1989, direct training expenses by ADEMI made up only 3 percent of the total budget (this does not include expenses related to Loan Advisers who provide training as a part of their loan monitoring function).

Organizational Structure

ADEMI divides its organization into three geographic regions. An Operations Manager oversees each region and supervises the activities of a Regional Coordinator and several Loan Advisers. The three Operations Managers report to the Executive Director, as do the Finance Manager and the Manager of Planning.

This organizational structure, adopted in 1987, delegates considerable responsibility to the Loan Advisers, giving them more authority in selecting and approving loans. Each Loan Adviser processes 15 loans per month. The average adviser's portfolio consists of 90 to 140 borrowers and US$30,000 in loans. ADEMI provides bonus payments to Loan Advisers based on the performance of their portfolio. Advisers can increase their salaries by up to 50 percent through these bonuses. In 1989 ADEMI had a staff of 96, 70 of whom were field officers.

Finances

Financial Structure

ADEMI has financed its loan portfolio primarily out of borrowed funds. At the end of 1989 ADEMI had borrowed nearly RD$10 million (US$1.67 million) with an average cost of funds of 10 percent.

Profitability

Since 1986, ADEMI's income from interest and fees has exceeded its operating expenses. Since 1988, ADEMI's interest and fee income has exceeded all expenses, including depreciation and loan write-offs. In 1989 grant income made up only 5 percent of ADEMI's total income.

Impact

ADEMI's records show that from 1983 to 1989 the microenterprises receiving ADEMI loans strengthened 31,155 existing jobs and created 8,745 new jobs. Women have received 38 percent of ADEMI's loans.

According to a survey ADEMI made of 100 borrowers, as loan amounts and terms increase so do the number of new jobs in the microenterprise. On average a microentrepreneur who has received 10 loans creates four new jobs; 15 loans, 12 jobs; and 20 loans, 16 jobs. ADEMI has found that employment creation has been highest among the larger microenterprises it supports and in manufacturing enterprises.

ADEMI's impact survey also shows that the average fixed assets of an ADEMI borrower have increased from RD$4,635 to RD$13,563 in real terms, an increase of 192 percent. Profits also increased dramatically, most significantly for those receiving six or more loans. These borrowers increased their profits by at least 175 percent in real terms, with borrowers who received 11-15 loans increasing their profits 267 percent.

In 1991 women held 38 percent of ADEMI's active loans.

ADEMI and Transformation Lending

ADEMI did not begin as a transformation lending program. At the start it provided short-term working capital to fund the expansion of microenterprises. Enterprise expansion loans still make up the largest share of ADEMI's portfolio. However, as the businesses supported by ADEMI grew, their needs changed and ADEMI adapted its practices to meet these changing needs. ADEMI's credit system can now support a microenterprise that is transforming itself into a small business.

ADEMI made three important decisions in this transition from an organization that funded only enterprise expansion loans to one that includes transformation lending. First, ADEMI phased out its solidarity group lending methodology so that, by 1987, all ADEMI loans went to individuals. The Dominican Republic Field Assessment of the A.I.D. microenterprise stocktaking report explained the reasons for this decision:

> Given its limited resources, ADEMI believed that it could have a wider and more sustainable impact on somewhat larger microenterprises than solidarity groups. ADEMI's own surveys showed that the individual enterprises had higher income and employment generation capacities. Service costs for microenterprises were projected to be lower. For ADEMI, given its initial limited institutional endowments, the promotion of individual and somewhat larger enterprises, rather than the smaller enterprises involved in solidarity groups was a more cost effective way of achieving its objectives (Poyo et al., 1989).

The second important decision came in 1988 when ADEMI abandoned its goal of graduating clients to the formal financial sector. This came about for two reasons. First, ADEMI had made several attempts to get commercial banks to take on ADEMI's most successful borrowers, including setting up a guarantee fund to limit the risk to the banks. However, except for a very small number of cases, banks showed no interest in assuming the higher transaction costs of lending to microenterprises graduating from ADEMI's program. Instead, the bank offered to lend ADEMI money at below market rates and allow ADEMI to operate as a financial intermediary for these larger clients.

Second, it did not make financial sense for ADEMI to abandon its least risky and least costly clients to the banks. ADEMI enhanced its financial viability by retaining these larger clients. Indeed, the income earned from making large loans to proven clients contributed to ADEMI's improving financial performance.

ADEMI's third important decision came as a natural consequence of the second. The larger businesses receiving support from ADEMI sought to expand their production by purchasing equipment. They required loans large enough to make the purchase and long enough to match the payback period on equipment purchases. ADEMI decided to allow loans for fixed asset purchases, increased the maximum loan size to US$5,000 and the maximum loan term to 24 months, and provided a grace period of one to three months.

Despite these changes, ADEMI has remained focused on what it does best — providing credit quickly and efficiently. It has not added extensive training programs for larger businesses or additional services for its larger clients. The loan processing and monitoring system for fixed asset loans builds on the system for short-term working capital loans. However, by increasing the maximum amount it lends, lengthening loan terms, and allowing fixed asset loans, ADEMI has developed a credit system that supports enterprise transformation.

The impact statistics cited earlier show that enterprise transformation is taking place. The average business supported by ADEMI has doubled the size of its asset base. Microenterprises that received 20 loans from ADEMI added 16 new employees on average. Microenterprises employing only a few family members, through a series of loans from ADEMI grow into successful small businesses with 20 or 30 employees, a secure asset base, and the ability to adapt to a changing economic environment.

INSTITUTO DE DESARROLLO HONDUREÑO[5]

The Instituto de Desarrollo Hondureño (IDH) began in 1978 with funding and technical support from OPPORTUNITY International, a U.S.-based private voluntary organization. From the beginning IDH focused on transformation lending. It required a detailed business plan from each applicant and also required that the business demonstrate the ability to grow and create new employment. IDH sought to provide financial assistance that would move businesses into the formal financial sector and, in the first few years, did not provide any second loans to its borrowers.

Growth of the loan fund, experience with its lending model, the desire of IDH's board to reach poorer clientele, and pressure from donor agencies led IDH to alter its emphasis and methodologies. As its loan fund grew, IDH found it difficult to locate borrowers who met its qualifications. It also found that the commercial banks would not provide loans to its successful borrowers. At the same time, several board members expressed concern that the IDH's high collateral requirements excluded the poor from receiving loans. During this same period donor agencies began to focus more on the poorest of the poor and self-sufficiency for credit programs. All of this led IDH to revamp its credit methodology so that it would be able to reach poor clientele on a cost-effective basis while still providing loans that foster enterprise growth and transformation.

From 1979 to 1991 IDH made 3,599 loans totaling US$4.2 million.

Credit Program

Loan Types and Sizes

IDH now operates three distinct lending programs:

- Individual loans of up to US$10,000 for working capital or fixed assets with terms of up to two years. Individual loans average $900 with a payback period of 15 months;
- Group loans made to other organizations (cooperatives and community development organizations) seeking to assist people in very poor communities to start businesses. Each group has at least 60 members. Loans average $200 per person with terms of two years; and
- Community bank loans to groups of around 30 people located in the major open market of Tegucigalpa. Community bank loans average $120 per person and are paid back in three months.

[5]This section is based on IDH's annual reports and internal documents and interviews with IDH staff.

Loan Appraisal and Security

Individual loans require significant investigation prior to disbursement, including an application of several pages. Community bank loans require very little documentation. With group loans the social welfare organization receiving the funds does all of the identification and screening of potential clients.

All loans require some form of guarantee, which may be collateral or a qualified cosigner (including joint guarantees by group members). Clients who graduate from the group loan or community bank programs can qualify for individual loans.

Interest Rates

IDH charges 24 percent interest on individual loans plus a 3 percent commission, giving it an effective rate of 29 percent. It also charges 24 percent to community banks. IDH charges a subsidized rate of 5 percent on group loans, based on a condition established by the donor agency providing the funds for these loans. This donor also provides IDH with a subsidy to cover the costs of the supervision of this program.

Lending Performance

In 1991 IDH made 700 individual loans, 60 community bank loans, and 12 group loans, giving it a total of more than 3,000 clients. IDH lent $530,000 in 1991 and has an outstanding portfolio of $618,000. IDH has an arrears rate of 20 percent and a default rate of 7 percent (IDH changed its default policy in 1991, causing it to write off a large number of large loans and giving it an abnormally high default rate for the year).

Savings Program

The community bank methodology used by IDH incorporates savings by the community. Participants in the community bank must contribute savings to the bank until their combined savings equals or exceeds the amount of the loan from IDH. IDH has found that after three years the community bank participants have saved enough to cover all of their credit needs and no longer require a loan from IDH.

Training Program

IDH offers training courses in basic business management and in technical areas such as sewing, carpentry, baking, and agriculture. Borrowers attend these courses on a voluntary basis and pay fees that cover the direct cost of providing the training. IDH opens these training courses to the general public as a means of earning revenue and attracting qualified loan candidates.

Participants in the community bank program must attend a training session on how to organize and run a community bank before they receive their loan.

Organizational Structure

IDH employs nine project supervisors to oversee the individual loan program, four supervisors for the community banks, and one supervisor for the group loans. In both the individual loan and community bank programs, each project supervisor manages an average portfolio of $55,000, while the group loans supervisor manages more than $100,000 in loans.

IDH operates from a central office in Tegucigalpa and four branch offices. It employs 22 people in total.

Financial Performance

Financial Structure

IDH's loan portfolio is made up of grants from international and local donors, reinvested earnings, and subsidized loans from the InterAmerican Development Bank and the InterAmerican Foundation. IDH pays an average cost of capital of less than 1 percent.

Profitability

IDH's total expenses exceeded its operating income (interest, fees, and commissions) by $15,000 in 1991. Donated funds to subsidize the expansion of the community banks and group loan programs more than made up for this deficit, giving IDH a "profit" of $20,000 for the year. However, this excess of income over expenses is not sufficient to cover the devaluation of the loan fund due to inflation.

Impact

IDH reports that its loans helped to create 1,452 jobs in 1991 and 8,295 jobs since 1979. On average, an IDH borrower creates a new job for every $366 IDH lends. IDH uses stringent criteria to determine job creation. Each job represents a full-time-equivalent employee whose job did not exist before the loan and who is observed at work by an IDH project supervisor.

IDH gives anecdotal evidence of clients who have graduated into the formal sector, but does not track this phenomenon in a formal way.

IDH and Transformation Lending

IDH has followed a course almost opposite to that of ADEMI in the development of its program methodology. At the start, IDH focused solely on transformation loans. It provided loans and training to larger enterprises with the goal of moving these enterprises into the formal financial sector. It used extensive screening procedures to identify larger microenterprises with the potential for making this transformation. However, IDH found that banks did not want to lend to successful IDH borrowers and the extensive screening procedures excluded poorer microenterprise owners from receiving loans. It also found the lending methodologies it developed for larger microenterprises expensive and ineffective when dealing with smaller loans. IDH responded by developing community bank programs for the smallest

microenterprises and group lending systems for slightly larger enterprises. These programs for smaller enterprises give IDH access to more clients and help develop clients for its larger individual loans. Successful borrowers from the community bank and group lending programs who demonstrate good growth potential graduate to the individual loans programs, where they can receive larger loans over longer periods of time.

IDH augments its credit activities with training programs. Through the training, borrowers can acquire the additional knowledge and skills they may need to expand their businesses. IDH does not require its borrowers to attend the training programs and charges fees that cover the direct costs of the training. Despite this, the number of participants in the training program equals 74 percent of the number of outstanding borrowers.

With this system, IDH supports the smallest to the largest microenterprises, assisting them to grow and create new employment.

NATIONAL DEVELOPMENT FOUNDATION OF JAMAICA[6]

The National Development Foundation of Jamaica (NDF/J) was founded in 1981 with the assistance of the Pan American Development Foundation, a U.S.-based private voluntary organization. NDF/J defines its mission as promoting the growth of the small enterprise sector through the provision of nontraditional credit, training, and technical services. NDF/J began lending in Kingston and has branched out into other urban and rural areas of Jamaica. From 1981 to 1990, NDF/J made 3,361 loans totaling US$6.7 million.

Credit Program

Loan Types and Sizes

NDF/J lends to individuals and groups for working capital and fixed asset purchases. NDF/J provides loans in amounts up to $35,000 and for periods of up to 10 years.

Loan Appraisal and Security

NDF/J's screening process includes an initial interview and a loan application of three pages. Next comes an appraisal by a Field Officer that covers the viability of the enterprise, the purpose of the loan, the character of the borrower, and the security offered by the borrower. NDF/J does not require borrowers to complete a series of small loans before they can qualify for larger fixed asset loans. A borrower may receive a large first loan from NDF/J if he or she can meet the screening requirements.

When NDF/J started, it based its lending decisions primarily on the character of the borrower and the viability of the enterprise. Over time NDF/J has come to rely more on hard collateral and loan guarantees in assessing the security of a loan (Stroh, 1896). NDF/J's Field Officers provide follow-up to borrowers, conducting monitoring visits on a regular basis to advise borrowers and assess the performance of the business.

Interest Rates

NDF/J charges a three-tiered interest rate based on the sector of the business: 18 percent to agricultural enterprises, 26 percent to manufacturing, and 30 percent to services and trade (reducing balance method). It also charges a 6 percent processing fee and 3 percent for insurance. This translates to effective interest rates to the borrower of 23 percent for agriculture, 32 percent for manufacturing, and 36 percent for trade and service.

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[6]This section draws heavily on NDF/J annual reports and interviews with NDF/J staff. Other sources are noted in the text.

Lending Performance

During 1990 NDF/J made 604 loans totaling J$28 million (US$2.6 million). NDF/J's loan portfolio at the end of 1990 totaled J$50 million (US$4.6 million). NDF/J makes about half of its loans for business expansion and the other half for new start-ups (Wieland, 1990). Fifty-six percent of NDF/J's loan portfolio has gone to businesses in the service and commerce sector, 22 percent to manufacturing, and 21 percent to agriculture. Loan losses totaled 2.1 percent of the portfolio in 1990, a marked decrease from a high of more than 7 percent in 1985. NDF/J officials report an arrears rate of 11 percent at the end of 1991. They also report that smaller loans (under US$500) had the highest delinquencies (38 percent at the end of 1991) while also requiring more time and services from loan monitors.

Savings Program

NDF/J does not operate a savings program, but does encourage its borrowers to save at commercial financial institutions.

Training Program

Training has always been a key component of NDF/J's program. NDF/J operates a separate Technical Services and Training (TST) unit to service the training needs of its clients. The TST unit provides a six-hour training program covering NDF/J's policies and basic business management for all new loan recipients. In addition, all loan recipients qualify for up to 20 hours of one-to-one business counselling services from TST.

In addition to these basic training services, NDF/J also conducts seminars on entrepreneurship, provides specialized agricultural training, and carries out surveys of borrowers broken down by gender or economic subsector. NDF/J recently added the Business Development Program to help small enterprises expand their markets both locally and internationally. NDF/J charges a consulting fee for these services and makes them available to all small enterprises on the island, regardless of whether they receive a loan from the credit program.

Organizational Structure

NDF/J operates, from a head office, four branch offices and six sub-branches. All lending activity takes place in the branch and sub-branch offices. The head office carries out administrative, fund raising, publicity, and financial functions. NDF/J operates two distinct divisions, Banking Operations and Technical Services and Training. The Banking Operations cover loan approval, disbursement, and collection, while Technical Services and Training provides training and other support services to the Banking Operations Division and its clients.

NDF/J Field Officers make loan appraisals and present loans for approval. Business Counselors provide ongoing monitoring of the loans and consulting to the borrowers. Loan approvals may be made by the Branch Manager, Operations Manager, Executive Director, or Credit Committee of the Board, depending on the size of the loan.

Financial Performance

Financial Structure

Borrowed funds make up 45 percent of the NDF/J portfolio and have interest rates ranging from 1 to 10 percent. This gives NDF/J an average cost of capital of 3 percent.

Profitability

In 1989 NDF/J earned enough from interest income to cover the expenses of the credit program.[7] In 1990, earned income, including income from the endowment fund, exceeded all expenses by J$764,943 (about US$70,000). Earned income includes the proceeds of an endowment fund set up to cover some of the costs of the Technical Services and Training Unit. In 1990, income from the fund covered 69 percent of training expenses.

NDF/J's income provides enough to cover its operating costs but not enough to cover the effects of inflation on the loan portfolio. A recent analysis conducted by Peat Marwick concluded that NDF/J would need annual increases in the size of its portfolio of 22 percent in order to maintain financial viability.

Impact

NDF/J reports that its loans have created more than 16,000 new jobs since 1981. On average, each loan creates four new jobs. NDF/J has also trained more than 18,000 people. In addition, NDF/J conducts entrepreneurship and business management seminars for the entire small business community in which most of the participants are not NDF/J clients. The extent of the impact of these training programs remains unstudied.

NDF/J and Transformation Lending

In the Jamaican economy, NDF/J operates as a bridge between the microenterprise sector and the formal financial sector. Most of its clients enter the program as large microenterprises and those that grow beyond NDF/J's maximum loan amount have attained a large-enough size to qualify for a loan from a commercial bank.

NDF/J's program focuses on supporting microenterprise transformation. Its high maximum loan amounts, long payback periods, and well-defined training program support the growth of microenterprises into small businesses. Although these aspects of the program allow for microenterprise transformation, NDF/J's focus on financial viability has increased its average loan size and made it less accessible to smaller microenterprises.

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[7] NDF/J attributes some costs to the Technical Services and Training unit that might be considered costs of the credit program. For example, NDF/J includes 60 percent of the salaries of the Project Development, Loan Monitoring and Collections Officers in the TST unit (Wieland et al., 1990).

NDF/J also reports difficulties with its loans to the smaller microenterprises. These loans require the most services, provide the least income, and have the highest arrears rates in the portfolio. This is not unusual for lending programs designed for larger-sized loans. Programs that do not start such microenterprises with very small and very short-term working capital loans (such as ADEMI and BRI) and that do not differentiate their lending methodology for the smaller microenterprises (such as IDH) often have poor results with their lending to this sector.

Transformation of the smaller microenterprises is still possible, however, to the extent that NDF/J coordinates with other microenterprise programs in Jamaica lending to the lower end of the microenterprise sector.

AGENCE DE CREDIT POUR L'ENTREPRISE PRIVEE[8]

The Agence de Crédit Pour l'Entreprise Privée (ACEP) began operations in 1986 as the Small Scale Enterprise component of a USAID-financed Community and Enterprise Development Project. USAID established the program to provide commercial loans to small and medium-sized Senegalese businesses. By the end of 1993, USAID expected to convert the program into a permanent financial institution.

After operating the SSE program for three years, USAID determined that Senegalese small enterprises could effectively use credit to expand their businesses, but that the program would need to expand substantially if it was going to achieve financial viability. This led to a reorganization of the program, a move of the office from Kaolack (a city in the interior of the country) to Dakar, the establishment of a branch network, and the hiring of a new expatriate director.

Credit Program

Loan Types and Sizes

ACEP makes loans to individual enterprises for both working capital and fixed asset purchases. It lends only to existing enterprises with a proved track records, though in some cases it will provide loans for the start-up of businesses introducing a new technology or product. ACEP establishes a monthly repayment schedule for its loans, and provides loams for a maximum of 16 months. ACEP lends up to US$12,000 for first-time borrowers and US$20,000 for subsequent loans.

Loan Appraisal and Security

ACEP Branch Managers take loan applications, visit the business sites of the applicants, and make recommendations on loan approval to the ACEP Loan Committee. The Loan Committee, made up of the ACEP Director, the head of the Legal Department, and the Regional Managers, makes all loan approval decisions. Loan applications must receive the unanimous support of the Loan Committee to be approved.

Borrowers must secure their loans with collateral, guarantees, or both. ACEP accepts real property, equipment, accounts receivable, and personal assets as collateral. ACEP also accepts third party guarantees from individuals or institutions. ACEP's Legal Department reviews the collateral as part of the loan approval process and formally registers the collateral after loan approval. All ACEP borrowers must take out a life insurance policy for the amount of the loan with ACEP listed as the beneficiary. Guarantors must take out similar life insurance policies. Borrowers with payments more than five days late must pay a penalty of 2 percent per month on the amount in arrears plus an administrative fee equivalent to US$10.

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[8]This section is based on Rolf, 1992, and interviews with the ACEP Director.

Interest Rates

ACEP charges the maximum interest rate allowed by the Senegalese government, which is 16 percent simple (flat) interest. In addition, ACEP charges an origination fee equal to 1 percent of the loan amount. This translates to a 28 percent annual percentage rate. For loans that use accounts receivable as their collateral, ACEP charges an additional 3 percent commission to cover the additional risk involved.

Training

ACEP does not operate a training program.

Operational Structure

ACEP has developed a network of 14 branch offices located in five regions (Kaolack, Fatick, Louga, Thiès, and Dakar) and employs 26 professionals. Branch offices generally contain only one employee operating from a store front office. Branch Managers produce the loan applications, and monitor client enterprises and follow-up on late paying clients. On average each Branch Manager generates US$280,000 in loans each year and maintains a portfolio of 100 clients. ACEP provides its Branch Managers an annual bonus equal to 5 percent of the profits generated by their branch.

The Regional Manager supervises the activities of the branches in his or her region. The Regional Manager will review the loan applications and check the data presented in the application forms. Each regional office contains a cashier's office where clients make their loan payments. In cases where branch offices are located far from the regional offices, Branch Mangers may also serve as cashiers.

ACEP maintains a Legal Department that checks and registers collateral and takes any necessary legal action against clients who have defaulted on their loans. An accounting office, located at ACEP's headquarters in Dakar, performs all accounting functions based on reports submitted by the branch and regional offices. An audit unit conducts periodic checks on the financial reporting provided by the Branch and Regional Offices.

Lending Performance

In FY 1991, ACEP made 1,373 loans totaling US$3.9 million. Since 1986, ACEP has made 2,142 loans totaling $7.8 million to 1,710 different businesses.

In FY 1991, ACEP's average loan size was $2,800 and average loan term was eight months. Forty percent of ACEP's loans go to agricultural businesses, 27 percent to general commerce, 17 percent to manufacturing, 10 percent to agricultural commerce, and 6 percent to agriculture. ACEP's loan write-offs in FY 1991 amounted to 2 percent of its outstanding portfolio. ACEP does not report its arrears rate, but it did not reschedule any loans over the course of the year.

Finances

Financial Structure

At the beginning of 1992, donated funds made up all of ACEP's loan portfolio. ACEP has begun the process of converting itself into a credit union owned by the proprietors of small-scale enterprises in Senegal. ACEP plans to fund future growth with the savings of the credit union members.

Profitability

In FY 1991 ACEP earned $423,077 in interest and fee income and incurred $370,237 in operating expenses, giving it a profit of $52,840 for the year. FY 1991 marked the first year that ACEP's income exceeded its expenses. Earned income amounted to 40 percent of operating expenses in FY 1989 and 50 percent in FY 1990. These expense figures do not reflect two subsidies that ACEP receives. First, ACEP does not have to pay the salary of its Director, and, second, it does not pay any cost of capital.

Impact

ACEP has established the following profile of its clients:

- Most come from the informal sector;
- Most receive their first formal credit from ACEP; and
- 65 percent never received formal education.

The average enterprise receiving an ACEP loan employs 4.6 people and has assets of US$19,000. In FY 1991 ACEP-supported enterprises created 1,301 new jobs (however, ACEP does not differentiate between permanent, temporary, and trainee jobs). ACEP does not have data on the increases in assets and income achieved by its clients.

Women received 23 percent of the loans made and 11 percent of the amount lent by ACEP in FY 1991. The value of the loans received by women average half that of loans received by men. ACEP gives two reasons to explain this: (1) on average, businesses owned by women in Senegal are much smaller than those owned by men; and (2) women do not have sufficient collateral to guarantee larger loans. ACEP will attempt to redress this problem by allowing group guarantees to take the place of collateral for women.

ACEP and Transformation Lending

ACEP has designed a program that supports the credit needs of enterprise at the upper end of the microenterprise scale and the lower end of the small business scale. By providing loans in large amounts (up to US$20,000) it provides the capital needed for the transformation of microenterprises. However, the maximum loan term of 16 months may limit the number of manufacturing businesses that can make effective use of the credit provided by ACEP.

Because ACEP provides no training, its clients must have the knowledge and skills needed to make the transformation on their own or know how to acquire whatever training they might need elsewhere.

In contrast to some of the other programs we have reviewed, ACEP has no small loan feeder system that helps it establish the creditworthiness of a client before it makes a big loan. Instead, ACEP secures its loan by requiring full collateral or guarantees. This generates additional costs for evaluating and registering the collateral on each loan. However, with its large average loan size (US$2,800), ACEP generates sufficient revenue on each loan to cover these additional costs.

ACEP has found that its collateral requirements exclude many smaller microenterprises, especially those enterprises run by women. ACEP realizes that reaching these smaller enterprises will require some changes in its lending methodologies.

Tables 2 and 3, which follow, summarize the information presented in this section.

TABLE 2

COMPARISON OF PROGRAMS
METHODOLOGY, TRAINING, AND PROGRAM PERFORMANCE

	BRI Unit Desa	ADEMI	IDH	NDF/J	ACEP
Background					
Year Started	1984	1983	1979	1981	1986
Year of Data	1990	1989	1991	1990	1991
Program Methodology					
Loans to Groups	No	No	Yes	Yes	No
Loans to Individuals	Yes	Yes	Yes	Yes	Yes
Maximum Loan Size	$13,500	$5,000	$10,000	$35,000	20,000
Max. Loan Term in Months	36	24	36	120	16
Average Loan Size	$419	$544	$683	$6,870	$2,877
Avg. Loan Term in Months	11	6	14	48	8
Effective Interest Rates*	32%**	74%	29%	32%**	31%
Training					
Has Training Program	No	Yes	Yes	Yes	No
Training Costs as % of Total	0%	3%	8%	24%	0%
Program Performance					
# of Loans Made/Year	1,379,000	7,619	778	562	1,373
Value of Loans/Year (000s)	$576,437	$4,142	$531	$3,861	$3,950

*Effective Interest Rates include commission and fees charges and are calculated using the average loan term for each program.
**Program uses tiered interest rate structure. Number given is the average rate.

Sources: BRI: Boomgard and Angell, 1990. ADEMI: Lewin, 1991. IDH: IDH, 1992. NDF/J: NDF/J, 1992. ACEP: Rolf, 1992.

TABLE 3

COMPARISON OF PROGRAMS
FINANCIAL PERFORMANCE, ORGANIZATIONAL STRUCTURE, AND IMPACT

	BRI Unit Desa	ADEMI	IDH	NDF/J	ACEP
Financial Performance					
Loan Portfolio (000s)	$535,040	$2,119	$618	$4,505	$2,570
Interest and Fee Income (000s)	$159,700	$945	$119	$1,015	$423
Total Expenses (000s)	$133,760	$643	$119	$946	$370
Earnings (000s)	$25,940	$302	$0	$70	$53
Cost/$ in Portfolio	$0.25	$0.30	$0.19	$0.21	$0.14
Income/$ in Portfolio	$0.30	$0.45	$0.19	$0.23	$0.16
Return on Average Assets	3.5%	14.6%	0.0%	1.1%	1.8%*
Average Cost of Capital	12.0%	8.0%	0.5%*	3.0%	0.0%
Arrears Rate	5.1%	10.2%	20.3%	11.0%	NA
Default Rate	1.2%	1.2%	7.1%	2.1%	2.0%
Organizational Structure					
Number of Branches	3,628	20	5	4	14
Loan Officers	10,950	70	14	23	14
Loans/Loan Officer	126	109	56	24	98
Loan Portfolio/Loan Officer	$52,825	$30,271	$44,143	$195,870	$183,571
Impact					
Jobs Created/Year	540,127*	2,011	1,452	2,675	1,301
Amt. Loaned/Job Created	$1,071	$2,060	$366	$1,443	$3,036
% of Loans to Women	25%	35%	74%	NA	23%
Total Beneficiaries/Year**	1,168,951*	4,555	2,230	3,237	2,674
Loan Portfolio/Beneficiary	$458	$465	$277	$1,392	$961

*Estimates
**Total Beneficiaries/Year equals new clients plus new jobs created in year.

SECTION THREE

KEY LESSONS

This review of five credit programs gives us new insight into the way lending institutions can support the transformation of microenterprises into small businesses. The key lessons learned from this review are given below.

1. Microenterprise lending programs can serve the needs of transforming enterprises in a financially viable way.

Liedholm and Mead (1987) state, "Those projects that have attempted to provide long-term, fixed asset lending to small firms have, with few exceptions, proved to be both unfruitful and high in administrative costs." In contrast to that assessment, this paper presents five programs that provide fixed asset loans in combination with working capital loans and in which income meets or exceeds expenses. Four of the five programs have returns on average assets that meet or exceed the 1 percent standard set by international banks (see Boomgard and Angell, 1991).

According to the typology of self-sufficiency levels developed by Rhyne and Otero (1992), two programs (IDH and ACEP) operate at Level Two, two programs (ADEMI and NDF/J) operate at Level Three, and one (BRI) operates at Level Four.

2. Successful transformation lending programs have characteristics in common with all successful providers of credit.

No matter what target group a credit program seeks to serve, it must obey certain principles of cost-effective credit delivery. These characteristics of successful credit programs include:

- Simple, streamlined procedures. All five programs have developed standardized lending procedures that speed the process of loan analysis and approval;

- Good information systems. All five programs maintain computerized information systems that provide regular and timely reports on loan repayments, arrears, income, and expenses;

- Loan costs commensurate with loan income. The five programs vary widely in number of loans per loan officer (24-156) and loan portfolio per loan officer ($30,000-$195,000). However, in all cases, the amount of work that goes into screening and monitoring a loan is in proportion to the amount of income earned from that loan. Those programs with smaller loan portfolios per loan officer (BRI, ADEMI, and IDH) have the simplest screening and monitoring procedures. Those program with more extensive screening, monitoring, or training programs (NDF/J and ACEP) offset these costs with higher average portfolios per loan officer;

- Decentralized program structures. All five programs operate from several branches. In four of the five the branch office level makes most or all of the loan decisions (ACEP being the one exception); and

- Positive interest rates. All five programs charge rates at or above those charged in the formal financial sector.

3. Successful transformation lending programs have developed lending methodologies or policies that differ from programs that provide only short-term working capital.

Common lending practices among the five programs include:

- Loans to individuals. Three of the five organizations made loans only to individuals. Two made both group loans and individual loans, but individual loans predominated;
- Both working capital and fixed asset loans, with long terms for fixed asset loans. Maximum loan terms in the five programs ranged from 16 months to 10 years;
- High loan ceilings. Maximum loan amounts ranged from $5,000 to $35,000; and
- Higher collateral requirements for larger loans. All five programs require some form of formal collateral from recipients of fixed asset loans.

These policies differ markedly from those of lending programs aimed at enterprise expansion rather than enterprise transformation. The expansion-oriented lending programs emphasize group loans in small amounts over short periods for working capital.

Evidence from these five programs and others show that lending methodologies aimed at transforming enterprises do not work well for expanding enterprises and vice versa. NDF/J reports that loans under $500 require more staff time and have the highest arrears rates (38 percent versus 11 percent overall). IDH found the procedures it used for screening and approving individual loans too costly and time consuming when making small working capital loans. It employed two different group lending methodologies for reaching poorer clientele.

On the other hand, ADEMI found the solidarity group methodology too costly and time consuming when it began targeting growing manufacturing firms. It scrapped group lending altogether. Other solidarity group lending programs have found that the group methodology does not work when successful borrowers need to purchase fixed assets. For these clients, the programs make individual loans in larger amounts with longer payback periods (Berenbach and Guzman, 1992).

4. Although the methodologies for lending to expanding firms differ from those for lending to transforming firms, the same institution can still serve both sectors.

BRI, ADEMI, and IDH serve both expanding and transforming microenterprises. For BRI and ADEMI, expanding firms make up a majority of their clientele. These three organizations successfully serve both sectors by having loan products targeted to the two groups. IDH does this by operating three distinct lending programs, with graduates from the two group-lending programs eligible to participate in the individual loan program. BRI and ADEMI do this with more of a progression from one type of lending to the others. Borrowers start by receiving small, short-term working capital loans. After repaying several successively larger working capital loans on time a borrower may qualify for a fixed asset loan. Fixed asset loans require additional screening and collateral.

5. Transformation lending programs have developed two different methods for identifying microenterprises that can successfully undergo transformation.

For a transformation lending program to be successful it must develop cost-effective means of identifying microenterprises capable of undergoing transformation. The five programs we reviewed employ two different methods for doing this. We call these two methods "Gradual Growth" and "High Hurdles."

BRI and ADEMI (and to some extent IDH) employ the Gradual Growth method. Borrowers move through a succession of loans of increasing size until they qualify for longer-term fixed asset loans. When a borrower qualifies for a fixed asset loan he or she has already demonstrated an ability to use credit effectively and the lending institution has a good knowledge of the borrowers capabilities. This greatly reduces the risk to the lending institution of making a large loan over a long term.

NDF/J and ACEP use the High Hurdles method. They have higher collateral requirements and employ more extensive screening procedures for first-time borrowers than do the other programs, but less stringent requirements than the formal banking system in their countries. Borrowers who meet these requirements can qualify for a long-term fixed asset loan immediately. They do not need to repay a series of smaller loans first. Thus, approved applicants of ACEP and NDF/J must have already demonstrated sufficient money management skills to have acquired the assets needed to qualify for a loan. They must also have sufficient business knowledge to present a rudimentary business plan that shows good potential for success.

The Gradual Growth methodology seeks to work with all microenterprises, while providing a means to support the credit needs of those enterprises experiencing growth. The High Hurdles methodology seeks to work with only a very small percentage of the microenterprise universe, those larger microenterprises that are growing.

Determining the appropriateness of either methodology in a given case depends on the goals of the lending institution, its target beneficiaries, and the existing availability of credit to the various sectors of the microenterprise community. However, Gradual Growth does a much better job of providing credit to the smallest microenterprises and to women (who control few assets in most developing countries) and of supporting their growth over time. Lending institutions that use the High Hurdles approach and that seek to serve more women or a poorer clientele must often develop additional lending methodologies for these clients. IDH has done this by creating two group lending programs. ACEP has begun testing group loans as a means of increasing the number of female borrowers.

6. Targeted training programs may support microenterprise transformation but they are not necessary parts of successful transformation lending.

Two of the programs we reviewed offer no training programs (BRI and ACEP). Another two (ADEMI and IDH) offer only voluntary training, charge for their training services, and spend a small proportion of their total budget on training (3 percent for ADEMI, 8 percent for IDH). Only NDF/J requires training, provides free training, and spends a large portion of its budget on training (24 percent).

The two programs that provide voluntary training give conflicting evidence on whether borrowers desire training. At IDH, the number of training participants in a year equals 74 percent of the number of active loans in the year. At ADEMI, the number of training participants equals only 8 percent of the active loans. Of course, many factors other than borrower interest affect the level of participation in

training courses, including the type, frequency, time, and location of the courses and the amount charged participants.

The two programs that do not provide training employ methods of ensuring that their clients have learned the lessons needed for transformation before they receive large loans. At BRI this happens through a series of successively larger loans. ACEP uses the client's years of experience as a screening device. The average ACEP borrower has 15 years of business experience.

7. Lending institutions can support microenterprise transformation and still reach a large number of beneficiaries at low cost.

To get some comparison among programs that emphasize job creation to a varying extent, we have defined the beneficiaries of a credit program as those receiving loans and those who gain employment in new jobs created in enterprises that receive loans. The total number of new beneficiaries per year in these five programs range from 2,230 (IDH) to more than 1 million (BRI). The loan portfolio per beneficiary ranges from $277 (IDH) to $1,392 (NDF/J). The three institutions that use the Gradual Growth method serve significantly more beneficiaries per dollar in the portfolio than do the two High Hurdles institutions. Gradual Growth institutions had at least one beneficiary for every $500 in the portfolio while it took $950 or more to serve one beneficiary in the High Hurdles institutions.

8. Preliminary evidence shows that transformation lending programs do support growth in assets, employment, and productivity of microenterprises, helping them to transform into small businesses.

Earlier, we defined microenterprise transformation as increases in assets and productivity to a level equal to that of small businesses in the same field of activity, accompanied by concurrent increases in sales, income, and number of employees. Preliminary evidence from these five programs suggest that this sort of transformation does take place. Some examples:

- IDH reports very high levels of job creation per dollar lent (one new job for every $366 lent). The fact that IDH uses very stringent criteria for defining job creation makes this statistic even more impressive;

- ADEMI reports that borrowers receiving multiple loans (five or more) experienced growth in fixed assets, profits, and savings of more that 175 percent in real terms (Lewin, 1991);

- ADEMI also reports high levels of increase in labor productivity among the larger firms it supports (Poyo, et al., 1989); and

- BRI reports that, among multiple borrowers, employment and household income grew in real terms and grew most rapidly in those businesses receiving larger loans (Sutoro, 1990).

Although giving indication that business transformation takes place, this evidence remains sketchy at best. Determining the full scope of business transformation among the microenterprises supported by these programs will require further study.

SECTION FOUR

AREAS FOR ADDITIONAL RESEARCH

This paper has reviewed the "state of the practice" in transformation lending by reviewing five microenterprise lending programs that help businesses move from the micro to the small enterprise sector. This review has helped to show that we do know more than was previously thought about how to support microenterprise transformation. However, the review also points out that there is a lot we still don't know. This section reviews key areas of transformation lending that need additional research.

TRAINING

The five programs showed significant differences in their approaches to training, yet all demonstrated an ability to assist microenterprise transformation. Additional research may tell us whether training programs play an important role in the transformation process and, if so, what types of training are most important.

SUBSECTOR ANALYSIS

The countrywide surveys of microenterprise cited earlier all report that rates of growth among microenterprises vary widely by economic subsector. Other studies suggest that the raw material, equipment, and capital requirement of transforming businesses vary by subsector (Mead, 1992). Additional study in this area might help microenterprise credit institutions target their transformation lending programs to specific subsectors.

IMPACT

All five of the programs reviewed had studies or statistics to demonstrate the impact of their program through increases in income, assets, profits, or employment generation in the businesses assisted. However, none of these studies compared the performance of borrowers to a control group of nonborrowers, so it is impossible to determine if the reported increases are caused by the lending program or by other factors.

Most of the studies also dealt only with current or recent borrowers of the programs studied. Because these programs support business transformation, long-term results are critical in assessing their impact.

In addition, transformation lending programs differ from expansion lending programs in the level of impact they have on their borrowers. However, no studies have been conducted that employ the same methodology to measure the impact of these two types of programs. Additional research may tell us how the long-term developmental impact of programs that provide only short-term working capital loans

compares with that of programs that support microenterprise transformation through a combination of working capital and fixed asset lending.

SECTION FIVE

SUMMARY

Microenterprises undergoing transformation into small businesses face increasing needs for credit. Most need increasing amounts of working capital. A smaller percentage also need to purchase fixed assets. Transforming microenterprise may find themselves in a gray area of microenterprise development. Their credit needs exceed the upper limits of institutions that specialize in providing small, short-term working capital loans, yet they still do not have sufficient assets to qualify for loans from the formal financial sector.

Microenterprise lending institutions can support business transformation if they provide individual loans for either working capital or fixed asset needs to their growing clients. Fixed asset loans should come in amounts sufficient for equipment purchases and in terms that match the amount of time it takes the equipment to pay for itself (often 16 months or more).

Transformation lending institutions can identify microenterprises with the potential for transformation either though a series of loans of increasing amounts (Gradual Growth method) or through project analysis and collateral requirements (High Hurdles method). Although both methods have their advantages, the Gradual Growth method does a better job of assisting the transformation of businesses run by poorer clientele and women.

With either method, transformation lending programs can make the costs of screening and monitoring a loan commensurate with the income derived from the loan and can become financially self-sufficient.

The larger and longer-term loans provided by transformation lending programs can help to generate increases in assets, income, employment, and productivity that enable a microenterprise to transform itself into a small business.

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