ACCION INTERNATIONAL

MICROENTERPRISE DEVELOPMENT PROGRAMS: IS CLIENT GRADUATION A MYTH?

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This document was born of the concern that donor agencies and policy makers sometimes have goals that differ from those that project directors consider important, or even possible. Client graduation may be a good example. While the idea is very popular in government offices in New York and Washington, the reality in the field appears quite different.

Without the enthusiastic collaboration of the program directors of all of the programs included, this document would not have been possible. A special thanks goes to the staff of AVANCE Microempresarial for their support and to the clients of AVANCE who took valuable time away from work in their microenterprises to share their views with me.

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Though many contributed, the opinions and conclusions are my own.

FOREWORD

This discussion paper examines the much-debated issue of graduation from microenterprise programs. It draws widely from the experiences of ACCION International in six countries of the Americas, and also includes information from three programs not affiliated with ACCION in Costa Rica. The paper shows that graduation can be interpreted in more than one way; and focuses primarily on the graduation of microentrepreneurs to the formal financial sector. The document presents the reasons that graduation has not taken place on a large scale, and raises many of the complex issues that contribute to this fact. In addition, alternative approaches to addressing the concept of graduation are proposed.

This paper is a preliminary study that we hope will elicit additional in-depth study in this area.

TABLE OF CONTENTS

I. INTRODUCTION

The term "graduation" has appeared in nearly every microenterprise project proposal. The goals behind a microenterprise project generally include enterprise growth, increased incomes, job creation, legalization, and access to credit from formal financial institutions for the program beneficiaries. These goals are associated with graduation, the idea that informal microenterprises can become formal businesses with access to bank credit.

The purpose of this document is to take a critical look at client graduation as a microenterprise credit program goal. The study focuses on the perspective of microenterprise programs, their goals and their relationship to beneficiaries. Various definitions of graduation are discussed as are the advantages and disadvantages that graduation brings for program clients, and the programs themselves. The graduation experience of ten microenterprise programs in six countries of Latin America and the Caribbean is examined to gauge the frequency of graduation and to identify some of the principal factors affecting graduation. Interviews with microenterprise program clients and several banks in Costa Rica reveal additional factors that help clarify our understanding of graduation. The study concludes with a discussion of possible alternatives to client graduation and with suggestions of related issues that require further study.

II. THE MEANING OF CLIENT GRADUATION

Graduation of microenterprise program beneficiaries, also referred to as program clients, can be defined in a variety of ways. One interpretation emphasizes formalization, in legal terms, of what previously were informal enterprises. A second approach concentrates on social considerations, making the personal development of the entrepreneur the focal point. By participating in the program a microentrepreneur develops self-assurance and knowledge that improve his or her interaction with bank staff, buyers, suppliers, etc., and thereby becomes more self-reliant. Another definition stresses the creation of direct links between banks, other commercial entities and microentrepreneurs that enable the latter to obtain financial services from the formal financial sector.

A. Graduation as Legalization

Most interpretations of graduation refer to specific legal or financial changes in the business. Legal graduation implies that a business fulfill all of the requirements necessary to be a legally licensed enterprise. These might include permission from the Ministry of Health and the Ministry of Industry, payment of taxes, payment of social security for employees, a license from the municipality, and frequently a slew of other requirements. As Hernando de Soto describes in detail, in some countries this legalization process is extremely complicated, expensive and lengthy if not impossible for microentrepreneurs. (De Soto, 1987). Under this interpretation of graduation, the microentrepreneur may or may not continue to work with the microenterprise program.

According to de Soto, the inability to legalize is the principal factor constraining the development and progress of microenterprises in Peru. Informality, equated with illegality, is very costly for microenterprises. They must use expensive mechanisms to avoid detection by the authorities. Owners try to keep the businesses small or to spread out their workers in different workshops. Shops do not openly advertise their location, and goods cannot be sold in established markets. De Soto finds that these costs, combined with bribes and other charges, make illegality the key constraint to the growth of informal microenterprises (De Soto, 1987). As much as entrepreneurs might want to become legal and graduate to the formal sector, the bureaucracy has made that process practically impossible for microentrepreneurs in Peru.

In her study of the UNO microenterprise program in Brazil, Judith Tendler offers a different view of legalization. Although becoming legal was costly both in terms of time and cash expense, it was not impossible. Growing firms tended to legalize once the costs of being illegal, including bribes, limited markets, and no access to credit on reasonable terms, outweighed the costs of legalization.

> Clandestine firm owners, and those who were once clandestine, have a clear concept of a 'break-even point' for legalization–a level of activity beyond which the costs of being clandestine become greater than the costs of legalization. These firms see legalization as marking a stage of their growth, rather than as an impediment to it. (Tendler, 1983, p. 137).

For these entrepreneurs, legalization was a type of graduation to the formal sector, sometimes including formal sources of credit, and though costly, was not impossible.

B. The Social Dimension of Graduation

The emphasis on preparing the microentrepreneur to operate more effectively within his or her enterprise and within the environment constitutes a different way of addressing graduation. Credit is one vehicle which can increase the microentrepreneur's capacity to move towards greater self-reliance and to build a more viable source of steady income for his or her family. Entrepreneurs without a source of loans frequently depend on the credit offered by the suppliers of their raw materials, which decreases their bargaining power as well as their ability to change suppliers. Training also emerges as a key tool for assisting microentrepreneurs to graduate under this interpretation, providing new knowledge, skills, and self-confidence as entrepreneurs.

In this definition, graduation does not imply ending the microentrepreneur's tenure in the microenterprise program. Rather, it suggests that his or her contact with the program, through credit and training, has prepared him or her to interact in a more favorable way in the context in which he or she operates. This could mean a better negotiating position with suppliers or buyers, greater participation in representative organizations, such as community or trade groups, a capacity to save, or better ability to identify and solve problems. For example, as a result of their involvement in microenterprise programs, groups of small-scale entrepreneurs have joined together in associations and have negotiated collectively for improved services and lower costs from suppliers.

C. The Financial Side of Graduation

The financial aspects of graduation have received more attention by microenterprise credit programs than the legal or social aspects. For program directors and observers, a graduating entrepreneur tends to be one that, legal or not, leaves the program to become a client of the formal financial sector where he or she can seek financial services, especially credit. The enterprise satisfies the collateral requirements of a bank and needs credit in sufficient amounts to make it profitable for the bank to lend to it.

This financial aspect of graduation is the focus of this study because it has been and continues to be an important goal of most microenterprise programs. When the early microenterprise credit programs in Latin America were studied, many argued that proving the "credit-worthiness" of microentrepreneurs with high payback rates would encourage banks to open their doors to the sector, giving large numbers of microentrepreneurs access to formal sector credit. Once again, the pioneer UNO program in Brazil is a good example:

> The UNO credit program...does not seek to alter the behavior or relationship of microenterprises except in attempting to bring them into the formal sector banking system. UNO's substantial experience in this area has disproved long held beliefs as to the lack of credit worthiness of microenterprises....UNO is making a strong case for state owned banks to extend credit to microenterprises. (Jackelen, 1982, p. 76).

The recent history of microenterprise development in Latin America is replete with programs that identify client graduation to the formal financial sector as a principal goal. The PISCES II studies suggested that graduation be an important objective of the microenterprise projects supported by the US Agency for International Development (Ashe, 1985). In a 1984 evaluation of a Colombian program, "the preparation of microentrepreneurs to enter the 'formal' economy, obtain legalization and become eligible for credit from conventional credit sources" was one of the main objectives of the program (Inter-American Development Bank, 1984). All ten of the programs examined in this study claimed that client graduation to formal sources of credit was an initial program goal.

The reasons behind the popular goal of client graduation are persuasive. A program with limited financial resources faces two alternatives if clients are not graduating but continue to need credit. The program can finance clients indefinitely, restricting the number of new clients that can enter the program due to limited funds, or the program can "kick out" clients after a certain period of time, number of loans, or loan size is reached, permitting new clients to enter the program.

Although empirical evidence is scarce, program implementors observe that requiring clients to leave credit programs when they have no alternative source of credit may stifle their growth. Even with relatively large loans and a good credit record from the programs, clients may still not represent attractive recipients for bank loans. They may not be legal; their credit needs may be too small; and they may not yet be in a position to comply with standard bank requirements. Worse yet, leaving the program may even jeopardize the growth and progress that they made while participating in the program. Tendler found a very low level of graduation from the UNO program and suggested that those clients that left the program with no alternative source of credit could not sustain their progress.

> Without permanent credit, they may have been unable to sustain the level of operation or employment achieved under the loan; hence, the crucial importance of graduation to the realization of job-creation. (Tendler, 1983, p.114)

Ending client dependency on a program constitutes another reason for graduation. However, if programs perceive that clients are graduating without having an alternative source of credit, they may be reticent to require them to leave. The alternative to leaving clients without credit seems to be to finance them indefinitely. Some argue that this response creates a dependency of the client on the program and limits the number of clients that can be attended. In an evaluation of a program in Bolivia, evaluators recommended that AID build in strong incentives to graduate multiple loan recipients to regular financial institutions and thus avoid client dependency on the program. (Development Alternatives Inc., 1987).

Other reasons that support graduation, most of them related to the issue of dependency, include:

1. Development programs are ideally seen as a temporary intervention. People should be taught how to fish, not given fish. After development assistance, micro-entrepreneurs should either be able to stand on their own without credit or find their credit through normal channels. An entrepreneur who gains access to formal credit through his/her participation in a microenterprise development program is the perfect success story for donors and programs alike.

2. Programs are supposed to be helping entrepreneurs to grow - increase their production, increase their sales, hire new workers. The logical result of this growth is that microenterprises become small enterprises and have access to bank credit.

3. The limited resources of microenterprise development programs require them to move clients out of the program if they want to include new clients. If clients move out, still need credit, but do not qualify for bank loans, then the program has only been a temporary response.

4. Initially, the informal sector was seen as a problem, something that needed to be fixed. Integrating marginal enterprises into the formal economy, including formal sources of credit, was seen as a way of diminishing the informal sector.

Given the traditional, strong rationale for client graduation to mainstream institutions, an examination of the extent to which certain programs have been able to reach that goal is both timely and useful.

III. THE METHODOLOGY FOR THIS STUDY

To determine the frequency of client graduation from microenterprise credit programs, information was gathered from ten microenterprise programs in Latin America and the Caribbean through a questionnaire (Appendix I). Four of these programs operate in Costa Rica where the questionnaire was administered by the author through conversations with program directors. The informality of these interviews permitted ample discussion regarding the variety of factors that surround graduation.

The remaining six programs in this study are in Guatemala, Bolivia, Dominican Republic, Mexico, and Paraguay, and are affiliated to ACCION International/AITEC (ACCION), a U.S.-based non-profit organization with over 15 years of experience in microenterprise promotion. They were selected for this study because they have been operating for at least three years. The one exception is Guatemala which has been operating for less than two years but has grown considerably and is now firmly established. The directors and other high level personnel in these programs completed the questionnaire and summarized each program's experience. Because none of the programs kept contact with clients that left the program, they had to estimate the number of graduates that currently receive bank loans. This represents a serious limitation in the current level of research regarding the question of graduation, and certainly merits future study.

Appendix II lists some of the basic characteristics of the ten programs included in this study. Seven of them are affiliates of ACCION. The ACCION methodology for microenterprise promotion is generally considered "minimalist" because it emphasizes agile credit as the most important component to microenterprise development, although many of the ACCION affiliated programs provide training and technical assistance as well.

The characteristics of the microenterprises that participate in ACCION affiliated programs vary from country to country but generally include:

the owner is the principal worker in the enterprise;

- there are maximum five employees, frequently family members;

- there is little or no management specialization nor accounting procedures;

- there is little or no access to bank credit;

- the firm is labor intensive, using rudimentary equipment and machinery;

- the activities are varied, including production, service, and commerce, providing products and services primarily for middle and lower-income consumers.

Some of the programs work through solidarity groups of three to five entrepreneurs that join together to guarantee a loan. Other programs extend individual loans, and others use both modalities. Initial loans are generally small for short periods of time, and subsequent loans increase both in amount and payback period and are disbursed automatically upon prompt repayment of the prior loan. Interest rates are generally equal to or higher than commercial rates in each country.

The microenterprise programs affiliated to ACCION share several key principles, which relate to graduation:

- Programs strive to serve thousands of clients in order to have a significant impact on the microenterprise sector and are not meant to be "pilot" projects;

- Programs attempt to cover their administrative costs with income from interest and commissions within three to five years of program start-up through efficient management and interest rates that reflect the cost of services provided;

- Programs aim to reach the poorest of the economically active population in order to strengthen their enterprises, increase incomes, and create jobs in the microenterprise sector;

- Programs develop direct links between microenterprise clients and financial institutions to integrate the formal and informal sectors (Olivares, 1989).

To complement the information gathered from the ten programs, the author administered an open questionnaire (Appendix III) to nineteen entrepreneurs who receive loans from AVANCE Microempresarial in San Jose, Costa Rica, an ACCION affiliated program. The interviewed clients were selected by AVANCE's loan officers as those ***most likely*** to qualify for a bank loan. They based their decisions for selection on the size of loans from AVANCE that these clients receive currently, the stability of their businesses, and their credit history with AVANCE. Neither their experience with banks nor their interest in bank loans were considered as criteria for selection.

The interviewer explained to the microentrepreneurs the confidentiality of the information and assured them that it would have no impact on their relationship with AVANCE. Nevertheless, the possibility that their answers were influenced by their interest in maintaining their line of credit with AVANCE cannot be overlooked.

Appendix IV presents the characteristics of the nineteen clients interviewed and divides them into three groups, depending upon their past experience with banks. Six of the nineteen have used bank credit, the most recent being in 1987 (group A). Eight have gone to banks to solicit credit but have not formalized a loan (group B). Five have never approached a bank to inquire about loan possibilities (group C). Fourteen of them currently have loans from AVANCE of over US$ 1,200 and the average loan size of the group is US$ 1,700, more than double the overall average loan size of AVANCE's clients.

In addition to interviews with program directors and microentrepreneurs who participate in a microenterprise program, the study also draws from conversations in Costa Rica with loan officers and managers of several banks.(1)

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(1) These include the Banco de Costa Rica, the Banco Anglo, and the Banco Popular.

IV. FINDINGS REGARDING GRADUATION

A. The Programs' Experiences

Of the ten programs interviewed for this study, only one program claimed to have graduated more than 100 clients in its history. Asesoria Dinamica a Microempresas, ADMIC, the ACCION affiliate in Mexico, estimates that 180 of its clients have graduated to formal financial institutions since the program began in 1981. Sixty percent of those continue to receive technical assistance from the program.

Like ADMIC, The Fundación Costarricense para el Desarrollo, FUCODES, in Costa Rica, which is not affiliated to ACCION, lends to larger enterprises and puts considerable emphasis on training and technical assistance. Its average loan size of US$ 3,000 is the largest of any of the programs interviewed for this study. Its director estimated that since FUCODES' inception in 1976, approximately 50% of the clients who completed 3-5 years in the program may have graduated to formal financial institutions. Through 1988, FUCODES had attended a total of 329 clients, 15 percent or 50 of whom had been in the program for more than three years. That means that in 12 years of working with micro and small entrepreneurs, FUCODES has graduated approximately 25 to the formal financial sector. FUCODES' vision is to graduate clients and have them become financial supporters (affiliated businesses) of the program. Since the program began, three clients have affiliated themselves to the program in this way.

The other eight programs have had less success graduating clients. Since 1983 the Asociación para el Desarrollo de la Microempresa, ADEMI, which has over 3,500 active clients and has reached more than 6,600 microentrepreneurs in its six year history, has graduated only 25 clients, despite ADEMI's considerable effort to work with the banks. In general, neither the clients were anxious to solicit credit from banks; nor were the banks able to or interested in providing credit to the microentrepreneurs. The 25 who have graduated continue to request loans from ADEMI as well as from the banks. It is interesting that ADEMI has had much greater success in promoting savings mobilization among its clients and experienced receptivity on the bank's part to capture savings.

The following chart summarizes the responses of the program questionnaires, showing estimates of the number of graduates from each program.

CHART 1

RESPONSES TO PROGRAM QUESTIONNAIRES

COUNTRIES	COSTA RICA				BOLIVIA	GUATEMALA		MEXICO	PARAGUAY	D.R
PROGRAMS:	AVANCE	ADAPTE	FUCODES	CREDIMUJ.	PRODEM	FUNDAP	GENESIS	ADMIC	FUND.PAR.	ADEMI
QUESTIONS										
How many clients have received bank credit since they entered your program?	15	18	25	3[1]	0	0	10[2]	180[3]	11[4]	25[5]
How many clients have loan sizes large enough to be considered by banks?	25%	15%	10%	70%	0%	0%	10%	30-40%	30%	1%
Was graduation to banks an initial program goal?	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Is graduation still a goal?	NO	NO	YES/NO[6]	YES	YES	YES	YES	YES	NO	NO

(1) All 3 are still involved in the program.
(2) GENESIS has a special arrangement with the bank for these clients.
(3) 60% still participate in the program.
(4) 8 still participate in the program.
(5) All 25 still participate in the program.
(6) Graduation is still a stated goal but not an operational goal.

Adding together the estimated number of graduates of the ten programs interviewed for this study, one finds that approximately 287 entrepreneurs have gone on to formal sources of credit, and nearly half of those continue to participate in the various programs. Currently, the ten programs are attending over 16.000 microentrepreneurs. Dividing the 287 graduates into the number currently being attended by the programs yields a graduation rate of about 1.8 percent. This figure would be much lower if one were to consider all the clients these programs have reached.

The comments of program directors reflect these estimated statistics. The first response by several of the directors when asked about graduation was: "it's a myth." While all ten programs interviewed indicated that graduation was an original objective of the program, only five still see graduation as a goal. One program director observed that although graduation is not an operational goal, it would continue to be an institutional goal "until the myth expires".

These findings corroborate the limited literature that exists on graduation. From Tendler's study of UNO in 1983 to Jim Boomgard's 1989 study of AID-supported microenterprise programs world-wide, the available evidence indicates that graduating clients to formal financial institutions is quite uncommon. (Tendler, 1983; Boomgard, 1989; Blayney and Otero, 1985; Development Alternatives, 1987; Wines, 1985; Inter-American Development Bank, 1984).

B. The Microentrepreneurs' Experiences

The interviews with microentrepreneurs in Costa Rica are also enlightening. Chart 2 below summarizes the clients responses to parts of the questionnaires and reflects the same groupings previously mentioned: group A are clients that have received bank loans; group B are clients that have had contact with banks but have not received loans; and group C are clients that have had no contact with banks about the possibility of a loan.

CHART 2

CLIENT RESPONSES TO QUESTIONNAIRES

	GROUP A	GROUP B	GROUP C	TOTAL
NUMBER OF CLIENTS INTERVIEWED	6	8	5	19
Enterprise is completely legal:	2	2	3	7
Think they qualify for a bank loan:	5	5	3	13
ould like to have a bank loan:	3	4(1)	2	9
Think AVANCE should try to help clients get bank loans:	1	2	1	4(2)
Hope to work with bank credit in the next 2-3 years:	1(3)	1	1	3

(1) Two of these responded that they would like a bank loan if it were not so difficult and were agile.

(2) 5 responded that AVANCE should not help clients get bank credit unless AVANCE could no longer meet their credit needs. One responded that AVANCE should help if bank credit could be agile.

(3) This client would like to be working with bank credit and credit from AVANCE in the next two to three years.

As the chart shows, over two-thirds of the clients are confident that they could receive a bank loan, suggesting that they could become program graduates. However, less than half of them would like a bank loan and more than three quarters hope to meet their future credit needs through AVANCE instead of a bank. Fifteen of the nineteen clients felt that there was really no reason for AVANCE to try to graduate clients by helping them attain bank loans.

In sum, while client graduation is a common goal of microenterprise credit programs, the interviews indicate that it is a relatively uncommon experience for programs and a relatively unattractive option for potential graduates. Despite the fact that microenterprise programs may charge higher interest rates than local banks –in this study five of the ten programs quote higher rates than that of the banks, with AVANCE charging twice the bank rate– and that clients are confident of receiving bank credit, still, two thirds of those interviewed show limited interest in graduating to bank credit.

These observations gather greater credence when one compares lending terms of microenterprise programs with those of the banks. The chart below summarizes the policies established by AVANCE and the small enterprise credit lines of the banks in Costa Rica. As indicated, the banks' interest rate is one half that of AVANCE's, and still many microentrepreneurs prefer to approach AVANCE for their loans.

CHART 3

VARIABLE	AVANCE	BANKS
Interest Rate	36% plus commissions	18-20% plus commissions
Loan Types	Working capital or equipment	Same
Loan Size	$120 - $3500 Avg. of $670	Min. $240 to $1200
Loan Periods	3 - 36 months Avg. of 8 months	Varied
Payments	Monthly	Same
Time to Process		
New Loans	2 weeks	1-2 months
Repeat Loans	Less than 1 week	1-2 months
Application Completed	By program adviser	By client
Guarantee	Equipment, inventory, or finished product	Equipment and 2 salaried co-signers

C. Factors that Affect Graduation

The client interviews, bank interviews, and program questionnaires revealed many factors that have an impact on graduation. The chart below summarizes both factors that would seem to encourage graduation as well as those that would seem to discourage it.

CHART 4

FACTORS THAT AFFECT GRADUATION

	ENCOURAGE GRADUATION	SOURCE
1.	Larger loan amounts in banks:	6 of 19 clients
2.	Longer loan periods in banks:	3 of 19 clients
3.	Lower interest rates in banks:	6 of 19 clients
4.	Bank credit may open new opportunities:	1 of 19 clients
5.	Graduation is a program goal:	10 of 10 programs initially; 6 of 10 programs currently
	DISCOURAGE GRADUATION	
1.	Time from first contact to loan disbursement longer for banks than for programs:	18 of 19 clients 10 of 10 programs
2.	Time client must dedicate to fulfilling requirements longer for banks than for programs:	14 of 19 clients 10 of 10 programs
3.	Clients feel more comfortable with program personnel than in banks with bank personnel:	8 of 19 clients 6 of 10 programs
4.	Banks guarantee requirements are more difficult to meet:	4 of 19 clients 10 of 10 programs
5.	Clients lack financial statements required by banks:	6 of 10 programs
6.	Loan amount needed by clients too small to be considered by banks:	2 of 10 programs
7.	Clients must be legalized to qualify for bank loans:	2 of 10 programs
8.	Clients do not have an investment project acceptable to banks:	2 of 10 programs
9.	Insufficient liquidity in banks:	2 of 10 programs
10.	Program's financial interests make it preferable for larger clients to stay in the program and not go to banks:	1 of 10 programs
11.	Banks prefer larger loans with less risks:	bank officials

1. *Factors that Influence the Client:*

Those clients that responded that they would like to have a bank loan (9 of 19) cited the banks' lower interest rates, larger loan sizes, and longer loan periods as the primary reasons. One also mentioned that a bank loan might open up future opportunities for the business. The fact that all of the ten programs interviewed claimed that graduation was a program goal when the program started would also seem to favor graduation. Indeed, while the banks estimated their process time as 1-2 months, the clients interviewed made estimates of 2 to 9 months.

The factors inhibiting graduation are numerous. The most important appears to be the time factor, both the processing time of the credit institution and the time the client must dedicate to paperwork and meeting requirements. These factors appear in Chart 3 where the most striking differences between bank lending and microenterprise program lending in Costa Rica are the length of the approval process for loans and the paperwork involved. In both cases, the microenterprise programs are substantially quicker, less bureaucratic, and more flexible than the banks.

The experiences of the group of clients that had had contacts with banks but never formalized a loan (Group B, 8 of the 19 clients) support this finding. All of them gave up before finishing the application process. One finished the process once, and after being turned down never finished it the second time. One gave up when the bank lost his application and another after spending a futile six months trying to get the loan processed.

Both clients and program directors mentioned that the atmosphere of the programs make clients feel more comfortable than do banks. Also, they found that it is easier to meet a program's guarantee requirements than those of the banks. These first four factors support the observation of one program director who summarized the issue by noting, "as much as the microenterprises might meet the bank's requirements, the methodology of the bank does not meet the needs of the microentrepreneurs."

Several other factors related to bank requirements and liquidity were also seen as significant impediments by several of the program directors. Frequently, microentrepreneurs cannot meet bank requierements unless they obtain assistance in preparing financial statements, investment projections and other documentation.

2. *Factors that Influence the Program:*

Although only one program director mentioned the financial interests of the program (factor 10 in Chart 4) as a factor discouraging graduation, it is an admission that might not be popular for program directors to make even when they recognize it. ***In fact, microenterprise programs may actually have financial disincentives for graduating clients.*** To move the most dependable clients, those with the best credit histories, the largest loan sizes, and the least need for costly follow-up or assistance out of a portfolio does not make financial sense. Those clients represent less risk than new clients, contribute to a good payback record, and their large loans make them relatively inexpensive to process.

Microenterprise programs that identify operational and financial self-sufficiency as a program priority consider that these low-cost creditworthy clients contribute to the program's financial viability. Fostering their graduation from the program affects self-sufficiency in an adverse manner. Therefore, microenterprise programs find that their own interests are undermined by establishing a client graduation policy. It appears that the goals of self-sufficiency and client graduation may be contradictory, and that some programs may sacrifice the latter to strengthen the former.

While microenterprise programs have financial objectives as cited above, they also contain a strong social dimension. They work with a low-income population and seek to provide credit to an otherwise ignored sector. They consider the risk and cost that new clients bring to the program as a consequence of their overall mission. The process of integrating new clients into the program and assuming the added risk becomes easier if the program also maintains long-standing and dependable clients.

Some donor agencies also encourage graduation and may request a program to add this objective to its stated goals. In some cases, therefore, graduation as a program objective is imposed by the donor agency rather than coming from the implementing organization.

3. *Factors that Influence the Banks:*

Other issues relate to the perspective of banking institutions regarding client graduation. The last factor in Chart 4 refers to the banks' preference for making larger loans with less risk and with solid guarantees. One bank official observed that even though the bank had a special line of subsidized credit for small enterprise, it preferred to make as large loans as possible and to minimize risk as much as possible. He added that when he is unsure about a potential client, he requests additional information to discourage the client from finishing the application process. Over half of the clients give up, sooner or later, without having satisfied the seemingly never-ending requests of the banks.

The view of this official is quite reasonable. Banks have high overhead and are geared to making large loans to big businesses. It is easier and cheaper for a bank to make five US$ 10,000 loans than fifty US$ 1,000 loans. The guarantees offered by microenterprises are less valuable and secure to a bank than those of larger businesses. Banks are not accustomed to working with microentrepreneurs, do not understand the dynamics of their production, do not know their reputation as clients, and thus prefer not to work with them.

For a microenterprise to reach a level of financial viability such that it becomes an attractive bank client implies that: (1) the business owner is able and willing to spend considerable time away from the business in banks and fulfilling loan requirements, suggesting that he or she is not a principal worker in the business; and (2) the business is capitalized well enough that several months without credit or between loans does not have a detrimental effect. This second condition implies that when an opportunity arises either in the form of a large order or the availability of a large quantity of inexpensive raw materials, the entrepreneur has the resources available ***on hand*** to take advantage of it.

Businesses have to be well-off to meet those two conditions. They require a level of formality and asset base that raises them above the microenterprise level into small enterprises. Microenterprise programs may be successful in assisting clients to move in this direction by enabling them to use and repay large amounts of credit efficiently –amounts well within the banks' small enterprise credit lines– and perhaps to expand, hire new workers, and increase their own incomes. What has proven to be extremely difficult, however, has been to overcome the time and capital base barriers that make dealing with banks unappealing and potentially detrimental for a growing microenterprise or even a small enterprise. This situation helps explain why, as one development worker in Costa Rica commented, "graduation is a quantum leap for any microenterprise".

Even though programs may have proven the credit-worthiness of microentrepreneurs, they have proven it by using a lending methodology that is different from a bank's. The short payback periods, progressively larger loans, periodic visits from advisers, fast application processing, lack of guarantees and reliance on character references which comprise the backbone of this approach to lending do not resemble formal financial lending practices.

Further, formal sector institutions do not consider that lending to the microenterprise sector, in spite of its size, will produce an acceptable level of profit. Risk and the high transaction costs of administering small loans factor into this assessment. As Henry Jackelen points out,

> Given the general state of formal sector financial institutions in the developing world, it is unrealistic to expect the massive reforms that would enable and encourage them to lend to microenterprises. Nor would such an expansion of purviews be advisable; these institutions have enough to do in carrying out their functions properly in the formal sector. (Jackelen, 1989, p. 133).

In this light, the comments of the director of ADEMI are not surprising, "Our experience has demonstrated that our formal financial sector is not interested in this segment of the market." ***This study suggests that banks have few, if any, compelling reasons to lend to clients graduating from microenterprise credit programs.***

Client graduation is not happening on a significant scale, at least in microenterprise programs in Latin America, and may be an unrealistic goal for the near future. Current formal financial structures are inappropriate for providing efficient credit services to entrepreneurs emerging from microenterprise credit programs. To date, the large number of potential new clients that the microenterprise sector represents for banks is not a persuasive enough incentive for them to change lending procedures to accommodate these potential clients. Likewise, lower interest rates, longer payback periods, and larger loans appear to be insufficient incentives for clients to give up the quickness, agility, and friendliness of credit from a microenterprise program. Indeed, these may even be insufficient incentives for the client to go through the bank's applications process when he or she is not participating in a microenterprise credit program.

V. ALTERNATIVES TO CLIENT GRADUATION

The reasons for wanting to graduate clients, explained in the beginning of this document, persist. If there is no graduation, clients stay in the program indefinitely and the program, without a constant influx of new funds, is limited in terms of the number of new clients it can attend. Or clients are moved out of the program into a situation where even if they qualify for bank credit, their needs of quickness and agility would not be met.

Within this context, one option open to microenterprise programs is to explore different alternatives available to encourage graduation in ways other than the traditional concept of turning their own clients over to the formal financial sector.

A. Program Graduation

One possible solution to this dilemma may be to "graduate programs" and not clients, as Jim Boomgard suggests (Boomgard, 1989). That is, microenterprise programs can explore ways of evolving as institutions so as to develop a closer link with the formal financial sector. Gradually, these microenterprise programs can become viable enough to constitute a necessary layer within the country's scheme of financial institutions.

Although a thorough discussion of the different financial mechanisms that could be used for microenterprise programs to expand their roles and capabilities is beyond the scope of this study, the following section presents a few of the alternatives currently being tested in Latin America, as well as some of their possible strengths and weaknesses.

B. Program Expansion

One approach to program graduation involves continuing a microenterprise program but expanding its reach on a much larger scale and with sufficient resources to continue funding participants even as their credit needs become large. This type of expansion or "massification" requires several important considerations for the non-profit organization including revision of the institution's structure, access to resources, methodological adaptations and the internal financial capacity to manage a very large program (Otero, draft, 1989).

Not all microenterprise programs are well developed and sustainable enough to scale up activities in a significant manner. Programs grow through various stages of growth as they evolve, and through their evolution may expand to reach several thousand microenterprises. Few programs in Latin America, however, have been able to expand activities in a truly significant manner, reaching ten thousand or more clients.

In her recent study for the Ford Foundation, Judith Tendler's observations address this issue of program expansion:

> The non-government sector...has a certain structural inability to expand or to have its experiments replicated. That is why the impact of NGO projects is usually quite limited, a disturbing finding for donors interested in having an impact on poverty. (Tendler, 1989, p.27)

Her reasons include insufficient funding, the smallness and social homogeneity that give non-government organizations (NGOs) a qualitative advantage; and their sometimes adverse relationship with governments, their high costs per beneficiary, and their own tendency not to see "massification" as a goal. Tendler's assertions are supported by experiences in Latin America, where the most successful non-profit institutions are only reaching several thousand clients. Whether or not a "massification" strategy can relieve the need for programs to graduate clients in order to meet the demands of new clients has yet to be proven.

C. Financial Intermediation

A second approach responds to the programs' need to access the large amounts of financing necessary to service new clients while continuing with the existing borrowers that require larger loans. The largest portfolio of the programs examined for this study is just over US$ 1 million in ADEMI, a program that has been operating for over six years. Most of the other nine microenterprise program portfolios stand at about US$ 500,000. Without adequate resources, large loans to growing microentrepreneurs instantly decrease the number of new microentrepreneurs that the program can fund.

One way to overcome the funding limitations might be for programs to increase their portfolios with borrowed funds from formal financial institutions. Four of the ACCION programs included in this study are experimenting with different schemes of this type. With an ACCION-backed guarantee, these programs obtain loans from local banks at the established commercial rate with which they capitalize their credit funds. Their link with the bank is not through the graduation of clients, but rather through the program itself, which requests a large loan that the bank can consider.

One obvious drawback to this alternative is the high financial cost that such arrangements imply for the microenterprise program. While programs that have reached a high level of financial self-sufficiency may be able to afford to pay a commercial interest rate for a large percentage of their portfolios, newer programs might find that such costs make it extremely difficult for them to reach self-sufficiency.

In Costa Rica, the bank of COFISA, has lent AVANCE US$ 300,000, a sum equal to half of AVANCE's portfolio. The scheme has been extremely beneficial for AVANCE and its clients for several reasons. The funds come from a rediscounted line funded by USAID, and therefore have a lower interest rate which AVANCE could afford even during its early years of operation. Second, because the funds are not COFISA's private funds, and because of close relations between the Boards of

Directors of the two institutions, a special guarantee arrangement was made. Whether or not programs could leverage enough funds through similar commercial arrangements to meet the needs of their existing clients and new clients, depends on their ability to absorb the costs of borrowing, to provide a guarantee, and to develop a good relationship with the bank.

Henry Jackelen suggests a link between program expansion and financial intermediation. He points out that many credit programs may not be able to significantly expand because, not only must they develop efficient methodologies for reaching microentrepreneurs, but they must also "build banks". Both tasks are complex, occasionally contradictory, and together may cause a certain schizophrenia that might inhibit program expansion (Jackelen, 1989).

Jackelen proposes that programs serve as intermediaries between microentrepreneurs and banks. For example, the program would provide a guarantee fund via which loans extended by the bank directly to clients would be 100% collateralized. The interest rate to the clients would need to cover the cost of the funds (a commercial rate) as well as the costs of the program, and might be quite high. Although the program would carry out the client follow-up, the bank would need to monitor the fund and could break the agreement if the payback rate dipped below an agreed level. Whether or not a bank would be interested in this approach at a significant level remains to be tested by microenterprise programs.

Another option, one that has proved quite successful for the Grameen Bank in Bangladesh, is for the microenterprise credit program itself to be a bank. The possibility of setting up a microenterprise bank in Bolivia is currently being studied by the Foundation for the Promotion and Development of Microenterprise (PRODEM), ACCION, and a group of other local and international institutions and individuals. Still at the development stage, this bank would be capitalized with US$ 3.5 million in investments by Bolivian and international investors and with US$ 5.5 million in long-term debt to cover operating cost deficits for an estimated 7-8 years until the bank is profitable. The bank option would also utilize client savings as part of the lending portfolio. As with the other schemes to graduate programs, this approach constitutes a major challenge for a microenterprise program.

Any of these approaches –"massification", financial intermediation, or microenterprise banks– could overcome the graduation dilemma. If programs have growing portfolios and are covering their operational costs through interest payments, there is no need for them to graduate clients. The programs will be stable financial institutions, meeting the credit needs of the microenterprise sector more efficiently than banks. These institutions would become more akin to formal financial institutions, and therefore the concern of creating dependency would no longer be an issue.

VI. CONCLUSION

The evidence presented here clearly indicates that client graduation is not a realistic goal for microenterprise credit programs. There are a wide variety of factors addressed in this document that demonstrate the complexity of the issue of graduation. Several topics deserve more in-depth study as part of increasing our understanding of graduation:

1. Client access to banks and their views about banks has not been studied in detail in many countries. This document has included a review of clients in Costa Rica. While some of AVANCE's clients appear to qualify for bank credit, the gulf between banks and microentrepreneurs in other countries is likely to be different. In countries with lower per capita incomes or large indigenous populations, the gap between banks and microentrepreneurs may be larger.

2. In the same light, further discussion with bankers in Costa Rica, and the initiation of discussion with bankers in other countries would enrich our understanding of the real possibilities for financial graduation.

3. The impact of non-financial assistance or training on the graduation of clients needs to be examined. Though several of the microenterprise programs studied for this document have active training programs, the impact of non-financial assistance on graduation was not addressed in this study.

4. The firm size and type of activity, as well as the educational level of the entrepreneurs may emerge as significant factors in the graduation issue. Programs that work with larger enterprises may have more possibilities of graduating clients. Entrepreneurs with higher levels of formal education might find it easier to move on to banks and adapt to their credit conditions. Perhaps clients in certain activities or sectors, like small industry, can graduate easier than others, such as those in commerce.

5. As mentioned earlier in this document, the study of the issue of graduation will not be complete until access to banks by potential microenterprise program graduates is tracked and analyzed in various settings.

There are numerous other issues that merit rigorous investigation in order to better understand the frequency of and the factors affecting graduation. However, the evidence presented here does indicate that client graduation, on any significant level, is not taking place. It is hoped that this preliminary analysis will encourage donors and practitioners in the microenterprise field to focus on finding alternatives to client graduation, rather than trying to find examples thereof.

APPENDIX I

Summary of Questionnaire to Microenterprise Credit Programs (Translated from Spanish to English)

A. General Information

Country:
Program Name:
Amount of Portfolio:
Date of Program Initiation:

Number of Active Clients:
Number of Individual Clients:
Number of Clients in Solidarity Groups:
Percentage of Female Clients:

Average Loan Size for Individuals:
Average Loan Size for Groups (per member):

Percentage of clients in each of the 10 most common activities that the program funds: (this question was followed by a list of 17 possible client activities and several blank spaces to fill in additional activities).

B. Experience with Graduation

1) How many clients from your program have received bank loans since they entered your program? Specify if they continue to participate in your program and if the number is the total in the history of the program, per year, per month, etc.

2) What has the program done for the bank to accept these clients? If the program has a special arrangement with the bank, please describe it.

3) Approximately how many active clients in your program have loan amounts large enough to qualify for local bank loans (without any special arrangement) if the clients met the rest of the bank requirements? In other words, for how many clients is the loan size NOT a barrier between the client and bank credit?

4) Please estimate the average length of time between a potential client's first contact with a local bank and the disbursal of the loan (in the case of a small entrepreneur). What is the average length of time between a potential client's first contact with your program and the disbursal of the loan?

5) What is the interest rate in your program? What is the rate of interest in the local banks?

6) Please list, in order of importance, the bank requirements that are most difficult for your clients to meet (such as guarantees, access to co-signers, financial statements, etc.).

7) It is possible that, instead of or in addition to the bank's requirements, there are cultural or other factors that limit the entrepreneur's access to bank credit, (such as the client is afraid to go to the bank, the bank takes three months to analyze a loan application, there is limited liquidity, or other factors). In your country, what factors of this type make bank credit difficult for microentrepreneurs?

8) When your program began was client graduation to the formal financial sector one of the goals? Is it still a goal? Why? What does the program do to promote graduation?

9) Additional comments about client graduation:

APPENDIX II

PROGRAM AND BANK CHARACTERISTICS (FROM PROGRAM QUESTIONNAIRES)

PROGRAM Country	Program Start-up Date	Number of Active Clients *	% in Solidarity Groups *	% Female	% Commerce	Average Loan Size US$	Program's Interest Rate	Bank's Interest Rate **	Program's Process Time (days)	Bank's Process Time (days)
AVANCE Costa Rica	April 1986	1200	0%	40%	20%	600	36%	20%	14	30-90
*ADAPTE Costa Rica	August 1982	300	0%	50%	0%	1000	24%	25%	30-45	180
*FUCODES Costa Rica	July 1976	254	0%	35%	0%	3000	24%	26%	24-30	90-180
*CREDIMUJER Costa Rica	October 1984	180	55%	99%	0%	850	24%	26%	14	150
PRODEM Bolivia	February 1987	5932	100%	69%	48%	169	24%	24%	6	30-90
FUNDAP Guatemala	June 1988	796	53%	18%	42%	404	30%	16%	8	90
GENESIS Guatemala	June 1988	1165	66%	49%	40%	196	22%	16%	15	90-120
ADMIC Mexico	January 1981	1280	0%	15%	0%	600	65%	67%	14	90
FUNDACION PAR. Paraguay	November 1985	1857	100%	60%	50%	290	36%	24%	15	60
ADEMI Dominican Republic	May 1983	3893	0%	34%	10%	470	44%	36%	7	90

Total Number of Clients: 16.857

* Program NOT affiliated to ACCION International/AITEC

APPENDIX III

Summary of Questionnaire Used to Interview AVANCE Clients
(Translated from Spanish)

A. General Characteristics

Name, date of interview, adviser from AVANCE, activity.

Date of first loan from AVANCE, amount, payback period, working capital or fixed asset.

Date of most recent loan from AVANCE, amount, payback period, working capital or fixed asset.

Total number of loans from AVANCE and total amount.

Actual guarantee with AVANCE.

B. Experience with and Interest in Banks

1) Have you ever had a bank loan?

If yes: name of bank, use of loan, date, amount and payback period, interest rate, guarantee. How long did it take for you to receive the loan and what did you have to do?

If no: have you ever gone to the bank to investigate the possibility of getting a loan? What happened?

2) Do you think you could qualify for a bank loan for your business now?

What do you think you would have to do (i.e. get permits, financial statements, co-signers, etc.).

How long do you think it would take?

Do you think there are currently funds available in the bank?

3) Would you like to have a loan from the bank? Why or why not?

4) If you could get a bank loan, why are you working with credit from AVANCE?

5) Should AVANCE encourage clients to go to the bank and help them get bank credit to develop their businesses? Why or why not?

6) Your business is formally registered with which entities or institutions (i.e. municipality, social security, etc.)?

   Which taxes or social security payments do you make, and which do you not pay?

   If you wanted to completely legalize your business, what would you have to do, how much would it cost, and how long would it take?

7) With what resources, machinery, loans, etc. did you start your business and how long ago (financial help or loans from family members, loans from other sources, savings, etc.)?

8) What stages has your business passed through? What have been the significant changes or successes in that process? Where has the capital come from (income from the business, family members, savings, loan programs, other sources of loans, banks, etc.)?

9) What vision do you have of your business and sources of financing in the next two to three years?

APPENDIX IV

CHARACTERISTICS OF CLIENTS INTERVIEWED

CLIENTS BY ACTIVITY	Date of 1st loan from AVANCE	Size of current loan (US$)	Legal status of enterprise	Future busines prospects
A. CLIENTS HAVE HAD BANK LOANS				
1. Shoemaker	April '87	696	Illegal	stability
2. Bakery	May '89	2,439	Legal	expansion
3. Shoemaker	May '87	366	Illegal	stability
4. Packages and sells products	June '87	2,439	Illegal	expansion
5. Tailor - men's clothes	April '87	3,659	Illegal	expansion
6. Tailor - women's clothes	April '88	1,829	Legal	stability/some growt
B. CLIENTS THAT HAVE APPLIED FOR OR BEGUN TO APPLY FOR BANK LOANS				
7. Artisan	July '08	561	Illegal	expansion
8. Metal worker	Sept. '87	1,220	Illegal	expansion
9. Bakery	Feb. '87	3,744	Legal	expansion
10. Bakery	Nov. '87	1,829	Legal	stability
11. Shoemaker	May '87	988	Illegal	diversify
12. Store - children's clothes	Aug. '88	1,829	Legal	diversify
13. Leather worker	Set. '88	1,829	Illegal	expansion
14. Ceramics	Sept. '88	1,220	Illegal	limited expansion
C. CLIENTS THAT HAVE NEVER ATTEMPTED TO APPLY FOR A BANK LOAN				
15. Seamstress-piece work	July '87	2,439	Illegal	expansion
16. Grocery store	Nov. '88	732	Legal	stability
17. Grocery store and bakery	Nov. '88	1,829	Legal	stability/some expansion
18. Makes knitted products	March '89	1,257	Illegal	expansion
19. Variety store	Dec. '87	1,829	Legal	stability

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