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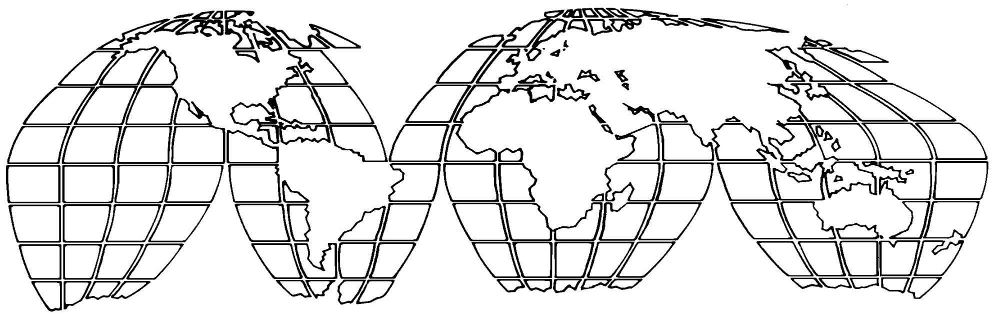
Maximizing the Outreach of Microenterprise Finance
The Emerging Lessons of Successful Programs



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Summary

The conventional view has held that microenterprise finance helps poor people and therefore is a desirable development activity but that it cannot be financially viable. Small loans, it is said, are simply too costly to administer, and the profits from such lending too meager to permit profitability. However, a study examining some of the best microfinance institutions concludes that this conventional wisdom is quite wrong. Microfinance institutions can and indeed need to be self-sustaining if they are to achieve their outreach potential—providing rapid growth in access to financial services by poor people.

Microenterprise development is a prominent part of USAID's economic growth strategy for reaching the poor. A microenterprise initiative has been launched that allocates $140 million for microenterprise funding during FY 1995. The initiative emphasizes financial service programs that serve the very poor.

To provide lessons from experience, USAID's Center for Development Information and Evaluation examined 11 successful microenterprise finance programs to identify "best practice." The study looked at performance from two perspectives: *outreach*, including access by the very poor, and financial *sustainability*. The study examined programs in Bangladesh, Bolivia, Colombia, Costa Rica, the Dominican Republic, Indonesia, Kenya, Niger, and Senegal. The study had two purposes:

- To analyze the performance of successful microenterprise finance programs and update USAID's knowledge of the field
- To contribute to the development of performance standards and a reassessment of USAID policy and programming priorities in microenterprise finance

The study tested the premise that large numbers of poor people, including the very poor, can be reached with financial services through financially viable institutions. The study considered outreach from three perspectives:

- Reaching the very poor
- Achieving significant scale of coverage
- Meeting client demands

The study also examined institutions' capacity to gain independence from donor or government subsidies. Programs are classified in three levels: subsidized, operationally efficient, and fully self-sufficient. Operationally efficient means salaries and administrative expenses are covered out of program revenues. Fully self-sufficient means program revenues cover both the costs of operation and of its financial resources, calculated on a nonsubsidized basis.

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The study demonstrated that

- Finance for the poor can consistently cover operational costs. Ten of the 11 institutions examined were operationally efficient and reached large numbers of poor people with financial services.
- Most programs can be fully profitable. Five institutions were fully profitable, generating positive returns on assets comparable to commercial financial institutions. Fully self-sufficient programs leveraged additional funds, dramatically increasing the number of poor people with access to loans. In the most favorable case, a microenterprise lender mobilized $19 in resources for every dollar of equity capital.

"Frontier" programs held unit costs to levels that can be sustained by financial market spreads. They met the challenge of operational efficiency by lowering costs, controlling delinquency, and adjusting their methodologies to fit their markets. Contrary to expectations, outreach to the very poor did not appear to limit profitability. Even institutions serving very poor clients (as seen by small loan size) could be financially viable. Standard cost measures, such as administrative expenses as a percent of the loan portfolio, were not significant in predicting financial performance of programs examined.

The only cost-related factor that influenced self-sufficiency was average salary when compared with gross national product (GNP) per capita. Programs that hired lower-cost employees, generally from the communities they serve, were more profitable than those that emerged from donor projects that stressed outreach over financial viability and hired more educated workers.

The most significant factor explaining higher self-sufficiency of some operationally efficient programs was the inflation-adjusted interest rate. Fully self-sufficient programs charged interest rates high enough to cover all their costs, including the costs of capital fully adjusted for inflation.

These results suggest that the two keys to full self-sufficiency are efficient operations and appropriate pricing policies. Self-sufficient institutions set policies on interest rates and cost structure, especially salary expenses, with full cost recovery in mind. Viability is not the direct result of context, culture, or target groups.

The findings imply that the best strategy for achieving significant outreach to the poor is for donors to concentrate resources on organizations with the potential to reach full self-sufficiency. Such organizations can develop the scale and leverage to reach large numbers of poor people. Donors should focus on technical issues of revenues, costs, and delinquency, fostering movement to greater levels of financial self-sufficiency.

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Key issues are an institutional commitment to efficiency; an interest rate policy that supports financial viability, accounting for the effects of inflation; and improved reporting standards.

Background

Effective provision of financial services to the poor has been an important challenge facing USAID and others working in developing countries. Past efforts using subsidized and directed credit have left a distressing legacy of failed programs and created many skeptics. The weaknesses of past efforts to reach small farmers and other priority groups have been in three main areas: lending institutions have not been financially self-sufficient and usually became decapitalized quickly; funds have not reached the intended target group; and programs have distorted financial markets in ways that interfered with the efficient evolution of finance for broad sectors of the economy.

The recent performance of "frontier" microenterprise finance programs demonstrates that some learning has taken place from the mistakes of subsidized directed credit. Programs are increasingly charging interest rates and fees that cover the real costs of delivering financial services and are embracing financial self-sufficiency as a primary organizational goal. More and more institutions have crossed major hurdles in terms of outreach, raising resources on commercial markets, and increasing service to difficult-to-reach populations.

Frontier institutions have generated dramatic growth in total assets and are self-sufficient. Some generate returns on assets that are satisfactory even by commercial bank standards. The largest are able to mobilize resources to reach hundreds of thousands of poor people.

This study explicitly chose to assess the experience of successful programs rather than of a random sample. The purpose was to identify elements critical to their success and to determine feasible performance standards for microenterprise finance.

The study looked at recent developments in microenterprise finance from two perspectives, *outreach* and *financial sustainability*. Outreach refers to the central purpose of microenterprise finance—to provide large numbers of poor people, including the very poor and women, access to quality financial services. Financial sustainability embodies the institutional capacity to become independent of donor or government subsidies. Both concepts are central to USAID's microenterprise initiative.

The study examined the performance of 11 microenterprise finance programs, selected on the basis of outreach and financial viability criteria. Criteria included loan size (a rough proxy for client income level), number of borrowers (a proxy for scale), and reputation for financial strength. The study made a special effort to select at least one institution serving exclusively the very poor in each of the three major geographic regions.

Programs examined were Agence de Credit pour l'Entreprise Privée (ACEP) of Senegal, La Asociación Dominicana para el Desarrollo de la Mujer (ADOPEM) of the Dominican Republic, Banco Solidário S.A. (BancoSol) of Bolivia, Badan Kredit Desa (BKD) of Indonesia, the Unit Desa System of the Bank Rakyat Indonesia (BRI), Banking Raya Karkara of CARE (BRK) of Niger, Corporación de Acción Solidária (CorpoSol, formerly Actuar/Bogotá) of Colombia, Fundación Integral Campesina (FINCA) of Costa Rica, the Grameen Bank of Bangladesh, Kenya Rural Enterprise Programme (K-REP), and Lembaga Perkreditan Desas (LPDs) of Indonesia (see table 1).

The study gathered data on outreach and financial performance for each program, principally through visits to selected sites. In some cases, analysis was based on prior visits, public sources, internal documents, and other information available to the authors.

The study also used standard accounting practices to make two major adjustments to the audited financial information. First, financial accounts were adjusted for inflation in each country. Second, adjustment was made for implicit and explicit subsidies, such as access to funds on a grant or soft-loan basis. These adjustments allowed each institution to be compared as if it operated on a fully commercial basis.

Findings

Outreach to the Poor

Significant outreach to the poor, including the very poor, can be achieved, judging by the microenterprise finance institutions examined.

Reaching the very poor. Clients were typically very small businesses that would otherwise be excluded from formal financial services. Most programs—6 of 11—cluster in the range of $200 to $400 average outstanding loan balances, with several well below that level. The very poor have access to financial services through all but one or two of these institutions. Moreover, these institutions reach large numbers of women, either by design or by virtue of the market they serve. Programs offering smaller loans tend to serve more women.

Achieving significant coverage. Several institutions, notably in Bangladesh and Indonesia,

Table 1. Age and Type of Selected Institutions

Name (country)	Age	Type of institution	Urban/ rural
ACEP (Senegal)	8	NGO/credit union	Both
ADOPEM (DR)	12	NGO	Both
BancoSol (Bolivia)	7	Private commercial bank	Urban
BKD (Indonesia)	40+*	Village-owned financial institution	Rural
BRI Unit Desa System (Indonesia)	10	Division of gov't commercial bank	Both
BRK (Niger)	3	NGO	Rural
CorpoSol (Colombia)	6	NGO/finance company	Urban
FINCA (Costa Rica)	10	NGO	Rural
Grameen Bank (Bangladesh)	18	Gov't/member-owned bank	Rural
K-REP (Kenya)	4	NGO	Both
LPD (Indonesia)	10	Village/government-owned bank	Both

*Originally established in 1897, BKD has existed in its present form since 1952.

have achieved major coverage on a national scale. The Grameen Bank's market outreach covers almost half the villages in Bangladesh, reaching 1.8 million very poor clients. In Indonesia, the BRI Unit Desa's system has more than 2 million borrowers and 12 million savers, and the BKD system covers 20 percent of villages in East Java with very small loans. In Bolivia, BancoSol and its predecessor, PRODEM, have reached 50,000 clients, about 10 percent of the potential loan market. Most other programs are growing rapidly and may soon be nationally important.

Experiencing rapid growth. The large numbers reached by some programs were the result of extremely rapid growth in the client base—rates ranging from 25 percent per year to 100 percent. The BRI program, with its 2 million borrowers and 12 million savers, is only a decade old. CorpoSol in Colombia increased its client base from fewer than 7,000 in 1990 to 54,000 by 1993. The keys to this rapid growth have been the ability to maintain financial viability—controlling bad loans, holding administrative costs to manageable levels, and developing a rapidly growing base of financial resources.

Meeting strong client demand. Dramatic annual growth in the number of borrowers, the loan portfolio, and, in some cases, savings deposits is evidence of strong client demand. Clients were willing to pay interest rates significantly above the rate of inflation and to repay loans on a timely basis, evident in low delinquency.

To motivate repayment, the programs examined used one of several approaches: groups, social pressure, or unconventional collateral.

Table 2. Interest Rates, Inflation, and Return on Assets at Selected Institutions, 1993				
Institution	**Nominal effective rate, percentage**	**Estimated current inflation, percentage**	**Real effective rate, percentage**	**Return on average assets, percentage**
ACEP	20	6	14	0.1
ADOPEM	72	5	67	–0.8
BancoSol	55	9	46	1.0
BKD	55	10	46	3.2
BRI	34	10	25	1.8
BRK Niger	18	0	18	–11.5
CorpoSol	71	19	52	4.9
FINCA	32	9	23	–6.3
Grameen	20	8	12	–3.3
K-REP	38	47	–9	–18.5
LPD	36	10	27	7.4

Note: Locally available data gathered by field team members.

They emphasized short-term working-capital loans and graduated lending, whereby initial loans are small, and loans are renewed and increased on the basis of the borrower's repayment record. Turnaround time for loans was significantly less than 2 weeks, and lenders were located close to the borrowers' place of work.

The study demonstrates that among high-performing programs there is no clear trade-off between reaching the very poor and reaching large numbers of people. Several very large programs (BKD, Grameen) have among the smallest loan sizes. Mixed programs, which serve a range of clients, not just those of a given average loan size, have successfully reached very poor clients. *It is scale, not exclusive focus, that determines whether significant outreach to the poorest will occur.*

Operational Efficiency and Full Self-Sufficiency

Efficient, financially viable institutions can develop the scale and financial leverage to reach large numbers of poor people. These institutions have the potential to multiply contributions from donors by tapping funds from commercial nondonor sources. Donors have an opportunity to reach the very poor through sustainable institutions and to make their investments reach far beyond a dollar-for-dollar effect.

Ten of the 11 institutions examined were *operationally efficient.* They fully covered the cost of day-to-day operations, including salaries and other administrative costs, with program revenues from interest and fees, while reaching large numbers of poor people. The programs achieved these goals in a variety of settings, ranging from rural Bangladesh to urban Bolivia, and with a range of clientele, with average loan sizes as low as $32. Five institutions were *fully profitable*, generating inflation-adjusted positive returns on assets (see table 2). Program revenues covered *both* the nonfinancial "operating costs" and the financial costs of obtaining loanable funds on a commercial basis. These programs no longer rely on concessional funds or other subsidies. The study showed that financial services can be provided to the poor on a financially viable basis. Microenterprise finance institutions can achieve operational efficiency consistently in a range of settings and with diverse levels of clients. But with only 5 of the 11 institutions examined surmounting the hurdle to full self-sufficiency, the capacity to achieve that level routinely has not yet been demonstrated. Still, the rapid progress of many institutions suggests that the number of profitable ones will grow.

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Keys to Financial Viability

The effective real interest rate is one factor that explains the greater self-sufficiency of some programs. Fully self-sufficient programs charged an effective real rate of interest high enough to cover all their costs, including the costs of capital fully adjusted for inflation.

For instance, a fully self-sufficient program in Colombia, CorpoSol, charged an effective real rate of interest of 52 percent, the highest of the sample. Even in an inflationary environment, it sustained a 4.9 percent real return on total assets. In contrast, K-REP of Kenya charged negative 9 percent, the lowest effective real interest rate of the sample. Its return on average assets was also the lowest, despite being operationally efficient. K-REP was unable to adjust its effective rate of interest to a surging inflation rate.

The only other statistically significant factor was the relationship of the program's average annual salary to GNP per capita. Programs paying lower salaries were more profitable than those that paid more. This appears to be related to the historical evolution of the microlending institution.

Programs with lower relative salary expenses, including BKDs, FINCA, Grameen, and LPDs used local personnel to staff their operations. Programs with significantly higher salary expenses, such as ADOPEM, BRK/Niger, and K-REP all began as donor or project-based NGOs stressing outreach more than financial viability. The former, which kept salary costs down by relying on community staff, have a distinct cost advantage.

A statistical analysis of outreach variables and financial performance suggested that among successful programs, there is no clear trade-off between outreach and financial viability. In addition, return on assets could not be explained by any unit cost-based variable, including administrative costs as a percent of the total portfolio.

The study results are counterintuitive. Programs with higher unit costs are logically less viable than those facing lower costs, and costs would seem intuitively to vary inversely with loan size. The explanation is that analysis was limited to frontier programs that had already achieved a significant measure of success in outreach or financial viability, or both.

Nearly all these frontier programs *decided* to be self-sufficient. They brought their cost structures in line with spreads available in local markets, controlling for delinquencies and increasing productivity through client/staff ratios. They adapted credit methodologies to the demands of the market, contributing to efficiency. For 10 of the 11 programs, administrative expenses fell into a narrow range of 9 percent to 21 percent of the average loan portfolio outstanding.

Recommendations

Assess organizations' commitment to achieving operational efficiency and ultimately full self-sufficiency within a reasonable period. Management commitment should be visible in concrete targets and credible plans.

Indicators of effective performance include

- *Operational efficiency.* The organization should be working to develop an efficient, low-cost credit methodology; to control delinquency; and to rationalize its cost structure, particularly salaries.
- *Interest rate and fee policy.* Costs of services should be adjusted for inflation and priced to support financial viability.
- *Reporting standards.* Financial reporting should meet private sector standards, and management should use such information effectively.

Invest in institutions with the potential to reach full self-sufficiency and significant outreach. Donors should focus on support that fosters movement to greater financial self-sufficiency. In considering whether support is warranted, donors need to take into account the time needed to achieve both operational and full self-sufficiency. Programs examined in this study typically required 5 to 10 years to become self-sufficient, often with substantial donor support.

To determine whether an organization needs support, and if so, what type, find out what hurdles the program has to overcome to reach self-sufficiency.

- *In the early phases of start-up,* donor support should concentrate on helping programs achieve operational efficiency, including establishing a lending methodology and operational strategy for service delivery. At this stage, donors are often a key source of start-up capital. However, start-ups should be granted a short time frame, such as one project cycle. If efficiency is not achieved, donors should cease support.
- Donors looking at *programs that have already achieved operational efficiency* should focus on institutions committed to tapping other sources of funds, with concrete targets and plans. Greater emphasis should be placed on improving financial performance reporting, given the higher standards required by investors; financial skills, such as spread management; and asset and liability management. In addition, attention should be directed at meeting the legal requirements to become a licensed financial intermediary or to tap other commercial funding sources. Also important is mobilizing savings to enhance institutional development.

Within a reasonable period, such as one project cycle, assisted institutions need to demonstrate sustained improvement in financial performance indicators, such as operational efficiency, that is revenues versus operating costs, return on assets, and leverage, or total liability versus total equity.

- *For top-performing programs,* donors should consider helping in the transition to full independence. Donor attention will most likely center on strengthening policy dialogue with the government regarding supervisory standards for microenterprise finance, increasing capitalization through retained earnings or equity investment, and mobilizing deposits.

Promote use of standard accounting practices for financial information in microenterprise institutions. Donors have typically required that grantee institutions report financial information, but the information requested varies widely from donor to donor—and institution to institution. Worse, reports prepared for donors often differ significantly from standard financial reporting principles.

Outstanding Issues

The importance of financial information. Even the frontier programs examined in this study had less than adequate standards for reporting on financial performance and outreach.

Accurate financial information, based on generally accepted accounting principles, is critical for two reasons. First, such information contributes to better decision-making and greater efficiency. Second, external sources, such as commercial lenders, depositors, supervisory authorities, and even other donors, rely on accurate financial reporting to decide whether an institution is creditworthy or financially sound. This information determines whether the institution will gain access to additional sources of funds for expansion.

The challenge of mobilizing savings. Possibly the greatest challenge in microenterprise finance is to expand the provision of savings services to the poor. Access to credit by the poor has been emphasized, but research has established that the poor can also benefit from access to secure and liquid savings. BRI's highly successful voluntary savings program demonstrates that many poor clients will save through deposits at financial institutions.

Still, institutions need to provide security, liquidity, and adequate returns to attract deposits. Although some institutions were establishing savings programs, few outside of Indonesia had achieved this on a large scale.

The hurdles are significant. Most institutions lack the capacity to meet the technical requirements of offering attractive financial services and the stringent criteria of bank regulators. Donors should be cautious in promoting efforts at savings mobilization to ensure that institutions have the financial capability to manage resources prudently.

This Evaluation Highlights *was prepared by James Fox of the Center for Development Information and Evaluation. It summarizes the findings from USAID Program and Operations Assessment Report No. 10,* Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Programs *(PN-ABS-519), by Robert Peck Christen, Elisabeth Rhyne, Robert C. Vogel, and Cressida McKean. Readers can order copies of CDIE reports from the DISC, 1500 Wilson Blvd., Suite 1010, Arlington, VA 22209–2404; telephone (703) 351–4006; fax (703) 351–4039; Internet docorder@disc.mhs.compuserve.com. Editorial and production services provided by Conwal Inc.*