KPMG Peat Marwick
Policy Economics Group
2001 M Street, N.W.
Washington, DC 20036
Telephone 202 467 3333
Telecopier 202 728 0546

PN. ACB-930
96379

2 August 1994

United States Agency for International Development
PPC/CDIE
Room 309, SA-18
Washington DC 20523

Gentlemen:

Enclosed please find an external review provided under PIO/T No. 930-0085-4022018 and Order No. AEP-0085-0-00-4026-00.

The review is of a paper entitled "Maximizing the Outreach of Microenterprise Finance: Analysis of Successful Microfinance Programs."

I will provide further comments when financial tables are available in the next draft of the paper listed above.

Yours sincerely

J.D. Von Pischke

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Senior Manager

Maximizing the Outreach of Microenterprise Finance: Analysis of Successful Microfinance Programs

An External Review
by J.D. Von Pischke
under PIO/T No. 930-0085-4022018
Order No. AEP-0085-0-00-4026-00

Submitted to Agency for International Development
PPC/CDIE
Room 309, SA-18
Washington DC 20523

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Copies faxed to Ms Cressida McKean, CDIE, 703 875 5269
and
Ms Annette Binnendijk, Senior Evaluation Advisor, 703 875 5269

Contents

Conclusions

These comments apply to the text of the report excluding the tables, which I have not yet received. I will provide comments on the tables when they become available.

The report is well-written, coherent and effectively covers the territory it explores. It makes a good case for the financial viability of microenterprise lenders as a necessary condition for their continued and expanding outreach to microentrepreneurs and to potential microentrepreneurs. This is an extremely important strategic and policy issue for donors. The report makes an original contribution in this area.

A problem facing any reviews of microenterprise finance is data quality. The study team appears to have dealt with this problem in reasonable manner. Based on this problem, however, the report could make stronger recommendations regarding the importance of good financial housekeeping in efforts to foster sustainable microenterprise lenders.

Comments on Evaluation Design

The design of this synthesis assessment was drafted by Cressida McKean: "CDIE Assessment of Microenterprise Finance: Concept Paper and Preliminary Design." Comments are organized below in the order specified in the external review scope of work, Section C.3.

Are the study questions stated clearly and explicitly? Are they relevant for their intended audience?

The design is comprehensive, clear, explicit and tight. Study questions are relevant to the issues explored and to prospective readers.

Is the conceptual framework clearly articulated? Are major hypotheses stated in the proposal? Are critical variables identified?

"The working hypothesis is that it is possible to reach vast numbers of poor people with financial services through financially viable institutions, and in fact that viability contributes to outreach." This is a clear statement, and the design lists the information required to test this hypothesis.

Does the proposal take into consideration the implications of the findings of relevant literature on the subject?

The design lists several earlier USAID studies and other recent literature having a bearing on the working hypothesis and on relevant donor strategy and policy. It indicates that many previous studies are not very relevant. Their usefulness is limited because the objectives represented by the working hypothesis have only recently been defined as a result of donor experience and some microenterprise lenders' initiatives.

Are the methods of data collection presented? Will they produce convincing, objective findings? Are they appropriate for the purpose of the inquiry? Are they practical given the constraints of time and resources?

The design does not go into detail on data collection. However, it covers the relevant types of information required. This information is largely financial, and standard techniques of financial analysis form the basis for the task. Hence, the lack of detail regarding data gathering does not compromise the integrity of the research design. A vulnerability is the quality of financial and other data available from microenterprise lenders.

Staffing is specified as four economists (including two financial economists) and one social scientist. It would have been better to have specified financial analysts rather than financial economists. Many financial economists are policy wonks concerned with capital markets or financial market structure and regulation. A number in the service of donors are not deeply familiar with accounting and thus not in a position to evaluate data quality judiciously. If financial economists are still preferred in order to avoid the stigma of the green eyeshade, it would be helpful to indicate that ability to judge the quality of accounting data would be required from any financial economist engaged.

Is the basis for selecting countries stated? Is it appropriate for making suitable inferences in the synthesis?

The focus of the task was on successful microfinance programs. There are relatively few of these, given the specifications of success in the "Purpose" section of the design document. The design listed good prospects in section B.1. The procedures used to identify suitable cases are adequate.

Are the time and level of effort provided for the assessment sufficient?

The time and level of effort appear a little tight. An unknown that faces any research using financial statements and related information produced by donor-assisted lenders is data quality, transparency and completeness. There are usually serious problems, which makes it quite difficult to specify the time that would be required to verify the data, reorganize it suitably for analysis, and tease out missing information or make assumptions on which to draw conclusions. The design recognizes this problem explicitly, but the extent of analytical detours that may be required is often hard to predict before the analysis gets underway.

The design seeks to manage this problem by beginning with desk reviews of the selected microenterprise lenders, which provide a basis for defining the additional information that would be required for the purposes of the study. This is a sound approach. Fieldwork is expected not to require more than two weeks, which should give an analyst a satisfactory feel even though it might take longer to get good data from a large lender with a number of branch offices or outposts.

Suggestions and recommendations for improving the evaluation design withi agreed resource constraints:

Overall, the design is comprehensive and satisfactory. It responds well to the issues and objectives stated. Its vulnerable point is use of economists to conduct financial analysis based on accounting data of questionable quality.

Comments on the Synthesis Draft Report

The draft report reviewed was prepared by IMCC: "Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Programs." Comments are organized below in the order specified in the external review scope of work, Section C.4.

Are the purpose, scope and audience stated clearly in the report?

The report is clear about purpose and scope. The audience is defined by the subject, and the report responds to their concerns.

What methods of data collection were used?
Were they appropriate for the assessment?

The report is the product of a literature review and of financial analyses. A bibliography could usefully be added to support the literature review. Results from this review are thoughtfully reflected throughout the report, following an initial discussion in the introductory section, but properly subordinated in emphasis to the empirical contribution of financial data analysis. Financial data were collected from the lenders reviewed. Comments on financial data are provided directly below.

What is the quality of data and information gathered by the team? Are there serious questions about their reliability and validity? If so, how [are] they resolved in the report? Does the report describe the relative strengths and weakness[es] of the data obtained?

The review acknowledges in section II.B. the types of problems encountered in using financial data produced by microenterprise lenders: "The team had great difficulty generating and standardizing the outreach and financial data from most of the individual programs." In confronting this problem, the researchers seem to have used sound approaches, adopting the CAMEL analytical framework used by bank, thrift, and credit union examiners in the US; adjusting for inflation; attempting to standardize data and presentation to permit comparisons; and providing many caveats for readers who might be tempted to read too much into the results.

However, the analysts could have gone further in helping readers understand data problems and the assumptions used in standardization. For example, it would be helpful to know if the institutions surveyed produce audited financial statements. If so is the auditor's opinion unqualified (a clean bill of health under GAAP) or qualified (because of inconsistencies, missing data, or other problems)? What did these institutions' engagement letters instruct auditors to do, i.e., what was the scope of the audit? What is the stature of the auditors? Questions such as these are standard in due diligence undertaken in modern financial markets. The researchers possibly conducted their own review of accounts, behaving as auditors, in the eight institutions they visited, but details of the depth of their probing are not provided.

The primary missing ingredient, however, is an explanation of the criteria used by the investigators to determine the probable extent of bad debt losses, starting from definitions of delinquency. More detail would indeed be helpful here, as bad debt losses are a primary threat to lender viability.

In this respect it should be pointed out that these data problems are not unique to this report. Anyone trying to make sense of donor-funded lenders, other than commercial banks, will be faced with the same frustrations. The researchers have probably done as well as anyone might. A standard of comparison would be analyses of microenterprise lenders by IPC, a German consulting firm. IPC has undertaken such studies for German aid agencies and for the Inter-American Development Bank. More would have to be known about the actual techniques applied by IPC and by the producers of this evaluation to make such a comparison meaningful.

One can assume that donors in general are really not too interested in the precision of the financial analysis. Why else could these problems continue after so many years and dollars of donor credit interventions? Why else would economists routinely be expected to do the work of accountants or financial analysts?

This evaluation may contribute to changes in the attitudes responsible for the relaxed approach to financial reporting, and it makes recommendations to this effect. An annex containing more details of the researchers' problems, procedures and assumptions could be a welcome contribution, and could well be worth a supplementary budget if USAID wants to exercise leadership in this area.

If previous studies and evaluations exist on the subject, were their finding and conclusions presented and reconciled with the findings of the assessment?

Previous work is dismissed as largely irrelevant in this evaluation. This judgment is probably correct, as the emphasis on financial viability as a means of enhancing outreach is quite new. Also, there is little definitive work because the analytical problems confronting these researchers also characterize earlier attempts to do research using financial statements produced by donor-supported lenders.

IPC studies for the Inter-American Development Bank do not appear to have been consulted, and these would be the only omission of any significance. It would probably not be worthwhile, from the standpoint of the objectives of this evaluation, to insist that IPC's reports be consulted or cited. However, if USAID wanted to become more deeply involved in diminishing the "noise" in microenterprise lending analyses, a separate study encompassing different evaluations would be extremely useful and important.

Are all evaluation questions answered in the report? Are the data and evidence for answers to these questions presented clearly?

The report does not respond fully to the preliminary design parameters. The design wanted to include many characteristics of the client population (Concept Paper, p. 6), for example. A reason that this may not have been done in much detail is because data are not available from the lenders studied. Also, Jacob Yaron's Subsidy Dependency Index (SDI) has not been calculated (p. 6), although the criteria for full self-sufficiency used in the study include most of the SDI's features.

The new institutional economics perspective on credit markets, associated with Stiglitz, do not appear to be reflected in the draft. This is not a disqualifying omission, but it could be politically useful to genuflect in that direction. It appears that a separate paper is contemplated by CDIE (Concept Paper, pp. 8 ff) that would contain this material.

Is the chain of reasoning between empirical data, finding, conclusions and lessons/recommendations explicitly articulated in the report?

Yes. The report is logical in structure.

Is the methodology used for synthesizing the findings of various reports sound?

This report is the first of its kind to be produced by USAID.

Comments on the Text

There are a number of points that might be helpful for the report's drafters that are not easily incorporated in the responses given above to the specific questions in the scope of work. Some of these are general, while others are most easily raised in the order in which they arise in the text:

General Comments

The report says almost nothing about **informal finance**, making it seem as if potential beneficiaries of microenterprise finance cannot get any financial assistance or have access to any savings vehicles unless they participate in a microenterprise program. This impression should be corrected, especially in view of recent literature on informal finance and the vitality of informal mechanisms, e.g., Westview Press offerings by Adams and Fitchett, eds. and Bouman and Hospes, eds.

Credit unions are mentioned only in passing, yet Rhyne and Otero in their "Principles and Institutions" article indicate that several credit union movements have achieved financial viability. USAID has assisted a number of credit union organizations, and there is a story to be told. If it is not told here, an indication of why credit unions were not included in the sample should be provided. Their different financial technology ("methodology" in the jargon of the report) may be sufficient cause. The fact that Rhyne and Otero hail them as being viable should be noted in order to ensure balance.

The report is quite well-written and has several statements that are masterpieces of clarity and construction. Examples include the last full para. on p. 5, the final para. on p. 7, the initial para. on p. 9, the para. that spans pp. 14-15, and the final full para. on p. 24.

Comments Arising from the Text

Some of these comments are meant to be thoughtfully entertaining, while others are based on concerns entirely devoid of frivolity.

p. 1, para. 1. Which is the mainstream economy in a country where most of the people are poor, working as farmers, microentrepreneurs or laborers for farmers and small businesses? If one does not participate in economic life, one must be dead or possibly a hermit or recluse. One also wonders about finance as being "among the most important" services, or the definition of finance that is applied. What would some of the others be? The introduction is overblown, too dramatic.

p. 1, para. 4. Mention of only donors and governments leaves open the possibility of private charity, such as through CARITAS or CARE or others. Does private charity play any significant role internationally to reach the poor through small business loans?

p. 1, para. 5. Most in the first hardline group mentioned would say that the poor already have access to a considerable range of financial services that are commercially self-sustaining, and others that are socially self-sustaining, i.e., informal finance. These hardliners have been known to become uneasy when donor money is on the loose in credit markets under conditions that are not likely to lead to commercial viability.

p. 2, top para. The group of hardliners who stress financial viability would not necessarily hold that outreach and sustainability are mutually inconsistent. The *Déjà Vu* scenario, for example, is that programs fail because they are not generally designed to be viable, and outreach shrivels. This is the other side of the coin from the arguments presented in the draft report yet fully consistent with the dynamics of its working hypothesis.

p. 3, para. 3. "Adequate access" is not appropriate for analytical use. It seems that in many donor-funded cases too much access has occurred, as people receive more credit than they can repay and as lenders provide more credit than they can administer and collect. Farm credit in India is an example. Again, overly dramatic. The problem should be viewed in terms of how good loans can be made to the targeted recipients.

p. 4, para. 1, last sentence. Trickle-up economics at its best! But, this is a very important point.

p. 5, first sentence. There has been almost no effort by donors to design risk management into credit projects. This unwillingness to address the obvious is the principal reason most of credit projects have failed. At the opposite extreme, much of the literature on "consumption smoothing" largely demonstrates Churchill's phrase: "a magnificent grasp of the obvious."

p. 6, para. 1. Most of us face "discrimination" these days. Is there some other way to make the point?

p. 6, para. 2. An "equitable income distribution" is hard to identify and is subjective. It did not lead to democracy and political stability in the USSR. Possibly what is more important are individuals' sense that they can improve their life in absolute and even relative terms.

p. 8, first para. of I.A.iv. Have the 1000 points of light and the small platoons been entirely discarded in favor of large agendas? What happens when the sun sets or the regiment loses its way? Can community organizations, such as credit unions, be replicated on a broad scale? Does one have to make a large dent every time to make a difference: a fender-bender theory of development? Risk management, anyone? Remember the US banks that were "too large to fail," costing taxpayers billions? Large organization bureaucracy? Jeffersonian factions or McRedit?

following para. Do most of these "well-functioning institutions" try to serve "the entire spectrum," or is it a question of specialization and division of labor, with lots of market niches?

p. 10, final lines. Are donor resources really "scarce," especially for WID and microenterprises? Interesting thought.

p. 11, penultimate para. Leveraging also grows over time as viable programs expand and scale greatly eclipses the seed money that USAID put in to get things moving.

p. 13. Here a sense of proportion would be helpful in creating a realistic perspective. One reasonable and fair introduction might go something like this:

> Since the beginning of US foreign assistance to poor countries, several thousand credit operations have been launched with American government funds. With respect to microenterprise finance, USAID has supported more than 1,000 PVOs and other lenders to the poor or to very small businesses. Possibly 50 of these have performed in a way that would enable them at some point to continue to operate without donor funds, and some of these would also be capable of sustained growth rather than simply survival. The present study is based on a sample of 11 of the very best, drawn from a field of 20 or 25 promising operations with a reasonable financial track record. It is hoped that the emphasis of this report, which is consistent with recent literature and operational realizations about the nature of small scale credit, will enlarge this field.

p. 15, para. 3, last sentence. One recalls Iacocca's observation that Chrysler lost money on every car it sold but made it up on the volume. It seems to have worked well for him.

p. 16, para. 5. If adjustment changes income, why would it also not change assets and net worth? An explanation would be helpful.

p. 26, second para. and p. 29, bottom para. ROAs exceeding 3% are extraordinary. Banks in the US are grateful to have a 1% ROA. High ROAs may also presage high risks.

p. 32, first para. following the heading. Who would buy the securitized loans of microenterprise lenders, unless great enhancements were offered? There seems to be a growing interest in international microenterprise "apex" funding organizations. These may have some things in common with banks for cooperatives and credit union central liquidity systems, although none of these have been international. Developing country experience with such "friendly" lenders, second-floor softies, has not been good from the standpoint of sustainability.

pp. 34 ff, on savings services. Offering savings services is very dangerous if loan portfolios are weak. The "third critical feature," safety, should be the first critical feature. This would reinforce the realization that good financial performance is unlikely to be sustainable without good accounting and reporting. This is not because these things are good for their own sake or because accountants have a tremendously important social mission, but because accountability is central to confidence. Supervision is meaningless without good data.

p. 36, para. 2. Good commercial banking performance in the US includes having less than 0.5% of the loan portfolio affected by arrears. At the height of the US banking crisis in the 1980s, 3% became a worry level and the banking system had severe indigestion.

pp. 36 ff, on regulation and supervision. Caution is important here. Donors are at the same stage with regulation and supervision that they were with microenterprise finance 10 years ago and agricultural finance 25 years ago: high hopes, unrealistic plans, unsustainable paths, (possibly) little corporate capacity to question critically, and just a touch of romance or self-righteousness, depending on initial dispositions. Interest in the risks attached to reliance on regulatory and supervisory agents is not likely to be kindled until there are failures, and only then, when it is too late, will answers or hypotheses be searched for diligently.

It is worth recalling that BCCI went down because of practices engaged in for years under the scrutiny of more than 20 national regulators, including the Bank of England. It is also worth recalling that the $50 billion or so US farm credit crisis of the early 1980s centered on the portion of the nation's total farm credit portfolio that was most closely associated with the Federal Government. And then the banking crisis that eclipsed it, costing at least $300 billion and possibly $500 billion (equal at the time to the combined GDPs of

Canada and Mexico), occurred in spite of well-trained regulators and responsible authorities as august at the Federal Reserve.

It is also worth reflecting on the fact that for some time after the US banking crisis the supply of credit to small business was greatly constricted. Contributors to publications of The American Bankers' Association state that regulators, once-bitten-twice-shy, tried to drive all risk out of bankers' portfolios, and that this hurt the little guys most. (ABA represents primarily the nation's smaller banks.) How much risk can be driven out of a portfolio until the function of banking is gutted?

At the moment the head of the National Credit Union Administration (NCUA) is chiding the 400 or so community development credit unions (in inner cities, poor rural counties in the South and Indian reservations) about their loan-to-deposit ratios of around 70% as being too low, while NCUA examiners are riding many of these credit unions pretty hard because of portfolio quality and procedural problems....(p. 38, end of middle para.).

In Bolivia the tail wags the dog (p. 37). Banks are not allowed to open because the bureaucrats are not well enough trained or financed to monitor them!

Before promoting regulation and supervision, the paper should consider just how cease and desist orders could be served on an NGO or other poverty lenders, how once served they could be enforced, how an NGO or poverty lender would be placed in conservatorship or receivorship, how mergers might be handled to absorb failing poverty lenders, how operations would be taken over by government officials, how clients will react (especially in urban areas), how depositors will be paid out, how outstanding loans will be collected and how a charismatic leader will be held negligible under civil penalties or tried and jailed for fraud. Possibly another study is needed.

Need Weeds

A personally distressing aspect of the report is frequent citations of needs, especially credit needs. Needs and finance are not good bedpersons, for reasons explored at length in *Finance at the Frontier*. Falling back on needs as a crutch for want of an approach that will produce good loans, to reinforce an otherwise weak proposition, or simply because of lazy drafting suggests that a less than professional approach is being taken, unless the profession is social work or psychology or snake oil marketing.

I found it fun to go through the text and weed out most references to needs, either dropping the term where it is redundant or replacing it with a substitute that has more to do with finance and the new world that one wants to create with microenterprise finance, which would presumably have fewer in need. The following may be of interest:

p. 4, para. 4. Omit

p. 5, para. 4. provide continuing liquidity for microenterprise operations...
liquidity management is the most difficult aspect of operating a microenterprise, having funds available at all stages of asset conversion cycles...

p. 5, para. 5. uses of funds

p. 9, third bullet. reveal potential scope for....

p. 11, penultimate line. into larger businesses.

p. 18, para. 3. opportunities

p. 19, para. 2. use.

p. 28, para. 3. and inflation

p. 30, para. 3. Omit.

p. 31, para. 3. importance of

SECTION C

DESCRIPTION/WORK STATEMENT

C.1. SCOPE OF WORK

C.2 Review Questions

Since the questions to be asked of the external review panels at the proposal stage are likely to differ from those asked at the report stage, they are separately mentioned below.

C.3 Evaluation Design

Contractor shall address the following questions in conducting the review of and preparing written comments on the Evaluation Design document:

- o Evaluation Questions: Are the study questions stated clearly and explicitly? Are they relevant for their intended audience?
- o Conceptual Framework: Is the conceptual framework clearly articulated? Are major hypotheses stated in the proposal? Are critical variables identified?
- o Literature Review: Does the proposal take into consideration the implications of the findings of relevant literature on the subject?
- o Methodology: Are the methods of data collection presented? Will they produce convincing, objective findings? Are they appropriate for the purpose of the inquiry? Are they practical given the constraints of time and resources?
- o Selection of Countries: Is the basis for selecting countries stated? Is it appropriate for making suitable inferences in the synthesis?
- o Time and Resources: Are the time and level of effort provided for the assessment sufficient?
- o Suggestions and recommendations for improving the evaluation design within agreed resource constraints.

C.4 Draft Reports (Country, Technical, and/or Synthesis Reports)

Contractor shall address the following questions in reviewing and preparing comments on each of the Country, Technical, or Synthesis Reports:

- o Purpose, Scope and Audience; Are the purpose, scope, and audience stated clearly in the report?
- o Data Collection: What methods of data collection were used? Were they appropriate for the assessment?
- o Quality of Data: What is the quality of data and information gathered by the team? Are there serious questions about their reliability and validity? If so, how they resolved in the report? Does the report describe the relative strengths and weakness of the data obtained?
- o Integration of the Findings of Earlier Evaluation: If previous studies and evaluations exist on the subject, were their findings and conclusions presented and reconciled with the findings of the assessment?
- o Study Questions: Are all evaluation questions answered in the report? Are the data and evidence for answers to these questions presented clearly?
- o Logical Coherence: Is the chair of reasoning between empirical data, findings, conclusions and lessons/recommendations explicitly articulated in the report?
- o Synthesis Methodology (for synthesis report only): Is the methodology used for synthesizing the findings of various reports sound?

C.5 Required Deliverables

Contractor shall submit written reviews addressing the questions listed above to the AID Project Officer for review and acceptance.

The contractor shall submit the following reviews:

Synthesis Report Review

The contractor shall submit each review within 10 working days of receipt of the document from AID Project Officer.

The review submission deadlines identified above may be modified upon the written approval of the AID Project Officer.

END OF SECTION C

SECTION D

PACKAGING AND MARKING

Not applicable.

END OF SECTION D

SECTION E

INSPECTION AND ACCEPTANCE

E.1. 52.252-2 Clauses Incorporated by Reference (Jun 1988)

This order incorporates the following clause by reference, with the same force and effect as if it were given in full text. Upon request, the Contracting Officer will make their full text available.

52.246-4 Inspection of Services - Fixed Price (Apr 1984)

END OF SECTION E