OCTOBER 1999

FIELD*forum*

ISSUE 2

FINANCING PRODUCTS

... since inception, microenterprise programs in the U.S. have struggled to reconcile the strong desire for capital expressed by low-income entrepreneurs with the difficulties in lending to these low-wealth, often inexperienced and often risk-averse business owners.

To identify new financing tools that can help low-income entrepreneurs obtain the capital they need to start or expand their businesses, FIELD selected this critical issue as one of its first grant-making areas. In June 1999, following a Request for Applications process, five organizations were selected to receive two-year, $100,000 grants to experiment with new ideas and approaches for providing business capital to the poor.

The purpose of these grants is to advance the scale and quality of the microenterprise field's efforts to help microentrepreneurs access capital. FIELD chose to invest in demonstration grants to microenterprise programs because its guiding principle is that practice advances more rapidly when leading practitioners have the opportunity to test new ideas, reflect on the results with their peers and share their findings with others.

This FIELD Forum presents the rationale behind this grant cluster, profiles the grantees and the projects they will undertake and describes plans for future learning from these efforts.

The Issue

Microenterprise development programs emerged in the United States in part because of the strong experience of microfinance efforts in developing nations. These efforts found a strong demand for credit among the many low-income individuals producing goods and providing services in largely informal economies, where traditional banking services are not available.

However, practitioners soon found that although microentrepreneurs in the United States express a desire to access credit, loan demand in this country has been much lower than expected. Indeed, since inception, microenterprise programs in the U.S. have struggled to reconcile the strong desire for capital expressed by low-income entrepreneurs with the difficulties in lending to these low-wealth, often inexperienced and often risk-averse business owners.

The relatively slow growth in loan portfolios of U.S. programs has been documented by several sources. In 1994, for example, only one of the seven senior agencies included in the *Self-Employment Learning Project (SELP)* made more than 85 loans.[1]

[1] Elaine Edgcomb, Joyce Klein, and Peggy Clark. *The Practice of Microenterprise in the U.S.: Strategies, Costs, and Effectiveness.* Washington D.C.: The Aspen Institute, 1996.

Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination

The Aspen Institute
One Dupont Circle, NW • Suite 700
Washington, DC 20036
Phone: (202) 736-1071
Fax: (202) 467-0790
email: fieldus@aspeninstitute.org

The 1996 Directory of U.S. Microenterprise Programs[2] found that the 51 peer lending programs surveyed averaged 42 loans in 1995, while 163 agencies providing individual loans averaged 29 loans in that same year. And, of the 28 microenterprise programs funded by the Charles Stewart Mott Foundation, more than half made fewer than 30 loans in 1995. Only five programs made more than 100 loans per year.

The relatively small numbers of loans made each year are mirrored in the relatively small microloan portfolios held by microenterprise organizations. At the end of 1995, one-third of the microenterprise programs funded by the Mott Foundation had less than $100,000 in outstanding loans; 89 percent had less than $500,000. The SELP agencies had similar experiences in 1994, with average loan portfolios for the year ranging between $156,000 and $503,000.

The small scale of loan activity among microenterprise programs raises two concerns. Foremost is the issue of whether prospective microentrepreneurs are receiving the financing they need in order to launch and operate their businesses.

In addition, the long-term sustainability of microenterprise credit activities is inextricably linked to their ability to cover at least a portion of their operating costs through interest and fee income. The level of cost recovery is tied to the scale of the loan portfolio. The programs in the U.S. that have made the greatest strides in moving toward self-financing of their lending programs are those that have achieved a significant level of lending activity.

There are a number of reasons for the slower-than-anticipated growth of microenterprise loan programs in this country. They include the following:

- The loan preparation and underwriting process generally takes far longer than originally envisioned.
- Microenterprise lenders have continually struggled to increase loan volume while maintaining credit quality. Most lenders have experienced periods of high delinquency and/or staff turnover. These, in turn, affect the rate of new originations as staff resources are diverted from serving new loan clients to addressing problem loans, implementing more stringent borrowing and underwriting requirements to reduce delinquency, and, in some cases, training new staff.
- Peer-lending programs have faced challenges in forming and maintaining groups. Because in the group model, microentrepreneurs can only borrow through the group, problems with the peer group affect the rate of loan originations.
- Perhaps most striking, programs have found large numbers of clients who elect not to borrow — choosing only to receive technical assistance or training, or to participate in a peer group without borrowing. Data from SELP's 1999 Directory indicates that only 11 percent of the clients of microenterprise programs receive loans from the program.

In struggling with the challenge of low loan demand, microenterprise programs explicitly targeting low-income customers have discovered certain characteristics of low-income borrowers that affect their willingness and ability to take on credit. These include:

- *Risk-aversion.* Many low-income borrowers are highly risk-averse in their attitudes toward borrowing. Given their precarious personal financial situations, they often are concerned about taking on debt. Microenterprise program staff often counsel their lower-income borrowers to minimize indebtedness by starting their businesses on a smaller scale, and by seeking ways to

[2] C. Alexander Severens and Amy J. Kays, published by the Self-Employment Learning Project of the Aspen Institute in conjunction with the Association for Enterprise Opportunity.

reduce the need for start-up capital. While these approaches make sense for individual clients, they also affect the rate at which program loan portfolios can grow.

- *Poor or no credit history*. Program clients with poor or no credit history can find that the underwriting process is delayed, as staff or peer group members seek to understand the reasons behind the credit problem and determine how that should affect the decision to extend credit.
- *Access to other sources of credit*. Banks and other lending institutions increasingly have begun marketing to small business owners and low-income borrowers. Increasingly, microentrepreneurs perceive credit cards as an alternative to microenterprise lenders. In addition, microenterprise programs often find that their most credit-worthy borrowers are able to access more traditional lending sources, leaving them with the riskiest and hardest-to-serve borrowers.
- *Lack of equity capital*. While microenterprise lenders have long recognized the lack of equity among their borrowers and have used nontraditional collateral to secure loans, the lack of capital can be problematic when a microentrepreneur faces lower than projected sales and has no excess resources to draw on to make loan payments. That has led practitioners to consider the value of adding equity products to the range of financing options they offer to customers.

The Challenge

Although the phenomenon of low-loan demand and the characteristics of low-income borrowers have been acknowledged for some time, the field clearly needs to develop more financing products and delivery systems to address those issues. Indeed, the industry continues to confront methodological questions about how to best meet the financing needs of low-income entrepreneurs. These include:

- Is it best to use a "stepped" lending approach to deal with both the risk aversion and poor credit histories of many borrowers? Or are larger initial loans preferable because small loans often lead to small businesses that have difficulty garnering adequate market share or generating significant enough income to support a family?
- Do low-income entrepreneurs really need access to equity (or equity-like) financing, rather than debt? Or does the use of equity instruments potentially reinforce a "grant mentality" among people who may have come to rely on welfare?
- Can microenterprise lenders effectively serve borrowers with poor credit histories? What types of lending strategies work well for them?
- Is credit from microenterprise programs important or are other loan sources readily available today?

Indeed, the industry continues to confront methodological questions about how to best meet the financing needs of low-income entrepreneurs.

For a number of reasons, addressing the issue of demand for business capital among the poor is important today. First, in-depth interviews conducted with microentrepreneurs indicate that features of currently offered loan products inhibit willingness and ability to borrow. Moreover, when microbusinesses owned by low-income entrepreneurs remain viable, they play a very significant role in a family's ability to move out of poverty. Building a strong business presumably will require access to sufficient capital. Finally, strengthening loan volume is critical to strengthening the sustainability of microenterprise financing programs.

Thus, FIELD challenged practitioners through a Request for Applications process to build on their lessons about lending to low-income entrepreneurs and enhance their level of financing to the poor. Applicants were asked to propose new financing products — such as equity products — or changes in their loan delivery process that could increase demand. In addition, to promote better-designed products, applicants were expected to conduct (or to have already conducted) market research on their proposed innovations.

Further, applicants were required to demonstrate a solid history of providing loans to low-income entrepreneurs in their past work, and a commitment to maintaining that focus in the activities undertaken with FIELD support. To receive a FIELD grant, applicants were expected to commit that at least 65 percent of the clients receiving the new financing product met FIELD's definition of low-income (that is, at or below 150 percent of U.S. Health and Human Services poverty guidelines).

The Grantees

In all, 35 organizations responded to FIELD's Request for Applications with letters of intent. The five organizations awarded grants proposed to test a range of innovations that could help put capital more readily in the hands of low-income entrepreneurs.

Key themes identified in the applications process include: the need for innovations in the field that affect loan quality, as well as demand; the need to simplify and standardize the loan underwriting process; recognition that equity is an important financing option for low-income entrepreneurs; and recognition that there are distinct niches among low-income entrepreneurs that require specialized products.

The following pages offer a brief description of each grantee and the demonstration project proposed:

ACCION U.S. Network, Cambridge, Massachusetts

Agency background: The ACCION U.S. Network is comprised of six affiliated nonprofit organizations, supported by the U.S. division of ACCION International, a private, nonprofit organization dedicated to reducing poverty by providing loans and other financial services to poor and low-income people starting their own small businesses. ACCION International is an umbrella organization for a network of institutions in 14 Latin American countries and 10 U.S. cities.

The affiliates participating in the FIELD research project are located in Chicago, San Diego, Albuquerque, El Paso, San Antonio and New York. All are credit-led programs, targeting Latino clients. To date, the ACCION Network has provided more than $17.8 million in loans to over 3,000 borrowers. Eighty-six percent of their clients are minorities, and slightly more than 30 percent meet FIELD's low-income guidelines.

Focus of grant: The ACCION Network believes that by increasing outreach and the overall efficiency of the lending process, it can reach and serve more borrowers. Thus, ACCION's FIELD supported project will focus on re-engineering two parts of the lending process: enhancing marketing and sales, and streamlining the underwriting process. Efforts to enhance marketing and sales will include implementation of a client-tracking system that ensures strong follow-up with clients expressing an interest in ACCION loans.

To streamline its underwriting process, ACCION plans to implement an informal credit scoring process, in which the affiliates will collectively identify and focus on the personal and business factors that are identified to be most central to the underwriting process. The Network will also partner with Fair, Isaac to develop a formal credit scoring model for microenterprise loans. ACCION believes that character factors can be scored, and that credit scoring can be responsive to the characteristics of low-income borrowers. The successful implementation of credit scoring will enable the affiliates to increase the efficiency of their underwriting process, focusing more of their credit officers time on providing technical assistance to clients, and marketing to new borrowers. Ultimately, ACCION believes that the availability of this model, which could be licensed for use throughout the U.S., will not only enhance efficiency in the microenterprise industry, but also will attract traditional financial institutions to this market.

Coastal Enterprises, Inc. (CEI), Wiscasset, Maine

Agency background: CEI is a private, nonprofit community development corporation engaged in a range of housing, commercial and economic development activities. CEI began microlending in 1980, lending to small farms and natural resource-based businesses. Since then, it has provided over $7 million in financing to over 500 businesses, and provided technical assistance to 8,000 entrepreneurs. In 1998, 48 percent of CEI's microenterprise clients were women, 3.5 percent were minority, and 30 percent met HUD low-income guidelines.

Focus of grant: CEI will offer two products aimed at increasing the level of its lending to low-income individuals: conditional grants teamed with flexible loans, and a "micro-equity" product. In its experience in lending to low-income borrowers, CEI has found that it needs to offer a range of flexible capital products that match the financial requirements of individual businesses and their owners. CEI already offers flexible term loans that can be structured to address cash flow requirements. However, it also has identified a need to offer equity financing as well.

For microenterprises that appear to have some potential for growth, CEI will be creating a "micro-equity" product. Drawing on its existing experience in community development venture capital, CEI will examine three models: (1) traditional equity financing for incorporated microenterprises, (2) a contract-based near-equity product for sole-proprietorship businesses, in which a contract outlining the investment relationship will substitute for the ownership arrangement in standard equity deals, and (3) a royalty-based near-equity product.

For microbusinesses with smaller prospects for growth, CEI is planning to expand a current program in which it teams conditional grants with flexible term loans. The grants provide a small amount of financing for business activities — such as attendance at trade shows — for which the potential return is uncertain. They also provide a means for highly risk-averse entrepreneurs to try out a new product or service without taking on additional debt.

Community Ventures Corporation (CVC), Lexington, Kentucky

Agency background: CVC is a nonprofit community development corporation that serves 25 counties in Kentucky's Bluegrass Region. CVC began its microlending program in 1992, with its Bluegrass Microenterprise Fund, a peer-lending program.

Since that time, CVC has also added a Small Business Administration (SBA) Microloan program through which it makes larger individual microloans. Over time, CVC has made more than $1.1 million in loans to 231 entrepreneurs. Ninety-five percent of these loans have been made to individuals meeting HUD low-income guidelines (43 percent meet FIELD low-income guidelines). In 1998, 64 percent of its 238 clients were women, and 71 percent were minorities.

Focus of grant: CVC proposes to create three new loan products that will expand the organization's continuum of loan products for low-income borrowers.

The new products are:

- A "Jump Start" peer loan that will provide up to $500 to finance predevelopment costs of its training program graduates. This product will have reduced underwriting requirements for clients who have some access to sources of repayment beyond their businesses.
- An "SBA Express" loan that will provide small amounts of capital with rapid turnaround to SBA Microloan applicants who need small amounts of financing to meet a short-term need (e.g., to fulfill a contract). Through this product, CVC hopes to serve clients who have found the current underwriting process to be too lengthy.
- A consumer loan product for business loan customers who experience personal financial needs that will impact the business. The purpose of this product is to assist clients to meet personal needs that would otherwise draw cash out of their businesses.

New Hampshire Community Loan Fund, Concord, New Hampshire

Agency background: The New Hampshire Community Loan Fund is a non-regulated Community Development Financial Institution (CDFI) that provides loans to support affordable housing, as well as self-help and economic development. Although it made its first microloan in 1987, the Fund became active in microlending in 1992, when it became a local affiliate of the Working Capital program. The Fund is now expanding its peer-lending program statewide. (Working Capital is no longer active in the state.)

Over the past three years, it has made almost 90 loans totaling approximately $175,000. In 1998, 53.8 percent of its clients were women, 14.1 percent were minorities, and 39.1 percent met HUD low-income guidelines.

Focus of grant: The organization plans to expand the level of microlending in the state of New Hampshire by offering three different loan products. In designing its products, NHCLF has sought to address two challenges. The first is to create a range of products (including both peer and individual loans) and modes of outreach (offering loans directly and in partnership with local organizations) that can attract larger numbers of entrepreneurs. The second is to carefully construct underwriting approaches and criteria that can minimize the often very high costs of making microenterprise loans. The three products to be offered by NHCLF are as follows:

- A statewide peer lending program.
- The "Towns" project, which will offer lines of credit to municipalities and other local development organizations that have business counseling and/or underwriting capacity, but lack flexible capital to make microloans.
- The "Specialty Trades" project, which offers lines of credit to trade associations, which in turn make microloans to members.

West Central Wisconsin Community Action Agency, Inc. (West CAP), Glenwood City, Wisconsin

Agency background: West CAP is a community action agency that serves low-income residents in seven rural counties in west central Wisconsin. The agency began its microenterprise program in 1991 by providing technical assistance and training, and added a loan fund in 1992. To date, the organization has made 89 loans, totaling just over $315,000. West CAP served 87 clients in 1998; 40 percent of these clients were women, and 69 percent met FIELD low-income guidelines.

Focus of grant: West CAP's project aims to provide equity to businesses facing cash-flow issues in their early years. In analyzing the performance of both its loan portfolio and the businesses it has financed, West CAP has observed its clients strug-

Grantees at a Glance

Grantee	Microlending History	Financing Hypotheses	Financing Product/Innovation
ACCION U.S. Network; affiliates in: • New York • San Diego • Chicago • Albuquerque • San Antonio • El Paso	• Since 1991 • More than $17.8 million in loans to over 3000 borrowers	• Credit scoring will increase the efficiency of the underwriting process, allowing credit officers more time for marketing and technical assistance. • Character factors can be scored. • Credit scoring can be responsive to the characteristics of low-income borrowers. • A successful credit-scoring model will attract traditional financial institutions to this market.	• Enhanced marketing and sales techniques for loan products. • Creation of an informal credit scorecard by ACCION U.S. affiliates. • Creation of a credit scoring model for microenterprise loans.
Coastal Enterprises, Inc., Wiscasset, ME	• Since 1980 • More than $7 million in loans to over 500 businesses	• A continuum of financing products is necessary to meet the capital needs of low-income entrepreneurs • Equity products should be included in this continuum.	• Blend conditional grants with flexible term loans. • Create a micro-equity product from among three proposed models: (1) traditional equity financing, (2) a contract-based near-equity product, and (3) a royalty-based near equity product.
Community Ventures Corporation, Lexington, KY Serves 25 counties in Kentucky's bluegrass region.	• Since 1992 • More than $1.1 million in loans to 231 entrepreneurs	• Developing a longer continuum of loan products will increase scale and sustainability. • There is a need to address the personal as well as the business financing needs of microentrepreneurs.	• "Jump Start" loan products that will provide small amounts (up to $500) to finance pre-development costs of training course graduates. • "SBA Express" loan, to provide access to small amounts of capital to SBA Microloan applicants who need capital to meet a short-term need (e.g., contract). • Consumer loan product for business loan customers who experience personal financial needs that will impact the business.
New Hampshire Community Loan Fund, Concord, NH Operates statewide in New Hampshire	• Pilor program begun in 1992; • Since 1996, has made almost 90 loans totaling approximately $175,000.	• Reaching large numbers of entrepreneurs requires a range of products and modes of outreach. • It is important to build off of the pre-existing relationships of entrepreneurs. • Microlenders must carefully construct underwriting approaches and criteria that can reduce their costs.	• Statewide offering of peer lending. • Exploration of an increased loan size in peer lending, using new underwriting approaches. • Line of credit to towns that have the capacity to provide counseling and underwriting. • Line of credit to specialty trade associations.
West CAP, Glenwood City, WI Serves 7 rural counties in west central Wisconsin	• Since 1992 • 89 loans total just over $315,000	• Equity is required to strengthen businesses in their early years of operations. • Equity can be used to strengthen repayment.	• "Business Investment Trust" accounts. 40% of the monthly loan payment is escrowed in the trust account. After 12 consecutive months of on-time repayment, the client can access the funds to invest in inventory, equipment, working capital or leasehold/property improvements.

gling with business operations and loan repayment at the 12- to 18-month period. At this time, they have invested significant time and energy into their businesses, but continue to face an ongoing trade-off between taking a salary or draw, and reinvesting in the business.

To address this need, they will create a Business Investment Trust, which will hold in escrow 40 percent of each loan payment. After 12 consecutive months of on-time repayment, the client can access the funds to invest in inventory, equipment or working capital. Thus, the trust will provide both an incentive for loan repayment and equity for the business.

The Learning Assessment

FIELD's mission not only is to seed innovation, but also to share the resulting lessons learned with the microenterprise field. To ensure that the findings from these grant activities will benefit other practitioners, the grantees and FIELD staff will work together to implement a "learning assessment" that will harvest and share the results of these demonstration efforts. The process will include:

- Meetings at which grantees can exchange information on implementation issues, preliminary findings and final results.
- Documentation of results from the financing products implemented by grantees.
- Production and dissemination of documents that capture lessons learned on issues relevant to the field.

Reports will be disseminated broadly to policymakers, practitioners and other interested parties during and after the two-year grant period.

About FIELD

The Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD) is a research and development fund dedicated to the expansion and sustainability of microenterprise development efforts, particularly those aimed at poor Americans. Designed to make a significant, strategic investment in building the capacity of the microenterprise industry, FIELD makes targeted grants to practitioner organizations pioneering promising approaches to key challenges facing the field today. Its mission is to identify, develop, and disseminate best practices, and to broadly educate policy makers, funders and others about microenterprise as an antipoverty intervention.

Common Themes and Issues

	ACCION	Coastal Enterprises	Community Ventures	NHCLF	West CAP
Equity Products		X			X
Pre-Startup Finance		X	X		
Continuum of Finance Products		X	X	X	
Underwriting Criteria	X			X	
Product Marketing and Sales	X				
Consumer Finance			X		