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BUSINESS CAPITAL FOR MICROENTERPRENEURS: PROVIDING MICROLOANS

In the United States, the term microcredit refers to loans under $25,000 made to entrepreneurs who typically cannot access traditional forms of commercial financing for their businesses. Loan features, including collateral requirements, size and term are tailored to the needs of low-income, higher risk entrepreneurs and are different from standard bank loans. Credit is one tool in the toolbox of services that microenterprise development programs use to support and foster this client group. Credit is most often paired with related business training and technical assistance, and together these three components represent a comprehensive set of services that constitute microenterprise development. This fact sheet, however, focuses on microcredit, summarizing for those new to the field its evolution, the principle methodologies, current product innovations and the institutions that offer these types of loans.

EVOLUTION OF MICROCREDIT IN THE UNITED STATES

Fostering self-employment among the poor in this country has various roots: the anti-poverty movement; the dramatic increase in numbers of women business owners; corporate downsizing; and the restructuring of the banking industry that has almost eliminated local lending by small community banks. (See Fact Sheet Issue 1 for a more detailed discussion of this history). In the 1980s, the gap between the terms of commercial loans and the needs of low-income entrepreneurs (or aspiring entrepreneurs) motivated pioneering nonprofit organizations to experiment with innovative lending characterized by small loans sizes and flexible collateral requirements for low-income clients. Many agencies enthusiastically adapted a group lending model brought to the United States from developing countries widely known as "solidarity" or "peer" group lending in which group members' guarantees and peer pressure replace collateral. These efforts quickly attracted community economic development activists eager to try a new strategy that targeted both personal and financial empowerment for the poor.

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Fairly quickly, however, practitioners' enthusiasm for credit was matched by two important realizations:

- Microentrepreneurs need more than credit if they are to use their businesses to move out of poverty. Both to protect their loan portfolios and to respond to clients' crying needs for assistance, many programs strengthened the business training components of their methodology, often linking loan eligibility to successful completion of training programs.

- Making loans to the self-employed poor is more difficult in the United States than it is in developing countries. Contrary to initial expectations that programs would operate like an automatic teller machine dispensing credit, microenterprise programs have long been perplexed by the apparent contradiction between clients' need for working capital and their hesitation to take advantage of available loans. While programs listed in the *1999 Directory of U.S. Microenterprise Programs* loaned almost $33 million in 1997, only 11 percent of their 57,000 clients nationwide are borrowers. The vast majority choose to participate in training and receive technical assistance only. Nevertheless, in surveys and focus groups across the country, clients continue to report their need for capital.

Against this backdrop, microenterprise development programs invested more in their training and technical assistance services, shifting the focus of the field to education, skill building and finding solutions to the unique issues that low-income entrepreneurs confront. Those programs focusing more on training have been distinguished as "training-led," while those choosing to maintain a singular focus on making loans and the business of lending became known as "credit-led." The latter have specialized their operations in pursuit of the right credit products and delivery mechanisms that will lead to a scale of operations that generates enough income from interest and fees to pay for itself (i.e. become sustainable). However, it is important to note that, today, this distinction between training and credit-led is less relevant as most programs offer some combination of credit, training and technical assistance.

Box 1:
Average Loan Size

Peer Group Loans
$1,081

Individual Loans
$10,631

LENDING METHODOLOGIES

Two principal methods, incorporating both the type of loan and the process to deliver it, have been used to make loans to microentrepreneurs– lending to individuals and peer group lending. Over time, some programs have developed credit services that constitute a hybrid of the two.

Individual lending involves the provision of loans directly to individual entrepreneurs or their business entity. Applications are made to the microcredit program and loan decisions are made by staff, board or a loan committee made up of organizational and community members. Loans are often "stepped," enabling borrowers to take successively larger loans based on their repayment record. Loans are made for different

business purposes, including testing a product or business idea, starting a new business or expanding an existing one. Although individual loans have traditionally required collateral requirements and/or co-signers, microlenders have proved very agile and responsive, finding flexible collateral requirements that facilitate lending to low-income entrepreneurs. And, as the field has matured, programs are making larger loans as well, ushering in more technical loan review processes and staff with more specialized skills.

Organizations using the peer group lending methodology make loans to individuals who are members of an established group of entrepreneurs. Group members co-guarantee each other's loans; with on-time repayment, they are eligible for subsequent loans that typically increase in size. But one member's failure to repay will prevent the others from accessing new loans. In some programs, loan eligibility is linked to mandatory regular saving by group members which creates a fund to partially cover defaults. Under the assumption that members know and trust each other enough to make loan decisions based on character, groups assume responsibility for loan screening and processing, thus reducing transaction costs for the lenders.

Box 2: Neighborhood Development Center
St. Paul, Minn.

When NDC Director, Mihailo Temali, wanted to start a loan program to bring home-based businesses out of the woodwork and onto the street to help revitalize inner city neighborhoods, he looked closely at the peer lending model. He felt that it might work if marketed through booster clubs, churches, city recreation centers or other community groups with established constituencies. But when such groups showed little interest, Temali opted for individual loans combined with neighborhood-based training.

Box 3: Working Capital in New England

Founded in 1990, Working Capital has been one the most enthusiastic advocates for peer lending in the industry. It makes stepped loans starting at $500, increasing to $10,000 (the average loan is just under $1,200). Its current portfolio of $500,000 lent out to 170 active borrowers places it among the largest microcredit programs in the country. Its peer group lending has been particularly relevant in Lawrence, Massachusetts, where 143 borrowers, mostly Dominican immigrants, are drawn to peer groups because they have few other sources of credit and minimal assets. Peer group members confirm that their group participation has led to increased self-confidence, community involvement and business activity through networking with other members.

Yet, over 50 percent of Working Capital's dues paying members join groups but do not borrow. To expand its base of borrowers, Working Capital is adapting and diversifying its loan products. Group loans can now start as high as $2,000 (up from the original $500). And, the organization has introduced individual loans for small businesses that have been in operation for at least one year. Starting at $2,000, these loans can increase to a maximum of $20,000.

Peer groups can also serve as an effective mechanism for peer support and networking. As such, they engender a host of important social benefits for members, including increased confidence, less isolation, and enhanced status within their households and communities. Yet, today only 16 percent of practitioner agencies provide credit using a group lending methodology, compared to 65 percent that make loans to individual, and 10 percent that use both methods.

**Box 4:
The Five Cs of Credit**

Capital	**Adjust for size**
Capacity	**Can be nurtured**
Collateral	**Is psychological**
Character	**Needs to be understood**
Conditions	**Are critical**

Source: Phil Black, Presentation at the National Community Capital Association

The peer group methodology has been much more difficult to implement than expected based on experience in developing countries. Borrower groups are labor intensive, both to organize and to maintain. The low concentration of microentrepreneurs in a robust formal economy has forced programs to bypass the principle of self-selection and organize groups, often with strangers who naturally resist exposing their private financial affairs to each other. Borrowers find group participation too time consuming, especially when personal conflicts or high turnover consume energy and erode cohesiveness. Practitioners have found that groups require a significant investment in building group commitment, trust and problem solving skills.

Drawing the best elements of these two methods, some lenders are combining individual loans with group mechanisms for training, support and networking. Whether using group or individual methods, lending to microentrepreneurs differs from traditional commercial lending in loan size, eligibility requirements and the borrowers' risk profile. Microcredit can be characterized by the Five "Cs" of credit in Box 4.

INNOVATION IN FINANCING FOR MICROENTERPRISES

With the exception of a handful of programs, loan volume– both numbers of loans and the dollar value of portfolios– is small regardless of the lending method used. The 281 programs listed in The Aspen Institute's *1999 Directory of U.S. Microenterprise Programs* disbursed an average of 24 loans in 1997.

Low lending volume can be attributed to several factors including:

- aversion to the risk of borrowing by those in a precarious financial situation;
- access to more rapid and flexible sources of credit such as credit cards, family and friends;
- inadequate loan products.

A leading practitioner in the field uses the metaphor of a combination lock to describe the challenge practitioners face in finding the right loan products: "It takes three numbers in the right sequence to open that lock, and we just haven't found the right numbers in the right sequence yet."

In response to this challenge, programs are beginning to experiment with different products and lend-

ing procedures to better meet borrowers' financial needs and increase their loan volume, with support from the Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD). Product innovations include:

- equity building products such as the West CAP's "Business Investment Trust" accounts where 40 percent of loan repayments are placed in escrow to be accessed by the borrower after 12 months of on-time repayment and used for inventory, equipment purchases, property improvements or working capital;
- specialized loan products for market niches, such as day-care providers and the disabled, enable programs to better address the specific needs within each industry or target group;
- consumer loans for business loan customers who incur personal expenses that could have a negative impact on the business;
- larger peer group loans with enhanced underwriting.

These products have been designed in response to challenges that microentrepreneurs face in different situations. A unique category of borrowers are TANF (Temporary Assistance to Needy Families) participants who want to pursue self-employment in their transition from welfare to work. For this group, more complex strategies are emerging, including financing components that incorporate very small initial loans, flexible underwriting criteria that accommodate lower asset levels, and small grants.

Programs are also looking for better procedures that enhance their efficiency and outreach to more borrowers including:

- more aggressive marketing of programs and their credit services using traditional marketing tools, including market research;
- a credit scoring system that incorporates important criteria in microlending, such as the borrowers' character, and increases the efficiency of the underwriting process, thus giving credit officers more time to

Box 5: Coastal Enterprises, Inc.

To increase the level of lending to low-income people, CEI is offering two products. The first is a conditional grant for microbusinesses with modest prospects for growth. Provided in partnership with Trickle Up, another microenterprise development organization, these grants can be paired with CEI term loans or accessed as a separate product. The grants offer an opportunity for risk-averse entrepreneurs to fund a business activity and to build a relationship with a financial organization.

The second is a micro-equity product which will furnish equity in amounts of up to $25,000 to microbusinesses that have some potential to grow. CEI will be testing models of micro-equity that can be applied to microbusinesses, regardless of organization structure.

spend on assisting current borrowers and marketing to potential new ones;

- centralized "back office" loan processing collections and administration by programs with multiple branches or storefronts will streamline loan officers' jobs, enabling them to focus more on outreach and loan generation;

- new modes of outreach with lines of credit to partners, such as trade associations and economic development agencies of local government, that have established constituencies.

PERFORMANCE IN MICROLENDING

While making loans to the entrepreneurial poor is a powerful concept, one must ask whether it can be done in a cost-effective manner. From the simple question "do these high risk clients repay?" to more complex ones about the cost of lending, programs are held accountable for their performance. Because microenterprise development, and credit in particular, is patterned after business operations more than other nonprofit services, its advocates have a high stake in tracking performance as they seek to attract bank partners and establish legitimacy among policy-makers as an economic development strategy (Source: Doyle, 2000).

Because microlending is their primary focus, credit-led programs offer the best window into its performance. These programs are driven to achieve the scale and efficiency that will lead to self-sufficiency. Table 1 provides a summary of loan activities in 1998 from five credit-led programs; credit is their primary activity, even though services include varying amounts of training and technical assistance.

Clearly, some of these credit-led programs are making progress toward covering a substantial portion of their costs. With limited training expenses and a focus on expanding loan portfolios to maximize income, the average cost per loan across the five programs is $3,598. However, these positive trends in cost recov-

Table 1: A sample of credit-led programs at a glance
(as of Dec. 31, 1998) [1]

	Average Loan Size	No. of Loans Outstanding	$ Value of Av. Portfolio Outstanding	Operational Self-Sufficiency[2]
Program A	$5,754	147	$777,033	128.0%
Program B	$4,034	113	$469,693	75.5%
Program C	$6,545	322	$1,197,767	114.5%
Program D	$1,180	43	$67,752	8.7%
Program E	$1,171	39	$38,300	7.8%
All Programs	$3,737	113	$603,737	75.5%

ery are tempered by the more uneven performance in loan repayment. The portfolio at risk rate ranges from 6 percent to 40 percent across these five programs.

Lending activity among training-led programs is less robust and more expensive, reflecting the fact that making loans is not their primary business. Among a sample of 14 core programs participating in MICROTEST, a national working group of 55 practitioners that develops and tests performance measures for the industry, only 48 percent of clients in training-led programs have a business, while in credit-led programs, the figure is almost 100 percent. However, training-led programs make more loans to clients that qualify as low-income, and more of their loans support new businesses (known as "start-ups"). This fundamental difference influences both volume and costs because these clients require more intensive assistance.

THE LENDERS

Microlending was introduced in the United States largely by nonprofit organizations established with a singular programmatic focus on microenterprise development. But increasing interest in the strategy has led to its adoption by a diverse range of institutions that lend to microentrepreneurs– in some instances through small departments or lending windows of larger financial institutions; in others through programs that are housed within community development agencies. The Coalition of Community Development Financial Institutions (CDFIs) has identified five types of CDFIs, three of which, summarized in Table 2, lend to microentrepreneurs.

Table 2: Comparison of CDFIs That Lend to Microentreprenuers

CDFI Type	Community Dev't. Credit Unions	Community Dev't. Loan Funds	Microenterprise Dev't. Loan Funds
Purpose	To promote ownership of assets and provide affordable retail financial services to low- and moderate-income people	To re-lend capital from social investors to support housing, businesses and social services in lower income communities	To foster social and business development among low-income and those unable to access con-
Borrowers	Individual credit union members	Nonprofits, social service providers, small businesses	Low-income individuals
Capital Sources	Members' deposits, limited deposits from social investors, government	Foundations, banks, religious organizations, individuals, companies, government	Foundations, state & federal government, corporations
Financial Products	Savings/checking accounts, personal loans, home rehab loans	Loans for construction, facilities development, business start-ups and expansion	Peer group and individual loans to microbusinesses
NOTES	The amount of microenterprise lending credit unions do is difficult to determine given that their popular consumer loans are often invested in businesses	Loans to individual microentrepreneurs are only part of a larger portfolio invested in a wide range of community development projects	Often housed in larger institutions such as Community Development Corporations and Community Action Agencies

Source: Coalition of Community Development Financial Institutions, 620 Chestnut St. Suite 572, Philadelphis PA. www.cdfi.org

CONCLUSION

The rich diversity of lenders, borrowers and products show that microcredit is no longer an isolated, experimental strategy. Rather, it is an important tool for many types of institutions and programs committed to economic development. More than a decade of experience also highlights key questions about microcredit that challenge its proponents. How can the usefulness and impact of these small loans on fledgling businesses be credibly and affordably measured? How can programs use equity financing as a complement to loans? What changes to current financing products will better meet entrepreneurs' needs and stimulate demand? With microcredit, practitioners have demonstrated that the poor are bankable; they need to continue paying close attention to how low-income entrepreneurs use financial services to respond to this next set of challenges.

RESOURCES

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ENDNOTES

1. Source of data: MICROTEST, a project of the Economic Opportunities Program of the Aspen Institute, Washington, D.C.

2. Total income from loan fund / credit program operational expenses.