Journal of Microfinance

Volume Two, Number Two
Fall 2000

MARRIOTT SCHOOL
BRIGHAM YOUNG UNIVERSITY

PROVO, UTAH

Journal of Microfinance
is published by
The Marriott School at
Brigham Young University
Provo, Utah
USA

ISSN: 1527–4314

www.microjournal.com

Journal of Microfinance
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Subscriptions and Submissions

Journal of Microfinance (ISSN 1527-4314) is published semiannually by Brigham Young University. Second-class postage paid at Provo, Utah, and at additional mailing offices. Postmaster: please send address changes to Journal of Microfinance, 790 TNRB, Marriott School, Brigham Young University, Provo, UT 84602.

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Submissions: *Journal of Microfinance* is pleased to accept submissions for publication sent to the special attention of the editor. All communications dealing with articles should be sent by email to gwoller@byu.edu; or to Journal of Microfinance, 790 TNRB, Marriott School, Brigham Young University, Provo, UT 84602, USA.

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Banking on Customer Loyalty

by Craig Churchill

ABSTRACT: Enhancing customer loyalty is a microfinance institution's most important business strategy. Every critical element involved in managing microfinance operations—from product pricing to staff incentives, from marketing to eligibility requirements, from client screening to the menu of available services—can (and should) be formulated to promote loyalty. While most MFIs recognize the importance of client retention, few have designed business strategies to maximize customer loyalty. Hopefully that will change. This article details the economic impact that customer loyalty has on a microfinance institution (and the negative effect of desertion).[1]

Most microcredit products were not originally designed to accommodate the specific and dynamic requirements of microentrepreneurs. They were created with rigid controls to compensate, or perhaps overcompensate, for the fact that the loans were unsecured. While group mechanisms, like solidarity groups and village banks, are the most obvious form of collateral substitute, other elements were also considered important, including frequent repayments, regular meetings, forced savings, small loans for short terms, and zero tolerance for delinquency. In the interests of delivering these loans efficiently, microfinance institutions adopted a one-size-fits-all mentality.

Some microfinance institutions used their loan products as a screening device. Almost anyone who applied for a loan received one, but a very small one. Those who repaid on time received another, slightly larger loan, while anyone who had difficulty repaying was not permitted to receive subsequent loans. This approach, designed to reduce the credit risk, inadvertently created an operational culture in which staff were actually encouraged to exclude borrowers over time. This credit-driven approach also assumed that the customers who were not weeded out would continue to borrow again and again.

The resulting experience with these rigid credit products was largely successful. MFIs served markets with a seemingly insatiable demand. Clients were not particularly discriminating. Large volumes of novice borrowers were thrilled that an organization was willing to lend them money. If 20 percent of the customers were kicked out because they did not meet the strict on-time repayment requirements, and if 30 percent stopped borrowing because they were round pegs forced through square holes, there were more than enough prospective borrowers ready to take their places.

However, the landscape is changing—in some countries it is changing very quickly. MFIs are losing their monopolistic control over the market, and customers are becoming experienced purchasers of financial services. The microfinance industry is also learning that some of its original assumptions are not true, or are no longer valid:

- Some controls designed to exact timely repayment are excessive, which unnecessarily encourages customers to stop borrowing or go elsewhere.

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- The market for microenterprise loans is not homogeneous; one size does not fit all.
- Many clients do not want to keep borrowing. They do not necessarily like being in debt.

Changes in these assumptions, as well as the realities of increasing competition and a more discerning clientele, suggest the need for a different approach to microfinance. This article proposes that MFIs should respond by adopting a business strategy to enhance customer loyalty. It begins by defining loyalty and then attempts to demonstrate that customer loyalty is the primary driver of long-term financial performance. It illustrates the positive effect of customer loyalty (or the negative effect of desertion) on the organization's ability to manage growth, retain staff, and improve the lives of its customers. The article concludes by describing indicators to measure and monitor customer loyalty.

What Is Loyalty?

Loyalty is the attachment a customer feels for a company's people, products, and services. Griffin (1995) defines a loyal customer as someone who

- Makes regular purchases.
- Purchases across product and service lines.
- Refers others.
- Demonstrates an immunity to the pull of the competition.

Loyalty can be broken down into four categories (see Figure 1) based on the customer's attachment or affinity to the products and services (or to the organization that provides them) and their purchase pattern (i.e., whether they take a repeat loan[2]):

Figure 1: Four Types of Loyalty

		Likelihood of Accessing a Repeat Loan	
		High	Low
Relative Attachment	High	Premium Loyalty	Latent Loyalty
	Low	Inertia Loyalty	No Loyalty

Adapted from Griffin (1995)

1. **No Loyalty:** Some customers, for some products, never become loyal. They switch their affiliations depending on who offers the best deal. In competitive markets with products that are reasonably indistinguishable, certain marketing strategies can unwittingly create customers who lack loyalty. For example, if businesses try to achieve market share by providing a service at the lowest price, by issuing coupons, or by making special introductory offers, then customers may keep following the best deal and may even feel cheated if they do not receive a discount.
2. **Inertia Loyalty:** In less competitive microfinance markets, MFIs can be lulled into assuming that their clients are loyal because they have nowhere else to go. Consequently, clients may borrow again and again, but not because they have a particularly high attachment to the organization. If a new player arrives on the scene, these customers would be the first ones out the door.
3. **Latent Loyalty:** While customers may feel loyal to an organization, they may not want to borrow all the time. Perhaps they only borrow to stock up on inventory during the holiday season, or perhaps their business is generating enough revenue that they no longer need to borrow. While not highly profitable, these

"latent loyals" represent a valuable market for new products as well as an indispensable source for referrals.

4. **Premium Loyalty:** Premium loyalty, characterized by a high affinity and repeat patronage, is the most desirable form of loyalty. Customers who exhibit premium loyalty are proud of their affiliation with an organization and they take pleasure in sharing their positive experience with others. The challenge is how to cultivate premium loyalty.

Loyalty and Profitability

Loyalty has to be earned. If an organization is loyal to its customers, if it is committed to providing them with a valuable service, and if it improves that service as its customers' needs change, then customers are likely to repay the favor in the form of a mutually beneficial, long-term relationship. Is customer loyalty worth the effort? This section attempts to demonstrate that the road to profitability is paved with customer loyalty.

Life Cycle Strategy

Many MFIs employ a life cycle strategy, which involves serving unprofitable clients in anticipation that they will become profitable customers over time. In this case, profitable means that the cost of providing a loan to a client is less than the revenue that loan generates. Following the life cycle strategy, the institution needs to retain clients at least until they produce enough revenue to cover the losses they accumulated during the previous loan cycles.

For the first few loans, the acquisition and screening expenses, on top of the regular transaction costs, are often higher than the revenue produced by low loan balances. Only after several loans do the unit costs come down (through more efficient servicing of repeat customers) and the revenues increase (through larger loans) to the point where that loan generates a net income. And still it may take several more loans before the accumulated income from that customer is sufficient to cover the losses from earlier loan cycles.

Figure 2: The Importance of Customer Loyalty

Loan Cycle	Loan Amount($)	Effective Rate(%)	Revenue($)	Unit Cost($)	Net Income($)	Cumulative Income($)
1	50	35	17.50	175	(157.50)	(157.50)
2	75	35	26.25	100	(73.75)	(231.25)
3	125	34	42.50	80	(37.50)	(268.75)
4	200	34	68.00	75	(7.00)	(275.75)
5	300	32	96.00	50	46.00	(229.75)
6	375	32	120.00	50	70.00	(159.75)
7	500	30	150.00	50	100.00	(59.75)
8	500	30	150.00	50	100.00	40.25
9	600	28	168.00	50	118.00	158.25
10	750	28	210.00	50	160.00	318.25

In a hypothetical example illustrated in Figure 2, the lender gradually raises the loan size from $50 during the first cycle to $750 for the tenth loan. Because of the administrative fee structure, the effective rate on this loan gradually declines. Through more efficient processing of repeat loans, the lender can lower the unit loan costs considerably after the first few loans, from $175 for the first loan to $50 after the fourth loan. In this highly stylized example, it is only in the fifth cycle that a loan becomes profitable, and the MFI does not recoup its accumulated losses from the first four loans until the eighth loan.

If this client leaves before the eighth loan, the MFI will have lost money on this borrower. If this client defects in order to borrow from a competitor, and she uses her exemplary repayment record with MFI #1 to access better terms from MFI #2, then MFI #1 lost money on the client and effectively subsidized the competition by teaching that client how to borrow and supporting her while she developed a credit history.

Portfolio Diversity?

Of course, accounting systems track profitability from year to year, so they do not consider a client's life cycle with an institution. An alternative way to measure client profitability is to consider an institution's portfolio mixture at one point in time. Figure 3 helps to highlight this point. For illustrative purposes, assume that the cost of providing a loan is basically constant regardless of the loan size, and that the price of the loan (interest rate) also remains constant. If these assumptions were true, then profitability would be purely a function of loan size.

In this example, the distribution of loans therefore represents the costs (i.e., approximately 12 percent of the administrative costs are involved in serving loans under $200) and the distribution of the value of the loans represents the revenue (i.e., 2 percent of the institution's revenue comes from loans below $200). By applying these assumptions to Figure 3, loans start becoming profitable somewhere around $1000. While the simplifying assumptions do not work because many MFIs offer variable pricing and because the costs of originating a loan vary somewhat by loan size, the basic premise still holds that larger loans are subsidizing smaller loans to some degree.

There are (at least) two responses to this information. One response is to target heterogeneous clients so that larger borrowers can subsidize smaller loans. The downside of this approach,

Figure 3: Distribution of Costs and Revenue by Loan Size (Gheen et al, 1999)

however, is that a lender will encounter high screening costs (and high risks) in delivering large loans to new customers. In trying to serve a heterogeneous market from the outset, the MFI may also be stretching beyond its core competencies.

The second (and preferred) response is to design and implement a customer loyalty strategy so that the MFI's portfolio is heavily weighted toward repeat clients. In a sense, this strategy achieves a heterogeneous portfolio organically. Loyal customers subsidize new clients because repeat borrowers are less expensive to serve and less risky, and they typically have higher loan balances. This is the preferred response because the MFI can focus on the market it knows best, and because a smaller loan to a repeat customer can be more profitable than a larger loan to a new client.

Improved Efficiency and Productivity

New clients are expensive to find and serve. The rule of thumb in many businesses is that it costs five times more to gain a new customer than to retain an existing one (Reichheld and Sasser, 1990). In microfinance, based on an analysis of six MFIs in Latin America, Gheen et al. (1999) estimate the average cost of attracting new clients is about one-fifth of the total unit loan cost.

Besides the acquisition costs, MFIs invest a considerable amount of resources in preparing and educating new customers. Loan officers may have to complete the applications for the clients, and if they have not been keeping business records, the process of creating cash flow or income statements can be time-consuming. With group lending, and after clients have formed a group, the MFI spends time informing them about the roles and responsibilities of the group and testing group cohesion to make sure that members will stick together over the long term. It is not unusual for the whole process to take two or three months; for group lenders using a staggered disbursement schedule, it could take well over four months before an MFI starts earning any revenue on some clients.

Microfinance institutions can significantly reduce the costs of delivering a loan to repeat borrowers in good standing.[3] Loan applications may be shorter for repeat loans; loan officers may not need to conduct on-site business evaluations for each loan; the due diligence requirements may be less stringent; and clients with good repayment records may make payments less frequently (e.g., monthly instead of weekly), which reduces transaction costs. The list of efficiency innovations is long and growing.

Client loyalty not only improves efficiency, but it also enhances productivity. Since repeat borrowers with good repayment records take significantly less time to manage than new clients, loan officers with large volumes of loyal customers can manage more clients. This compounding effect of improved efficiency and productivity is invaluable, particularly for MFIs serving the lower income markets, because they need to compensate for low loan balances.

Desertion and Loan Losses

A loyal customer is also likely to be a low-risk borrower, assuming that an MFI tailors its services to the specific requirements of each client.[4] Since this customer has borrowed repeatedly, the institution should have amassed sufficient information to make wise credit decisions. If repeat clients represent a greater percentage of the portfolio than new clients, the MFI should extract a cost savings in the form of lower loan losses.

When the customer base consists of many new faces, the portfolio is invariably riskier than it appears on the surface. New clients tend to pay well for a while, but if a few of them start having repayment problems, delinquency can spiral out of control if the portfolio does not have a bulwark of tried and true customers to stabilize the situation. While portfolio volatility is a recognized risk in microfinance, particularly when large segments of the portfolio are unsecured, this risk should be substantially reduced if repeat customers represent the bulk of the portfolio.

If those repeat clients have a strong affinity to the MFI, portfolio quality is likely to be even better. High-affinity clients value the service that they are receiving. Since they want to continue to receive access to this service, loyal customers are more likely to maintain an unblemished credit record than a low-affinity client who will desert as soon as a better opportunity arises.

Word of Mouth Referrals

A loyal customer is the best source for new customers. People are much more inclined to go to a movie, eat at a restaurant, or borrow from an MFI based on the recommendation of a friend rather than some form of mass advertising. Customers will have a higher attachment to the organization if it was recommended to them, and this creates a perpetuating cycle of referrals and retention.

Word-of-mouth marketing is obviously attractive because it is free, but it can also reduce the expenses associated with client acquisition and screening. Loan applicants who are referred by existing customers often know the rules of engagement, a fact that lowers acquisition costs. MFIs that use a group lending methodology, for example, often find that prospective clients arrive on their doorstep with their groups already formed because they heard about this requirement from other clients. The relationship between the referral and the referrer also provides invaluable information to a character lender. If a prospective client is recommended by a good customer who is willing to vouch for her character, that reflects more favorably on the applicant than if the referring client was a new borrower with chronic delinquency problems.

Compounding Profits

The combination of these factors—higher loan balances, lower acquisition costs, greater efficiency and productivity, lower loan losses, word of mouth referrals—produce an increasing volume of profits during the customer's relationship with the MFI, as Figure 4 depicts. The relative value of each factor depends on institution-specific details, such as its cost structure and interest rate; but the result is that loyal customers generate increasing profits over time. Research in other industries has determined that companies can improve profits anywhere from 25 to 85 percent by reducing customer defections by 5 percent (Reichheld and Sasser, 1990).

Loyalty and Debt

It is unreasonable to assume that all customers will want to borrow all the time. Credit-only programs have natural desertion rates that vary by region. Some customers will no longer need to borrow; others will only borrow when they absoultely have to. It is difficult to be a staunch advocate of customer loyalty for organizations that provide loans only because many people do not like being in debt.

For credit-only programs, the best way to enhance customer loyalty is by developing voluntary savings products. Microcredit alone does not provide the institution with a sufficient array of services to establish lifelong relationships with its customers. While some regulatory environments present significant obstacles to

Figure 4: Why Customers Are More Profitable over Time

mobilizing deposits, if an MFI recognizes the potential loyalty benefits of offering savings, it will find a way to deliver.

Desertion Causes Growth Problems

Another way to understand the value of loyalty is to consider the alternative: desertion. When an MFI starts losing its best customers, it is bound to experience difficulties. The MFI will be running in place instead of growing, because new customers first have to replace the ones who left. Since the defectors probably had larger loan balances than their replacements, the MFI might see its portfolio decrease.

Desertion among group borrowers creates additional complications. Often the group is required to replace the departing client, but this can result in wide loan-size differences between new and old members. Since it is unrealistic to expect someone with a $100 loan to accept joint liability for members with $1000 loans, either the new client will borrow a large amount, creating a credit risk, or the old clients will accept smaller loans, which do not meet their needs. Alternatively, the group can continue without replacing the lost member, but attrition over the years can result in groups of one or two members, and this defeats the purpose of the group methodology.

Many microfinance institutions experience roller-coaster growth cycles of exponential expansion followed by consolidation. More often than not, this fits-and-starts growth pattern is evidence that the MFI has significant retention problems. This common experience of growth and then consolidation goes something like this. First, senior managers push for expansion, perhaps because the institution just received a grant or access to new loan capital. Loan officers, who already had some excess capacity, drum up a lot of new business. The organization gets flooded with inquiries, and to respond to all the new applications, loan officers take shortcuts in the screening process.

During this rush of new business, loan officers neglect their current clients. Existing borrowers stop receiving the levels of service they deserve, and they become disgruntled. If there are other service providers in the area, they may consider defecting; or they may conclude that if they are not treated well, they are not going to bother borrowing. If they become really irritated, they may even bad-mouth the MFI to prospective clients. Bad news travels far and fast, complicating the challenge of recruiting new borrowers. At the same time, the retention of the new clients is low because the screening shortcuts are creating portfolio quality problems. The burdens of delinquency management distract loan officers from providing quality service to their most valuable customers. Twelve months after a huge growth spike, the number of clients is back to square one, and the institution is facing significant loan losses.

Customer Loyalty Breeds Staff Retention

The value of customer loyalty is further enhanced by the important influence it can have on staff retention. All other things being equal, an MFI that serves loyal, satisfied clients will have a good chance of keeping its employees—most loan officers prefer interacting with happy customers.

In microfinance, staff retention is as important as customer retention. It is expensive to hire and train new loan officers to replace departing employees. If experienced staff members leave to work for other institutions, then the MFI is training the employees of its competitors. Green loan officers are not as productive as their seasoned peers, and they are more likely to experience portfolio quality problems. Over the years, loan officers hone their skills to identify credit risks and develop screening tricks that cannot be taught or built into a credit-scoring model. With a mature portfolio of repeat borrowers, senior loan officers tend to have higher productivity.

If an employee's job satisfaction is a function of customer satisfaction, then efforts to retain clients will likely have the additional benefit of retaining staff. This works the other way as well. The personal relationship between loan officers and their clients is a critical factor in promoting loyalty. Clients keep coming back because they like the loan officer, they trust her, and they receive a good service from her. If she leaves (especially if she goes to work for the competition), some of her clients may not come back. Consequently, there is a cyclical relationship with customer retention and staff retention reinforcing each other.

The Impact of Customer Loyalty

Most microfinance institutions have a dual mission with social and commercial objectives. While this article has focused on the commercial benefits of customer loyalty, for many MFIs the social mission of helping low-income persons to work their way out of poverty is even more important than profitability. For MFIs to make a lasting and tangible impact on the lives of their customers, they need to serve them on an ongoing basis.

A single $100 microenterprise loan will not make a dramatic difference in most people's lives. But if the microenterprise grows so that it can make use of increasingly larger loans, the business is likely to spin off impact benefits such as increased income and assets for the household, and perhaps even job opportunities for other low-income persons. Even if the business never grows, regular and sustained access to financial services can stabilize a household's income and reduce its vulnerability to risks.

A customer loyalty strategy that involves tailoring services to individual client's needs has the additional benefit of not causing damage (or at least causing less damage). When an MFI uses its loan product as a screening device, it may cause more harm than good, particularly with the most vulnerable clients. If a client receives a loan that is beyond her capacity to repay, she will face the moral dilemma of choosing between three undesirable outcomes: either she will have to reallocate resources from essential expenditures like food to repay the loan; or she will disappoint and perhaps be ostracized by her friends and neighbors (guarantors or members of a peer group or village bank); or she will be blacklisted by the MFI and not be able to access financial services again in the future. By responding to the unique needs of each client, a customer loyalty strategy will reduce the likelihood that round pegs are forced through square holes.

Measuring Loyalty

To enhance loyalty, the first step is to measure it. With a set of baseline data, an MFI can gauge whether its efforts to improve loyalty are or are not successful. While loyalty defined as a feeling or an attachment may seem like an elusive and subjective characteristic, there are ways to monitor it.

Customer Retention

The most common indicator of customer loyalty is the retention (or desertion) ratio. Tracking client retention serves two purposes. First, it provides a blunt indicator of customer satisfaction. Second, it is important in forecasting the overall financial health of the MFI. To develop accurate financial projections, an MFI needs information about client retention to predict the effect on average loan size (which determines revenue) and on the recruitment costs necessary to replace lost customers.

Calculating a retention rate for depositors is more difficult than it is for borrowers. For liquid savings accounts, it is necessary to consider both the changes in account balances as well as the number of transactions. An inactive account with a low balance is almost as bad as closed account. On the other hand, a closed account may not mean lost customers if they are transferring their balance to another savings instrument. For example, when a certificate of deposit comes due, rather than renew it the customer may deposit the funds in her current account instead.

Primary Behavior: 3-D Loyalty

MFIs should also monitor the three dimensions of customer loyalty: length (longevity), breadth (range of services), and depth (share of purchases). Longevity is the number of years that clients have accessed the MFI's services. This can be expressed as an average or, more usefully, as a distribution. It is strongly recommended that MFIs monitor the percentage of clients (or portfolios) who have been with the organization for specific periods of time, such as (a) less than one year, (b) between one and two years, (c) two to five years, and (d) over five years. A healthy and mature organization should see a heavy weighting toward the latter categories.

For MFIs that offer a variety of voluntary financial services, another measure of client loyalty is the breadth of their relationship. A customer who has two different savings accounts, a housing loan and a business loan, and a life insurance policy—and her husband, mother, and daughter all have savings accounts—is a much more loyal customer than someone who has just an outstanding loan. To measure the breadth of relationship, MFIs need an information system that is organized around the customer, rather than the product, and if possible the opportunity to establish family linkages. Not only is the family linkage information useful to measure loyalty, it also helps loan officers to keep an eye on household overindebtedness.

Exclusivity is also an indicator of loyalty. In fact, the ultimate measure of loyalty is the customer's share of purchases. With deposits, for example, what percentage of a client's savings or assets is held by the organization? For loans, does the client have any other outstanding debts? Besides indicating the degree of loyalty, these details are also important for two other reasons. First, if a customer has outstanding loans from other sources, the MFI needs that information to gauge whether the client has the capacity to repay. Second, information about the client's use of financial services from other sources provides invaluable information for new product development that may allow an MFI to increase its share of purchases.

Secondary Behavior

Referrals, endorsements, and spreading the word are examples of secondary behavior that indicate customer loyalty. Although it is difficult to quantify the rumor mill, there are two ways to measure this secondary behavior. The first is to monitor the number of referrals made by existing clients and how recent they are. Customers who regularly refer other clients could be categorized as highly loyal advocates. If they have not referred any new clients recently, after a flurry of referrals early on, then perhaps an intervention is warranted, since it appears that their level of allegiance has waned.

While an active list of referrals is a strong indicator of a customer's loyalty, the opposite is not necessarily true: not all loyal customers are outgoing and know lots of other people who are potential customers. Another way to measure the secondary behavior is to use customer surveys to inquire whether they would recommend the organization to their friends and neighbors. The answer to this question is a good loyalty indicator, and the simple task of asking the question may stimulate another round of referrals.

Conclusion

For a microfinance institution, customer loyalty is the primary driver of long-term financial success. If an MFI can retain a strong cadre of loyal repeat customers, it will be well on its way toward profitability. As such, every critical element involved in managing microfinance operations—from product pricing to staff incentives, from marketing to eligibility requirements, from client screening to the menu of available services—should be formulated to promote loyalty.

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Notes

1. This article is extracted from a forthcoming MicroFinance Network Technical Guide by Craig Churchill and Sahra Halpern entitled "Building Customer Loyalty: Measuring and Maximizing Customer Satisfaction." The full publication includes detailed examples of ways to improve loyalty and specific tools to measure satisfaction.

2. Loan products are used as examples throughout this article because they have a determinable term, so it is easier to demonstrate or measure loyalty—customers either return for a repeat loan or they do not.

3. See Brand and Gerschick (2000) for examples of improving efficiencies in delivering loans to repeat clients. In their research, however, Gheen et al. (1999) concluded that MFIs make few, if any, changes in the screening and processing phases for repeat clients, and therefore that they are not taking full advantage of the opportunities to reduce unit loan costs for repeat borrowers.

4. A microfinance institution that automatically increases the size of each subsequent loan without carefully monitoring the repayment capacity of its borrowers can find itself in the counterintuitive (and undesirable) situation of having worse portfolio quality from the clients that it should know the best.

Microfinance in the United States

The Working Capital Experience— Ten Years of Lending and Learning

by Jeffrey Ashe

ABSTRACT: Working Capital is the United States' largest peer-group lending program. This article reviews what Working Capital has learned about the market, its customers, program impact, and service delivery over its ten year history. It presents a model for understanding how participating in peer lending groups develops "social and economic capital" in poor communities. The article then discusses how participants judge the group model as they identify the characteristics of successful groups and the impact of the group on their businesses, on themselves personally, and on the larger community. The rest of the article discusses how Working Capital evolved from a start-up operation in a single town into a multistate program and explores the advantages and limitations of rapid expansion. A checklist for choosing affiliate partners is presented, along with a list of the lessons learned about delivering services though affiliates.

The article concludes with a discussion of the differences between running a group-lending program in the United States and in a developing country and the implications of Working Capital's experience for the microfinance industry in the United States. Noting that the hundreds of microenterprise programs in North America are reaching less than seventy thousand businesses, the author makes the case for

going back to the customers of these programs to learn from them how to set up a microenterprise service initiative as a business. This would generate new ideas on how these programs could best be carried out within the context of hard-pressed, low-income communities.

Introduction

This article examines the ten-year history of Working Capital, a pioneer in the domestic microenterprise field, a principal advocate of peer-group lending, and one of the largest institutions of its kind in the United States. It reviews what Working Capital learned as it grew from a small start-up microenterprise program into a multi-state initiative with national aspirations, and then subsequently scaled back its operations to refocus and rebuild from a more solid base.

It also examines the advantages and drawbacks of building and serving an extensive affiliate network as a strategy for reaching scale. There are, on reflection, very good reasons why most microenterprise programs remain small and localized. The issues of replication, perfecting a methodology, and creating a stable affiliate structure are complex, and hence difficult to pin down. Nevertheless, those who wish to embark on a similar path are invited to learn from Working Capital's experience.

Jeffrey Ashe, currently a Senior Fellow at Brandeis University's Institute for Sustainable Development, founded and served for eight years as the Executive Director of Working Capital, the United States' largest group-based microlending program. He has served as a consultant to microfinance programs in the United States and twenty-five countries, with clients ranging from the World Bank and the foreign aid programs of the United States, Canada, and England; to NGOs, including Freedom from Hunger, Catholic Relief Services, and Pact. He was previously Senior Associate Director at ACCION International, where he directed the AID-sponsored Pisces Project. Pisces, the first worldwide investigation of microenterprise programs, provided the base for much of the work that has followed in this field. He has lectured and taught at major universities, published widely, and earned a BA in Political Science from the University of California at Berkeley and an MA in Sociology from Boston University.

This article is written to warn an organization of the challenges before it starts, so that it will be more likely to avoid difficulties later on. Thus, this article will serve its purpose if it helps practitioners "see around the corner" to better understand the issues they are currently facing or may face in the future.

Working Capital

Working Capital began operations in Massachusetts, Vermont, and New Hampshire in 1990–1991 with the objective of serving the owners of very small, often part-time and start-up businesses in low-income communities. Its peer-group lending methodology was adapted from the Latin American programs of FINCA and ACCION International. Two years later, the program expanded to Maine and also began to serve a largely Dominican clientele in Lawrence, Massachusetts, and a largely African-American clientele in Boston, marking the increasingly urban and minority focus of the program.

Then in 1994, Working Capital set up "franchise" programs in Delaware and Florida and three years later in St. Louis, Atlanta, and the Russian Far East. Franchisees purchased the Working Capital package of manuals, curriculums, systems, and software; they were trained and monitored by the Working Capital staff. They operated under the Working Capital name and were considered an integral part of the organization, but used their own loan funds and tracked their loan performance. Of these programs, New Hampshire, Delaware, Atlanta, and Russia have since reorganized themselves as freestanding microenterprise institutions after they severed their ties with Working Capital. The programs in Vermont, Maine, and Missouri closed down for lack of funding and internal problems within the local sponsoring agencies.

Over the years, Working Capital and organizations using the Working Capital methodology have served over five thousand microbusinesses and distributed some four thousand loans. Currently Working Capital is serving 542 businesses in Massachusetts and Rhode Island and 607 businesses in Florida, most members of active loan groups. Of the sites now operating independently, New Hampshire is serving 200 business owners, Atlanta 210, and Delaware 247. In the Russia program, there are currently 129 outstanding loans with 40 to 50 new loans gaining approval each month.

Working Capital also provides training and consulting services to groups interested in using its methodology, manuals, and systems through its "Working Capital Institute." Organizations in Philadelphia, Los Angeles, Hartford, and Maryland received this training, and Philadelphia, Los Angeles, and Hartford have already initiated peer-lending programs after the Working Capital model.

Working Capital provides a comprehensive package of business services to its customers that include credit, training, and the opportunity to participate in a group of peers for support, advice, customer referrals, joint marketing, and joint venturing. Through its peer-lending program, Working Capital extends credit to self-selected member groups who review and approve each other's loans, with no secondary review or collateral required by Working Capital. This "radical decentralization of authority" to the groups is a hallmark of the Working Capital methodology and was inspired by FINCA's village bank model. A high rate of loan repayment is required from all the group's members to access larger loans, which at above $4,000 also require the approval of program staff and outside advisers.

Over the past year, individual loans have been extended by Working Capital for better established businesses and businesses graduating from the peer groups. All members, both members of groups and individual loan recipients, are required to join local Working Capital business associations, which serve as a source of additional training and further networking.

What Working Capital Learned

Working Capital learned a great deal over the decade about the market, its customers, its impact on its members, and how to best deliver its services. In brief:

The Market and Working Capital's Customers

- There are a vast number of entrepreneurs in low-income communities. Most of their enterprises are invisible, are often based at home, serve local markets, represent a supplemental source of income, and provide personal fulfillment far beyond what they bring in financially.
- Mainstream services—banks, technical assistance providers, etc.—reach only the larger and more established businesses within this market.
- Working Capital serves business owners that mainstream financial and business training services seldom reach. Most of Working Capital's customers are start-ups or very small part-time and home-based enterprises, and their owners generally lack business plans and adequate records. Some are not even registered.
- About a third of Working Capital's customers are at or near the poverty level; close to two-thirds are women; many are middle aged and the single head of household. Working Capital's services

are particularly attractive to city-dwelling minorities and immigrants living in low-income communities.

- While the interest in networking and training cuts across all groups, the demand for business loans from Working Capital is greatest in the Hispanic community, less in the African American community, and least in the non-Hispanic, white community, closely reflecting the availability of credit options for these different groups.
- Working Capital had little trouble recruiting new members in the early 90s when unemployment was high and institutional credit providers pulled back from poor communities. With current prosperity, credit is much more widely available and there is more competition. Working Capital responded to evolving market conditions by changing its group product, adding individual loans, placing a greater emphasis on marketing, and concentrating its efforts on the best performing sites.

Program Impact

- The average Working Capital customer substantially increased sales, profits and owners' draw since joining. The percentage of businesses staying in business is also very high.
- The poorest and minorities reap the greatest social and personal benefit from peer lending groups. In these groups, intense networking and support are most likely to "spill over" into increased self-confidence, community involvement, and improved family relations—an observation noted in three evaluations.
- Those members whose businesses are full-time and growing when they join are most likely to expand their businesses further and add employees, but the owners of these businesses also tend to be better off than the average Working Capital customer. There is a

tradeoff, then, between substantially increasing sales and profits and creating jobs, and working with poorer and less educated business owners who are seldom interested in business training, or transforming their often part-time enterprises into full-time businesses.

- The bonds created in successful groups often extend beyond their formal membership in Working Capital, and ex-members, now friends, often keep in contact with each other over the years.
- It was initially assumed that a majority of Working Capital businesses would eventually graduate to bank financing, but only about one in fifteen does. The number using supplier credit (and to a lesser degree other credit sources) increased substantially, however, reflecting that of these credit sources better fit this level of enterprise.
- Business owners often join Working Capital for the credit, but they often stay for the networking and support, reflecting the limitations of a "credit only" approach. Only a half to a third of Working Capital members are currently borrowing. Providing nonfinancial services is expensive, making it more difficult to cover program costs.
- Support and mutual assistance—such as customer referrals, business advice, joint marketing, and joint venturing—are most likely to occur in groups with outstanding leadership and if all the members are fully committed to their enterprises. You "get out of a group what you put in it," most members say.

Service Delivery

- Training and monitoring a peer group is a difficult and long-term task that requires the highest level of skill as marketer, organizer, trainer, facilitator, good parent, and enforcer. All these traits are required for an "Enterprise Agent"—the staff of the local nonprofits responsible for outreach, forming the groups, and supervision—to be effective.

- Although there are exceptions, the best Enterprise Agents are from the community, have their own business, are or have been members of groups, and are fully committed to the program's social and economic objectives. Most of the best agents so far have been middle-aged minority women with a fierce sense of commitment to their communities, who are not afraid of holding groups accountable for their promises.
- The success of a local program depends largely on institutional commitment, leadership, adequate funding, and the quality of the local agent. Of the close to one hundred local affiliates that Working Capital has trained over the years, only a small number have produced most of Working Capital's customers and loans.
- If there is a strong commitment to replicate Working Capital at a new site, staff can be trained within a week, with brief follow-up training sessions over a year, at which point the transfer of technology to the new institution should be largely complete. Replication is facilitated by the fully developed set of manuals, policies, and administrative systems that Working Capital provides.

Despite its undeniable benefits, Working Capital has concluded that microenterprise development is not the "magic bullet" for alleviating poverty, or for moving many from welfare to work, that it hoped for initially. At best, it may be of help to the one in ten in the active labor force who has the interest, commitment, and skills that it takes to build a business. Furthermore, developing microenterprises is not sufficient as a strategy to turn around failing or declining local economies (although a comprehensive business development strategy that includes microenterprises could do so). Local economies grow or decline due to forces largely beyond the influence of microbusiness owners, but participation in a program like Working Capital can provide an alternative and a source of income in a downturn, and open new opportunities when the economy begins to grow.

Carrying out a substantial microenterprise program in this country and sustaining it year after year has proved to be an exceedingly difficult undertaking as evidenced by the fact that only five programs across the United States make more than one hundred loans per year, and all the programs taken together reach less than seventy thousand businesses. After years of tinkering with the model, Working Capital has accepted that it is unlikely to cover as much as half of its operating costs through interest and fees and still serve the population it seeks to reach with the range of services it believes necessary. Individual lending and serving somewhat better established businesses will be required for Working Capital to approach its goal of covering a substantial part of its costs.

What Working Capital Hoped to Accomplish

Working Capital strengthens very small businesses and creates income and new jobs in low-income communities, as any microenterprise organization does, but it has always had a much wider set of objectives. At its core, Working Capital sees growing businesses through peer-lending groups as a tool for creating and strengthening "social capital" in low-income and minority communities with the expectation that the skills, commitment, and relationships developed in the group will ripple out into the community and to the member's family. Other objectives include building links between local business owners and creating a cadre of nonprofit organizations with the institutional will and capacity to deliver services to microenterprises.

Strengthening Social Capital

Social capital is a term coined by Jane Jacobs (1968, 1984) to describe the networks, norms, and trust that enable people to cooperate effectively to pursue shared objectives. Working Capital fosters social capital precisely where it is most needed: in low income communities with declining economies, outward flight, declining local enterprises, and persistent crime and violence.

Working Capital builds social capital by requiring that the group members follow a set of carefully constructed "rules of the game"—writing bylaws, electing officers, reviewing loan proposals, etc.—that build mutual assistance and accountability. Unlike mobilizing for a community project or a specific campaign, business loan groups meet for years, and the relationships have time to mature and influence families and the larger community. Program evaluations (Mt. Auburn Associates 1994; Anthony, 1996; Ashe and MacIntyre, 2000) show that the impact of participating in a Working Capital group for personal empowerment and networking is the strongest in the poorest communities.

Working Capital, and the peer lending groups its members set up and manage, are an effective mechanism for developing social capital because they embody three essential conditions that make sustained change more likely:[1]

1. **There is a realistic opportunity to improve one's economic lot (or at least a realistic hope that one's position can improve) through taking risks, changing one's behavior, and hard work**. Through Working Capital, hard work is repaid in increased income through one's entrepreneurial efforts and

increased status in the family and community. It is difficult to think seriously about change if there is little realistic possibility of improving one's situation. If the worldview of a person living in a stagnant or worsening economy is that resources are fixed and declining, participation in an effective enterprise development program changes that vision by providing the resources needed to achieve one's dreams.

2. **Membership in a group of peers reflects an ethos of self-improvement that supports the individual's efforts to change.** A business lending group is a new structure in the community with a definite point of view. The ethos underlying the program encourages and supports individual initiative along with mutual assistance and accountability. It provides encouragement when the individual feels discouraged or is under pressure by friends and family to return to customary ways . Not only does the group reinforce and support Working Capital's credit, training, and networking services, it strengthens the commitment to make changes within the community.
3. **Dynamic group leadership drives the change process forward.** The strongest groups are those with good leadership and a high level of commitment. Groups with strong leadership that push ahead the group's agenda for business development and mutual assistance and accountability thrive; those lacking these characteristics tend to flounder and eventually fall apart.

By helping individuals meet their goals through collective action and support, these groups have encouraged similar changes in the United States as they have in the developing countries where this methodology was perfected. The universal outcomes of group-based enterprise development is an important finding in its own right.

Strengthening Economic Capital

Creating a strong support group (social capital) is not sufficient in itself to generate sustained change. The group also needs access to external credit and technical assistance (economic capital) to achieve the desired results. The importance of both social and economic capital and how they build on each other with synergy can best be observed in immigrant communities with thriving enclave economies. In these communities where many new immigrants establish small businesses, prosper, and escape poverty within a generation or so, success depends on being part of a community whose traditions and institutions support their entrepreneurial efforts, not on each business operating alone.

The Koreans and other Asians in this generation, and the Jews and other Europeans in previous generations, provide good examples of how this works. Community-based traditions and institutions in each of these communities provide the four critical ingredients of business success: (1) support and encouragement from other business owners, (2) customer referrals without which it is difficult to build a clientele, (3) business knowledge that is shared by established entrepreneurs with those who are just starting, and (4) capital. Working in a family business from an early age, later starting a business, and then financing the start-up of a friend or a relative's business is an integral part of the social fabric of these communities.

Since immigrants have a difficult time accessing banks and other mainstream financial resources, they often turn to traditional mechanisms such as the Korean Gae, the Jamaican Partner, the West African Susu, or the Dominican San to finance their businesses. Those who need capital contribute to a fund on a regular basis, and each member in turn withdraws the entire amount saved that period so that she or he can use it to launch or grow an enterprise. Like the business loan groups, these "ROSCAS" (Revolving Savings and Credit Associations) require forming a group, selecting a leader, tracking payments, and holding other members accountable. They serve both a social as well as a financial purpose and build both social and economic capital. The characteristics of a strong ROSCA and a strong business loan group are virtually identical (as are the characteristics of weak ROSCAS and weak loan groups).

The high level of collaboration among the closely linked community of grocery store owners, bakers, transport service providers, artisans, traders, contractors, doctors, dentists, and restaurant owners within the Korean community in Manhattan illustrates how social and economic capital are intrinsically linked. A thriving business community attracts more customers, which generates more sales. Growing local businesses, as they trade and subcontract with each other, now have a market for more increasingly sophisticated goods and services that are not only consumed locally but also increasingly "exported" outside the community. This brings more money into the community, thereby increasing local sales, and so on. Like the national economy, a local economy thrives when there is a positive balance of payments, and exports exceed imports (Jacobs 1968, 1984).

The Koreans in Manhattan and the residents of the Pine Ridge reservation in North Dakota illustrate the polar extremes between a thriving economy and one that has stagnated. In the Korean community in Manhattan, a dollar spent in one Korean business is spent in twelve other Korean businesses before it leaves the community, generating sales and income each time.

On the Pine Ridge reservation, of every dollar that enters the community (often through transfer payments), ninety-eight and a half cents is spent in the white-owned businesses that surround the reservation. The Lakota Fund, a microenterprise program that has operated for more than a decade in the Pine Ridge reservation, has begun to make a difference, however, with growing Indian-run businesses capturing more of the sales that would have been made outside the reservation before. The slow but necessary process of building social and economic capital and strengthening the multiplier effect as dollars are spent in local businesses is underway even in this difficult setting. This underscores the important role that a microenterprise development program can play in an impoverished community.

The rate of growth of different programs, and the amount of subsidy they require, need to be judged within the context of where they are working. Microenterprise programs will tend to reach more businesses and cover more of their costs when (1) the population reached is entrepreneurial and has experience in business, (2) the market is strong, (3) population density is high, and (4) there is a comparatively high level of social and economic capital. Working Capital has found that it is far more expensive to serve rural businesses than urban businesses because of the time and cost of transportation and the difficulty of bringing disbursed group members together. The potential market is also much smaller in rural areas. Even within cities, there are also significant differences. It has proved far easier to serve highly entrepreneurial Dominican immigrants, for example, than other Latino communities. Working Capital has provided nine hundred loans and served over 350 businesses to a community of only twenty thousand Dominicans in Lawrence, Massachusetts, nearly a third of all the loans it has provided in the entire state. The costs of delivering services in Lawrence are, consequently, substantially lower than in other urban sites.

The Effectiveness of the Business Loan Group As a Tool to Develop Social Capital

Working Capital is based on the assumption that a business loan group is an effective tool for growing social as well as economic capital. But how do the members see these groups? Is the group seen as a help or a hindrance?

The Role of the Group

In a recently completed study by Jennifer Barsky (2000) based on interviews with current and former group members throughout Massachusetts, in Newport County, Rhode Island, and from South Florida and Delaware, members were asked about their experience of being group members.[2] The following summarizes what they said.

Characteristics of Successful Groups

There is no "right way" to organize a lending group, and because microentrepreneurs join Working Capital to fulfill different needs, there is no "right group" for everyone. Some characteristics of a group, however, do improve the chances of a successful outcome. Among these are commitment and determination to build a successful business and a successful group, as well as trust, honesty, and open communication among members. Good leadership is also indispensable. Depending on the group, leaders may be required to act as facilitators, mediators, collection agencies, enforcers, innovators, or in some cases—as described by one group chairman—as babysitters. Members of successful groups are unanimous in their belief that you "get out of Working Capital what you put into it."

Business Growth and Social Capital

The clearest link between group participation and the growth of the business is the creation of networks and solidarity. Among the benefits are customer referrals, networking, joint marketing and joint venturing, business advice, and mutual assistance. The opportunity to share the experience of running a business and to offer support and advice contributes to the development of business skills and knowledge and ultimately, business growth. One group member said, "All these experiences are brought together, given to other members, and passed around." Continuous learning and feedback have been described as one of the greatest benefits of group membership.

Economic Capital

The Working Capital business education curriculum structures the sharing of business experiences within the group. As members work through the case studies that are based on businesses much like their own, they come to understand the principles of marketing, record keeping and business planning and apply them to their own enterprises. This curriculum reflects Working Capital's belief that group members can largely teach themselves. Four self-training mechanisms are built into the methodology: the informal exchange of business knowledge among members; the loan approval process; the business education curriculum; and meetings with local accountants, lawyers, and marketing experts who provide their services on a volunteer basis, facilitated by the program staff or the group leaders.

Working Capital's loans are also often seen as critical to the growth of the businesses. Most minority and immigrant members cite lack of capital as the greatest impediment to starting and growing their enterprise. Faced with few options, many welcome the opportunity to access credit from loans approved by peers without the complicated paperwork or embarrassment of being turned down by a mainstream financial institution (although they can, of course, be turned down for a loan by their fellow group members).

Personal Growth

Beyond facilitating business growth, Working Capital peer groups also build microentrepreneurs personally and professionally. For some, membership in the group was instrumental to their success; for others it kept them accountable, taught them communication skills, brought out leadership skills, built their self-confidence, got them more involved in the community, and even helped improve the relationships between family members. Members also report a feeling of fraternity with the other members that eases the isolation entrepreneurs battle when trying to grow a business. Starting a business, no matter how small, is a long and arduous process. Most of all it requires initiative and the determination and courage to keep moving.

Community Building

Economic and community development is the process by which individuals and organizations come together to increase the wealth of an area. Working Capital aims to promote economic and community development in exactly this way. One member put it this way: "Any time you are interacting with other businesses in your community, you are looking at your community as a microcosm and as a whole. You look at what opportunities there are in the community, how your business affects the community and what services the community needs that you or one of your colleagues can provide."

Summary

It is not that these results have been achieved without difficulty and struggle, or that all these interactions within the groups have been positive. Most groups start strong and with great enthusiasm, but some fall apart when problems emerge, often around loan repayment, or because commitment is weak, or leadership is poor. In many instances, members have betrayed the trust of their fellow members and defaulted on their loans, reflecting how tenuous life is for low income people, and sometimes how even friends can mislead each other.

Understanding the Stages of Group Development

One reason why so many groups have problems or ultimately fail is that the agents and staff knows very little about the process of group development. Working Capital management called in Dr. Alyce Getler, a psychologist knowledgeable about group process, to provide guidance to the Enterprise Agents.[3] She identified the predictable stages that any group moves through and spelled out what these stages look like in Working Capital groups. She also pointed out that the foundation for a well functioning group is laid before the group even begins with good selection and training. Most problems can be avoided before they start by encouraging the members to consider carefully whom they accept as members.

During the initial "honeymoon" stage, which typically lasts through the training process and the approval of the initial loans, members are typically very supportive of each other. This is the "us against the world" and "we can do it" stage. The problem is that in their eagerness to be supportive, they avoid asking the tough questions, especially around reviewing the proposals the members submit. As problems inevitably arise, the “we are all in this together” atmosphere begins to unravel, and personal conflicts and competitiveness emerge. The challenge is to learn to tolerate and grow from differences and work through conflicts productively.

If the group weathers these problems, it evolves into the “working stage,” in which members know each other well and respect each other for who they are. They feel comfortable expressing differences and conflicts, and the Enterprise Agent can take a much less active role. This, however, is not the end point of the group development process. The challenge now moves to avoiding complacency. The group has reached the “reassessment” stage, in which the group must decide “where we go from here” if it is to move forward. At this point, some members may leave, or the group could merge with another group. What is important is that the group have a clear direction and a clear vision for the future.

Dr. Getler trained Enterprise Agents in understanding these predictable stages in the evolution of groups and suggested guidelines for Enterprise Agents to use at the different stages. If building businesses and social and economic capital is the desired outcome, groups must stay together long enough to achieve this objective.

Delivering Services and Creating an Affiliate Network

When Working Capital started ten years ago, few institutions knew about microenterprise development, and banks had little interest in funding grassroots programs. A far different situation exists today. Now there are many programs and banks, often encouraged by the Community Reinvestment Act, which provide lines of credit to these programs more readily. Early on, Working Capital recognized that to reach microenterprises over a wide geographic area, it would need to enlist local organizations to deliver its services, and it would need lines of credit from banks to finance its loan portfolio. This section of the article tells the story of how Working Capital developed its affiliate network and enlisted the banks, and the lessons it learned along the way as it evolved from a small project to a multistate institution.

Working Capital began operations in September 1990 soon after the New England real estate crisis of the late 1980s. The crisis led to a spate of bank closings and mergers and the contraction of access to credit of all types, especially loans to small businesses. As unemployment in some rural areas in New England edged towards twenty percent, and many who could secure jobs were working for less than half of what they earned before, the number of people turning to self-employment increased. Those who had businesses were struggling as others were attempting to start their enterprises, and conditions were difficult for both. In this setting, Working Capital's offer of unsecured business loans was embraced as one of the few available alternatives.

The formula Working Capital offered at the time was simple: a group of about five formed a peer-lending group, which, after writing its bylaws and electing officers, reviewed and approved each other's loans. Business loans started at $500 and, assuming payments on loans by all group members were current, progressed in stages up to $5,000. Peer-group support and pressure, it was assumed, would keep loan payments up-to-date. Groups made payments for members when a member could not (or would not) do so, using the "buffer fund" that each group set up. Although members did not cosign each other's loans, and default by one member would not affect the credit ratings of the others, there was an implicit assumption that group members would be responsible for each other's payments.

Phases in Working Capital's Growth

Phase I: Getting Underway

Working Capital sold the idea that peer group lending based on the Latin American models could be adapted successfully in this country and with similar positive results. The founder and first executive director of Working Capital had worked with ACCION for many years and was thoroughly versed in the group lending methodology. He had introduced group lending to ACCION almost a decade earlier.

By mid-1990 he secured funding totaling $125,000 through the Ford Foundation, the Charles Stewart Mott Foundation, and the New Hampshire Community Trust. Since Ford funding was secured through the rural poverty window, Working Capital began its operations in rural areas. At that time, Working Capital was a project of the Institute for Cooperative Community Development (ICCD), the nonprofit arm of the Community Economic Development Program at New Hampshire College.[4] It would become an independent nonprofit organization three years later.

Since Working Capital in 1990 had only one staff person, no operational presence in any community, and lacked even a loan fund, its initial strategy was to leverage the executive director's knowledge of microlending by recruiting local nonprofit organizations to deliver Working Capital services locally. It is perhaps not surprising that there were no takers in these early months, and considerable skepticism: "Yankees will never join groups." "If they join groups they will never pay their loans." "There are no deals to be made out there." "The businesses you are talking about don't even exist."

However, one nonprofit, the Millers River Community Development Corporation, agreed to try Working Capital's peer group lending model on a pilot basis, and even to use their own loan fund and track their loans. Millers River was based in Athol, Massachusetts, a once prosperous tool-making center that had since fallen into sharp decline. A VISTA volunteer was assigned the task of recruiting business owners for an information meeting that was to be held at the local YMCA. In September 1990, twenty-five business owners came to the meeting and formed two peer groups. The groups were trained, and the first loans were issued in October.

With two groups now in place, a Community Action Program in Bellows Falls, Vermont, became the second Working Capital affiliate, and the CAP Enterprise Agent formed a third group. Now that Working Capital had a Vermont presence, it negotiated a \$100,000 line of credit from Vermont National Bank, secured with a \$30,000 deposit from its grants. Working Capital was so sure there would be an avalanche of requests for loans that it felt that only banks would have sufficient capital to meet the demand.

That Vermont National Bank agreed to make a loan to Working Capital was precedent-setting in 1991 (although, years later, banks were clamoring to provide credit lines). According to the hard-fought agreement, the bank grudgingly gave up the authority to review the underlying loans, which were made solely on the recommendation of the groups with no review, credit checks, or collateral required even by Working Capital. The line of credit also contained, to use banking parlance, an "evergreen" clause. As long as repayment was satisfactory, the line would not have to be paid down and could be renewed from year to year without further action by Working Capital.

Once Vermont National Bank broke the ice, Fleet Bank in New Hampshire agreed to provide a similar line of credit for group loans in New Hampshire and Massachusetts. ICCD took a major role in securing these credit lines for the program.

With three groups in place and two lines of credit from banks that were promised to be available soon, the stage was set for further expansion. Eleven more organizations in New Hampshire, Vermont, and Massachusetts were recruited as affiliates. The Enterprise Agents received two days of training on the Working Capital peer-lending methodology, the first of what were to become scores of Enterprise Agent training sessions over the years.

Agents were trained using a step-by-step guide for forming a group (albeit not the sophisticated manuals that emerged later), and each agent was to follow the manual exactly. If all used the same methodology, it was reasoned, it would be possible to share experiences and upgrade the manual as Working Capital expanded exponentially. The clear delineation of responsibilities between Working Capital and its affiliates also made expansion easier and gave Working Capital some measure of control. Working Capital was designed, then, for replication since its inception.

By April 1991, seven months after the initial information meeting in Athol, Working Capital had affiliates in three states. In June, a part-time administrative officer, responsible for managing the loan portfolio and other administrative matters, was added to the staff. Part-time work study students from New Hampshire College's Community Economic Development program assisted her in managing the loan portfolio.

Two years later, an evaluation of Working Capital, completed by Mt. Auburn Associates (1994), pointed out four ways Working Capital was different from other U.S. experiments with microenterprise development: (1) its commitment to achieving "scale and cost-efficiency," (2) its program flexibility and ease of use, (3) its relationship with banks, and (4) its "minimalist" approach to overseeing borrower groups, since Working Capital places virtually all the decision-making process within the group. The evaluation went on to say, "By minimizing 'barriers to entry,' the program makes forming and managing borrower groups attractive to potential affiliates. At the same time, centralization of some of the more sophisticated tasks, such as securing loan capital and handling loan servicing, allows affiliates to operate the program with a minimum of capacity building and resource commitments" (p. 24).

Phase II: Expansion in New England

By the end of 1993, the fruits of Working Capital's expansion efforts in New England were evident, and Working Capital was seen as one of the leaders in the domestic microenterprise movement. During 1992 and 1993, Working Capital's initial expansion into urban areas started in Lawrence, Massachusetts, where the Lawrence Minority Business Council began to serve a largely Dominican constituency; and in Boston, where it operated through thirteen local affiliates, with a largely African-American constituency. Working Capital had also expanded into Maine. The division of responsibilities between Working Capital and the affiliates played to the strengths of both parties. The affiliates had outreach capacity, while Working Capital was knowledgeable about microenterprise development and had money to lend.

Working Capital was accepted in so many communities because it helped local organizations carry out their missions, rather than undermine them and compete with them for limited funding. Since Working Capital targeted businesses that were far smaller than those served by other institutions, Working Capital was welcomed by other business development agencies, which saw Working Capital as a resource where they could send those they rejected for assistance. Through these tactics, Working Capital gained access to communities where it would have otherwise been very difficult in turf conscious New England.[5]

By involving so many other agencies through its "piggyback" strategy, Working Capital was, up to the mid-1990s, the largest microenterprise program in the country, with each of its state programs the largest microenterprise initiative in that state. Working Capital preached the importance of scale since its inception. To achieve scale, it provided only a "minimalist" package of services— loans, a self-taught business education curriculum, and networking opportunities— that were designed for easy delivery by Enterprise Agents whose level of skills varied considerably.

Phase III: Working Capital Expands outside of New England by "Franchising" Its Model in Other States

In 1994, Working Capital "franchised" its model at two sites, responding to requests from local groups. In Delaware, it operated through the YWCA and the First State Community Loan Fund, where Working Capital was only one of the many services offered by those agencies. In Miami, Working Capital operated through a newly created organization, Partners for Self-Employment, whose sole mission was to deliver Working Capital services. These "franchise" sites (or "Hubs," as they came to be known) were different from the affiliates in that they paid a fee for the right to use the Working Capital name and all of Working Capital's systems and manuals, and, like the affiliates, were considered as integral parts of the Working Capital network. Working Capital also provided its "Hubs" training and ongoing support. The Hubs, in turn, developed their own affiliate networks, replicating the way that the home office worked through its Massachusetts affiliates. The Hubs provided and managed their own loan funds both for their own operations and their local affiliates.

By September 1996, a total of 2,400 customers had joined loan groups, of whom 1,880 were current members in over 350 groups system wide. Since the inception of the program, Working Capital members had, by September 1996, received 2,700 loans valued at almost $2.5 million, of which only three percent had been written off. By then, Working Capital was operating through some seventy local, nonprofit agencies and affiliates in seven states. Of these Massachusetts, Rhode Island, New Hampshire, Vermont, and Maine used Working Capital's centrally managed loan fund.

In 1997, Hubs were set up in St. Louis, Missouri, Atlanta, Georgia, and in Working Capital's first foray outside of the United States, in Khabarovsk in the Russian Far East. By late 1997, Working Capital was planning to expand its Hub network to Los Angeles, Knoxville, Philadelphia, and Coastal Maryland. Working Capital had also been recognized at the White House with the first Presidential Award for Excellence in Micro-Enterprise Development for its innovative replication package.

Phase IV: Consolidation and Rebuilding in a Changing Market

By early 1998, it was evident that a strategy based on rapid expansion—although it led to the rapid dissemination of Working Capital's methodology throughout New England and even to states outside the region—was impossible to sustain with its limited staff and resources. While the overall statistics were impressive, there were issues underlying the apparent success that put the program in jeopardy.

Creating more Hubs was exhilarating, but some Hubs lacked the resources or the capacity to deliver Working Capital services on an ongoing basis. As Working Capital pressured the affiliates to be responsible and the Hubs to toe the line, the relation with the Working Capital staff quickly became adversarial. The Hubs thought they were being harassed, while Working Capital believed they were being irresponsible. While the Hubs complained that the home office did not support them adequately, they increasingly wanted to chart their own path, another source of tension between the Hubs and the home office.

By late 1998, the Hubs in Vermont and Maine had collapsed, and the Hub in Missouri had virtually stopped functioning because they were unable to secure adequate funding. Furthermore, many of the affiliates in Massachusetts that the Cambridge office directly supervised were barely serving even their existing groups, much less creating new ones, despite the intensive support they received, also mainly because raising money to support their local Working Capital programs was becoming increasingly difficult. Loan payment began to sag alarmingly throughout the Working Capital system in the regions where there was now no effective local presence.

It became evident that a fresh perspective and new leadership were required to deal with the crisis. The founding executive director stepped down, and the current executive director assumed responsibility, with the founding director focusing his efforts on Massachusetts programs, innovation, and research.

The new executive director refocused the program and made the difficult decisions that would reduce the scope of Working Capital's operations to match its capacity to deliver quality services. This was accomplished by spinning off franchise sites that wanted to operate independently or that were not functioning well; eliminating affiliates that were not expanding the number of customers they served; and increasingly serving customers directly with Working Capital staff, and through a smaller number of closely supervised affiliates. In addition:

- The staff was completely reorganized, a chief financial officer and director of development were hired, and the board of directors was replaced.
- There was a complete halt to expansion; and potential additions to the Working Capital network received only materials and training in the methodology.
- There was a major effort to improve loan repayment; and non-recoverable loans were written off.
- A monitoring system was developed that tracked the performance of each affiliate and group; and affiliates were required to report their performance.
- Agreements were made with Working Capital's major affiliates to hire jointly the local program managers and jointly review their performance.
- Affiliate monitoring was greatly intensified.

- Working Capital participated in raising funds for the most important affiliates.
- All manuals and systems were reviewed and upgraded.

Working Capital also restructured its group-lending product to provide larger loans and introduced an individual loan product with loans up to $20,000. Introducing the individual loan product required developing credit committees and retraining the staff, and although individual loans have been issued by Working Capital for less than a year, they have been responsible for most of the recent increase in the portfolio.

Since these changes were made, Working Capital has stabilized and is expanding again. Although the process of consolidation and rebuilding was controversial and painful, it was necessary; and Working Capital now is on a sound footing for its future growth. The next challenge is to build the program in what has become in the last few years a highly competitive market.

Selecting and Working with Affiliates

Working Capital developed a list of criteria for selecting new affiliates and renegotiating its relationship with its current ones, based on its experience over the years. These criteria have guided Working Capital's reorganization efforts and may prove useful for any organization contemplating partnerships with other organizations. The agency's level of interest, the quality of the staff assigned to the project, their ability to support a quality program, and their willingness to work in close partnership with Working Capital are more important than the size or prominence of an agency. The criteria are these:

- A well regarded, well managed and adequately funded local agency with a businesslike focus and mentality. Affiliates that are likely to be operating years from now should be selected.
- A service area with a high concentration of potential customers (minorities, recent immigrants, low-income residents) within three hours of the headquarters office. The highest priority should be given to communities within an hour from headquarters.
- A congruence between Working Capital's mission and the mission of the local agency.
- Active support for the initiative at the level of the Board and Executive Director and other key staff. Generally a new initiative, to be successful, needs a champion within the organization, an individual who is willing to push hard to make sure the program is and remains an agency priority.
- Real enthusiasm for the program's mission and methodology.
- Good outreach to the population the agency aspires to reach and easy access to the agency's offices for the program's potential customers.
- Willingness to accept Working Capital's involvement in the selection, training, supervision, and review of the local staff assigned to the program. (This factor has proved to be critical for ensuring quality performance.)
- Willingness to enter into a contract with Working Capital, meet performance objectives, complete monitoring forms, receive additional training, and participate in Enterprise Agent meetings.
- Allocation of significant affiliate resources to the local initiative, including at least one staff person who is acceptable to Working Capital and who is assigned preferably full-time to the project. (Working Capital has had little success with staff for whom

Working Capital is only one of their many responsibilities, whatever their level of interest or capacity.)
- The provision of the necessary managerial, administrative, and logistical support for the local staff person(s) by the local agency.
- Funding for at least one year of program operations, with a strong commitment to ongoing funding.

In essence, what any sponsoring agency should be looking for are partners that strengthen the program and bring in substantial numbers of new customers and loans and that do not represent a managerial burden that is greater than their value.

This is what Working Capital learned as it developed its affiliate network:
- Affiliates should be recruited close to headquarters.
- Affiliates with real commitment and real capacity should be selected.
- The field staff must be motivated and have both the time and the skills to do the job.
- Good systems are needed to manage a network.
- A network should only be as large as the agency's capacity to provide quality support.
- Resentment is inevitable if headquarters lacks the systems and capacity to support the network.
- Not all opportunities must be taken.

It is this last lesson which is perhaps the most difficult to accept. Each opportunity needs to be carefully scrutinized, and only the best organizations should be selected. In truth, only a few affiliates and a few Enterprise Agents organized the majority of the groups that produced most of the loans. It proved far easier to transfer Working Capital's technology than to support an affiliate network on an ongoing basis. Affiliates and franchisees will inevitably have problems, which will absorb an enormous amount of central office staff time.

Why Covering Operating Costs through Interest Income Proved Difficult for Working Capital

Working Capital was set up to replicate the FINCA and ACCION models developed in Latin America, including the objectives of reaching substantial scale and covering operating costs through interest payments. Why then has Working Capital only covered a fraction of its operating costs through interest and fees? There are reasons that have to do with differences between microenterprise development in the lesser-developed and industrialized countries:

In developing countries, virtually every adult is involved in some type of individual economic activity. In New England the percentage involved in self-employment ranges from sixteen percent in Massachusetts to twenty percent in New Hampshire, Vermont, and Maine, and full-time self-employment is half that rate.

In developing countries, a business can be as simple as selling oranges on the curb. Here even the simplest business must be reasonably sophisticated to find a niche in an economy where large businesses predominate.

In developing countries, there is virtually no access to capital other than from loan sharks and pawnshops, which charge from twenty percent per month (secured by goods) up to ten percent per day for unsecured loans. Here most can secure a credit card, supplier credit is readily available, and banks actively seek out solid small business loans. With an improving economy, access to credit has become much easier. Since credit is readily available, the interest rates that microfinance programs can charge are low compared to the developing world programs: 7 percent to 8 percent per annum, compared to 24 percent to 36 percent in developing countries.

In developing countries, virtually all group members take out a loan, and most take out repeat loans. Here, while eighty-five percent eventually take out one loan, a much smaller number move up the loan ladder. Interest income per business served is much lower. Currently only a third to a half of the group members have an outstanding loan.

In developing countries, jobs are scarce and pay poorly. Here, while unemployment was close to twenty percent in Western Massachusetts when Working Capital began, it has declined to under four percent now. Those who were not fully committed to their businesses have found jobs. In developing countries, unemployment and underemployment rarely reach as low as twenty percent, but are often double that. Self-employment is often the only option.

In developing countries, there is only a rudimentary safety net. Here there are alternatives to not being productive.

In developing countries, there are strong traditions and strong personal relationships that support the creation of solidarity groups and village banks. It is understandable, then, why Working Capital's has had its greatest success with Dominican immigrants. They not only have the least access to institutional capital; they are accustomed to joining groups, such as Sans, that have traditionally been sources of capital for them.

In developing countries, groups with twenty-five to fifty members are relatively easy to form and sustain, especially with women in rural areas. Here groups larger than five are difficult to organize (although groups up to ten have been formed). Since it costs as much to train a group of five as a group of twenty-five, operating costs per business are high.

In developing countries, overhead costs are low. Here the costs of rent and salaries far exceed any potential income that can be derived from loans.

All these factors, which now appear clear enough in hindsight, worked against cost recovery. While Working Capital proved it could deliver business services through groups, and that the impact of the group was equally as impressive as it was Latin America, interest and fees cover only a small fraction of program operating costs. Delivering Working Capital services through groups is a losing proposition financially for Working Capital and the participating affiliates, a conclusion regretfully reached after years of tinkering with the model and the delivery of services. This fact threatens the long-term continuance of the program, since Working Capital and its affiliates must be permanently subsidized if they are to provide services on an ongoing basis.

Working Capital's recent foray into individual financing with larger loans directed to better established businesses reflects the high cost and low cost recovery of the group loan product. It also reflects the fact that with many credit options available in a booming economy, business owners are less willing to join groups and take out loans through a structure that requires so much effort to ensure that others pay them.

Working Capital's Impact on Its Members

The impact of the Working Capital program on its members, documented through three evaluations (Mt. Auburn Associates, 1994; Anthony, 1996; Ashe and MacIntyre, 2000), is consistent with the perspectives of creating social capital and economic capital described earlier. On average, the business income of Working Capital members increased $5,000 per year from when they joined—not a large amount but a significant source of supplemental income for a low to moderate-income family. Jobs have also been created in the minority and low-income communities where Working Capital concentrates its efforts (although much more often for the owners of the businesses than for new workers).

Reflecting the ethos of mutual support and mutual accountability that permeates the group lending approach, group members refer customers to each other, use each other's goods and services, set up joint ventures, and often turn to each other for advice and support. Many describe their groups as "like family," with relationships often continuing for years after the groups disband. Most have sharpened their business and leadership skills through the frequent meetings that the program requires, and some are using these skills and connections to take a more active role in their communities.

The results of Working Capital's evaluations show that most businesses being served by Working Capital have (1) achieved a high rate of survival, (2) increased sales and profits, (3) secured access to new sources of credit, especially supplier credit, (4) improved management skills, and (5) created jobs—mainly for the owners, but also for local residents.

The three characteristics of an intervention that encourage rapid change—a real opportunity to increase one's income, a group that supports these aspirations, and leadership that drives the process forward—are found in Working Capital's peer group model. The documented changes correspond to its theory on how social capital is created. Understanding the long-term implications will require more study, however.

Implications for the Microenterprise Industry in the United States

This sobering assessment of Working Capital's first decade shows that bringing Third World methodologies to this country and applying them in a new setting was not as easy an undertaking as initially hoped. While peer groups have led to many of the same benefits they do in developing countries, the initial plans for achieving scale and self-sufficiency have been dampened by the realization that providing business services through peer-lending groups is a slow and costly undertaking in the context of the hard-pressed communities of urban and rural America. It is also sobering to realize how difficult it is to create or strengthen institutions— even those that have the will, the leadership, and the long-term commitment necessary to carry out this work effectively—given the constant struggle for funding in addition to staffing and management issues.

Is it worth the effort? Major benefits of participating in Working Capital have been identified, but it may prove in the last analysis that developing "social capital" was more important than increasing business income. The observation that communities with strong local economies are characterized by *networks, norms, and trust that enable people to cooperate effectively to pursue shared objectives* is compelling. Our inner cities, declining rural areas, and reservations are a source of much of the endemic poverty, violence, and hopelessness in our society. The costs of dealing with the symptoms and not the causes of these problems are doubtlessly much higher than the costs of doing something constructive about them, and microenterprise development is one of a small arsenal of constructive alternatives.

The Challenge

Reflecting on the joys and travails of carrying out a program over many years, I am discomforted by the fact that our work is based on enterprise development models we have imposed on the communities we serve. When we evaluate our work, we ask our customers to rate the services we provide them, but what if we asked them how they would propose to make a business out of developing enterprises like theirs? Would they come up with approaches that could help us see our programs from a fresh perspective?

Millions of microentrepreneurs in low income communities across our country earn a living every day from their businesses. Less than seventy thousand of them are reached by the hundreds of microenterprise programs that have sprung up across this country over the last decade, with the number of businesses assisted growing very little over the past several years. Is it worth a small additional investment at this point to learn what our customers and potential customers suggest if they were designing and implementing their own programs and then let them test some of their ideas? We may be pleasantly surprised at the results.

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Notes

1. This three-step model of change was developed by the author based on his participation in agrarian reform efforts in Ecuador. He observed that in the site where significant and sustained change resulted, the amount of land distributed was substantial. The land-buying cooperatives required by the government also represented a new form of organization whose officers were young literate men who seized this opportunity to take a leadership role. In the failed site, the amount of land distributed was too small to make much of a difference, and the government, instead of requiring the peasants to organize themselves into a cooperative, permitted them to use the traditional comuna system whose leadership was old, self-serving, and largely discredited. There was little sustained change in this second area.

2. Read the report available from Working Capital for a detailed presentation of the impact of the peer group model.

3. The issues and guidelines for Agents at each stage of the group process are detailed in Getler (1997). Copies of this report are available from Working Capital.

4. Working Capital's legal name is "Peer Partnerships, Inc.," organized as a Massachusetts corporation in 1993.

5. In the first two years, Working Capital offered affiliates a small stipend for each group it formed. As the program became much larger, however, it quickly became evident that paying even a small stipend would bankrupt the program, and payments to the affiliates were dropped.

Acknowledgments

This report is respectfully dedicated to the hundreds of Enterprise Agents who have trained and supervised Working Capital groups over the past decade. It was the Enterprise Agents who in their day-to-day interaction with the groups brought the benefits of Working Capital to so many communities. Working Capital's motto is "they know how." I say to the Enterprise Agents, "you know how."

My deepest thanks as well go to the many current and past colleagues and board members with whom I spent so many hours discussing the arcane details of program design and implementation as we became fast friends over meals at diners along the Northeast Corridor. My wife, Alyce, was my partner and adviser through it all, and my children Whitney and Katya were the willing (and sometimes not so willing) participants.

I thank you all, and I say goodbye as I leave the joys and travails of the "field" for teaching, writing, and consulting with Brandeis University as my new base of operations.

Working Capital is now in the very capable hands of its current executive director, Jim Kaddaras, a (mostly) new staff, and a new board of directors. I have the greatest hope that Working Capital will grow and prosper in ways that we who started it cannot even imagine.

Replication

Regressive Reproduction or Progressive Evolution?

by Graham Wright

ABSTRACT: Increasing numbers of organizations are "replicating" the programs of successful microfinance institutions (MFIs). This approach allows rapid start-up using tested models and systems. These strengths are also weaknesses, though, since the models being replicated usually require substantial modifications to make them appropriate for local conditions. Furthermore, close adherence to "blueprints" is likely to substitute for careful research into the needs and opportunities for the provision of financial services to the poor—and thus the design of appropriate systems. Replication also risks the suppression of innovative ways of providing still better financial services—particularly when promoted by powerful apex funding organizations, as is currently in vogue among donor agencies. Perhaps the most dangerous form of replication is that driven by consultants, lenders, or donors who design or recommend systems they only partly understand, thus giving incomplete or blurred blueprints. Credit is also used as a way to attract clients to meetings (where they may be required to participate in other activities, such as family planning, etc.). This "part-time banking" is dangerous, both as a result of the complexity of providing financial services, and because clients come to rely on permanent access to these services.

> Ironically it is the success of the "first wave" finance-for-the-poor schemes . . . that is the greatest obstacle to future experimentation. Most designers and sponsors of new initiatives have abandoned innovation, and replication is leading to a growing uniformity in financial intermediation for the poor. (Hulme, 1995)

Introduction

The MicroCredit Summit and its adherents seek to reach 100 million poor by the year 2005—and to that end recommend and assist with the "replication" of microcredit schemes. In the rush to reach so many, one can easily imagine that quality may be sacrificed to quantity.

This fear was heightened for those practitioners who attended the MicroCredit Summit Preparatory Committee meetings, which were ably managed by the dedicated and professional RESULTS team. During the second of the Preparatory Committee meetings, in Washington, D.C., in September 1996, practitioners attempted to stage a revolution in the interest of best practices. Speaker after speaker noted that the very name "MicroCredit Summit" would send the wrong message, and that with microcredit as the rallying cry, the vision could be more simply stated as "driving 100 million poor women into debt by the year 2005." Others noted that the

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astronomical projections for the amount of capital required from donors to fund the effort could be raised substantially by providing appropriate savings services. Almost all concluded that the name should be changed to "MicroFinance Summit" or perhaps "MicroEnterprise Summit"—but *not* "MicroCredit Summit."

The reaction from the podium was to agree politely that savings might be important, and then to stick firmly to the Summit's original name on the basis that it was easier to explain to the general public that poor people needed loans so that they could develop profitable microenterprises. Besides, the name "MicroCredit Summit" had already gained some substantial recognition and the stationery had been printed. A few changes referring to the importance of savings and financial services were buried in the Summit's Final Declaration, but the credit-driven model had won the day.

In retrospect, what the practitioners had failed to understand was that the Summit was being staged primarily as a public relations exercise to raise public awareness of the potential of "credit for the poor." The Grameen Bank's name and its remarkable success in reaching literally millions of poor women in Bangladesh (and Bangladesh, sadly, still represents a hopeless "basket case" to many people in the developed world) would be a powerful symbol to demonstrate that there was indeed a way to help the very poor. In a time when governments all over the world seem to have dwindling funds for development programs, it was (and still is) important to showcase the "success stories." Thus, the inspiration and driving force behind the Summit was the Grameen Bank's internationally renowned and respected credit-driven model. The ultimate aim of the Summit was to publicize microcredit's success and potential, and thereby raise funds to "put money into the hands of poor women."

In order to reach the Summit's ambitious goals, existing institutions will have to expand, and many new microcredit organizations must be established. In many respects, the easiest way to establish new organizations is through the process of "replication," whereby the "replicator" organization takes the blueprint of an existing successful institution and attempts to implement it. Indeed, this approach is being promoted by many agencies. But it requires careful consideration.

There is a remarkable level of diversity in the implementation methodologies followed by organizations inspired to replicate—even among those replicating the same model. This diversity, however, is not usually driven by careful research and design methods to create economically appropriate systems tailored to meet the needs and opportunities of the environment in which the organization operates. More generally, the diversity of systems is driven by the needs of the project or the institution implementing it: their existing groups, nonfinancial service objectives (such as the delivery of family planning commodities or community conscientisation), the donor agencies' disbursement schedule, or blueprint implementation models. These systems often perform poorly and require extensive modification in light of hard reality (geography, topography, demography, economy, society, culture, communications, infrastructure, etc.) in the field.

There is now an increasing recognition that donors' microfinance "projects" should support the development of sustainable institutions designed to deliver cost-effective, quality financial services to their poor clients on a permanent basis. This is a big step forward: previously, projects came, delivered loans, and then left, often leaving "beneficiaries" in much the same position as they were before. This recognition also makes clear the need to identify and support an institution separate and distinct from the "project." Implicit in attempts to create sustainable institutions is the need to make the institution, its financial services, and the systems to deliver them appropriate for the local conditions—and not just to impose a blueprint microfinance program developed and designed in a distant land and alien environment.

Blueprints for Replication

When an institution is developed (or under the old school, when a project is implemented) from the beginning as a microfinance program, it is common to see the system driven by blueprints (such as those promulgated by the Grameen Trust/CASHPOR, Foundation for Development Co-operation (FDC), or FINCA), rather than by a careful analysis of needs and opportunities in the communities in which the institution operates.

Churchill's (1997) description of the rehabilitation of South Africa's largest NGO lending program by the Calmeadow team—from 50% to 3% loan loss—demonstrates how blueprints can often cause profound trouble for those who follow them without reference to clients' needs. "Based on the original recommendation of USAID, Get Ahead only issued loans for 12-month terms. After conducting market research in 1993–4, Get Ahead realized that its product was inappropriate for the needs of its clients. Borrowers complained that loan sizes were too small and the loan term too long. . . . Get Ahead's decline, and recovery, emphasize the importance of adhering to the two basic tenets of microlending: excellent client service and strict delinquency management" (p. 35).

The blueprint approaches, such as those being promulgated by Grameen Trust/CASHPOR, and more recently ASA, risk attempting to standardize rather than optimize systems and client service, and do it irrespective of the diverse settings in which they are implemented. In many ways, these approaches help by offering tested methods and systems, but hinder because they do not encourage adequate research into local constraints, needs, and opportunities. The blueprints can be seen as substitutes for research and analysis. In this respect the emphasis of United Nations' Development Programme's (UNDP's) MicroStart on reviewing the "Strategic Environment" and "Market" through secondary data analysis and multiple interviews makes this a more situation-responsive and responsible blueprint. But despite these significant limitations, some notable successes have arisen as a result of these types of blueprint approaches. The blueprints often give a reasonable starting point that can then be modified in the light of experience and client demand—if the institution learns to listen.

For example, the Centre for Agriculture and Rural Development (CARD) Inc. in the Philippines defines itself as "A Grameen Bank Replication Project" and has replicated the Grameen methodology faithfully with little deviation, except to drop the Grameen Bank's salutes and exercises. As of December 1997, it had 10,868 members who had borrowed nearly $500,000 and maintained a 100% repayment rate. This is particularly remarkable in that CARD was previously a community development organization offering balloon-based repayment loans and suffering the consequences in repayment terms—with default rates in excess of 50%. In response to client demands, however, CARD is now transforming itself into a rural bank in order to offer savings services—thus demonstrating the flexibility of an experienced, self-confident organization increasingly committed to providing quality financial services to its clients.

But blind adherence (often enforced through donor implementation methodology and reporting requirements) to these blueprint replication programs does little to innovate or to search for improved ways of meeting the needs of the poor. This failing is one of the most dangerous, since it not only risks failing to address community or location-specific needs and opportunities, but also ingrains and institutionalizes a limited number of high-profile models with their increasingly well-acknowledged shortcomings. Less well-known, but in many ways more successful, models (often those which have not accessed large amounts of donor funding and therefore have not been subjected to endless evaluation missions, peer-reviewed research, and profiling in public relations publications) are often overlooked.

Furthermore blueprint programs usually ignore existing informal sector savings and loan groups or systems from which they could learn and which they could harness to strengthen their programs. Pal (1997) provides an interesting description of Credit with Education, the Freedom from Hunger model, modified to fit the local situation using preexisting systems of "caisses populaires" (credit unions), "caisses villegoises" (smaller village banks), and "tontines" (ROSCAs) in Burkina Faso. This helped the program overcome not only the challenges of Burkina Faso's social systems, but also those presented by the huge distances between villages. She notes that in this case, "Replication . . . does not refer to what Hulme termed the 'blueprint method,' (1993) whereby one approach, in this case the GB [Grameen Bank] model, can be universally applied to a variety of situations and contexts" (Pal, 1997, p. 17).

This need to explore the existing informal and formal sector environment (the "financial landscape") has largely been ignored to date, but its importance is increasingly recognized as a prerequisite for designing appropriate quality financial services for the poor (see, for example, Johnson and Rogaly, 1997). Rutherford (1996) has listed the types of questions that a client-responsive microfinance institution (MFI) should ask in designing its system and products.

Rutherford's Questions: The Basis for Designing Quality Financial Services

According to Rutherford, an organization wishing to get involved in financial services for the poor might ask the following questions during its surveys of its proposed area of operation :

- How do poor people manage their savings deposits? Are there savings banks, deposit takers, insurance salesmen, or savings clubs? Do the poor have access to them? If not, how do they save, and how convenient do the poor find the available forms of savings?
- Can the poor temporarily realize the value of assets they hold? Are there pawnbrokers or are there schemes that allow them to mortgage land or other major assets safely? If such devices exist, are they exploitive or enabling?
- Can poor people obtain access to the current value of future savings? Are there moneylenders willing to advance small loans against future savings? Are there rotating savings and credit associations (ROSCAs), managed or commercial chits, cooperative banks, or NGOs that offer loans against small regular installments? Do the very poor have access to them?
- Can poor people make provision for known life-cycle expenses? Can they provide for daughters' marriages, their own old age and funeral, and for their heirs? Are there clubs that satisfy these needs, or general savings services or insurance companies that will do as well? Are there government-run or employer-run schemes?
- Can poor people secure themselves against emergencies? What happens when the breadwinner is ill, or when a flood or drought

occurs? Does the government have schemes that reach the poor in these circumstances? If not, what local provision can people make?

- Can poor entrepreneurs get access to business finance? If so, in what amounts and at what cost?

Answering these questions will allow an MFI to identify opportunities to provide savings and credit facilities or alternative pawn/mortgage facilities, to promote Rotating Savings and Credit Associations (ROSCAs) or Accumulating Savings and Credit Associations (ASCAs), self-help groups, or credit unions. The process of asking and eliciting answers to these questions will also give the MFI important information on the magnitude of financial transactions underway within the community, and thus useful information for setting loan sizes, etc. In short, the process will give a good overview of "the financial landscape," and what, if anything, the MFI can contribute, as well as an overview of the competition it will face.

Mass Production Blueprints

Similar blueprint approaches are coming to the fore with the increasing interest in second-tier, apex organizations. These are greatly favored by donors as a way to finance many small microfinance organizations without having to worry about them on an individual basis—the responsibility for supervision is given to the apex organization. Furthermore, some argue that the better apex organizations do not simply wholesale capital funds but also provide technical training and backup. There are two fundamental problems with this: first, it sets up an inherent conflict of interest; and second, it can lead to suffocation of innovation.

The conflict of interest arises from the apex organization's dual role as financier and technical assistance provider. As a financing institution, the apex will want to lend its capital to its client MFIs as quickly as possible (and therefore may be willing to cut corners in terms of quality irrespective of concerns relating to long-term portfolio quality). The apex will also be keen to demonstrate (both to the MFI and the world at large) the effectiveness of the technical assistance it delivers, and be under significant pressure from the recipient MFI to follow the assistance through with capital funding. Should one of the MFIs it funds face problems that threaten its investment, the apex is likely to deploy its technical assistance capability to protect its capital. In addition, in the words of Gonzalez-Vega (1998, p. 39), "When large amounts of credit are used to *persuade* the MFO [MicroFinance Organization] to accept the technical recommendations of the apex organization, the MFO may find that it is not really obliged to repay the loans if failure of its own lending activities can be attributed to poor technical advice from its dominant implicit partner [the apex organization]." Gonzalez-Vega goes on to note, "Furthermore, a *sine qua non* for institution-building to be effective is the willingness of the MFO to accept the advice of the provider of technical assistance. When technical assistance is tied to borrowing, it is hard to tell if the MFO wants the advice" (p. 39).

This leads to the second fundamental problem posed by apex organizations: they once again risk the promotion of one specific approach to providing financial services without adequate recognition of all the options open to client organizations. The level of risk depends largely on the philosophy and approach of the apex organization, but these apex institutional arrangements can result in the suffocation of more creative approaches to providing financial services to the poor. This risk needs to be better acknowledged by the donor agencies that fund the apex organizations; and mechanisms to support more innovative and client-driven models should be promoted.

Palli Karma Shahayak Foundation

The Palli Karma Shahayak Foundation (PKSF) has become a successful and often cited "model" apex wholesaling financial institution. Established by the Government of Bangladesh in 1990, it has an independent, seven-member Governing Board, which is responsible for policy decisions.

PKSF has received grants of nearly $25 million from the Government of Bangladesh, and (in 1996) another $105 million soft loan from the World Bank. These funds are lent out to partner organizations at rates varying between 3.0% and 4.5% per annum depending on the size of the partner organization. This interest is used to cover the costs of delivering credit and monitoring its use, as well as to provide some basic technical assistance and training services to approximately 150 partner organizations. PKSF does not favor any one specific microfinance model, program, or system and theoretically encourages innovation and research. In practice, however, PKSF insists that its partner organizations charge a "reasonable" rate of interest to customers for their loans, and the interest rates of NGOs financed by PKSF range between 9% and 15%. In the interests of operational efficiency, PKSF has standard monitoring, management information, and reporting systems for small organizations. This effectively forces these partner organizations to follow a PKSF-driven (Grameen Bank-based) model and stifles any significant innovation or departure from it.

This may be changing; after long negotiations, PKSF has showed admirable flexibility, compromised, and agreed to lend to Proshika without insisting on major changes in Proshika's savings and credit methodology. Whether this precedent reflects the large amounts being borrowed by Proshika or is indicative of a more flexible policy in the future remains to be seen.

PKSF's understandable search for quality partner organizations also has had another, little recognized, but very dangerous result. One of PKSF's requirements is that partner organizations have a track record: that they have been operating for at least one year, and have a 98% repayment rate. This has meant that many well-intentioned, would-be credit NGOs have set about forming groups, collecting savings, and lending them back to their members with the aim of achieving PKSF's track record criteria and accessing capital funds from PKSF. At the beginning of programs, clients are justifiably skeptical about the capacity of NGOs to deliver on their promises, and almost inevitably the demand for loans far outstrips the capital raised through the (usually compulsory, locked-in) savings program. If, as is often the case, confidence lapses and repayments falter, the NGO suddenly faces a situation in which it cannot meet PKSF's requirement for a 98% repayment rate and is unable to access additional capital funds to meet its clients' demands for loans. Then the vicious circle is complete, for without funds from which to offer loans, the would-be MFI is unable to meet the demands of its clients who begin to lose confidence in the organization and opt to reduce or withdraw savings deposits, thus further reducing the organization's ability to lend. Soon the repayment rates falter further, confidence declines even more and finally the savings of poor clients are lost to loan defaulters or in the costs of administering the program. One cannot help worrying that the enticing prospect of

PKSF funds may have encouraged several of the failed NGOs that litter rural Bangladesh to "take a gamble" on their members' savings.

Incomplete Blueprints

But perhaps the most dangerous form of "replication" of all is that promulgated by consultants or leaders in agencies with limited knowledge and experience of the systems they recommend. The Grameen Bank name has now acquired such an aura, such a mystique, and is so closely associated with successful credit operations that it is invoked as a matter of routine in all matters dealing with development credit. In other parts of the world FINCA's name has acquired a similar mystique.

The Catanduanes Agricultural Support Programme (CatAg) was set up on the basis of the preproject report of a senior consultant hired by the European Union. His recommendation was a blurred photocopy of the Grameen Bank's system with several key pages missing. He recommended the establishment of five-member "Guarantee Groups" that would federate together into "Savings and Loan Societies" (SLS) and operate their own revolving loan funds injected into the SLSs by the benign donor. Thus each twenty-five to fifty-member SLS would be capitalized and trained how to manage its revolving loan fund, and would live happily ever after.

Experience has shown us time and again that without external support, such self-managing groups rarely work. For example, CARE Bangladesh's Women's Development Project delivered a broad range of health information, skill development, and savings and credit with group formation, under a community development program in Tangail for three years before withdrawal. Ritchie and

Vigoda's (1992) subsequent evaluation found that "over half of the savings and loan groups . . . are no longer in existence" twenty to forty-four months after withdrawal. Many community development specialists in Bangladesh would see it as an impressive success that so many groups had survived. BRAC has also given up as impractical trying to create free-standing village organizations to look after their own affairs.

This problem is not confined to Bangladesh—the entire village banking movement has long-since recognized and responded to the need to provide ongoing services to village-based groups. "At the International Village Banking meeting in 1994, the concept of graduation was discussed by managers and proponents of village banking from all over the world. The failure to have banks actually graduate from their programs is a phenomenon witnessed by many programs. . . . At this meeting, it was decided that the word 'graduation' in reference to village banking should be abandoned. Instead, there was an emphasis on establishing ties to as many formal financial institutions as possible" (Paxton, 1997).

These ties are important to help the village-based group manage their funds better: excess savings not lent out among the group can be placed on deposit to earn interest, and when there are inadequate funds to meet the group's credit needs, additional funds can be borrowed from the formal financial institution. Furthermore, and in many cases most importantly, the formal financial institution can provide the security, bookkeeping, and auditing services necessary to maintain cohesion and trust among the village-based group's members. For this reason, most indigenous, self-started village groups such as revolving savings and credit associations (ROSCAs), Christmas clubs, or funeral funds tend to be time-bound and self-liquidating. This built-in natural termination provides the benefits of having an automatic audit as the scheme closes. Either all the money is there and everyone has been paid, or it is not and they have not; and this is the basis for the participants' decisions whether to participate in the next "round" of the scheme if it is to continue. In addition, regular payouts solve the problems that large, accumulating sums of money create in villages—onerous bookkeeping, the envy and attention of those outside (and sometimes even inside) the scheme, the need to store and protect the capital, and so on.

The model proposed by the consultant and adopted by CatAg made one other fundamental error: it put revolving capital funds directly into the village-based group. Capitalizing the group directly adds to the need to maintain excellent records and trust among its members, and provides a large temptation to "split the money and run." Even at this early stage, it would not be imprudent to suggest that, as soon as the CatAg program finishes, many of the SLSs will find the weekly meetings or bookkeeping too onerous, or will lose faith in the treasurer, and will simply divide up the SLS's fund among the members and disband. Indeed, even as CatAg is being implemented, examples of this are already happening.

To compound the problem and make it even more intractable, because the capital funds have already been handed over to the SLSs to manage, they have no incentive to link to an apex formal financial institution. The SLSs have the capital funds (indeed in most cases the amount of capital held by the SLS exceeds the demand for loans among its members) and do not wish to pay for the services of an apex organization at all. CatAg now recognizes this problem and is scrambling to find a solution—and it is proving to be very difficult. Almost every possible solution requires significant additional investment and still carries a high risk of failure. There is a very real possibility that this five-year, $14 million program may prove to have been an extremely elaborate way of handing a few thousand pesos to each "beneficiary." It would have been more cost effective to distribute the cash from the outset and wrap up the project after a month.

Two Strategies and Two Outcomes

Stuart Rutherford (personal communication) differentiates between the two strategies pursued by outside agencies (be they development or private sector) and poor people themselves as they seek to design and deliver financial services. The former tend to use a strategy of permanence and growth and look to create sustainable institutions that deliver financial services to an ever-increasing number of clients—MFIs, banks, cooperatives, etc. By contrast, poor people themselves generally use a strategy of replication and multiplication and look to create many small self-contained, often self-liquidating schemes—ROSCAs, Christmas clubs, etc.

There is another important difference between these two strategies and the types of schemes they spawn. The permanence and growth institutions tend to encourage the long-term build-up of funds through relatively slow, but steady, savings (and are therefore extremely well suited to address longer-term savings needs such as house building, pensions, etc.). The latter replication and multiplication schemes tend to encourage the rapid accumulation and disbursement of funds (and are therefore better suited to meeting shorter-term savings needs, such as purchasing small assets or financing festivities or rituals).

These differences explain why the poor will often hold accounts in permanence and growth institutions while enthusiastically participating in a variety of replication and multiplication schemes—the different schemes fulfill very different needs.

Furthermore, it is because of their differing roles that ROSCAs and other shorter-term schemes often attract markedly more savings than secure, interest-bearing accounts with financial service institutions.

Invoking the Name of Grameen

One final example of replication in the name of Grameen can be taken from the Central Cordillera Agricultural Project area in the northern part of Luzon, Philippines. In 1997, the project began to hear of a special preelection project proposed and driven by the president's office, for the benefit of the poorest provinces in the Philippines. In the Province of Ifugao alone, the LandBank's National Livelihood Support Fund was lending (at 12% per annum) 3 million pesos ($120,000 when the scheme was devised) to a selected cooperative in *each* municipality (populations averaging around 2,500 households) for on-lending (primarily) to agrarian reform communities (ARCs).

These cooperatives were given a list of agrarian reform communities members divided into groups of five, thus creating "instant" Grameen groups as lucky recipients of loans. The Department of Agrarian Reform has submitted the lists of agrarian reform communities to the cooperatives involved, and they appear to contain a cross-section of the community, including the elite. These "Grameen groups" will take loans at 20% per annum, repayable either on a monthly or balloon basis. The cooperatives involved retain their own collateral requirements, and simply worry about collecting loans. Thus the scheme uses the Grameen name and then proceeds to break almost every one of the fundamental principles that have made the Grameen system successful.

The National Livelihood Support Fund program is by no means an isolated example—many schemes worldwide claim Grameen inspiration and then ignore the principles that have made the Grameen Bank so successful. Perhaps one of the most important tasks for those involved in the microfinance "industry" is to help clarify and promote some basic principles and best practices, without issuing them as commandments set in stone—a difficult balance to strike.

Part-time Bankers

In addition to poorly designed "blueprint programs," increasing numbers of the development organizations—both governmental and nongovernmental—are jumping on the microfinance bandwagon as a sideline. These organizations tend to get sucked into providing savings and credit services by a combination of two factors. First, their clients demand these services, and they are seen as a way to persuade them to come to meetings (which are then also used to pursue other agendas). Second, the organizations often see savings and credit as a way to make a little money and thus address their donors' demands for "improved sustainability" or "increased self-financing." Neither of these is a good reason for organizations that do not specialize in savings and credit to enter into this complex field. The risks are too high.

Certainly, increasing numbers of NGOs (and indeed government programs) are using credit as the lure to encourage the poor to form groups which are then used to deliver other extension services—health and family planning, literacy, etc. In Bangladesh, JOICEFP's programs in Gorashal and Feni, Gashful's in Chittagong, as well as many others are using credit as the chief motivating force to gather groups, which are then given the family planning and health inputs that address the central or real objectives of the programs. Freedom From Hunger's experience is typical: "Freedom From Hunger [FFH] entered village banking with the underlying aim of reducing malnutrition. In FFH's experience, providing solely nutrition information was not enough to attract regular active participation by poor people. The financial services portion of the program was developed to entice participation and improve poor people's ability to generate income for food" (Holt, 1994, p. 162). Fortunately, the credit program has now become an integral (some might suggest, central) part of the FFH approach.

It is difficult to overstate the dangers of getting into savings and credit as a sideline. Banking is a complex business. The financial accounting, the systems of control, the management of cashflow and client confidence, the management information systems, and the staff and client training necessary to implement a savings and credit program are extremely complex. And once an organization has started to provide savings and credit services to its clients, it is almost obliged to continue to provide them. This obligation arises from two sources. First, recovering loans from clients who know that no further loans or financial services are going to be made available is notoriously difficult; and if the organization cannot get its loans back, it probably cannot give its clients' savings back. Second, clients who have had access to financial services use these to better manage their household income and expenditure, and they and their businesses become increasingly dependent on having access to those financial services, on a long-term basis. Few readers of this article, and no business of any size, could manage without access to a bank account, credit cards, and periodic loans. It is therefore imperative that those organizations which get involved in the provision of financial services not only do it on a professional basis, but also do so with a clear commitment to provide *permanent*, quality services to their clients. Anything less is a recipe for disaster.

Conclusion

Perhaps it is the complexity of delivering financial services and the knowledge that organizations must seek to establish sustainable MFIs, together with the success of microfinance programs worldwide, that has given rise to the epidemic of blueprint-driven replication. After all, there is still a huge unmet demand for *quality* financial services. Despite this widespread demand, it is estimated that institutional finance is unavailable to over 80 percent of all households in developing countries (Christen et al., 1996; Rosenberg, 1994). A conservative estimate of microfinance demand all over the world is about 2.5 billion people or 500 million households (Robinson, 1997). The MicroCredit Summit's ambitious target of "reaching" 100 million families by the year 2005 would therefore address only 20% of the demand. But blueprint replication will not lead to quality financial services tailored to meet the local needs and opportunities of the community the institution is trying to serve. Indeed, it is likely to result in a system that forces users to manage their way around its inappropriate rules, regulations, systems, and services. Introducing a system of financial services without having researched the financial landscape and the needs and opportunities it presents is similar to assuming that you can drive a city sedan on all roads. What worked in Bangladesh will not necessarily work in Nepal, Burkina Faso, or the Cordillera.

The process of replication must include a period of research and reflection, pilot-testing, monitoring, and modification to tailor the "model" system being replicated for local conditions. And the modifications should maintain most, ideally all, of the basic principles of microfinance (see, for example, Christen et al., 1996; Johnson and Rogaly, 1997). Without this the microfinance industry, which was born of a willingness to experiment and take risks, will perpetuate inbred systems in a spate of regressive reproduction instead of researching, learning, and tailoring in a process of progressive evolution to optimize services. In the rush for replication, we *must* not sacrifice quality for quantity.

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Acknowledgments

Thanks to all those who reviewed the various drafts of the article and gave their valuable comments. All the remaining opinions, errors, omissions, and grammatical howlers are mine, and mine alone.

Capital Enhancement Guarantees and Risk Management by Capital-constrained Lenders

by J. D. Von Pischke

ABSTRACT: Commercial lenders require capital to bear risk. The capital enhancement guarantee (CEG) encourages lenders to make loans they would not otherwise make, such as microenterprise loans. The CEG is auctioned and awarded to bidders who promise the greatest amount of new lending for a given increment of permanent capital. Whether the incremental lending causes losses or gains for the lender, the incremental capital is free. The CEG subsidizes innovation in risk management. It places the analytical focus on risk and its cost, supports the key party to the lending decision, promotes skill in managing risk, is transparent, minimizes moral hazard, and has trivial transaction costs. The CEG should be attractive to donor agencies.

Introduction

The capital enhancement guarantee (CEG) is a new financial instrument designed to encourage innovative lending in situations in which capital is a greater constraint than liquidity. This is typical in well-managed commercial retail lending institutions, including banks and credit unions, that have been in business for several years or more. CEGs enable such institutions, including microfinance operations, to expand their outreach.

The purpose of the CEG is to use market-based, risk-sensitive measures to direct subsidies to lenders and their clients (the ultimate borrowers) that qualify for guarantees. Accordingly, criteria must be provided for the types of borrowers who are supposed to benefit. Relevant variables may include location, the value of assets or sales, the size of the workforce, the type of economic activity or function performed by the borrower, the loan purpose, and other features favored by the donor. The selected targeted characteristics that define eligible borrowers should be specified in the funding agreement that governs the CEG program or in criteria for specific allocations of CEG coverage.

The CEG proposal originated during an Food and Agriculture Organization of the United Nations (FAO) mission to a transition economy. The mission was organized in response to a request from the country's government to design a system for agricultural credit guarantees,[1] based on the assumption that grants would be forthcoming for this purpose from an official source in western Europe. Existing guarantee mechanisms were examined, and alternatives were explored. Major concerns of the mission were to diminish possibilities for political patronage and to minimize transaction costs such as those that seemed likely to arise if a tiered system of local, regional, and national guarantee associations were formed, pat-

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terned after those of certain Western European countries. This never implied that such structures were characterized by patronage and inefficiency in the western European countries where they developed. The mission's view was simply that such results would be likely if they were transplanted to the country concerned. The results of the mission were inconclusive.

Capital in Microfinance Institutions

Capital (also called equity or net worth) is not generally a constraint in microfinance institutions (MFIs). Grants commonly fund their operations, giving them plentiful capital. Their grant-funded capital comprises a high proportion of their total assets: reliance on borrowing to fund operations is relatively low. Because a number of official donor agencies are enthusiastic about providing equity capital for these ventures, capital is also not initially a constraint for specialized microfinance institutions that seek to operate on a commercial basis. In both these cases capital-to-asset ratios (also called capital ratios) are higher, often much higher, than the 8% or 10% regarded as standard in commercial banking.

These high proportions of capital tend to decline as commercial microfinance institutions grow (introducing a wider range of services including deposit accounts), as they become regarded as creditworthy in local financial markets, and as they begin to tap local credit sources. Donors may be less willing to deal with profitable commercial microfinance institutions, but on the other hand, donors are at times attracted to them because their service to the target group coincides with donor priorities. It seems probable, however, that loans from donors would represent a diminishing portion of the expanding balance sheets of such institutions.

However, the microfinance field is too new and therefore too heterogeneous to define a standard minimum capital ratio, such as regulators have done for commercial banks, which are much more homogeneous. At some point, as the capital ratios of commercially oriented MFIs decline through liability-funded growth, capital enhancement guarantees may become interesting to them because they seek more capital in order to grow and because liquidity can be obtained at reasonable cost from a number of sources, such as depositors and local money markets.

The growth constraint posed by capital may be illustrated as follows: if the board of an MFI feels that a minimum capital ratio of 20% is required, one additional peso of capital at the 20% minimum level permits a growth in total assets of five pesos. A board would be concerned about the relationship between capital and total assets because of capital's role as the ultimate cushion for risks and because of leverage. Losses reduce capital disproportionately. A loss of one peso by an institution that is operating at its minimum target capital ratio of 20% would require a five-peso shrinkage of total assets. Beyond some normal level of comfort (20% in this example), risk aversion rises. This causes lenders to decline to undertake lending at the margin that they regard as too risky, novel, or inconvenient. These are the constraints the CEG is designed to ease.

Expressions of Risk Aversion at the Margin

Why do banks reject loan applications when liquidity is not a binding constraint?[2] Common reasons are that loans requested are:

- too risky.
- inconsistent with the lender's business strategy and credit policy.
- unlikely to meet the standards of banking regulators.

These reasons for rejecting loan applications are generally applied as follows:

Loans That Are Too Risky

If lending is asset-based, loan applications are rejected when collateral is insufficient. If lending is based on a loan applicant's expected future cash flow, applications are rejected when cash flow[3] is regarded as inadequate to service the loan within a time frame acceptable to the lender. Loan applications are also rejected as being too risky when lenders are not comfortable with the type, amount, or content of the information provided by or otherwise obtained about a loan applicant.

Loans Inconsistent with Business Strategy and Credit Policy

Loans that do not conform to a bank's business strategy and lending policy include those rejected as too risky because of collateral, cash flow, and information deficiencies. Additional strategy and policy reasons for rejecting loan applications include (1) the lender's desire to avoid risk concentrations by diversifying their portfolios as a means of controlling overall credit risks; (2) avoidance of lending for activities with which the lender has little experience or expertise; (3) loans that are likely to be costly to administer because of the location of the applicant, the type of business in which the applicant engages, or the applicant's credit history; and (4) managing loan portfolio size to maintain consistency with the liquidity and capital positions of the bank, i.e., maintaining capital adequacy as measured by the capital ratio, and liquidity sufficient to meet the bank's obligations. Increased lending funded by growth in deposit liabilities, for example, can lower the capital ratio. Increased lending funded by drawing down a bank's cash and government securities reduces the bank's liquidity.

Loans Unlikely to Meet Regulatory Standards

Regulatory standards include collateral adequacy, projected cash flow, source of repayment, and information and documentation on which the credit decision is based. Banks that do not meet standards and standard application may be subjected to unusual transaction costs that may result in higher costs of funding.

Traditional Credit Guarantees and Incentives

Traditional credit guarantees are defined here simply as those provided by governments and development assistance agencies that are off the guaranteed lender's balance sheet. Several dimensions are explored here.

Purpose

The purpose of a loan guarantee is to encourage a bank to make a loan that it would refuse without a guarantee. The successful traditional guarantee or loan insurance enables the lender to make such a loan by (1) reducing the credit risk burden; (2) providing a substitute for collateral; (3) offering comfort when cash flow is problematic; (4) diminishing the risks of portfolio concentration; or (5) meeting regulatory standards.

Traditional guarantees are usually only partial, requiring the lender to assume some of the risk, thereby creating incentives for lender diligence. Traditional guarantees are not shown on a lender's balance sheet because of their contingent nature. They may be unlikely to persuade bankers to lend in the following three cases: (1) bankers constrained primarily by their capital position may be unwilling to undertake any incremental risk because of leverage—losses reduce their capital at a faster rate than their assets and may be only partially offset by a guarantee; (2) bankers constrained primarily by their liquidity positions fear that the loan applicant's presumed inability to service debt in a timely manner depletes liquidity, again partially mitigated by a guarantee; (3) bankers would not be interested in a guarantee if they believed that the costs of obtaining, monitoring, and realizing a guarantee would be excessive relative to expected income from the relationship with the proposed borrower. Realization of the guarantee may take time and effort, including documentation and delays in compensation.

Risk Management

Traditional guarantees associated with development finance usually fail to deal directly with risk management and reduction. They clearly transfer risk to the guarantor. In most cases, however, they are not structured in a way that increases lenders' or guarantors' knowledge about what is most likely to go wrong with guaranteed loans or the actual (i.e., nonfinancial) activities they finance. These guarantees are usually not integrated with the promotion of better management or financing techniques that borrowers and lenders alike could use, with or without a guarantee, to reduce the incidence and impact of risks such as business failure, livestock mortality, or crop failure. As a consequence they do not necessarily generate insights into how real risks facing the borrower can be reduced.

Costs and Benefits

Traditional guarantees add transaction costs to the credit process in the form of their own overheads, which are often substantial in relation to amounts guaranteed. A common source of these costs occurs when the banker and the guarantor each perform a detailed credit analysis of the loan applicant and application, in effect duplicating effort. However, this cost rarely appears to create better management of real risks. Provision of guarantees through traditional guarantee funds is almost always very costly in the long run, as suggested by the demise of such funds and calls for replenishment of their capital. They tend to decapitalize slowly, because risks take time to become apparent.

Moral Hazard

Traditional guarantees may also create moral hazard, which occurs when the guaranteed party behaves in a way that increases the cost to the guarantor. For example, a guarantee may lessen a lender's incentive to manage loans well and analyze risk intensively, thus weakening credit standards and discipline. It may likewise diminish a borrower's commitment to the success of the loan-financed venture. In each case this tends to occur because the financial cost of failure is reduced for the party or parties benefiting from a guarantee.

Capital Enhancement Guarantees and Risk Management

Capital enhancement guarantees provide a mechanism that avoids the disadvantages of traditional guarantees, while offering a basis for lenders to explore and assume risk on an incremental basis, as explained below.

Capital

CEGs operate entirely through the financial system and the regulatory framework at negligible administrative costs. They are based on the principle that banks require capital to bear risk. Insufficient capital limits a bank's ability to bear losses, and in extreme cases can cause a bank to fail. Well-capitalized banks are more willing and likely to undertake risky lending in a sustainable manner.

The CEG simply provides additional, free capital to bankers willing to make more risky loans in return. A bank does not have to pay for the guarantee but does have to perform as it contracts to do under the guarantee. Regardless whether a bank obtaining a guarantee suffers a loss on guaranteed loans, the amount of the guarantee obtained is transferred to the bank, assuming adherence to the guarantee contract.

Banks' losses from guaranteed loans would provide extremely important information in judging the performance of CEGs. The impact on a bank's capital resulting from its lending supported by CEGs should be calculated by the bank and reported periodically over the period for which CEG-supported loans are outstanding. This information should be reported publicly, possibly excluding the names of specific banks.

CEG Award Mechanics

In countries with a number of lenders (e.g., microlenders), capital is provided by the guarantor through auctions. A simple participation agreement between bidding banks and the guarantor could specify criteria determining a bank's eligibility to participate (details are provided in Appendix 1), targeting objectives, bidding procedures, rules and enforcement measures; and other operating details and instructions regarding remittance of guarantee funds to successful bidders. It would also include performance-monitoring requirements that govern guaranteed loans and specify sanctions against unacceptable behavior.

The guarantor's requirements would define eligible loans, based, for example, on types of loan recipients, amounts, maturities, and purposes that the guarantee is intended to support, which would otherwise be nonconforming and hence ineligible for bank credit. Periodic auctions are envisaged, making management easier. This would also facilitate segregation of activities: i.e., today an auction devoted to microenterprise loans, two months from now small farmers, four months from now loans for environmental purposes, six months from now small enterprises in export sectors, followed by home improvement loans, etc.

A bidding bank's "price" is its ratio of additional capital to additional loans. The funding provided by a CEG, therefore, amounts to only a fraction of the additional risk that a bank could incur on a loan supported by a CEG. The calculation would begin with the bank's present capital ratio, specified as a percentage (e.g., a bank with total assets of 10,000 and capital of 800 would have an 8% capital ratio). The bank's bid would be expressed in percentage points above its capital ratio. If a bank with an 8% capital ratio wanted to make an additional loan of 100 and felt that capital of 10 would be required to support the risk it perceives, the bank's bid would be 2%. The 2% is the difference between its capital ratio of 8% and the 10% capital base that would enable it to make the proposed loan of 100. If this bid were successful, the bank would receive 10 from the guarantee fund in the form of subordinated debt (which is treated by bank regulators as a form of capital). Unsuccessful bids could be resubmitted in later auctions.

Awarding capital on the basis of bids approaching banks' own capital ratios has several implications. One is that all eligible banks are treated equally at the margin. Banks with relatively low capital ratios could not use this characteristic to outbid banks with relatively high capital ratios. The fact that banks with higher capital ratios would receive more capital from a CEG than banks with low capital ratios is not relevant in this context.[4] The purpose of the CEG is to encourage banks to explore risks incrementally, dealing first with loan applications that they would otherwise reject by narrow margins. This is consistent with good risk management, which is a source of profit for lenders; failure at risk management creates losses for lenders. Furthermore, the purpose of the CEG is to subsidize banks' efforts in risk management and help donors find productive outlets for funds.[5]

Successful bidders are those who submit the lowest bids, offering the most leverage for guarantee capital, relative to their present capital. In other words, winners would promise the most additional lending for a given size of guarantee, relative to their capital position. A bank has to have at least the minimum capital ratio prescribed by the central bank or other bank regulatory authority to be eligible to bid.[6]

The guarantee award is in the form of subordinated debt convertible into permanent capital. However, bank regulators often specify that to be treated as capital at all, subordinated debt must have a minimum maturity, such as three years. In this case, guaranteed lending would have to have maturities of at least three years. With respect to short-term loans, banks would have to agree to continue cycles of such lending for at least three years. Conversion of subordinated debt to permanent capital would occur on the third anniversary of the award, or as the retail loans under the guarantee fell due, whichever occurs later. If a five-year loan were made, for example, the principal portion repaid by the end of year three would be converted at that time, and the remaining installments of principal would be converted as they were received.

Receipts of subordinated debt or permanent capital should not be booked as income, but rather treated as a “below the line” transfer to capital. As permanent capital the funds would rank just below owner’s equity. They could be eroded by losses but could not be withdrawable except in the liquidation of the bank.

The amount of a bank’s subordinated debt (Tier 2 capital in international terminology) that can be treated as capital is usually limited by regulators, often not to exceed 50% of permanent capital (Tier 1 capital). Eligibility for CEG capital may have to be more limited. Assume that the bank with an 8% capital ratio (cited above) wanted 1000 and that its successful bid would still be 2%, resulting in a transfer of 100 to the bank, or assume that a 10,000 deal was based on a transfer of 1000. Without a monetary limit, bidding could produce an unsatisfactory result in which one bank absorbed all auction funds. The monetary limit should be related to a bank’s Tier 1 capital, which reflects the bank’s basic risk-bearing capacity. The monetary limit could possibly have a cap to encourage active bidding by banks of all sizes. Such requirements could keep guarantee operations within feasible limits.

It is also necessary to set a maximum capital ratio for participation. For example, an MFI that has just converted into a bank may have a very high capital ratio, given the minimum capital requirement for establishment of a bank and its previous dependence on capital grants. An institution with a 50% capital ratio, for example, could bid 2%, and receive 52 for every 100 of new lending promised. It is not reasonable to permit such an institution to compete for CEGs because it is not capital constrained, and the impact of its winning a CEG would have little impact on its aversion to or capacity to manage risk.

The transfer of capital to a successful bidder is permanent[7] unless the bank fails to make the specified loan or unless irregularities are discovered. Such failure or irregularities should be reported by the bank concerned. Bank supervisors should ensure in their periodic examinations that loans have been made as specified in the bank's bids. Failure to perform as promised requires the bank to return the funds to the donor.

Multiple Roles of Guarantee Capital

The capital provided to a bank under the guarantee is regarded as (1) shadow collateral provided by the loan applicant; (2) a shadow addition to the loan applicant's own funds invested in the project supported by the guarantee; and (3) shadow equity on the loan applicant's balance sheet. In other words, the bank's increased capacity to bear risk exactly offsets an equal amount of a loan applicant's deficiency in the ability to bear risk, as determined by bankers in the application of their credit policies or as defined by regulators.

This feature enables banks to make loans that they would otherwise like to make but which, without the guarantee, would neither meet their credit standards nor conform to regulatory guidelines. Clearly, this would influence banks' bids as banks endeavor to obtain sufficient shadow enhancement for applicants. (This compensating feature could require changes in bank regulatory practices or laws in some countries.)

It is expected that banks charge higher effective interest rates on guaranteed loans than on similar loans because the risks remain higher. Also, guaranteed loans may have longer maturities than other loans because these borrowers' cash flows may be insufficient to support rapid repayment. Guaranteed loans should not differ, after these shadow or regulatory adjustments, from otherwise similar loans in a bank's portfolio; i.e., because of the CEG, they should conform to the lender's credit standards.

Bankers' bids would have to specify the grounds on which the guaranteed loan would otherwise be unacceptable (see Appendix 2). Regulators would routinely check ex post that the bank did not make similar nonconforming loans at the same time without a guarantee, or adjust credit policy opportunistically in order to obtain a guarantee.

Related Concerns

The CEG in the form articulated here may not be suitable for all countries. The fact that some markets have only a handful of banks, and hence only a limited number of competitors, makes it difficult to establish efficient auction prices. Noncompetitive auctions defeat one of the primary purposes of CEGs, which is to ensure that risk taking and risk management are market based. How should awards be made in such cases? One alternative is for donors to specify a threshold bid and invite eligible lenders to participate. Another is to have negotiated bids, but this increases transaction costs. Yet another is to regionalize coverage, as in East or West Africa or the Balkans.

Other concerns are what features other than bid ratios could be used to prioritize bids with identical ratios, and how prepayments by guaranteed borrowers should be handled. In addition, CEGs should not be issued to insiders or other parties related to banks that are successful bidders. This would create moral hazard, possibly leading banks to write off a portion of loans to such parties equal to the capital enhancement received. CEGs could also be accompanied by technical assistance in risk management.

Conclusion: The Capital Enhancement Guarantee Scorecard

Several objectives are accomplished by the CEG:

1. The analytical focus is on risk, its precise cost and management.
2. The guarantee supports the key party to the lending decision who requires support to make the loan.
3. Greater skill in managing risk, not merely transferring it, is accumulated through experience in pricing and making more risky loans, representing a permanent enhancement in the risk-management skills of participating banks.
4. CEGs operate through leveraging financial capital; better risk management lowers banks' bid ratios, enabling guarantee funds to underwrite even more lending.
5. Better risk-management techniques developed from experience with guaranteed lending are likely to be applied to other lending and to be adopted and adapted across the banking community.
6. Moral hazard is greatly reduced if insider transactions can be avoided. Banks have relatively undiminished incentives for good credit decisions and loan administration because their capital and liquidity remain at stake.
7. Banks would presumably include a profit margin in their bids, the result being a permanent capacity to make higher-risk loans.
8. The process is entirely transparent, diminishing possibilities for corrupt practices and perpetuation of bad practices.
9. Administration costs are trivial, consisting of the costs of operating periodic bids for guarantee funds (Appendix 2 consists of a one-page bid sheet), banks' costs of submitting undertakings to make specified guaranteed loans, and verification by bank supervisors who would in any event examine a bank's loan portfolio.

10. Donor funds provided for auction as capital enhancement guarantees can be disbursed very quickly, preferably on the day of the bidding and award.
11. No permanent guarantee organization is created, which means that future losses are contained and that taxpayers are not burdened, given that virtually all such traditional guarantor organizations fail or require continued taxpayer support.
12. The auction process makes it impossible (except through collusion) for those responsible for setting conditions for guarantees and operating auctions to direct guarantees to specific borrowers. Administrative direction of guarantees to specific borrowers would corrupt the system and usurp lenders' role and responsibilities in credit allocation and risk management. However, broad conditions defining the target group are easily accommodated through the CEG.
13. When guarantee funds are exhausted through auctions, they remain at work in the banking system as capital, as experience with losses, or both.
14. No social loss, discontinuity, or transition requirement is created by the termination of the guarantee program.

Finally, it is important to maintain perspective on what finance can actually contribute to equitable, broadly based development. Being market-based through an auction process, capital enhancement guarantees will fail to satisfy promoters of certain projects and activities that they feel should be supported by banks or by taxpayers at all costs. This is in fact one of the strengths of capital enhancement guarantees. For credit allocation to be efficient and developmental, lenders have to be skilled at identifying bad, unremunerative projects as well as good projects and activities that are rewarding. Lenders can often do as much good socially and economically by saying no and preventing the misuse of scarce resources as by saying yes to productive uses of resources. Skilled bankers in competitive financial markets work with loan applicants to structure deals so that they are acceptable and are within reasonable ranges of risk. This is of course not possible for deals that are fundamentally bad.

Appendix 1
CEG Administration

Certain administrative measures are required to provide and monitor capital enhancement guarantees. Some considerations are explored here.

Ownership

Guarantee funds must be obtained from a donor, or from the government if there is no external donor. Their ownership must be established. The owner acts as the guarantor and as the creditor, providing temporary subordinated debt to successful bidders.

Possible owners include the donor, the government, a trust, or an official agency, such as the central bank or banking regulatory authority. A fiduciary such as a foreign bank (not interested in bidding) or the central bank could hold funds and execute transactions requested by the owner. The owner should establish an accounting system for the transfer of funds and design reports that would indicate the activities of the fund.

Eligible Bidders

CEGs may be awarded to banks, finance companies, credit unions, or other regulated retail financial institutions. Eligibility standards would include satisfactory capital adequacy as specified by regulators, adequate liquidity as demonstrated through the clearing system and interbank transactions, presumably some minimum level of return on assets to eliminate desperate lenders, financial statements audited by an audit firm of acceptable standing, and other criteria specified by the donor, owner, or regulator.

Auctions

The auction should be conducted by an existing impartial entity and follow procedures that make corruption difficult. Examples may be the central bank, a donor's office, a legal firm, an insurance company, the local office of the International Monetary Fund, or even the national lottery. No additional, permanent institution is required to administer CEG operations, minimizing costs. Complete auction results should be made public and communicated immediately to all banks and other interested parties.

The auctioneer should prepare tallies of auction results immediately and make them public so that more information is generally available about risk and its management by banks. A representative of the owner should be present during the auction and indicate whether any irregularities were observed. The owner is responsible for examining bidding patterns to identify unusual activity or behavior and for investigating rumors or complaints about collusion.

Banks that collude should, at the least, be barred from further participation, and this information should be made public; such a bank should be required to return the CEG funds it has received, become ineligible for future bidding, and be subject to legal proceedings. These measures should be specified in the process used to identify eligible bidders, and should be a condition for the acceptance of bids.

Likewise, actions by governments that interfere or attempt to interfere with the process should also be subject to surveillance, because these upset the market-based nature of CEGs.

Each bidder uses sealed bids, or secure electronic bids sent to the auctioneer by fax or email, to indicate the amount of additional capital needed to support a given amount of additional lending that conforms to the requirements of the guarantor specified in the CEG contract. A sample one-page bid sheet is included as Appendix 2.

Bids should not be accepted for loans that are unlikely to be made within a reasonable period of time, such as six months after the award. This limitation would curb preemptive behavior by bidders and also simplify CEG administration. Allowing a reasonable time limit would permit unsuccessful bidders to resubmit their rejected proposals, possibly modified, to subsequent auctions prior to the time the funds would be used by their client(s) or prospective client(s) who are in line to receive CEG support.

Appendix 2: Sample Bid Sheet for a Capital Enhancement Guarantee

For the auction at (time and date):__________________
Time and date received by auctioneer: ______________________

Our bid in 2 decimal
points of a percent: ___.____%

Our serial
number of this bid: _____________

CEG amount
requested: ________________

Amount of new lending
to be undertaken: ____________

Maturity(ies) of subordinated debt requested (not less than 3 years):

The more recent of our externally audited data for our last full financial year or our last examination by the banking regulatory authorities indicates that our capital ratio was ___.___%. We certify that no material change in this ratio has since occurred and that our Tier 2 capital would not exceed (50% or other specified proportion, i.e., ____%) of our Tier 1 capital if this bid is successful.

Name of our bank: ____________________________

Our sorting code/identification number: ____________________

We expect to make _______ new loan(s) under this guarantee.
Without this guarantee we cannot undertake this new lending because of one or more considerations, as follows:
__ Insufficiency of applicant's(s') collateral
__ Insufficiency of applicant's(s') cash to fund new investment
__ Insufficiency of applicant's(s') capital
(debt-to-equity ratio is too high)
__ Our liquidity position
__ Our capital position
__ Other (please explain below)

Credit proceeds to our account
___________ at the central bank

or at ___________________ Bank,
______________________ branch.

Signature:
Name:

Title:
Date:

Reference

Michael Gudger, "Credit guarantees: An assessment of the state of knowledge and new avenues of research," FAO, Rome 1998.

Notes

1. To the best of the author's knowledge, this instrument is original, dating from work done for FAO in collaboration with Richard Roberts and the late Michael Gudger. Also to the best of the author's knowledge, no capital enhancement guarantee has ever been executed. An earlier, modified exposition was provided in Michael Gudger (1998). For purposes of simplicity, the discussion here uses banks as the point of reference. Credit unions are subject to many of the same dynamics, as are mature specialized commercial MFIs, such as banks and finance companies that operate for profit in Bangladesh and Bolivia. In the case of credit unions and other cooperative financial institutions, capital as used in this paper would be called "institutional capital" in credit union terminology. Institutional capital excludes members' withdrawable shares and normally consists primarily of retained surpluses.

3. The cash flow that lenders usually focus on is "free cash flow," defined as the amount of liquidity available after the borrower has met other expenses (called "senior claims") which are essential to maintaining the operations and status of the firm, household, or person seeking credit. Free cash flow projections may also be adjusted downward to reflect reasonably predictable risk.

4. Assume that two banks want to make different loans of equal size (e.g., 100) and that each places a successful bid of 2%. One bank has an 8% capital ratio and wants capital of 10 to undertake the otherwise unacceptable deal. The other bank has a capital ratio of 11%, and is willing to make an otherwise impossible loan against capital of 13. The first bank receives 10, while the second receives 13.

5. The author's view, after 35 years in the development assistance business, is that official donor agencies have considerable difficulty finding productive outlets for their funds, while facing very strong political and institutional imperatives to lend or to make grants. At any given time, depending on current priorities, and from the perspective of sustainable ventures, donors face a relatively restricted set of useful things to do, especially when they seek to intervene in financial sector activities.

6. Regulatory capital ratios are customarily calculated using risk weights for different types of assets. For example, cash may have a zero risk weight, while

commercial loans would have a 100% risk weight. Eligibility could be determined according to the risk-weighted or the unweighted capital ratio, but would require consistent application of whichever measure is selected.

7. Why should a bank receive free capital from a donor? Retail lenders in most developing countries lost a lot of capital as a result of participating in donor-funded credit projects through the early 1990s. Hence, CEGs could offer a crude form of restitution or apology, but not a foolproof one—bankers who fail to price risk correctly can still lose money with CEGs. Further justifications, less fanciful, are provided in the text.

Acknowledgments

This article is printed with FAO's permission. Helpful comments on a draft were received from Gary Woller and Juan Buchenau Hoth.

Credit Scoring for Microfinance

Can It Work?

by Mark Schreiner

ABSTRACT: In rich countries, lenders often rely on credit scoring—formulae to predict risk based on the performance of past loans with characteristics similar to current loans—to inform decisions. Can credit scoring do the same for microfinance lenders in poor countries? This paper argues that scoring does have a place in microfinance. Although scoring is less powerful in poor countries than in rich countries, and although scoring will not replace the personal knowledge of character of loan officers or of loan groups, scoring can improve estimates of risk. Thus, scoring complements—but does not replace—current microfinance technologies. Furthermore, the derivation of the scoring formula reveals how the characteristics of borrowers, loans, and lenders affect risk, and this knowledge is useful whether a lender uses predictions from scoring to inform daily decisions. In the next decade, many of the biggest microfinance lenders will likely make credit-scoring models one of their most important decision tools.

Introduction

Credit scoring uses quantitative measures of the performance and characteristics of past loans to predict the future performance of loans with similar characteristics. For lenders in wealthy countries during the past decade, scoring has been one of the most important sources of increased efficiency. Such lenders, however, score potential borrowers on the basis of comprehensive credit histories from credit bureaus, as well as on the experience and salary of the borrower in formal wage employment. Most microfinance lenders, however, do not have access to credit bureaus, and most of their borrowers are poor and self-employed. The two chief innovations of microfinance—loans to groups whose members use social capital to screen out bad risks, and loans to individuals whose loan officers know them well enough to screen out bad risks—rely fundamentally on qualitative information held in human memory. Scoring, in contrast, relies fundamentally on quantitative information stored in lenders' computers. Can microfinance lenders use scoring to cut the costs of arrears and loan evaluations so as to improve efficiency, and thus both outreach and profitability?

Experiments in Bolivia and Colombia (Schreiner, 2000, 1999a, 1999b) suggest that scoring for microfinance can indeed improve the judgment of risk and thus cut costs. For example, scoring may save a Colombian microfinance lender as much as $75,000 per year (Schreiner, 2000). In present value terms, this approaches $1 million.

Scoring may be the next important technological innovation in microfinance, but it will not replace loan groups or loan officers. In Bolivia and Colombia scoring will never be as effective as in wealthy countries because much of the risk of microloans is unrelated to characteristics that can be quantified inexpensively. Still, scoring is useful in microfinance because some risk is related to characteristics that are inexpensive to quantify, and current micro-

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finance technologies do not take full advantage of this. This paper describes how scoring works, what its capabilities are, and how microfinance lenders should prepare themselves to implement it. Other basic introductions to scoring include Mays (1998), Hand and Henley (1997), Mester (1997), Viganò (1993), and Lewis (1990).

How Scoring Models Work

Scoring assumes that the performance of future loans with a given set of characteristics will be like the performance of past loans with similar characteristics. If the future is not like the past—as is often the case for microfinance lenders who grow, develop new products and niches, confront competition, or work in fluctuating markets—scoring will not work well.

A *credit-scoring* model is a formula that puts weights on different characteristics of a borrower, lender, and loan. The formula produces an estimate of the probability or risk that an outcome will occur. For example, suppose a lender wants to estimate the likelihood (risk) that a given loan to a given borrower will result in at least one incident of arrears of seven or more days. A simple scoring model might state that the base risk for very small loans to manufacturers is 0.12 (12 percent), that traders are 2 percentage points (0.02) less risky, and that each $100 disbursed increases risk by half a percentage point (0.005). Thus, a trader with a $500 loan would have a predicted risk of 12.5 percent ($0.12 - 0.02 + 5 \times 0.005$), and a manufacturer with a $1,000 loan would have a predicted risk of 17 percent ($0.12 + 0.00 + 10 \times 0.005$). The weights in the formula are derived from statistics, but the math is elementary; the difficulties arise in collecting data on the performance and characteristics of past loans, grafting scoring into the current loan-evaluation process, and adjusting the organization to accept a technique so fundamentally different from what has previously been successful.

Databases for Scoring

Microfinance lenders who wish to someday use credit scoring should begin collecting appropriate data now. Without a database on the performance and characteristics of many past loans, scoring is impossible; lenders with small portfolios may never benefit from scoring. The database must be computerized, and ideally it would include both approved and rejected applicants, although most lenders only keep approved applicants' records. The database should also include a full range of borrower, lender, and loan characteristics, as well as data on the timing and length of each arrears spell. Such characteristics are simple and inexpensive to collect, and most microfinance lenders compile them when a loan officer visits a potential borrower.

All microfinance lenders who want to use scoring—even those who already have large, comprehensive databases—should start to quantify and record the subjective assessments of loan officers. In the field, loan officers would still be free to "sniff" for hints of risk as they see fit, but in the office, they should convert their subjective judgments into quantitative forms amenable to scoring. For example, they may rate potential borrowers as very below average, below average, average, above average, or very above average on such qualities as reputation in the community, entrepreneurship, experience with debt, and informal support networks.

Perhaps the greatest lesson of scoring is that the rigorous analysis of a database containing past microfinance loans offers vast power to improve managerial decisions. A large, accurate, and comprehensive database on past loan performance is an asset that many microfinance lenders have failed to develop or use to its fullest.

What Type of Risk to Predict

Once data are in hand, microfinance lenders must choose what types of risk to predict. Scoring is most useful for risks that are costly for the lender and that the lender has some power to control. For example, one-day spells of arrears may be frequent but not very costly, whereas fifteen-day spells may be infrequent but very costly. Scoring is better used to predict fifteen-day spells than one-day spells. Likewise, scoring can be used to predict default due to borrower's death, but lenders have no control over this risk, even if they can predict it.

Given these criteria, six basic types of scoring models are relevant for microfinance. The first model predicts the likelihood that a loan currently outstanding or currently approved for disbursement under the standard loan-evaluation process will have at least one spell of arrears of at least *x* days (Schreiner, 2000 and 1999b). This information can be used to guide risk-based pricing or to mark potential loans for extra review and outstanding loans for a preventive visit from a loan officer before they fall into arrears. The second type of model predicts the likelihood that a loan *x* days in arrears will eventually reach *y* days of arrears. This information can be used to prioritize visits by loan officers to delinquent borrowers. The third type of model predicts the likelihood that a borrower with an outstanding loan in good standing will choose not seek a new loan once the current debt is repaid (Schreiner, 1999a). This information can be used to offer incentives to good borrowers who are likely to drop out. The fourth type of model predicts the expected term to maturity of the next loan of a current borrower.

Likewise, the fifth type of model predicts the expected disbursement size of the next loan. Sixth and finally, the ultimate scoring model combines information from the first five models; knowledge of the expected revenue of a loan with a given term to maturity and disbursement; and knowledge of the expected costs of dropouts, loan losses, and monitoring borrowers in arrears. This ultimate model—currently used by credit card lenders in wealthy nations—estimates the financial value of the lender-client relationship. Rather than gauging the client's risk, it measures her profitability. Estimating profitability does not imply that lenders must reject all unprofitable clients; it merely helps them to recognize the trade-offs between profits and depth of outreach (Schreiner, 1999c). Most microfinance lenders tend to start with one simple model, and if they find that it works well, they add the other simple models one at a time.

Scoring in a Microfinance Organization

The greatest difficulties in a credit-scoring project are not technical but organizational. Given a database, consultants can straightforwardly derive a scoring formula. The difficult part is the implementation of the formula in an existing organization with an existing lending technology. Managers and board members must understand the strengths and weaknesses of scoring so they can commit to support its adoption and integration within the organization. Otherwise, a scoring model may sit unused; an unused model serves no purpose, and a misused model is worse than no model at all. One way to encourage managers to support a scoring project is to ask them to choose a type of risk to model, suggest which characteristics to include in the formula, and then design the implementation. Loan officers and credit managers in the branches may feel threatened by scoring; they have devoted time and effort to learning to judge risk and may be suspicious of a computer program—written by someone who has never met one of their clients—that claims to improve on their judgments. The employees who run the management-information system must also be brought onboard. At first, they may view scoring as nothing more than extra work, but they will soon recognize it as a fundamental transfer of organizational power toward their department.

Ease of Use

One key to the acceptance of scoring in an organization is ease of use. This requires that scoring systems be integrated into the existing management-information system and that they require little data entry beyond standard processes. Such integration also allows the estimates of risk to be included in standard reports. In Colombia, for example, the management-information system generates a report with the estimated risk of "costly arrears," along with other key information about potential loans to be reviewed in the daily meeting of the credit committee in each branch. Loan officers also receive a list of their currently outstanding borrowers in order of estimated risk, thereby prioritizing preventive visits. In short, a good scoring system allows a lender to continue with business as usual, but with the addition of quantitative estimates of risk.

Out-of-Sample Tests

The acceptance of scoring within an organization also requires a proven track record. One of the greatest strengths of scoring is that it can establish a track record even before being put to use. For example, Schreiner (2000) derived a scoring formula from data on loans disbursed in 1993–1998. This formula was then used to estimate the risk of arrears for loans disbursed in 1999. Because the performance of these loans was already known, the comparison of predicted and observed risk showed how the model would have performed had it been used in 1999. Such inexpensive out-of-sample tests are perhaps the best way to convince skeptical managers that scoring works for microfinance.

Tracking Performance in Use

Once in use, scoring continues to build a track record. Lenders with scoring models must track both predicted risk and actual performance, even if they decide to ignore the risk estimate from the model. Through time, careful records will reveal how well the model works. For example, if scoring works well, 20 percent of loans with a 20 percent estimated risk of "costly arrears" should turn out to have such arrears. Likewise, lenders must track overrides—cases in which credit policy dictates a certain action for loans above (or below) a risk threshold, but in which loan officers or credit managers break with policy because they know something the scoring model does not. They often do know more, and it is important to track the outcomes of overrides to determine how much they improve on the scoring model. Because scoring works only if the past is like the present, and because the recent past is more like the present than the distant past, the performance of scoring models degrades with time; careful tracking helps to signal when a formula needs to be rebuilt.

How Characteristics Affect Risk

Beyond estimates of risk, the process of developing a scoring formula reveals a lot about how the characteristics of the borrower, loan, and lender affect risk.

Characteristics of the Borrower

In Bolivia, the derivation of the formula shows that past arrears help to predict future arrears: compared with borrowers with no arrears in the previous loan, borrowers with arrears of more than 15 days in the previous loan were 2.8 percentage points more likely to have a spell of at least 15 days in the current loan (Schreiner, 1999b). Manufacturers were about 4 percentage points riskier than traders, and first-time borrowers were about 1.2 percentage points riskier than second-time borrowers. This knowledge helps to target marketing campaigns and screen applicants.

Characteristics of the Loan

The derivation of the formula also reveals how the terms of the loan contract affect risk. In Colombia, the risk of loans with monthly installments increased by about 3 percentage points for each additional installment (Schreiner, 2000). Likewise, given the number of installments, a loan repaid monthly was about 0.6 percentage points riskier than a loan repaid weekly. Colombian lenders used these results to adjust loan contracts until expected risk was acceptable.

Characteristics of the Lender

Finally, the derivation of the scoring formula illustrates how the lender affects risk. In Bolivia, the borrowers of the loan officer with the least risk of dropouts were about 25 percentage points less likely to drop out than were the borrowers of the loan officer with the greatest risk (Table 1; Schreiner, 1999a). This knowledge could guide the allocation of performance bonuses or help to target training. In Colombia, scoring showed that most learning by loan officers occurs directly after they start work (Figure 1; Schreiner, 2000). Compared with loans from a new loan officer, loans from a loan officer who has had experience with 50 disbursements are about 7 percentage points less likely to have "costly arrears" than loans from an inexperienced loan officer. An increase of experience from 50 to 1,100 disbursements decreases risk only by about 2 additional percentage points.

Table 1: How the Specific Loan Officer Affects the Risk of Dropouts in Bolivia

Loan officer	Effect on risk
1	-0.048
2	-0.038
3	-0.037
4	-0.037
5	-0.033
6	-0.025
7	-0.024
8	-0.024
9	-0.023
10	-0.020
...	...
30	0.005
31	0.005
32	0.007
33	0.007
34	0.008
35	0.009
36	0.009
37	0.021
38	0.021

Source: Schreiner (1999a)

Figure 1: How the Experience of a Loan Officer Affects the Risk of "Costly Arrears" in Colombia

Selecting a Scoring Model

Scoring is difficult for any lender, and scoring for microfinance is even more exacting. As discussed, the main difficulties are the organizational adjustments required to integrate scoring into the lending process. Amassing an adequate database is a second challenge, and a third difficulty is that one size does not fit all. Because of differences in lending technology, clientele, competition, and general economic environment, a scoring model developed from the database of one lender will be much less powerful if applied to a second lender.

To my knowledge, scoring models have been built for microfinance lenders in Bolivia, Burkina Faso, Colombia, Chile, México, Panamá, Perú, and Thailand. Only the models in Schreiner (1999a, 1999b, and 2000) use statistics to derive the scoring formula; the rest use simple heuristics or rules of thumb. Such nonstatistical models may be better than no model at all, especially if a lender lacks a database capable of supporting a statistical model. Statistical models, however, probably have greater predictive power. Furthermore, statistical models *derive* the relationships between specific characteristics and risk; rule-of-thumb models *assume* these relationships. Regardless of the technique used to derive the formula, the power of any scoring model should be demonstrated in an out-of-sample test before implementation.

Conclusion

The essence of finance is the prediction of the risk—whether borrowers will keep their promises. Risk estimates are based on information; and in microfinance, this information is usually qualitative and informal—it resides with group members or with loan officers. Credit scoring takes a different tack. It predicts risk based on quantitative information that resides in the management-information system of the lender.

Credit scoring for microfinance can work. It is not as powerful as scoring for credit card or mortgage lenders in wealthy countries, and it will not replace the judgments of loan officers or loan groups based on informal, qualitative knowledge, but scoring does have some power to predict risk (and thus to cut costs) even after the group or loan officer makes its best judgment. Thus, scoring complements—but does not replace—current microfinance technologies. Furthermore, scoring not only helps to predict risk, but also reveals how characteristics of the borrower, the loan, and the lender affect risk. This knowledge is useful whether a microfinance lender uses risk predictions from scoring to inform daily decisions.

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Acknowledgments

I am grateful for support from the Division of Asset Building and Community Development of the Ford Foundation. I also thank the microfinance lenders in Bolivia and Colombia for the use of their databases and their willingness to pioneer credit scoring for microfinance. Hans Dellien was instrumental in the work in Colombia.

Impact Assessment of Microfinance and Organizational Learning

Who Will Survive?

by James Copestake

ABSTRACT: To what extent is it possible for organizations to reflect honestly on their own performance, draw appropriate conclusions, and then act on them? For many microfinance organizations this is now a question of survival. This paper argues that formal impact assessment can assist in the transition from donor-controlled replication projects to autonomous and adaptable organizations—but it often fails to do so. Pitfalls include inadequate attention to methodological detail and to the links between impact assessment and wider aspects of organizational change. The paper starts by highlighting the complexity of the overall task to which impact assessment is expected to contribute. It then critically reviews methodological options—why do impact assessment, what indicators to use, how to collect data, how to analyze it, and who should be responsible for which tasks? It concludes that the key to success is the quality of the relationship between microfinance managers and impact assessment specialists. A prerequisite for this, in turn, is the transfer of greater responsibility for managing impact assessment from donor agencies to the leaders of microfinance organization themselves.

Introduction

The world of microfinance is moving fast. Financial landscapes once denuded by inflation, state regulation, and economic stagnation are showing renewed signs of life in the form of consumer credit companies, long-dormant cooperative associations, and nongovernmental organizations (NGOs) bent on scaling up as specialist financial service providers. Where once a microfinance organization (MFO) enjoyed a virtual monopoly, a growing band of rivals now compete for the loyalty of its clients.[1] Much of the new activity has been nurtured with donor funds and remains fragile (Copestake, 2000b). Survival depends on an ability to meet more exacting conditions for donor money or to do without it altogether.

In this context, the need for reliable, cost-effective, and timely information about the impact of services on different users is increasingly important (Cheston & Reed, 1999). But there is less clarity about how to meet it because the art of impact assessment (IA) also has to adapt to rapidly changing environments. In 1999, this prompted the "Affinity Group" of staff responsible for supporting development finance initiatives within the Ford Foundation to commission an action research project into impact assessment. The first phase of this work included a methodology workshop at the Institute of Development Studies in Brighton, England, in June 2000. This article is based on one of four theme papers prepared for the workshop and is concerned specifically with the role of impact assessment at the level of individual MFOs. The other three address the themes of participation, wider impact, and networking.[2]

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The Challenge of Impact Assessment, and an Opportunity

Both parties in the establishment of a new financial relationship incur fixed learning costs. Assume that the mission of the owners of an MFO is to maximize profits. Setting prices too high (relative to service quality and cost) will cause some clients to leave who might otherwise have remained. This reduces the return on the initial investment in establishing the relationship. But a low price also reduces the profit. To maximize overall profits, the owners need to know which combinations of price and service quality will encourage how many existing clients to leave and how many new clients to join. They also need to know what new services may be diversified and how delivery of existing services can be made more cost-effective. Ideally, they need accurate unit costs and returns for different kinds of services and different categories of clients. They also need information on client turnover. Do clients keep leaving and rejoining, or does the business rely upon a steady stream of brand-new but transient clients?

As if this is not challenging enough, the task of maximizing profits is further complicated in at least three ways. First, all this information must be collected and digested fast enough to permit the owners to adjust services and prices before market conditions change. Indeed, the owners need to be able to anticipate changes in demand. Quantitative historical data may be less useful than qualitative data to promote understanding of how different types of clients behave and why.

Second, the MFO may not be seeking to maximize profits. For example, it may be seeking to maximize some function of the flow of benefits to current and future clients. Implicit in these weights will be preferences over time between benefits now and in the future, as well as preferences within any period between, for example, richer and poorer clients. Profitability remains an important performance indicator, inasmuch as it reveals capacity to continue to serve clients in the future and to grow (Otero, 1999). But lower profits may be justified if they indicate that more benefits are being passed on to current clients. Such judgments require accurate knowledge not only of how services are valued by different categories of client, but also of how they affect their welfare.

Third, the income of the MFO may not come exclusively from its clients. Various public-minded organizations may be subsidizing some of the services in the belief that they have benefits that go beyond the ability of clients to pay for them. They may develop their leadership skills, be weaned off welfare or crime, and so on. This goodwill must be sustained by evidence of these impacts (Morduch, 1999). Having less direct personal experience of the business and being more accountable to the public, sponsors often require more rigorous evidence of impact than the owners.

A fourth complication arises from variation in ownership structure or governance. In the case of cooperatives, for example, clients are also owners. Multiple owners also have different views regarding the weight that should be given to profitability, growth, client welfare, depth of outreach, and so on.

These complicating factors highlight that effective IA is not just about producing timely, reliable, cost-effective, and relevant information about the impact of services on clients. It is also about producing this information in a way that contributes constructively to policy debates among internal and external stakeholders. Reference to the concept of *organizational learning* illustrates the point (Agyris & Schon, 1978). While it refers to a self-conscious process, it stresses the importance of organizational structure and culture, over and above the caliber of individual stakeholders. The term also explicitly confronts the need for organizations to adapt, rather than remain in some fictional state of equilibrium. Organizational learning is not just a rational process, but a struggle against those with a vested interest in the *status quo*.

In this respect, it is worth highlighting two major obstacles currently facing many MFOs. The first is confusion about ownership arising from the leverage of sponsors. Their support can complement income from clients and may be critical both for growth of the organization and fulfillment of wider social goals. But sponsor satisfaction must always be subordinate to client satisfaction—whether articulated through voice, willingness to pay, or exit (Hirschman, 1970). Symptoms of this problem include impact assessment which is linked too rigidly to sponsors' project cycles and which is regarded as a condition for funding, rather than as useful in its own right. Sponsors have a legitimate interest in understanding the impact of their investments, and the bureaucracy of aid *hydraulics* cannot be wished away.[3] But if they are serious about organizational development or capacity building, then the IA they promote should also serve the goals of the MFO itself.

The second obstacle is adherence to blueprint financial technologies. Much of the rapid growth of MFOs has taken the form of replication of established models: village banking, savings and credit cooperatives, farmers savings associations, solidarity groups, and so on. Imitators have thereby benefited from the experience of pioneers, and growth into new areas has been accelerated. Setting up a new financial organization has already proved a perilous activity, without the added complication of constantly changing the product. Urgent "fire-fighting" to preserve existing services, plus the myriad tasks associated with rapid scaling up, have left owners and senior managers with little time or energy for reflection on strengths, weaknesses, opportunities, and threats of existing services in relation to possible alternatives. Growing competition from other providers may reinforce a preoccupation with improving efficiency and achieving financial self-sustainability through scaling up. But product diversification based on a detailed understanding of market opportunities is also likely to be essential to survival, particularly for pioneers who have been able to enjoy growth in spite of high client desertion rates (Calmeadow, 2000).

Putting these two obstacles together and turning them around, it is possible to see a significant historical opportunity. In many countries a transition is taking place from an era of sponsor-funded replication to an era of more open markets.[4] MFOs that are good at learning will thrive. Others will experience more traumatic restructuring, or lose out to leaner and slicker new entrants, as did many of an earlier generation of specialist development finance agencies (Adams & Pischke, 1992). On the positive side, the diversity, cost, and quality of services received by clients should improve.

IA Design Issues

This section reviews methodological issues arising from the design of IA work in the light of the foregoing discussion. It starts with the question of goals—why do IA at all and for whom? It then considers how data should be collected and analyzed, what indicators should be selected, and who should be responsible for which tools. Reference to IA "tools" is avoided because the intent is to examine the logic linking IA goals, methods, and resources rather than review the relative merits of packaged solutions.

Goals—Integrating or Separating Impact Assessment from Market Research?

A common starting point here is the distinction between proving and improving impact assessment. While linguistically eloquent, this is also highly simplistic, given that some degree of proof or reliability is a requisite for information to be useful. Alternatively, impact assessment can be classified according to the stakeholder interests it serves: MFO owners, sponsors, clients, etc. But this assumes a greater divergence of interests between stakeholders than may actually exist. As the opening part of this paper suggests, another approach is to distinguish impact assessment, which is concerned with welfare effects on clients, from *market research* (MR), which is primarily concerned with improving business profitability. The contrast between these two activities can be drawn starkly. IA talks about primary stakeholders and intended beneficiaries, while MR talks of customers and clients. IA is linked to external sponsorship; MR is concerned with new product development. IA is mostly for public sponsors, MR for MFO managers. IA is carried out by trained social scientists, MR by business consultants. These distinctions, however, are not so clear cut. MFOs seeking to maximize social impact over time need both. And it is likely that in finding out about intrahousehold relations and livelihood dynamics a researcher will also learn about client satisfaction and how to secure repeat business. In contributing to improved understanding of the complexity of clients' requirements, both IA and MR have converged in their emphasis on product diversification to support clients' risk management, consumption smoothing, and adjustment to shocks, as well as demand for working and investment capital.

A key question resulting from this discussion is whether MR and IA goals can be served through integrated data collection and analysis. Copestake (2000a) explores the scope for doing this. Yet care must be taken in rapidly changing markets to retain flexibility by avoiding elaborate blueprints. The more general point for organizations that have both social and commercial goals (and sources of income) is that it is necessary to evaluate new products against both criteria simultaneously. The alternative is a form of schizophrenia.

Data Collection—Routine Information Systems or Ad Hoc Studies?

The idea of embedding impact assessment into organizational learning can easily be confused with that of building data collection into computerized management information systems. Most organizations routinely collect relevant information about their clients, particularly when they first join, including details of past financial transactions (loans received, savings accumulated, repayment performance, etc.). The case for adding a few extra variables may seem obvious. An example is a *means test* or relative poverty data (Hatch & Frederick, 1998). If clients are routinely ranked in this way, then there is considerable scope for interesting statistical analysis. For example, how do the probabilities of client retention and exit vary between richer and poorer clients? Or are relative poverty indicators useful lead indicators of repayment performance that might be incorporated into a credit-scoring system? The potential for such analysis is often unfulfilled because data collection tools are poorly designed, inadequate resources are allocated to analysis, or data is entered and coded in a way that impedes consolidation of databases. For example, many organizations are unable to do this because clients are not given a unique identification code.

Routine and joined up data collection may seem ideal, but it has a number of disadvantages. It entails collecting information about all clients all the time, whereas for many purposes sampling may be more cost-effective.[5] It is possible to handle only a relatively small number of quantifiable or easily coded variables, and these variables need to be robust, rather than constantly having to be modified. Finally, data is restricted only to those clients who remain in the program, yet it is important to know more about those who exit too. Routine and comprehensive data collection can never substitute fully for richer, more intensive, and flexible ad hoc studies. Rather, the key issue is to identify a relatively small number of variables (over and above those needed for accounting and portfolio management purposes) that can be reliably, routinely, and robustly recorded and analyzed to complement them.

Data Analysis and the Attribution Problem—Positivist and Interpretive Solutions

All impact assessment is based on judgments about what would have happened to clients under different conditions—if they had not received a loan, if repayment schedules were more flexible, if interest rates were lower, and so on. One way of doing this is by statistical analysis of differences between groups, in the hope that differences arising from different access to services can be separated out from incidental differences (Moffitt, 1991). Opportunities to do this empirically by randomly assigning potential clients to different treatments are rare, so selection-bias problems abound (Coleman, 1999). The approach is most feasible when new services are being introduced, and supply constraints result in arbitrary differences in access within the pool of potential clients. As the market for financial services becomes more integrated and competitive, however, such situations are likely to become rarer.

An alternative approach relies on informed explanations of impact, rather than their direct measurement. Credibility here hinges on two things. First, there is the nature of the primal encounter between client and researcher. Incentives to biased interpretation by both have to be minimized, use of leading questions avoided, and so on. There is scope for learning both from consumer research and from ethnography—in the use of focus groups and tape-recorded narrative interviews, for example. Second, there is the issue of how representative the samples are. Debate here is again often unnecessarily polarized. There is a great deal of scope for sampling systems that fall between the purely anecdotal and the formally representative to known degrees of statistical significance. Quota sampling, for example, whereby a minimum number of interviews are undertaken for predetermined types of client, can help ensure that studies capture diversity while still introducing randomness into selection.

Indicators—Industry Standards and Context Specific Benchmarks

Microfinance has undoubtedly developed into a self-conscious global industry, and many specialists in the field take for granted that this is a good thing. The World Wide Web, cheap international travel, and the nodal policy position of Washington, D.C., all enable ideas to spread rapidly from country to country. Donors have helped to raise standards of good practice—through the AIMS program (Assessing the Impact of Microfinance Services) and through CGAP (the Consultative Group to Assist the Poorest), for example.[6] This global dimension acts as a major spur to many organizations to improve their standards and performance, not the least in establishing criteria for public and private investors into the sector. But this process has proceeded more rapidly in relation to indicators of the financial performance of MFOs themselves, and there is a risk that the importance of less easily measurable and comparable performance indicators (such as client impact) will be correspondingly devalued (Cheston & Reed, 1999).

One response is to develop a standard set of complementary indicators. This has already happened to some degree for *outreach*. The MicroBanking Bulletin includes, for example, statistics on the number of active borrowers and savers, average loan balance as a percentage of GNP per capita, and the percentage of women to total borrowers. Meanwhile, CGAP has recently commissioned the International Food Policy Research Institute to develop a standard tool for measuring relative poverty of clients.

Should we also be aiming to establish a standard set of indicators of impact? One line of argument against this is that it is unnecessary. MFOs cannot force people to use their services, and if financial indicators reveal a high willingness to pay, then positive impact can be taken for granted. In the case of subsidized programs, evidence is needed that one MFO is not expanding at the expense of others, but outreach indicators can provide some reassurance of this. This argument is based on the assumption that clients are rational and free to make individual choices. More dangerously, it assumes that people are fully informed and will not make mistakes that land them in chronic debt. High cycle-to-cycle exit rates in village banking programs have not stopped growth. In other words, growth is not necessarily incompatible with doing serious harm to a minority of customers—often the most vulnerable (Copestake, Bhalotra, & Johnson, forthcoming). This suggests a strong case for developing a standard client loyalty or retention indicator of *outreach over time* to complement static indicators of *depth of outreach.*

A second argument against universal impact indicators has been eloquently advanced under the AIMS program. In brief, impact chains are so complex that a whole battery of indicators would be needed. The appropriate choice for a particular MFO depends on its goals and also on the context. For example, some studies have taken separation of business and household accounts as a proxy indicator of business management ability. But there is an obvious downside if this practice increases the risk that relatives, tax collectors, protection squads, or debt collectors will be able to work out more precisely what the business is worth. Short of securing agreement on a universal set of human needs and rights, indicators will always need to reflect local values and development priorities.[7] Moreover, the usefulness of an indicator cannot be evaluated in isolation from the reliability of the methodology used to calculate it.

While it would thus be inappropriate to privilege a standard set of impact indicators, there is a stronger case for seeking more limited harmonization of definitions of different kinds of impact indicator. Obvious examples are ways to calculate change in household income, business employment, and livelihood diversification. More interesting would be some convergence over how general questions are framed about client satisfaction and influence over business decisions.

Staffing—the Balance between Internalizing and Subcontracting

A final balancing act concerns the allocation of responsibility for carrying out different IA tasks between MFO staff and subcontractors. Assigning data collection to operational staff has been criticized for distracting them from core activities, and it may increase response bias. On the other hand, encouraging field staff to participate in open-ended interviews with their clients, and to discuss what they learn, may help to motivate them and enhance data quality. Better staff-client understanding also helps ensure that the wider development mission of an MFO is not lost in the rush to expand. By reducing dropout rates it also makes good business sense (Simanowitz, 1999).

Long-term employment of staff to oversee data collection and analysis is expensive, and technical specialists can easily become isolated or caught up in overcomplicated systems (Hyman & Dearden, 1998). Consequently, there is a strong case for subcontracting this work to specialist consultants, who can absorb fluctuation in demand for their expertise, and can also be more easily called to account for delivering on planned outputs.

That said, one general lesson about organizational change appears to be that it depends on the establishment of a self-sustaining group committed to the change. This group must have strong support from owners of the MFO and be able to build a network of alliances throughout the organization. It must be close enough to operations to understand their complexity, but avoid being coopted too intimately into routine operations. Above all, the group must include individuals who have a clear vision of what they want to achieve, plus the competence, time, and energy to bring it about. This point should be a prime consideration in determining whether to hire consultants or rely on internal staff. Internal leadership is likely to be essential, but external consultants or researchers may be needed to provide necessary momentum, technical skills, and capacity. The contracting process can also help to ensure that a focus is maintained on changing the organization in the desired direction rather than defending or hiding its weaknesses. But it is important that MFO management play an active part in tendering and contracting processes, rather than allowing these to be taken over and made excessively complicated by external sponsors.

Conclusions

The microfinance industry is going through a period of rapid change. An organization's ability to adapt and to learn systematically from what it is doing determines whether it will flourish or flounder. Formal impact assessment can contribute to adaptive learning. But it often fails, either because methodological weaknesses undermine the credibility of findings, or because technically proficient research has marginal influence on complex internal policy processes. Two factors are likely to be crucial in raising the standard of impact assessment. First, the leaders of microfinance organizations need to have greater ownership and control over the commissioning and management of impact assessment work. Second, the cadre of professional impact assessment researchers needs to be enhanced. Impact assessment work that is commissioned by MFOs, drawing upon a larger pool of local specialists, will benefit from and in turn strengthen local policy networks. Aid donors have a crucial role to play in facilitating this process, particularly in relation to the new generation of MFOs that they have helped to create. They can also play an important role in continuing to facilitate the establishment of norms of good practice. This argument extends the analogy between impact assessment and financial auditing drawn in an earlier article in this journal by Cheston and Reed (1999).

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Notes

1. The term *microfinance organization* (MFO) is preferred to microfinance institution (MFI) because it sustains a useful distinction between organizations, or agencies, involved in provision of services and institutions, or *rules and norms of behavior*, such as marketing tie-ups and mutual liability.

2. Views expressed in the paper are those of the author alone and do not necessarily reflect those of the Ford Foundation or any other agency. I am grateful for comments on an earlier draft from Susan Johnson, Anton Simanowitz, Paul Mosley, Gary Woller, and other participants at the Brighton workshop. Those interested in more information about the workshop and the Ford Foundation action research project should consult A.Simanowitz@ids.ac.uk.

3. Aid hydraulics refers to the tendency to manage aid primarily to maximize throughput of aid funds (Bennett & Cuevas, 1996).

4. Markets are defined broadly here to include *quasi-markets,* in which demand for services is partially determined by public sponsorship in the belief that people have a right to access to services (whether housing, health, schooling, or basic finance services) regardless of their ability to pay.

5. An alternative approach that limits the data-handling problem is to develop the MIS at the level of village banks or solidarity groups. But even the task of entering and analyzing data per village bank per loan cycle is often far from trivial (Painter & McNelly, 1999).

6. A useful source of reports from these and other programs is the CGAP-sponsored "Microfinance Gateway" http://nt1.ids.ac.uk/cgap/index.htm

7. An important example relates to social stability and the tunnel effect (Hirschman, 1973). Hirschman argues that people are less angry (and more inclined to rebel) when all lanes of traffic are equally stuck than when one lane is moving faster than another. But the importance to be attached to an indicator of the polarizing effect of microfinance, if one could be constructed, would clearly depend on cultural and historical context. See Gore (2000) for a more general critique of ahistorical performance measurement as a key feature of the Washington Consensus era of development practice.

Moving Microenterprises beyond a Subsistence Plateau

by C. Beth Haynes
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ABSTRACT: Enthusiasm for microcredit programs has increased during the past decade. The attention these programs have drawn stems philosophically from progress in cultivating self-sufficiency among those in abject poverty, and practically from the viability and high loan repayment rates of many microfinance institutions. The programs assume that lack of capital is the main barrier to the economic progress of the poor. The lack of entrepreneur business management experience and training, however, may create a barrier equally powerful and limit the growth potential of microenterprises. Microcredit programs could foster even greater economic progress by ensuring that clients receive appropriate human capital development. Without adequate training of microentrepreneurs, microloans may allow the poor to move from abject poverty to subsistence income levels, but limited skills leave the opportunity for substantial firm growth untapped. The potential of these firms to employ others also remains unfulfilled. This paper reviews relevant microcredit and microenterprise literature, and then argues for increased microentrepreneur training based on the case of a Manila microentrepreneur.

Microcredit is hailed as a means of helping individuals in developing countries lift themselves out of poverty, putting the poor in greater control of their financial futures. Evidence for the impact of microcredit programs is mounting. Concerns are also emerging, however. In particular, the lack of business management experience and understanding among microentrepreneurs may limit the growth potential of their enterprises. Microloans for seed capital may allow the poor to move from abject poverty to subsistence income levels, but limited skills may cause microentrepreneurs to plateau at this improved yet low standard of living. The potential for substantial firm growth remains untapped. This untapped potential could lift these entrepreneurs completely out of poverty and, through growth of the enterprises, provide employment opportunities for others.

Issues in the Microcredit Literature

The primary objective of MFIs in developing countries is to alleviate poverty. The relevant literature cites numerous contributions of microcredit programs in achieving this objective. Perhaps the most fundamental benefit is that microcredit programs have been successful in allowing microentrepreneurs to increase both output and income. These improvements in physical living standards, though

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small, often make the difference between abject poverty and independent subsistence.

Microcredit fosters self-reliance and dignity (De Gent, 1999). Beyond increased household income, these programs engender self-confidence and move the poor away from a dependence mentality or low self-esteem. Personal growth is fostered beyond physical economic progress. Microcredit programs also may empower the poor, not only individually, but as a population who once felt powerless (Johnson, 1998). This collective impact can be significant.

Microfinance institutions have sponsored many successful lending programs. Though overhead costs are high relative to loan value, many of the programs have become increasingly efficient, and repayment rates are high (Woolcock, 1999; Stallings, 1999).

In spite of evident advantages in the microcredit movement, concerns are emerging. Some programs have struggled. Woolcock (1999) points out that success is not automatic, inevitable, or guaranteed. Accordingly, microcredit challenges are noted in the literature. Most microenterprises are profitable, but progress is slow, often resulting only in small marginal changes that affect the lives and household income levels of the poor (Fairley, 1998).

There is little evidence to suggest significant and sustainable increase in income levels or firm growth. Buckley (1997) explains that certain challenges to microenterprise creation and growth—for example, structural or socioeconomic conditions—cannot be tackled solely by capital injections. Incomes may bump up slightly, but without attention to structural and socioeconomic barriers, they may then stagnate. Limited educational background of microentrepreneurs may also contribute to the lack of ongoing enterprise growth. Smith and Metzger (1998) found that education of small entrepreneurs enhanced earnings after controlling for capital investment.

The labor market implications of microenterprise activity in developing countries are not entirely favorable. When microenterprises remain small, an underclass of self-employed, overworked, and undercompensated business owners forms (Johnson, 1998). With growing numbers of microenterprises (each seeking to provide a relatively low-skill, low-technology product or service), it is likely that the number of firms providing similar goods and services will rise. Competition between these firms will increase, intensifying the challenges to individual firm growth and profitability.

Microenterprise Growth and Training Issues

Microcredit programs in developing countries are designed to alleviate poverty, and there is clear evidence that microcredit programs are helping to boost incomes to, or slightly above, subsistence level. But the literature indicates that microcredit programs may not be effective in alleviating poverty in an environment of continuous improvement and growth. Though subsistence is preferable to abject poverty, complacency with slight progress may conflict with the goal of continued economic growth for the poor. Rather than accepting subsistence plateaus, we need to examine alternatives aimed at increasing the likelihood of ongoing microenterprise progress.

Significantly different factors may influence an MFI's financial viability, the sustained viability of funded microenterprises, and the potential for continual microenterprise growth. To the extent that the microcredit literature focuses on any of these, the viability of MFIs appears to receive the most attention (Schmidt, 1997; Woller et al., 1999). Certainly microenterprise viability and growth become moot issues if the lenders disappear. However, as increasing numbers of MFIs and microenterprises remain profitable and stable, a primary focus on the viability of lenders and microenterprises ignores a greater potential for the alleviation of poverty. If designed to provide increased incentive for and probability of continual firm growth, microcredit programs could have more impact on poverty reduction. Instead of stagnating, microenterprises may grow to become significant employers. This could enhance household incomes beyond the families of the microentrepreneurs.

Barriers to continual microenterprise growth identified in the literature include structural and socioeconomic conditions, increasing competition, and the lack of microentrepreneur business skills and understanding. Of these barriers, it may be easiest for MFIs to provide training to enhance the probability of continuous growth in funded microenterprises. Many MFIs provide, or even require, training in basic management skills prior to the issuance of loans or during repayment ("A dream," 1997; "India," 1998; Kole, 1999; Platt, 1998; "Small loans," 1997; Stanley, 1999; "We need," 1998). Nevertheless, there is not complete agreement on the need for microentrepreneur training. Initially, Mohammed Yunnus, founder of the Grameen Bank focused on the lack of seed capital as the main barrier to economic progress among the poor; he asserted that the poor are both creative and competent. To this end, his program originally deemed training unimportant (Singh, 1997). More current information on Grameen guidelines, however, indicates support for client training programs (Foote, 1997).

Even though a lack of capital funding is universally recognized as a significant barrier, there is no consensus that it is the only barrier. Some observers focus on lack of training as another significant barrier (Stallings, 1999). Frequently the poor are unskilled; they lack the educational opportunities necessary to develop many basic and higher-level skills needed for greater productivity.

The human capital economic literature documents that returns to investments in human capital are positive (Romer and Barro, 1990) and are often at least as high as the returns to investments in physical capital (Psacharopoulos, 1985; Psacharopoulos et al., 1986; Funkhouser 1998). Returns to human capital investment in developing countries tend to exceed those in developed countries (Funkhouser, 1998), and human capital investments are recognized as a key factor in the economic development of poor countries (Thomas, 1991; Maital, 1992; Tallman and Wang, 1992; Dougherty and Jorgenson, 1996; Mather, 1999). Thus, investments in human capital should be at least as desirable for alleviating poverty (even at a micro level) as investments in physical capital. There is still an unsettled debate concerning the desirability of general versus vocational education as the focus of human capital investment in developing countries' schools. At an individual level, however, entrepreneur education does seem to affect the probability of the success of new businesses (Robinson and Sexton, 1994). In some cases, the extremely poor, due to their lack of skills, may not be in a position to start businesses even if physical capital funding were readily available ("The power," 1999). In other cases the poor may be able to start a viable firm with little or no training, but the growth potential of the firm may remain untapped for lack of owner skills and understanding. Whether the main priority of a microcredit program is social welfare or economic or employment progress, training programs can be vital to the achievement of both foci (Johnson, 1998).

Many organizations do seek to ensure microenterprise success by coupling investments in human and physical capital. However, the duration, focus, and instructional method of training provided by these institutions vary a great deal. Some programs require training either as a precondition for a loan or as a requirement during a loan repayment; other programs simply make the opportunity available to borrowers. Alternatively, community-based training programs are available in some areas. Some train in classes or groups; others train through individual consultations. The content of the training differs across programs, but often includes skills in such areas as literacy ("Study confirms," 1999), small and basic business skills (Aziz, 1997; Fairley, 1998; Johnson, 1998), basic skills (Platt, 1998), savings (Fairley, 1998), costing, pricing, insurance, lease terminology, and human resources management (Stanley, 1999).

When the skills of beginning microentrepreneurs are minimal, training in fundamental business areas may be critical to the initial start-up of the enterprise. Once the enterprise is up and running, microentrepreneurs will learn from experience. More could be learned from experience, however, if it were intertwined with additional, more sophisticated training. This could be the key to fostering more rapid and continual growth of microenterprises, eliminating the plateau to which many microenterprises ascend but which they fail to exceed.

Many MFIs offer gradually increasing loan amounts. This suggests the need for incremental training over time as a business grows. Larger loans allow a microenterprise to explore more complex investment opportunities. The need for higher-level tactical and strategic planning grows. Without increasing the depth of training, microentrepreneurs may be able once again to lift themselves to a subsistence-level income without fully tapping the potential toward eradicating poverty. These microentrepreneurs unwittingly be in positions to make only profit-satisfying decisions, rather than decisions that consciously maximize profits or enhance competitive advantages. Microcredit programs that do not ensure that borrowers of increasingly larger loans have the requisite skills for appropriate analysis may cause their clients to increase risk and fixed costs through higher debt ratios without improving their abilities to leverage this debt into an improved strategic position and greater profitability. Microentrepreneurs need increasingly sophisticated training to accompany expanding loan amounts. The case of Victoria Bermillo in the Manila area illustrates her need for increasing depth in training.

Victoria Bermillo's Situation

Victoria Bermillo (pseudonym), a forty-four-year-old mother of three daughters, sells a variety of goods from a street-side booth near an open market in Pasig City, Philippines. Pillowcases produce the majority of her revenue, but she also sells other items. Victoria began her business many years ago, selling goods in a building on the market. Seven years ago that building burned down. She has since moved her business to a street location where foot traffic is much heavier. The new location has resulted in greater sales than experienced at her previous location.

Victoria keeps her goods in a large wooden box behind her stand. The box was purchased with a microloan that has been repaid. She must pay thirty-five pesos a day to hire a man to protect the goods each night. The land where her stand sits is the property of the city of Manila. One of Victoria's greatest concerns is that the city will evict her and other vendors off the land, as they have occasionally threatened to do. For now, Victoria pays the city twenty pesos a day for rent. This money allows her to stay there temporarily, but she could be asked to vacate the property at any time.

Victoria's pillowcases are always obtained from the same supplier, from whom she purchases 60 to 100 units per week. Other vendors in the area also sell the same style of pillowcases, purchased from Victoria's supplier.

Victoria has a small bank account. At one time she kept detailed records of her business transactions, but she stopped keeping any records as record keeping became a burden. At the present time, she has no formal way of recording her finances. Table 1 is a weekly income statement based on information provided by Victoria. Due to the lack of formal records, the data contained in the statement are based on estimates. This income statement is for a typical week with average sales.

Table 1: Weekly Income Statement (in Filipino pesos)

Revenue		12,000
Cost of Goods Sold		9,000
Gross Profit		3,000
Other Costs		
Transportation (30/day x 7 days)	210	
Owner's Labor (56/day x 7 days)		
Opportunity Cost*	392	
Security (35/day x 7 days)	245	
Rent (20/day x 7 days)	140	
Total Other Costs		987
Net Profit		2,013

*Costs estimated by authors

Victoria's total revenue from the sale of all goods is approximately 12,000 pesos per week. Approximately 75% of the total revenue, or 9,000 pesos, is generated by pillowcase sales. The approximate cost of all items she sells is 75% of the sales price. Sales are always highest during the Christmas season and school vacations.

The business seems to be profitable, but the majority of the profits are used to pay for her children's schooling and other necessities. Victoria wishes she could have more merchandise in her booth at one time, but the needs of her family do not permit the cash flow that would be needed to purchase more goods at one time from her suppliers.

Victoria has considered another alternative to increase her income: buying an electric sewing machine for 6000 pesos and manufacturing her own pillowcases. She currently has electricity at her home. Victoria estimates that materials for homemade pillowcases would cost about half the price she currently pays her supplier. Victoria thinks she could make all the cases she would need for the next day by sewing about three hours each night. Alternatively, Victoria could hire someone to do the sewing for 7 pesos per hour. The extra electricity used in sewing the pillowcases would cost about 20 pesos per day.

Helping Victoria Understand Her Situation

At least three levels of training can help Victoria grow her enterprise beyond its current level of profitability:

- Training in record-keeping to verify estimates of expenses and revenues,
- Training in analytical skills to determine the most profitable alternatives, and

- Training in strategic understanding, in order to earn above-average profits in her area.

Managers in extremely small enterprises may not see the value of record keeping. Tracking costs, revenue, and other data can be time-consuming and stressful, especially when skills in this area are not well developed. When profit and cash flow calculations are quite simple, microentrepreneurs may not be motivated to invest the time and effort required to go beyond these calculations and keep detailed records. They need to understand the role of accurate information in decision-making before the value of records becomes evident.

Once accurate data are available, microentrepreneurs can conduct cost-benefit analyses by examining and evaluating new options that have potential to help grow their businesses. Some training is required to identify relevant cost items, to determine prior costs, and to reasonably estimate future costs and revenues.

Microentrepreneurial profits can be threatened as increasing numbers of enterprises open in nondifferentiated markets. Victoria already has many competitors who sell pillowcases produced by her supplier. She also faces the threat of additional sellers of the same pillowcases entering her market, which would place pressure on her to lower prices. Strategic understanding of operations in a nondifferentiated environment, or training in methods of differentiation, can provide microentrepreneurs the knowledge they need to earn above average profits and to carve out a competitive advantage in difficult and increasingly competitive markets.

Since Victoria previously kept records, she has probably received some training in that area. Now she needs to understand that basing decisions on more accurate information increases the likelihood that her decisions will lead to the anticipated outcomes.

Experience and training in decision analysis may motivate Victoria to track essential costs and revenues diligently.

Table 2 presents two analyses of Victoria's profit potential from pillowcase sales, calculated from her memory-based estimates of costs and revenues. The first scenario assumes a continuation of her current purchase of pillowcases from a supplier (cost of goods sold). The second scenario assumes that she produces her own pillowcases (cost of goods manufactured).

Table 2: Make vs. Buy Analysis (weekly amounts, in Filipino pesos)

	Buying From a Supplier	Producing Pillowcases
Revenue	9,000	9,000
Cost of Goods Sold	6,750	3,375
Gross Profit	2,250	5,625
Other Relevant Costs (pillow cases)		
Electricity(20/day x 7)*	0	140
Labor(21/day x 7)	0	147
Transportation(15 x 7)*	0	105
Loan Payment**	0	173
Total Other Relevant Costs		565
Net Profit	2,250	5,060

*Costs estimated by authors

**Weekly profits to increase by this amount when loan matures

Focusing on pillowcases alone, Victoria currently generates 9,000 pesos (75% of total revenue) from pillowcase sales weekly. With costs averaging 75% of revenue, her pillowcase costs would be 6,750 pesos (9000 x .75). If she spends the extra three hours each night making her own pillowcases, she will save approximately half of the 6,750 pesos she normally pays her supplier, or 3,375 pesos. However, she would need to pay for her sewing machine and an increase in her electric bill, and sew three hours each night in addition to working at the booth each day (or hire someone to sew for her). In addition to these added expenses, Victoria would have extra transportation costs in obtaining the materials. If Victoria were able to purchase the sewing machine through a microloan, she would need to pay interest with her weekly payments. Assuming a simple interest rate of 50% on a one year loan of 6000 pesos paid in weekly installments, Victoria would have loan payments of 173 pesos per week. Her weekly profitability for pillow case sales only would more than double, rising from 2,250 to 5,060 pesos per week if she could obtain a loan for a sewing machine. Even if the interest rate were higher or the loan repayment time were shortened, Victoria's business would still be more profitable if she chose to make rather than buy her pillowcases.

Victoria needs the skills to do this type of analysis if she is to make profit-maximizing decisions. Alternatively, she at least needs to consult with someone who can help her understand these things. Since basic record keeping is confusing to Victoria, it is doubtful that she could undertake this more sophisticated analysis of her costs and revenues on her own with her present level of understanding. This depth of understanding was not critical to her firm's initial development. In fact, this level of analysis would likely overwhelm many beginning microentrepreneurs. Victoria's firm is profitable, but it has reached a plateau at a level commensurate with her business skills. If Victoria gains additional record keeping and cost-benefit analysis skills, she will be able to make decisions to substantially increase her family's income with much more confidence that her expectations are realistic. As her business grows, necessitating the hiring of additional workers, she may be able to contribute to the alleviation of poverty in her community.

Victoria's development of cost-benefit analysis skills is certainly important, but over time, her business will likely stagnate at a new plateau. Strategic training could make an even greater difference in her long-run profits. When many in a locality are selling the same items, it can be difficult to sustain a competitive advantage. Product differentiation is one strategy that can lead to a long-term competitive advantage, especially in a market of effectively homogeneous goods. Differentiating her products would give Victoria the opportunity to earn the boon of a successful differentiator, which is an above-average income (relative to other pillowcase vendors) generated by a premium price (Porter, 1985). With her own sewing machine, Victoria would be able to make slightly, or even boldly, different pillowcases than those sold by other vendors. She could begin to make and sell complementary products, such as table cloths, to go with her pillowcases. She might even enlist other microentrepreneurs to sell her products, thereby increasing her profits and providing business opportunities for others.

Without purchasing the sewing machine, Victoria is subject to her suppliers for her main tangible product. The only alternative way she can currently differentiate her business is to create a competitive advantage through superior service or superior location.

Purchasing a sewing machine could increase—more than double—the income for this struggling microentrepreneur. But this is not clear to Victoria because of her current lack of analytical skills. Furthermore, with appropriate training, the purchase could become the means of business growth over several years. A pillowcase production business can also alleviate Victoria's fear of losing her retail location. If such a loss occurred, her entire business would not be destroyed. Victoria would achieve a higher level of self-sufficiency, gaining more control over her own destiny.

Microentrepreneurs often lack the skills to visualize competitive opportunities through differentiation. A microentrepreneur such as Victoria, who receives training allowing her to successfully gain a competitive advantage and carve out a market niche, is more likely to expand the enterprise (and income) beyond the poverty level. This enterprise growth also provides the best opportunity for the eventual employment of additional workers, benefiting local economic development even more.

Conclusion

Victoria's case is not isolated. Many microentrepreneurs, especially those in developing countries, would move forward, either in small increments or large leaps, if knowledge and skills were developed alongside expansions in capital funding. Investments in human capital need to be coupled with seed capital funding if these firms are to fulfill their potential toward poverty eradication. With increasing loan amounts, it is important to provide insights into cost-benefit analysis—based on accurate records—so that sound business decisions can be made.

As businesses grow beyond the subsistence level, training in simple strategic principles can empower many microentrepreneurs to change their lives radically by lifting themselves out of and well beyond poverty. Associated with this growth, microenterprises will employ additional workers, allowing more individuals to move out of abject poverty. To alleviate poverty through microcredit programs, programs must emphasize expansion and provide the training necessary to achieve it.

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Acknowledgments

The authors express gratitude to the Reed Dame Fellowship for support for this research.

Book Review

Microfinance and Poverty: Questioning the Conventional Wisdom, by Hege Gulli

by Lisa M. Jones

Hege Gulli's work is a highly accessible guide for the layperson new to microfinance. The book outlines key issues in the field, presents competing viewpoints equitably, and offers conclusions based on (often limited) research.

The layperson will appreciate how Gulli elucidates the contrast between two approaches to microfinance. She briefly explains the financial systems approach (whose proponents she describes as desiring sustainable financial services for low-income people), and the poverty lending approach (whose proponents desire poverty reduction and empowerment). However, in choosing to side with neither "camp" (as Gulli terms them), she also serves neither one. Her decision to take the "contingency" approach and answer "how, to what degree, and under which conditions microfinance can contribute to poverty reduction" means that she effectively sidesteps one of the most interesting and pivotal questions about microcredit—whether microfinance is a tool for poverty reduction. Since microfinance has outgrown its infancy, and has come into vogue in recent years, she has chosen to sidestep this pressing and prescient issue.

Gulli also dedicates a few pages to outlining some of the "real constraints" faced by the poor. In doing so, she helps the layperson place her later statistics in context. However, if she had dedicated even a minimal amount of additional space to discussing constraints faced by most MFIs and related NGOs, the work would have been stronger. Such information would help explain the paucity of information and comparative data in the book (and in fairness, in the MFI world in general).

Gulli's work becomes more interesting to practitioners, scholars, and the layperson in Parts II through IV. Part II is dedicated to analyzing the "common assumptions about microentrepreneurs and microfinance institutions." While she addresses three such assumptions in this section, the most controversial point was made addressing the assumption that "the most serious obstacle facing microentrepreneurs is lack of access to credit." Gulli uses information from Honduras, the Dominican Republic, and Ecuador to point out that in two of these countries, the most serious obstacle (according to rankings by the local microentrepreneurs) is problems related to markets. It was validating to see what many of us know intuitively substantiated by a modicum of data.

Other highlights from the second section: Gulli provides a clear typological breakdown of various MFIs (p.13), which she claims shows the heterogeneity of the field, and her typology appears useful to a variety of audiences.

Lisa M. Jones, who holds an MBA/M.A. in International Development, is the co-founder of HELP Honduras (now HELP International). She is now focused on microenterprise projects in Sichuan, China.

Part III of the book addresses outreach and Part IV looks at impact. These chapters had more data and offered a richer set of conclusions. For example, in Part III Gulli uses data from Bolivia to combat the all-too-common assumption that there is a clear relationship between lending methodology and the poverty level of the borrower. (i.e., most assume that the poorest are reached using the solidarity lending method). In the same section, Gulli is honest and fair about having reached an impasse in terms of the research in the area of whether there is a trade off between financial sustainability for an MFI and reaching the poorest of the poor.

Key learnings Gulli highlights in both sections:

1. MFIs should not necessarily always target the poor; instead, to combat poverty both sustainable institutions are required for scale and poverty-oriented programs are required for innovation and market-seeding.
2. Even if pilot projects (primarily in rural areas) merit subsidies, such subsidies should not be given through the interest rate.

Part IV addresses assumptions about the impact of microfinance. This is certainly an area of interest for both practitioners and observers (let alone participants!), and the book makes clinincal what many know more personally from fieldwork—essentially, her conclusion about impact is that "it depends." Of course, the chapters are more detailed, and again Gulli offers research from several studies. Gulli also points out what many analysts need to note—that when analysts claim that people below the poverty line experience lower percentage increases in income after borrowing than people above the poverty line, it must be stated that people below the poverty line use more income for consumption and so their income should not be expected to increase as much. Gulli carefully guards the reader from accepting easy conclusions without questioning.

The most compelling contributions discussed in part IV:

1. Few studies assess the improvements in clients' financial management, which is a main justification of microfinance.
2. Evaluations of MFI programs should evaluate both the client-service relationship and the financial performance of the MFI.
3. In questioning whether high interest rates inhibit the growth of microenterprises, Gulli concludes that financing costs constitute an insignificant portion of microenterprises' total costs.
4. Gulli places herself in the camp that says "to secure outreach in the future, MFIs need to charge adequate interest rates so they can cover their costs" (p. 66).
5. Savings should be a more important component than they have been to date in MFI programs.
6. Commercial MFIs are likely to be less effective when they expand to nonfinancial activities and thus will reach fewer poor.

These are just a few of the conclusions Gulli proffers. This author leaves it to the reader to determine which of the other conclusions are most controversial or helpful. In total, Gulli should be commended for addressing key questions and placing research behind the answers, not just anecdotal evidence.

Gulli does not so much "question the conventional wisdom" (as the title implies) as she outlines and organizes it. Hampered by a general lack of data, and limited to information that is dated, Gulli still does an excellent job of placing central issues in context, showing readers some of the harder questions circulating in the field, and presenting conflicting viewpoints fairly. However, the practitioner or scholar looking for concrete strategies or creative new options for use in addressing such issues as sustainability or poverty outreach will find neither in Gulli's work. Nonetheless, Gulli's book makes for an excellent primer, while still constituting a strong enough (and controversial enough) work for the initiated to enjoy. Researchers and scholars will also find ideas for new or more in-depth research in this work. In this era where knowledge management in the microfinance industry (and many other industries) is discussed, Gulli advances knowledge management in the field of microfinance by thoughtfully and cogently framing the questions.

Publisher: Washington, D.C.: Inter-American Development Bank, 1998. 124 pages. ISBN: 1886938458

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