

# microenterprise lending 101

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If this component of business development is ever to come of age, it requires more Science & less Art

**W**e've been obliged to "walk the talk" recently. For a number of months now, Lutherwood Community Opportunities Development Association has been working in partnership with the local food bank. This is an organization with some very exciting ideas. It has established a business development program that goes beyond business planning to build the entrepreneurial skills and outlook of participants. Moreover, the program links prospective microentrepreneurs with key businesses in the local specialty food market.\*

Feeling satisfied with our efforts, we were taken aback when the pilot group from that program asked us where they might get a small loan to assist with the costs of pre-market testing. The amount was more than their collective (modest) household incomes could muster. But the requested amount was so small, and their enterprise so fledgling, that the banks *would* not even consider it. The challenge of developing a microenterprise development infrastructure is far from over.

The major barrier to enterprise start-up and growth identified by potential microentrepreneurs is access to capital. Over 70% of those surveyed in a national U.S. study, for example, identified lack of capital as the major constraint in getting their business started and growing. Similar concerns are

expressed by prospective Canadian businesses.

Banks, which hold by far the largest pool of debt capital in the country, are often accused of creating these barriers. They are criticized for being overly reluctant to give out small loans and for having high collateral requirements. The banks are *said* to be very risk adverse, unwilling to bank new ideas or untested entrepreneurs.

but these practices are not rooted in a callous attitude towards small business. Even credit unions, which are meant to be more responsive to the needs of local business owners, shy away from small business lending.

The fact is that microlending is tough business. Small loans are comparatively expensive to administer. Small businesses

The disappointing record of microenterprise development programs in training and consulting - two major program components - has been the subject of two previous articles in this series (*Making Waves*, Vol. 8, No. 4, and Vol. 9, No. 1). The authors, all Lutherwood CODA staff members or contractors, made two recommendations to program co-ordinators. First, they should focus training and consulting primarily on the development of the entrepreneur, not the business plan. Second, they must actively assist entrepreneurs to establish strong distribution networks - one of the greatest challenges to small business.

tend to fail at higher rates than larger firms. Fledgling entrepreneurs rarely possess sufficient assets against which to secure a loan in the possibility of business failure. The net result is that lenders find it difficult to recover their costs of lending and even more difficult to generate a return to shareholders.

Whether banks should subsidize small business lending in light of the increasingly large profits in recent years is an entirely different matter, worthy of discussion on its own. In the meantime, this article explores grassroots experience to fill the yawning microcredit gap.

### **MICROENTERPRISE LOAN FUNDS**

Microenterprise loan funds are a relatively recent community innovation designed to remove the economic barriers with microenterprise lending.

The funds vary widely in which barriers they target and how. Some use character rather than assets collateral. Others provide credit at less than market rates (50% of Canadian and 71% of U.S. programs surveyed in 1990). Still others impose a very loan ceiling on the microloans they are willing to provide.

In addition to credit, nearly two-thirds of funds offer their borrowers “hands-on” technical assistance to develop their businesses. This country’s 200-plus Business Development Corporations, for example, assist borrowers with the preparation of business plans. Van-City Savings Credit Union in Vancouver is devising a program that links entrepreneurs with business mentors.

Institutional models also vary. Several mainstream financial institutions reserve part of their depositors’ capital specifically for microenterprise lending. Chicago’s South Shore Bank, for instance, invests up to US\$12,000,000 annually in small businesses owned by ethnic minorities. Assiniboine Credit Union has recently initiated several initiatives to increase microentrepreneurs’ access to its conventional lending pools.

Community loan funds are generally somewhat smaller and operate much like a

nonprofit bank, owned and managed by local nonprofit agencies and supported by capital from local residents, businesses, and governments. Loan funds in a recent U.S. study had assets in the range of US\$200,000-\$600,000. The Montreal Community Loan Association is a community-based lender with a large capital pool of \$12,000,000 to invest in ventures with both social and economic impacts.

Peer lending funds, inspired by examples in the developing world, are yet a third approach. These institutions require peer borrowers to become peer lenders by assuming the management and risk of the funds. This reduces somewhat the administrative cost per loan and vastly improves the default rate. Calmeadow is Canada’s

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major peer lending group. Until until recently it had major lending operations in British Columbia, Nova Scotia, Ontario, and several Aboriginal communities.

In short, the microenterprise loan sector is diverse, but the goal of expanding access to microentrepreneurs is the same across the sector. Some, such as Calmeadow, have an even more ambitious agenda: to show that microlending is a viable business proposition and to encourage mainstream institutions to serve this growing market.

And the field does appear to be growing. It is estimated that there are grassroots microlending initiatives in six of ten provinces and the federally-sponsored Business Development Corporations are to be found right across the country.

### **WHAT HAVE WE LEARNED TO DATE?**

Microlending is certainly a relatively young socio-economic development experiment. Like all experiments it must prove two simple points before it can expect to gain the broad support required for a wholesale expansion of the concept.

Microlending must first prove it can achieve the objective loan funds are designed to achieve: to provide credit to marginalized entrepreneurs. Second, it must prove that this objective can be reached with acceptable costs – a fair requirement in a world of limited resources.

If loan funds, and any other socio-economic experiment, are unable to meet these two objectives, then the case for expansion is weak. On the other hand, if the results are positive on both fronts, then significant effort should be put into designing a replication strategy to reinvigorate microlending in Canada.

Firm conclusions are not common in CED research. There never seems to be enough good information on which to base them. Nevertheless, in the decade or so of microlending experimentation to date, compelling evidence has been generated for at least four general observations.

**1. Loan funds are generally accessible.** Loan funds undeniably fill a gap in credit left at the margins of the economy. Because loan funds are “lenders of last resort,” the vast majority of borrowers would not have received financing anywhere else. Although there continue to be concerns that even loan funds recreate some of the “social” barriers associated with mainstream institutions (e.g., making credit less accessible to female applicants, under the assumption that they are less suited than men to small business), the number of “socially”-guided funds that target marginalized groups such as women, ethnic minorities, etc. is growing.

**2. Microlending has a positive impact on borrowers’ businesses.**

Microentrepreneurs who do get financing make good use of it. A study of microenterprise development programs in Canada and the United States showed that participants who received loan fund credit had nearly twice the business start-up rate of other program participants.

The evidence on the impact of loan funds on business health, although sparse, is encouraging. An evaluation of the self-employment programs sponsored by Human Resources Development Canada shows that program participants who received credit had better survival rates, employment, and sales than businesses that did not receive such financing.

**3. Microlending generates significant “community” returns.**

Microenterprise loans funds have the potential of generating significant community benefits. An external assessment of the Colville Investment Corporation has shown that the new wages and business activity induced by the loans outweighed the various funding costs. In short, the Loan Fund’s activities had expanded (ever so slightly) rather than diminished the local economic pie.

Similarly, an assessment of labour-sponsored venture capital funds determined that the fiscal spin-offs generated by socially-guided investments - captured in the form of income and corporate taxes as well as saved Employment Insurance costs - repaid the public’s investment and then some after only three years of operation. Not a bad return for a new institution.

While these techniques fail to ensure access to capital for marginalized entrepreneurs (the primary motive for creating such funds in the first place), they do underline the fact that loan funds have the potential to generate more economic benefits than

costs. The funds therefore have the potential of becoming very sustainable community resources.

**4. Loan Funds are not, however, self-sufficient.**

The average loan fund is unable to cover its own operating costs, preserve its capital pool, and generate a return for investors. In fact, a recent study of seven loan funds in the U.S. (a mix of peer lending and community loan funds) found that every single one was running a deficit.

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The reason for this situation is not a lack of management capacity. Three mainstream, well-managed, American financial institutions (a credit union, a venture capital fund, and bank) that lend to microenterprises find they must subsidize microlending through other lending activities. Rather, the root of the problem lies in the very nature of small business lending: every barrier to credit that a loan fund removes, creates a barrier to fund’s own self-sufficiency.

Let’s look at the evidence again. Lending to risky businesses means high default rates (an average of nearly 10% in an Aspen Institute study of U.S. loan funds). Charging market or below market interest rates means marginal returns on the remaining businesses. Moreover, small loan sizes and loan portfolios (loan sizes of \$2,000-\$9000, a portfolio median of 43, according to the

same Aspen study) mean high administration costs. The net result is a financial loss – the very reason banks do not get involved in the first place.

**WHAT DOES THIS MEAN?**

Whether or not you consider loan funds a success in the pilot phase depends almost entirely on your expectations. If the objective is to fill the credit gap for marginal entrepreneurs at a reasonable cost to society, then microenterprise loan funds appear relatively successful. Access and community return are there. Cost recovery could be improved. But all in all, despite a need for a lot more data, the initial evidence is very promising indeed.

If, however, in addition to the above, microlending is to create a model for conventional financial institutions to apply with their vast resources, then the jury is still out. To our knowledge, every microenterprise loan fund in the country currently requires

subsidy to cover costs.

On both counts, the implication for the field is clear. There must be a significant amount of experimentation and testing of various microloan fund initiatives, particularly with regard to cost recovery, before the design of any replicable strategy can be considered in Canada.

**THINGS TO CONSIDER IN FURTHER EXPERIMENTATION**

If indeed the field of microenterprise is to continue with the second half of the experiment – the drive to efficiency - there is evidence sufficient to support the following recommendations.

**1. Balance Accessibility with Cost-Recovery.**

For those interested in improving loan

funds' cost recovery, there is a range of potential options to consider.

The first is to attempt to increase the number of loans and thereby lower the relatively high administration costs per loan. The median number of loans made in the Aspen Institute study (43) is about a third of the portfolio of a loan officer in a conventional bank. Of course, until the loss rate falls to an acceptable level, increasing the number of loans would simply deplete the capital pool. For those funds that have managed to find a balance, however, there is a good case to expand the pool to meet the demand.

One group already working on this strategy is Calmeadow. This organization's lending program in Vancouver posted a loan loss rate of a modest 4%. This is a tribute to the model's financial and moral incentives for repayment, its low-cost administrative structure, and its sophisticated trade-off between very small loans, above-market interest rates, and an administrative fee. To build on this success, Calmeadow is currently expanding the credit services of its Toronto operation in order to reach the scale of lending necessary to achieve self-sufficiency. This experiment should be supported and watched carefully.

A word of caution however. As another Aspen Institute study has pointed out, there is a mistaken belief in some circles that "megamodels" from the developing world (like Bangladesh's highly-successful Grameen Bank, which lends out \$9,000,000 to 800,000 borrowers) can be directly transplanted to North America. These models operate in an environment where there is an underdeveloped banking sector and (often) a rapidly-expanding goods and services sector. There are few barriers to market entry. The context is just the opposite in North America, with its relatively developed banking sector, a mature economy, and comparatively severe entry barriers.<sup>17</sup> In fact, many North American loan fund programs have reported "demand" problems. It may be that the only places where peer lending programs can achieve scale and sustainability in Canada are the big urban centres, like Toronto, Montreal, and Vancouver.

A second option is stricter lending crite-

ria. Loan funds often misunderstand their mission to mean that they should increase access of credit to almost anyone interested in starting a business. This generosity is misguided. Prospective entrepreneurs, like business ideas, are not all created equal. The loan fund that allows people to go into debt in the pursuit of risky ventures does

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these borrowers no favour. Loan fund managers should recognize this and tighten up their lending criteria accordingly.

A third option is to provide technical assistance and training to borrowers. Although there is little evidence as of yet to support the claim, it seems intuitively obvious that “hands-on” assistance in the planning and implementation of a business plan will result in a stronger businesses and fewer defaults. In fact, the

U.S. microenterprise development programs struggling with poor loan performance are banking on it.

Loan funds should take considerable care, however, before making the move from a “minimalist” microenterprise development model to an “integrated” one. The data is too sparse to get a sense of the impact of such programs on default rates. Moreover, training and technical assistance dramatically drive up the costs - and reduce the community return - of a microenterprise development program.

## 2. Continue Subsidization.

Whether you are satisfied with the community return of loan funds, or feel more experimentation for self-sufficiency is in order, loan fund operations require further subsidy. Here is where governments, foundations, and (yes) banks can help by providing multi-year funding to cover the costs of fund operations. Without this support, rather than perfecting their lending programs, the funds will spend an inordinate amount of time raising money - not what the field needs at this critical stage.

## 3. Educate Stakeholders.

Educating loan fund stakeholders on the primary mission of the fund and the associated economic and fiscal benefits is critical to increasing the capital pool and to mobilizing any resources required to subsidize operating costs.

This has proven key time and time again. The case of the Waterloo-Wellington SEED Fund is a good example. The Fund's board managed to convince local investors to keep their money in the SEED Fund after the provincial government withdrew the loan guarantee. This was possible largely because the industrialists on the board - all of them hard-nosed business people - sold investors on the notion of a “guaranteed no financial return” and a more “equitable community and stronger economy.” The same pitch is used successfully by the Montreal Community Loan Association.

The field cannot do enough in this area. The “cult” of self-sufficiency (see *Making Waves*, “The Practice of Self-Sufficiency,” Vol. 9, No. 1) is very strong, rooted as it is in narrow understandings of how local economies and communities work.

#### 4. Research, Research, Research.

Robert Friedman, president of the Corporation for Enterprise Development, once noted, "Until those of us who would build a more adequate human investment system establish our own standards of performance and rigor, we invite others to impose restrictive and inappropriate standards upon us and the programs we champion." This is good advice for the microlending field.

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Despite the critical need for this type of accounting, we have only identified three development finance institutions (and only one of them with a focus on microcredit) that have undertaken such analyses. While these assessment efforts generated invaluable information on the costs and benefits of alternative capital pools, only one of these organizations continuously monitors these impacts.

This knowledge gap must be corrected if loan funds hope to generate the government and community support required to survive and prosper. It shouldn't require a lot of effort. Although it requires some significant up-front work to understand, cost-benefit analysis is a relatively straightforward technique and easily embedded into the monitoring operations of any loan fund with solid financial reporting systems.

To ensure that this information can be used for evaluation and policy-making purposes, some organization(s) must be assume responsibility (and be adequately supported) to undertake this work. Organizations such as the CED Technical Assistance Program and the Digby Network, new CED support groups at the national level, or perhaps even the Social Investment Organization, are possible candidates for this function. There may be others.

These recommendations represent only the tip of the iceberg. Loan funds could organize themselves to establish regional

intermediaries to avoid the infrastructure costs of locally-delivered programs. Governments could sponsor loan guarantee pools specifically for community-based lending to help offset loan losses and depletion of capital pools. (Mainstream banks have one, after all. Why can't the alternative sector?) The funds could establish closer relationships with banks both to take advantage of their lending expertise and to find ways of avoiding unnecessary operating costs (e.g., advertising, client referrals, etc.). While the final list may prove endless, we think the points presented above represent the most important agenda for the field for the time being.

#### CONCLUSIONS

The field of microlending is an exciting one with every sector of the community - community groups, government, labour, and business - actively participating to create opportunities for marginalized entrepreneurs. This enthusiasm has been amply rewarded with an explosion of programs, a new class of entrepreneurs, and what we all strongly suspect are healthier local economies.

The explorative phase is not yet over, however. Loan funds face the dual challenges of improving cost recovery while at the same time pursuing a social mission. Indeed there exists a still greater challenge: to get our heads around the deceptively simple concept that correcting mis-performing institutional practices, despite real or perceived economic costs, is in everyone's best interest. That is what community economic development is all about. As Mike Lewis has so aptly noted, "the challenge is clear, lets get on with the job".

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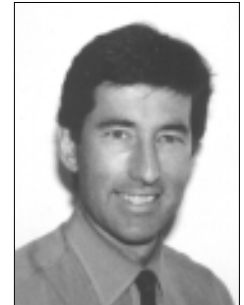


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Another principal of OP2000, ALLAN DAY was also responsible for the management of Opportunities Planning, the initiative

which assisted 1100 social assistance recipients to find or create work in the early '90s (reported in *Making Waves*, Vol. 8, No. 4, Winter 1997). Allan's record also in-



cludes Canadian cultural orientation (in Thailand) for Southeast Asian refugees, and the development and co-ordination of housing co-operatives.

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