❑ FINANCING DEVELOPMENT: BANKING ON MICROENTERPRISE

By Katharine McKee, Director, Microenterprise Development Division, U.S. Agency for International Development

Only 5 percent of low-income households around the world have access to financial services. Yet these services are now considered critical to small business development, income, and employment growth in all countries, says Katharine McKee, director of the Microenterprise Development Division at the U.S. Agency for International Development (USAID).

McKee outlines key strategies used by USAID in its support of microfinance, which is now at the forefront of global anti-poverty strategies. Innovative approaches to serving low-income entrepreneurs and households, she said, include finding substitutes for traditional collateral, promoting flexible repayment schedules, and offering a broader range of financial services such as insurance and flexible savings accounts.

To grow and prosper, businesses of all sizes and in all countries need access to financial services. Such access is a particular challenge for poor families around the world that need loans, credit, and savings to establish, sustain, and expand small businesses and microenterprises. Once considered peripheral to mainstream development policy, access to microfinance is now at the forefront of a global anti-poverty strategy that has tremendous potential to generate income and expand employment at both the local and national levels.

Financial services are equally important in protecting against the unforeseen consequences of illness, incapacity, or death of a breadwinner; natural disasters, war and other crises. With financial services, poor families can send their children to school, buy medicine, and get through lean times when cash and food are scarce.

Despite the importance of financial services for both poverty reduction and equitable economic growth, experts estimate that only 5 percent of low-income households around the world have access to such services. The international development community, with a vision it calls "financial sector deepening," is promoting the extension of diverse financial services by a wide range of bank and non-bank financial institutions to ever larger numbers of low-income and middle-class households around the world.

Support for microfinance has been a focus of U.S. foreign assistance programs for more than 25 years. The United States Agency for International Development (USAID) annually provides over $100 million for projects that create large-scale, effective, and sustainable microfinance services for the poor in developing and transition countries.

The United States complements its direct investments in microfinance development through its support for international financial institutions (IFIs) such as the World Bank, the International Finance Corporation (IFC), and regional development banks. Several IFIs, including the Inter-American Development Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development, have strong track records in supporting financial services for micro and small enterprises.

The results of USAID's investments over the years are impressive: (see microenterprise investments table).

In some countries, support for microfinance over the years has transformed the national financial landscape by incorporating hundreds of thousands of bank-ready clients and stimulating innovations that change the way mainstream banks do business. Microfinance customers now make up the majority of financial services clients in countries as diverse as Kyrgyzstan, Uganda, and Bolivia. In Bolivia, for example, USAID's microfinance program has been instrumental in a massive expansion of financial services in terms of the number of borrowers and savers as well as the overall performance of the country's financial markets.

According to information collected by USAID based on data furnished by central banking authorities, the dollar assets of microfinance institutions (MFIs) — those groups that lent money principally to small businesses and low-income households — operating in Bolivia rose nearly 300 percent between 1992 and 2001, a rate of growth

USAID Microenterprise Investments

	1999	2000	2001	2002
Loan clients	1,997,839	2,175,198	2,904,152	2,723,146
Total loan portfolio	$655,906,588	$883,273,258	$934,253,554	$1,269,622,200
Savings clients	3,069.604	3,155,100	3,514,200	3,196,300
Total savings portfolio	$349,663,487	$533,500,000	$424,800,000	873,400,000
BDS* clients	401,530	254,809	835,458	668,808
Women clients (MF)	69%	70%	73%	69%
Women clients (BDS)	61%	75%	47%	48%
Very poor clients (MF)	67%	67%	69%	59%
Very poor (BDS)	29%	18%	30%	53%

*BDS Business Development Services
MF Microfinance

more than eight times that of commercial banks. By 2001, the number of borrowers from MFIs was more than double the number of borrowers from commercial banks, and 797,000 Bolivians held savings at MFIs compared to just 658,000 in commercial banks.

USAID provides the majority of its microfinancing through its field "missions" in developing and transitional countries. Currently, approximately 50 USAID missions support microfinance and microenterprise development programs. Funding is divided roughly equally among the four USAID regions — Africa, Latin America and the Caribbean, Asia and the Near East, and Europe and Eurasia.

RESPONDING TO LENDING REALITIES

Enterprises need working capital loans, longer-term financing for equipment and other investments, and savings and payment services in order to create jobs and to take advantage of new economic opportunities. Families need access to flexible savings accounts, remittance and payment services, insurance, loans for housing, school fees, emergencies, and so on, to be able to increase their income and assets, reduce their vulnerability to crises, and meet obligations related to such events as births, deaths, and weddings. USAID has invested in developing a wide range of services to meet these disparate needs.

One key lesson from its work is that careful market research is critical before financial institutions introduce new financial services. For too long, for example, most MFIs offered only short-term working-capital loans. Faced with new competition for clients, the MFIs now understand the importance of tailoring product features and service delivery techniques to meet the needs of various clients. An MFI seeking to serve farm families in remote rural areas, for example, must adjust its loan repayment terms and savings services to the cash flow cycles of the families and community, which can vary dramatically by season and agricultural cycle. The same MFI might find that, instead of setting up a fixed branch office, it needs to employ mobile loan officers who travel throughout the countryside to serve its clients.

Microfinance has come a long way from the days when few believed that poor families' repayment of their loans for business and household needs could rival the performance of the most high-performing banks. Nor did many believe that poor families could be successful savers, building up financial assets of their own. How were these breakthroughs in microcredit and microsavings achieved? A few key principles have been critical to the successes — charging interest rates that cover lending costs, managing delinquency carefully, and tailoring flexible financial products in terms of collateral and repayment schedules (see box on "Best Practices in Microenterprise Development: A USAID Perspective).

MFIs recognize that few new clients have the kind of collateral many banks require to secure loans. Therefore, MFIs have developed collateral substitutes — products designed to create strong incentives for repayment. One such technique is a system of "stepped loans." Initial loans are small and short-term, but larger loans of longer maturities become available to borrowers with perfect repayment records. Another collateral substitute is a group loan program that requires clients to essentially guarantee the repayment performances of other group members; if one borrower misses a payment, others will be unable to borrow, motivating fellow members to both pressure and support each other.

Another initiative would base access to credit on a household's entire income rather than just from the real or projected revenue of the business for which the loan is sought. This recognizes that cash is fungible within households.

Innovations have not been limited to credit programs. Savings innovations include the deployment of mobile staff to collect savings on a daily basis from vendors and the introduction of rural automatic teller machines (ATMs) that use thumbprint recognition technologies to enable illiterate clients to access their accounts.

LINKING FINANCIAL INSTITUTIONS WITH MARKETS

USAID's second key microfinance strategy is to invest in diverse retail financial institutions able to serve different markets. With USAID support, many nongovernmental organizations (NGOs) and associations and credit unions, as well as commercial banks, are now able to specialize in offering microcredit and microsavings services, as well as other financial products, to poorer clients and smaller enterprises.

In countries with little microfinance experience, USAID often supports the creation of "market leaders" — financial organizations that demonstrate that the poor are creditworthy and responsible users of diverse financial services. Equally important, the initiative proves that financial services to this market segment can be profitable, which encourages other commercial players to enter underserved markets.

USAID has provided grants for initial operating funds, loan capital, and management information systems to help hundreds of specialized MFI market leaders get started. Follow-up grants have enabled these institutions to grow and achieve sustainability, in which revenues from operations fully cover the costs of offering the services, including loan losses, inflation, and costs of financing future growth through borrowed funds.

Providing young MFIs access to specialized technical assistance and training has been a critical ingredient for their success. The leading international microfinance networks such as ACCION International, FINCA International, and Opportunity International have helped their affiliates become market leaders and demonstrate the viability of microfinance in diverse countries around the world. With USAID support, the World Council of Credit Unions' "savings first" approach, in which communities mobilize their own savings to serve as the capital for loans, is operating successfully in more than a dozen countries to support networks of local credit unions that offer a compelling model of how to provide viable savings, credit, and other services to low-income and working-class families.

Loan guarantees and other credit enhancements, provided through USAID's Development Credit Authority, have enabled successful MFIs to access local and international capital markets to finance rapid growth through debt and bonds. Targeted small grants and technical assistance have also helped banks and other mainstream financial institutions begin offering microfinance services, often delivered through a specialized affiliate that tailors its products and delivery methods to the needs of smaller businesses and poorer households in a community.

SUPPORTING MARKET INFRASTRUCTURE AND REGULATORY REFORM

In some countries with more mature microfinance markets, USAID has shifted from supporting individual retail institutions to a strategy of giving broader support to the microfinance industry as a whole and to the market infrastructure it needs to thrive. This often entails competitive grant funding to help providers with new product development, or investments in specialized institutions such as credit information bureaus and microfinance ratings agencies. The resulting increased competition can be an effective path to product innovation, greater efficiencies, and better services and prices for clients.

Undergirding USAID's three strategies are efforts to improve the legal and regulatory environments for microfinance. If interest rates are capped, for example, financial institutions might not be able to charge enough to cover the higher costs and risks of serving poorer and more remote clients. Laws passed to protect the poor might block their access to the financial services they need. Banks may be unable to serve them if loan documentation and reserve requirements are not adjusted to reflect the distinctive risk management and cost-control methods employed in successful microfinance. Successful

NGO MFIs with proven ability to lend over the long term in this market might be good candidates to offer the flexible savings services that poorer customers typically demand. However, without changes in banking laws, they may be prohibited from offering deposits to the general public.

USAID assistance in the policy arena has sought to remove those legal and regulatory barriers that currently restrict NGOs and other specialized providers from providing microfinance. USAID funding has also helped build the capacity of bank and credit union regulators to protect poor people's savings. Well-trained regulators help to ensure that microfinance providers are adequately overseen. As top-notch NGO microlenders transform into regulated depositories, bank supervision agencies may need to adapt their rules, systems, and staffing.

SUPPORTING GROWTH OF SUCCESSFUL MICROENTERPRISES

Attention has begun to focus on a new gap in the finance market — the "missing middle." As the most successful microenterprises expand, they may need growth capital beyond what MFIs and microfinance programs can provide. In many countries, small- and medium-sized firms find that their access to appropriate financial services is even more limited than it is for microenterprises and self-employed individuals. Recent U.S. foreign assistance efforts have taken aim at the missing middle — trying to ensure that successful micro-, small- and medium-sized firms in developing and transitional economies are not starved of the capital they need to create new jobs, increase productivity, upgrade technologies, and tap new markets and export opportunities.

One major initiative addressing this financing gap is the new Africa Small Business Fund. This $225 million pilot program is a joint venture between the World Bank's concessionary lending arm, the International Development Association, and its private-sector affiliate, the IFC. The Africa initiative builds on a strong microfinance track record, in particular the successful collaboration between the European Bank for Reconstruction and Development, IFC, USAID, and others to create high-performing specialized micro- and small-business banks in transition countries such as Georgia, Kosovo, Serbia, and Russia.

The first project to be approved under the Africa Small Business Fund is a $32 million World Bank credit for Nigeria. In response to the Nigerian government's request for assistance to enhance its bottom-up economic growth, the small business loan program will direct funds to strengthening local financial and non-financial institutions that support small businesses so they can operate more effectively and deliver sustainable commercially based services.

The United States government is committed to helping create vibrant financial sectors in developing and transitional countries around the world. Financial services spur broad economic growth, promote job creation, and generate new opportunities for all citizens. As such, they represent a critical element in the worldwide battle to eradicate poverty. ❑