This will be the final issue of the *Journal of Microfinance* before it changes its title and focus as explained below. As we mark this transition, we look back with appreciation on the genesis of the journal. Particular thanks go to Gary Woller and Warner Woodworth for their vision in seeing the need for a journal that would formalize microfinance as a serious topic of academic research.

This vision of a journal that would open the dialogue between practitioners and academics on the topic of microfinance was only realized through the hard work and support of many individuals and institutions. Gary Woller is especially deserving for his efforts as editor in the earliest years of the journal. He worked tirelessly to create awareness of the *Journal of Microfinance*, recruiting a strong group of reviewers as well as establishing the journal’s reputation among researchers. As a result of his efforts, the journal reached a point where only about twenty-five percent of articles submitted were accepted for publication, putting the *Journal of Microfinance* on par with other top journals in the field.

Gary was supported in this effort by the George W. Romney Institute for Public Management and the Center for Economic Self-Reliance of the Marriott School at Brigham Young University. Additional support came from the School of Business at Brigham Young University–Hawaii, both financially and editorially through Beth Haynes, who served as Book Review Editor, while I served as co-editor of the journal.

Of course, additional thanks go out to our fine editorial board, consisting of many leaders in the field of microfinance. I also wish to express gratitude for the fine work of our many volunteer reviewers, who worked hard to ensure the quality of the articles that appeared in the journal.

Finally, to the authors of the research appearing in the *Journal of Microfinance*, I wish to extend my congratulations for having made the journal into a demanding and innovative publication. Your efforts have led us all to think about the practice of microfinance in ways that will push the movement forward for years to come. In fact, the journal’s shift from a more narrow focus on microfinance to a broader focus on economic self-reliance is indicative of the lessons we have learned as we have sought better ways to reduce poverty throughout the world.

Again, I thank all who have been involved in trying to make this world a better place through the use of microfinance. Your work continues to be valuable in the push toward greater economic self-reliance and will find a
welcoming home in the new publication, *Advances in Economic Self-Reliance*.

Norman Wright  
Editor, *Journal of Microfinance*

With the next issue, the name, focus, and format of the *Journal of Microfinance* will change—the new name will be *Advances in Economic Self-Reliance*. In March of 2003, the Center for Economic Self-Reliance was formally established at the Marriott School of Management at Brigham Young University. The Center was founded on a vision of improving the economic self-reliance of individuals and families around the world by bringing researchers, practitioners, and donors together through action research.

Microfinance deals with the provision of financial services to the poor to establish and sustain microenterprises, thus improving their earning capabilities. As such, the principles and practices of microfinance represent one important vehicle through which people can improve their economic self-reliance. Economic self-reliance is a broader concept that includes education, work within traditional employment relationships, principles of personal prudence and discipline such as budgeting or resource management, and concerns such as risk management through social networks or insurance. Each of these components, coupled with individual initiative, works to create or improve self-reliance. The name change of the journal signifies our willingness to publish articles on these important broader topics as well as continuing to support microenterprise efforts.

The focus of the journal will be broader than before, and the writing style and article selection policies will change as we attempt to reach out to practitioners and donors as well as researchers. The initial issues will include pieces from thought leaders in the area of economic development, a theory article that outlines new and important concepts in the field, a research and case study section, a short description of best practices in the areas of self-reliance or NGO organizational management, and a book review. We expect the format and content of the journal to evolve as we better understand and model the processes of economic self-reliance. We invite you to evolve with us and hope you will continue to see this publication as valuable to your efforts to build a better world.

Paul C. Godfrey  
Editor, *Advances in Economic Self-Reliance*
**Subscriptions and Submissions**

*Journal of Microfinance* (ISSN 0360-151X) 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, 712 TNRB, Marriott School of Management, Brigham Young University, Provo, UT 84602.

**2006 Subscriptions:** The subscription rate for subscribers in the U.S. and Canada for two issues of *Advances in Economic Self-Reliance* is the following (in U.S. Dollars):

<table>
<thead>
<tr>
<th></th>
<th>Individuals</th>
<th>Libraries</th>
</tr>
</thead>
<tbody>
<tr>
<td>On-line</td>
<td>$30</td>
<td>$75</td>
</tr>
<tr>
<td>Hard Copy</td>
<td>$50</td>
<td>$250</td>
</tr>
<tr>
<td>Combination</td>
<td>$70</td>
<td>$300</td>
</tr>
</tbody>
</table>

Add $10 for non-U.S./Canada hard copy or combination subscriptions. Please send all correspondence regarding subscriptions to microjournal@byu.edu or Journal of Microfinance, 712 TNRB, Marriott School of Management, Brigham Young University, Provo, UT 84602; call (801) 422-9009; or visit us online at http://www.microjournal.com.

**Submissions:** Since *Advances in Economic Self-Reliance* is a practitioner-oriented journal, we welcome article proposals dealing with various aspects of self-reliance from thoughtful practitioners, researchers, and donors. Please email a one page article proposal to the editor at aiesr@byu.edu to begin the submission process, or mail your proposal to: *Advances in Economic Self-Reliance*, BYU Center for Economic Self-Reliance, 712 TNRB, Provo, UT 84602.

**Content:** Views expressed herein are to be attributed to their authors and not to *Journal of Microfinance* or Brigham Young University unless otherwise indicated.

**Copyright:** Except as otherwise noted, *Journal of Microfinance* is pleased to grant permission for copies of articles to be made for classroom use, provided that (1) a proper notice of copyright is affixed to each copy, (2) the author and source are identified, (3) copies are distributed at or below cost, and (4) *Journal of Microfinance* is notified of the use.

Copyright © 2005 Journal of Microfinance
EDITORS

Norman Wright
Brigham Young University–Hawaii

Beth Haynes
Book Review Editor
Brigham Young University–Hawaii

EDITORIAL BOARD

Craig Churchill
International Labour Organisation

Sam Daley-Harris
Microcredit Summit

Christopher Dunford
Freedom From Hunger

Elaine Edgcomb
Aspen Institute

Jason Friedman
Institute for Social and Economic Development

Kathleen Gordon
Working Capital Florida

John Hatch
FINCA International

Gerald Hildebrand
Katalysis North/South Development Partnership

Mildred Robbins Leet
Trickle Up

David Richardson
World Council of Credit Unions

Mark Schreiner
Washington University, St. Louis

Hans Deiter Seibel
International Fund for Agricultural Development

J. D. Von Pishke
Frontier Finance International

Muhammad Yunus
Grameen Bank
CONTENTS

ARTICLES

1  Nurturing Joint Forest Management Through Microfinance: A Case from India  
   K. K. Kaushal and J. C. Kala

13 Microfinance and Rural Development: A Long-Term Perspective 
   Henk A. J. Moll

33 Data Standards for Connecting to Commercial Sources of Capital 
   James Dailey

47 Commercializing Microfinance and Deepening Outreach? Empirical Evidence from Latin America 
   Francisco Olivares-Polanco

71 Building Economic Self-Reliance: Trickle Up’s Microenterprise Seed Capital for the Extreme Poor in Rural India 
   Jan Maes and Malika Basu

101 Microfinance Institutions in Transition: Fonkoze in Haiti Moves toward Regulated Banking Status 
   Michael Tucker and Winston Tellis

127 Microentrepreneurship and Job Creation: A Multiple-Case Study of HUD Microenterprise Development Assistance Programs in Upstate New York 
   James O. Bates

BOOK REVIEW

149 The Private Sector in Development: Entrepreneurship, Regulation, and Competitive Disciplines. By Michael U. Klein and Bita Hadjimichael 
   Richard Norton
Nurturing Joint Forest Management Through Microfinance

A Case from India

K. K. Kaushal and J. C. Kala

Abstract: India has embarked upon a community involvement process to restock the state-owned forests through a recent approach called Joint Forest Management. But the success of the Joint Forest Management program lies in the provision of alternative livelihoods to woodcutters and grazers. This article presents how the forest department of a southern state of India devised a potent tool of microfinance promotion for weaning those who are dependent on the forest by implementing a massive externally aided Joint Forest Management Project. Based on a study of 27 program villages in the Tamilnadu state, this paper proves that the success of Joint Forest Management is dependent on and directly linked to the provision of microfinance to villagers through a people’s representative body—the Village Forest Council. The forest department was successful in this unusual task of promoting microfinance even in villages where formal microfinance institutions have failed, which corroborates an earlier finding that microfinance is more workable and successful if it is properly packaged in a locally suitable development program.

A substantial track record of accomplishment and a significant body of empirical studies worldwide together underline the significance of microfinance as an effective antipoverty and development strategy (Wright, 2000; Zaman, 2000; Khandker,
However, even a well-designed microfinance program is unlikely to have a positive impact on the poorest unless it specifically seeks to reach them through appropriate product design and targeting (Wright, 2000). It is clear from various reports that there are strong potential synergies between microfinance and the provision of basic social services to clients. However, the services provided need to be relevant to the needs of the target groups and not just an add-on that is of poor quality (Marcus, Portes, & Harper, 1999).

Of the 63.72 million hectares (ha) of actual forest area of India (most of which is state owned) almost 38% is degraded, with a canopy density\(^1\) of less than 40% (FSI, 2000). This degradation of forests is mainly ascribed to the rigid state control and the resulting disempowerment and displacement of indigenous tribal and hill communities, accompanied by the disintegration of community-based resource management (Fernandes & Menon, 1987; Guha, 1991; Kelkar & Nathan, 1991; Gadgil & Guha, 1992). Consequently the Government of India made a major policy shift in 1988 and switched over to Joint Forest Management (JFM). JFM is an evolving policy-based program, which sets out to establish management “partnerships” between local forest-dependent communities and the state for the sustainable management and joint benefit-sharing of public forest land (Sarin, 1995). To accomplish this, JFM seeks to shift the existing inequitable distribution of management control by directly involving local people and institutions in forest management (Campbell, 1996). JFM does not involve the transfer of ownership over forests, but attempts instead to restructure the formal system of access, decision-making, and sharing of benefits to account for the needs of local communities. So far, 22 state governments have issued orders to implement JFM and the states have evolved their own mechanisms of involving local communities in conformity with the proclaimed policy.

---

K. K. Kaushal is Deputy Conservator of Forests in Madurai District of Tamilnadu State for the Indian Forest Service. Email: kkaushal@eth.net

J. C. Kala is Principal Chief Conservator of Forests, Tamilnadu State Government, Indian Forest Service. Email: jckala@yahoo.com
About 36,130 Village Forest Councils are managing a total of 10.25 million ha of forest area in the country (FSI, 2000).

It is a known fact that during the last 140 years of state control, most of the land with the potential for agriculture was cleared of forests. The remaining forest in India is now concentrated in rugged and inaccessible areas, and this reduces the potential to harvest and manage the forest for production purposes. The abutting population has increased manifold; their needs have also multiplied. It is impossible to create forest-based livelihoods for all the abutting population. Consequently, most of the states are following a two-pronged approach to involve communities: increasing the stake of the neighboring communities in the management and utilization of the forests, and creating alternative sources of employment to reduce the pressure on forests (Kumar, Naresh, Yogindra, & Kinsuk, 2000). But the resources to promote alternative income are limited and cannot wean all forest dependents (Kaushal & Kala, 2004). However, if the limited available funds are used for the creation of a revolving fund for microfinance provision instead of providing doles to a few individuals, then the impact can be larger and more sustainable also.

This paper seeks to present how microfinance as a component of the Joint Forest Management project has emerged as a potent tool for the development of forest villages in Tamilnadu and is reducing people’s dependence on forests to nontimber forest products and indirect benefits. Further it substantiates with field data that the regeneration of forests is directly linked to the successful working of microfinance.

Tamilnadu Forestry Project

Tamilnadu, the southern state of India, has a geographic area of 13 million hectares, which constitutes 3.96% of the land area of the country. The total population of the state is 55.86 million (1991 census), accounting for 6.60% of the country’s population. The recorded forest area\(^2\) is 2.26 million hectares, which constitutes 17.40% of the land area of the state. But the actual forest cover\(^3\) as assessed through remote sensing is only 1.71 million hectares—a mere 13.13% of the land area. Furthermore, half of this actual for-
est cover is degraded and has a canopy density of less than 40% (FSI, 2000).

There are 15,822 villages in the state, of which 1405 are forest abutting. The total population of these forest villages is estimated to be 3.11 million. No separate consumption or income data are available, but it is a known fact that forest communities are the poorest of the poor (Tiwari, 1994; Kaushal & Kala, 2004). Because of remoteness and a thin and scattered population, modern development and amenities have not reached them. Moreover, the development departments hardly reach these areas. Likewise, the cooperative banks and grameen banks restrict their operations to the villages in the plains, which have more productive lands that allow their people to make gainful use of loans.

The Tamilnadu Forestry Project (TFP) is a Joint Forest Management (community forestry) Project that is funded by the Japan Bank for International Cooperation at a level of US$100 million. This project has been implemented in Tamilnadu state since 1997–98. In the Project, degraded forest microwatersheds along with abutting habitations are selected. The forest area is divided into three zones—Lower zone or Utility zone, Middle zone or Asset creation zone, and Upper zone or Eco-restoration zone. Normally, the area for all three zones is 250 ha, in which the zone-wise gap planting is taken up. The unique feature of the Project is that it has a provision of $12,000 for the development of abutting village population over a period of three years. The aim is to reduce the dependence of villagers on forests by initiating alternate activities for generating income.

In each of the identified management units, the people’s representative body, called a Village Forest Council (VFC), is formed which is fully involved in the planning and execution of works, protection, harvesting, and benefit sharing, with focus on degraded forests. One man and one woman from each household, provided that they are willing, are enrolled as its members. Any person who opts out from the membership of VFC is not entitled to any benefits. The VFC meets as and when called for, but in any case at least once in three months.
Each Village Forest Council elects an Executive Committee, with each hamlet electing at least two members; each VFC elects a minimum of 5 and a maximum of 15 members to the Executive Committee. The panchayat members of the management unit are co-opted as ex-officio members of the Executive Committee (EC). The members of the Executive Committee elect a President from among themselves who is also President of the VFC. The Forest Ranger concerned is the Member Secretary of the Executive Committee, who facilitates the election of the members and President of the Executive Committee. The Executive Committee is responsible for the day-to-day activities of the VFC and meets at least once a month. A Memorandum of Understanding is signed in the beginning between the Divisional Forest Officer (on behalf of Forest Department) and the VFC President. This gives the details of the roles and responsibilities of the Forest Department and VFC—the partners in Joint Forest Management. All the VFCs have been registered under the Societies Registration Act 1975.

The government order sanctioning funds from JBIC soft loan defined the objective of the program as increasing the tree cover through the involvement of people. But once the program was launched, it was continuously reviewed, modified, and broadened in consonance with the feedback from the people and the field officers. The amount for development of forest dependents was increased to $12,000 from $6000. The individual grants were converted into interest free loans so that the VFC can build up its corpus fund and extend loans to the remaining forest dependents for acquiring productive assets. The VFC President was made the joint signatory for the withdrawal of funds and the submission of accounts. State Government ordered the involvement of all other line departments, like Public Works Department, Electricity, Health, Agriculture, Animal husbandry, and Tribal Development, etc., for the holistic development of these microwatersheds on a priority basis. Thus the Project has come to acquire a multidisciplinary approach in which the promotion of microfinance plays the lead role.
TFP and Microfinance

Each VFC opens an account with the nearest post office and bank, which account is jointly operated by the President and Member Secretary. Income from the following sources accrue into that account:

1. Fines imposed for offenses (like grazing or illicit removal) in the JFM area.
2. Recovery of loans.
3. Income from the sale of nontimber forest products (NTFPs).
4. Membership fees.

Out of $12,000 meant to be spent on the buffer zone in each village, about 30% is spent on village development and community assets like threshing floors, community halls, etc. The remaining amount is given to individuals for acquiring productive assets. Soon after the launching of the Project, this amount was declared as a loan, which individuals have to pay back to the VFC so that it can give loans to other people, as well as later further assistance to the same individuals. In fact, this buffer zone amount is the major source of VFC fund, as income from the sale of NTFPs will take many more years to be significant.

Presently, extending credit is the main financial activity of the VFC. But the term microfinance has been applied to the VFC because it arranges insurance for the cattle purchased through its loans. Some VFCs have also taken group insurance policies for their members. Further, NTFP sales are done by the VFC only.

Methodology

Study Area
There are 48 field-level implementing units called Forest Divisions in Tamilnadu State Forest Department which have been implementing TFP. Plantation Division, Madurai is undertaking TFP
implementation in Madurai and Theni districts of Tamilnadu State. So far 27 villages have been brought under the Project in this division and this study was conducted in the 27 villages of the Plantation Division, Madurai.

**Procedural Description and Results**

Data regarding the financial position and recycling of money were collected from the records of each VFC, since each VFC maintains the loan disbursement and loan recovery registers and cashbook. Recovery and recycling were separately rated on a scale of 0 to 1. If loan recovery for the village showed 100% recovery, we gave it a value of 1, and if loan recovery was less, then the decimal value corresponding to the loan recovery percentage was assigned. For analyzing recycling, evaluation considered whether the funds after recovery were kept in a bank account or given as fresh loans to new individuals within a reasonable period, with a value from 0 to 1 assigned. We allowed a period of 1 month and an accumulation of up to Rs 50000 for giving fresh loans. As per expectations, the values were almost the same as the better recovery villages for early disbursal. The average of loan recovery and recycling values was taken to arrive at the value of the combined parameter of loan recovery and recycling.

Then a team of three Forest Range Officers assessed the protection and regeneration status of each program area. Better protection through effective social fencing was reflected in the growth of planted seedlings, the regeneration of existing rootstock, and the absence of goat or cattle dung on the forest floor. The team perambulated the forest area of each of the 27 forest villages to assess the protection and regeneration status and independently rated the same on a scale of 0 to 1. The average of the ratings assigned by the three rangers was taken as the value of forest protection status for the respective villages.

Data regarding the financial position of each village is presented in Table 1, which shows the year of the formation of the Village Forest Council, the amount extended as loan, along with the ratings of the VFC fund and forest protection.
<table>
<thead>
<tr>
<th>Year</th>
<th>S. No.</th>
<th>Name of TFP Village</th>
<th>Total Loan given</th>
<th>Rating of Loan Recovery and Recycling (0 to 1 scale)</th>
<th>Rating of Forest and Protection Regeneration (0 to 1 scale)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997–</td>
<td>1</td>
<td>Konapatti</td>
<td>375365</td>
<td>0.40</td>
<td>0.60</td>
</tr>
<tr>
<td>1998</td>
<td>2</td>
<td>Thethoor</td>
<td>344000</td>
<td>0.40</td>
<td>0.60</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>Krishnapuram &amp; Vasinagar</td>
<td>270400</td>
<td>0.50</td>
<td>0.50</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>Kaloothu</td>
<td>36600</td>
<td>0.50</td>
<td>0.50</td>
</tr>
<tr>
<td>1998–</td>
<td>5</td>
<td>M.Ayyampatti</td>
<td>290249</td>
<td>0.50</td>
<td>0.60</td>
</tr>
<tr>
<td>1999</td>
<td>6</td>
<td>Nallathathunaickanpatti</td>
<td>310000</td>
<td>0.50</td>
<td>0.60</td>
</tr>
<tr>
<td></td>
<td>7</td>
<td>Nagamanaickanpatti</td>
<td>304000</td>
<td>0.50</td>
<td>0.50</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>Mondikundu</td>
<td>464480</td>
<td>0.30</td>
<td>0.50</td>
</tr>
<tr>
<td>1999–</td>
<td>9</td>
<td>Srirangapuram</td>
<td>495000</td>
<td>0.50</td>
<td>0.60</td>
</tr>
<tr>
<td>2000</td>
<td>10</td>
<td>Thatchapatti</td>
<td>397000</td>
<td>0.50</td>
<td>0.70</td>
</tr>
<tr>
<td></td>
<td>11</td>
<td>Kunnuvarpatti</td>
<td>490000</td>
<td>0.70</td>
<td>0.60</td>
</tr>
<tr>
<td></td>
<td>12</td>
<td>Gunnuthupatti</td>
<td>390000</td>
<td>0.70</td>
<td>0.60</td>
</tr>
<tr>
<td>2000–</td>
<td>13</td>
<td>Rengarampatti</td>
<td>510000</td>
<td>0.70</td>
<td>1.00</td>
</tr>
<tr>
<td>2001</td>
<td>14</td>
<td>Vannathiparai</td>
<td>516000</td>
<td>0.70</td>
<td>0.80</td>
</tr>
<tr>
<td></td>
<td>15</td>
<td>Chithayagoundanpatti</td>
<td>450000</td>
<td>1.00</td>
<td>0.80</td>
</tr>
<tr>
<td></td>
<td>16</td>
<td>Nottampatti</td>
<td>396900</td>
<td>0.40</td>
<td>0.50</td>
</tr>
<tr>
<td>2001–</td>
<td>17</td>
<td>Aruguveli K.S.Puram</td>
<td>440000</td>
<td>0.50</td>
<td>0.80</td>
</tr>
<tr>
<td>2002</td>
<td>18</td>
<td>Sukkanodai</td>
<td>510000</td>
<td>0.70</td>
<td>0.80</td>
</tr>
<tr>
<td></td>
<td>19</td>
<td>Solaihevanpatti</td>
<td>500000</td>
<td>0.60</td>
<td>0.80</td>
</tr>
<tr>
<td></td>
<td>20</td>
<td>Nehrujinagar</td>
<td>725000</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>2002–</td>
<td>21</td>
<td>Errampatti</td>
<td>210000</td>
<td>0.70</td>
<td>1.00</td>
</tr>
<tr>
<td>2003</td>
<td>22</td>
<td>Panamooppanpatti</td>
<td>472900</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>23</td>
<td>Pommampatti</td>
<td>150000</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>2003–</td>
<td>24</td>
<td>Kuranguthoppu</td>
<td>210000</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>2004</td>
<td>25</td>
<td>Sanampatti</td>
<td>279200</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>26</td>
<td>Pandiyarajapuram</td>
<td>287500</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>27</td>
<td>Sathiravellalapatti</td>
<td>200000</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Keelamettupatti</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>GRAND TOTAL</strong></td>
<td><strong>9927794</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Income from fines, membership fees, and NTFP sales is almost negligible in all the villages and has not been shown. The main source of VFC funds is the amount given by the department to individual beneficiaries for alternative income promotion, which they pay back to the VFC concerned. Most of the loans are for purchasing hybrid cattle, because cattle rearing comes naturally to them, and if a village has 20 cattle, the milk procurement society gets started at the nearest road head. Hybrid cattle are not amenable to grazing and have to be stall-fed. They yield 10–12 litres of milk per day in comparison to 1–2 liters from indigenously bred cattle. In some cases artisans have taken loans to improve their profession. In Rangarampatti village, people have taken up iron file making, and as many as 102 men and women are gainfully engaged in that trade (Kaushal, 2004). The forest department has not imposed an alternative income generation activity and the people decide on their own. Almost all the successful VFCs have voluntarily imposed an interest rate of 1% per month on all the loans given by them. For instance, in Naurjinagar village only Rs 4 Lakhs was given from the project fund, but with 1% per month interest, the total amount has grown to Rs 7.5 Lakhs. As can be seen in columns 5 and 6 of Table 1, there is a direct correspondence between the VFC fund working and forest protection; this shows that once the people get alternate livelihoods they need not do woodcutting and consequently forest protection improves. In the villages where loan recovery is poor, the remaining forest dependents could not be provided with productive assets and they continue to indulge in the grazing of goats or the removal of firewood from the forest. In successful villages, the people received loans two times and are therefore able to engage themselves in other vocations. The social fencing of the forest area is complete in such villages and there is no reason why it should not sustain itself in future. The concept of Joint Forest Management hinges on social fencing, which means the local people agree through their local institutions and mechanisms not to indulge in grazing and woodcutting and to ensure that others also comply with it.
The VFC President handles the loan collection and only in case of default is persuasion by the VFC members and forest staff adopted, because most of the people do not have collateral securities and even when they do, the tedious legal process of loan recoveries cannot be pursued by the VFC President or Member Secretary. Since the Forest Ranger enjoys a tremendous amount of respect and fear in forest villages, his persuasive role, if enacted sincerely, is enough to keep people paying on their loans even in villages where formal financial institutions have failed.

The results are the poorest in 1997–98 villages, because the Project was launched hastily and initially loan recovery was not envisaged. Only in February 1998 was it announced that individual beneficiaries have to pay back the loan amounts to the concerned VFCs. The results are better in recent years due to better interest taken by a fresh set of Rangers in the latter years. Nurturant style of Forest Ranger is more successful in JFM (Rishi, 2003). Also, the Department personnel have learned the technique of fostering the VFCs in the latter years.

The efficient working of a VFC fund is reflected not only in forest protection but also in the improvement of the living standards of the people, as evidenced through the increase in the number of concrete houses, people switching over to the use of cooking gas from firewood, number of cycles and mopeds, etc.

Conclusions

1. In Joint Forest Management programs, forest regeneration and a profit yield from NTFPs will take years; hence the people have to be compensated for the lost opportunity cost of grazing and illicit removal to ensure effective social fencing of the forests. If properly applied, microfinance is a potent tool in this regard.

2. In Joint Forest Management Program villages, forest regeneration and protection show a direct correspondence with the working of Village Forest Councils as microfinance institutions.
3. Microfinance is more successful if it is launched as a component of a development package relevant to the people and the area.

4. In forest villages, the Forest Department has more interaction and rapport with the people. Hence any development initiative including microfinance implemented by the forest department has a better chance of success.

5. The post-Project sustainability of the program is assured in all such villages, where microfinance has been well established, because the people need not revert to grazing and illicit woodcutting and can pursue alternative livelihoods through microfinance. Also, the Village Forest Councils in such villages acquire more popularity and authority, which further helps in forest protection.

Notes

1. Canopy density indicates the extent to which sunlight is prevented from falling on the ground by tree crowns. Canopy density of 40% and above is taken as dense forest whereas 10–39% is taken as degraded.
2. Forest areas in all lands statutorily classified as forest, though they may not necessarily bear tree cover.
3. Forest cover is all lands with a tree canopy density of more than 10%, though they may not be statutorily classified as forestland.
5. The panchayat is the lowest tier of local self-government in India.
6. NTFPs are goods of biological origin other than wood that are derived from the forests. These include fruits, nuts, tubers, mushrooms, essential oils, medicinal herbs, spices, resins, and gums.

References


Journal of Microfinance


Microfinance and Rural Development

A Long-Term Perspective

Henk A. J. Moll

Abstract: The long-term perspective on microfinance starts with a discussion of three central issues: first, views and policies, with two opposing views: “credit for target group” and “pushing the financial frontier”; second, the performance of microfinance institutions measured via two objectives: outreach and financial sustainability; third, microfinance and rural development. This latter issue is approached through analyses of the effects of financial services on rural households and analyses of long term national financial development. Both micro and macro studies show positive effects of an expansion of savings and lending services, financial deepening. The negative side of financial deepening, the apparently unavoidable occurrence of bank insolvencies, is also reviewed. The concluding section argues that the microfinance sector should be guided by “stability and expansion”: stability to withstand shocks and to maintain the relationships established between rural households and microfinance institutions, and expansion to include more people within the financial frontier.

There have been government policies on the role of microfinance in the rural development process for more than four decades. In the 1960s and 1970s, the policies focused on the provision of agricultural credit as a necessary support to the introduction of new, more productive agricultural technologies...
that would simultaneously improve farmers’ incomes and feed the
nation. Later, the focus broadened to include credit provision to
the rural population engaged in other enterprises, such as trade,
handicrafts, and small-scale industry. Presently the international
development agenda is dominated by the Millennium Goals, with
poverty eradication heading the list of goals, and with microfi-
nance firmly linked to this goal.

The implementation of rural credit policies through financial
institutions has been debated internationally. What triggered this
debate was the publication of the “Spring Review,” an evaluation
of small-farmer credit programs by USAID in the 1970s (Donald,
1976), which made available world wide experience on the achieve-
ments and failings of credit programs supported by governments
and donors. In the 1970s, the discussion shifted from “lack of cap-
ital” and consequently “the need for cheap credit,” to “cost-covering
interest rates” that would enable financial institutions to continue
to operate (Adams & Von Pischke, 1992). Later, the discussion
widened to include imperfect information as one of the distinctive
characteristics of rural credit markets (Hoff & Stiglitz, 1993) that
leads to insight into the screening, monitoring, and enforcement
problems that rural microfinance institutions face. Presently we see
a sort of consensus about the operations of microfinance institutions:
they should strive towards both outreach and financial sustainability.

The debate on microfinance largely assumes a micro perspec-
tive, with a short- to medium-term horizon. From this perspective,
assumptions about the behavior of farmers, the rural population,
or the poor, and about the constraints these groups face lead to
policies to be implemented by financial institutions. These institu-
tions measure the effects of access to finance on their target group
after a couple of years. Finally, the objective to become financially
sustainable is to be reached in a few years’ time. Long-term analyses
of the role of microfinance institutions in rural development are
scarce. Mellor (1966) and Timmer (1988) deal in macro terms with

Henk A. J. Moll is associate professor in the Development Economics Group of Wageningen
University, the Netherlands. Email: henk.moll@wur.nl
the role of the agricultural sector in national development and discuss the transfer of people and capital from the agricultural (or rural) sector to the services and industrial sectors in the urban areas. They do not, however, discuss the mechanisms for such a transfer of capital. McKinnon (1973) and Shaw (1973) deal explicitly with the development of the financial sector within economic development and plead for financial liberalization to enable savings to be mobilized, followed by an efficient banking system that lends to investors with expected high return investments. More recently, financial development and the links with economic growth and with poverty reduction have been discussed by King and Levine (1993) and Li, Squire, and Zou (1998). Though these authors make no distinction between the rural and urban sectors, their analyses are relevant for the rural sector too.

The three issues introduced above, views and policies regarding microfinance; the operations of microfinance institutions; and the position of microfinance in rural development, are linked. In this article I will discuss these issues and then draw overall conclusions regarding the long-term role of microfinance institutions in rural areas.

The reason for focusing on rural microfinance is because this differs from microfinance in urban areas in several ways. The most obvious difference is that the dominant economic enterprise in rural areas is agriculture, with known seasonality and unpredictable climatic conditions. This results in similar cash flow requirements for many households and in co-variant risk. Additionally, in many rural areas the population is widely dispersed, which means high transaction costs for clients and possibly low volumes of services per microfinance location. These aspects require specific attention from microfinance institutions operating in rural areas, in addition to the general microfinance problem of handling financial transactions for the small sums low-income clients require.
Nowadays microfinance enjoys widespread support from governments, development agencies and nongovernmental organizations. The reasons for this support are, however, diverse, and the term microfinance is linked with very different views and assumptions about the relationship between finance and development. Various authors have attempted to classify these views. Krahnen and Schmidt (1994), for example, distinguish four views by tracing development thinking from the 1950s: capital as the engine for economic growth, financing specific target groups, the focus on financial systems, and, from the 1990s onwards, the insights from the new institutional economics emphasizing the dominant role of institutions in development and with specific views on the peculiarities of financial institutions. Robinson (2001) distinguishes two approaches to microfinance: the poverty lending approach and the financial system approach. Different views or approaches have consequences for the policies shaping the environment of microfinance institutions, the financial services provided, and microfinance institutions themselves. Below I will discuss two opposing views and their resulting policies. The consequences for microfinance institutions and for the role of microfinance in rural areas will be discussed in the sections that follow.

The two opposing views are: (a) credit for target group and (b) pushing the financial frontier. Based on Robinson’s poverty lending approach, the first view is defined in a wider sense, with the poor being replaced by any target group. The phrasing of the second view echoes Von Pischke (1991), who refers to the financial frontier as the dividing line between the established formal financial institutions with their large-scale business and private clients, and the majority of the rural population without access to formal finance.

Credit for target group is the oldest view and can be summarized as follows: A specified group of people lacks the capital to undertake certain enterprises that would lead to development. The group of people and their enterprises can be specified to a greater or lesser degree: small farmers, fishermen, market women, or
small-scale entrepreneurs with their respective enterprises in agriculture, fishing, trade, and industry. The specification of development too may differ: improved health, food security, poverty reduction, or improvement in general welfare. The perspective on the financial environment of the specified group is limited: the only way the target group can access credit is through private moneylenders whose interest rates are unacceptably high and would nullify any positive effect of the credit.

It was this view that led many governments in the 1960s and 1970s to provide targeted credit with or without support from donors; for example, to enable small farmers to use modern production technologies, such as hybrid seeds or imported dairy cows. This credit would increase their incomes and provide enough and sufficiently diversified food for the domestic market. The credit for target group view is still widespread and nowadays is generally targeted at “the poor,” in line with the international attention for poverty eradication. The micro-credit summit (not microfinance summit) held in Washington in 1997, for example, advocated providing credit to the world’s poor to enable them to shed their poverty. Barrett (2003) mentions targeted microfinance (together with land reform, targeted school meals programs, and subsidies for agricultural inputs) as one of the “cargo net policies” that can lift people out of poverty. In short, the credit for target group view is based on the following two central assumptions:

1. The factor constraining development is capital.
2. The target group is unable to mobilize this capital under acceptable conditions.

The policy implication of these assumptions is straightforward: lend capital to the target group.

The pushing the financial frontier view developed in the 1970s to the 1990s from an increasing understanding of the financial capabilities of low-income rural households and the existing formal and informal financial institutions in rural financial markets. According to this view, rural households are economic units that make daily decisions about production, consumption, and the
resource base under conditions that are characterised by (a) seasonality that rules rural economic life, (b) uncertainty about future production and consumption requirements, and (c) income levels that are generally not far above subsistence. The decisions are reflected internally in the size and composition of the household’s assets and in the enterprise choice, and externally in the household’s participation as buyer and seller of financial assets in rural financial markets (Moll, 1989).

This sharper focus on rural households was accompanied by insight into the rural financial markets (Von Pischke et al., 1983), defined as the totality of relationships between buyers and sellers of financial assets who are active in rural economies. Rural financial markets are characterized by having a range of institutions that are usually divided into formal institutions, such as state or private banks, semiformal institutions such as cooperatives and NGOs involved in financial services, and informal institutions, ranging from private moneylenders and traders to relatives and friends and groups. Despite the wide range of institutions present, individual rural households generally have access to only some of the institutions and the products these institutions provide, as rural financial markets are highly segmented (Moll, Ruben, Mol & Sanders, 2000).

New, comprehensive explanations for the observed segmentation in rural financial markets have been offered by Bell (1988), Hoff and Stiglitz (1993), and others. These focus on the information asymmetry between lender and borrower as a central issue in credit provision, with as consequences the absence of credit relationships where information on borrowers was perceived as insufficient, and the failure of government-supported financial institutions if these information asymmetries were neglected.

The insights gained firstly contradict the two assumptions of the credit for target group view: (a) low-income rural households can and do save both in kind and in financial assets through a variety of informal arrangements, and (b) the existing savings capacity in rural financial markets refutes the assumption that capital as such is the major factor constraining rural development. Secondly, the insights into rural households and the rural financial market
institutions revealed the limitations of the informal financial institutions in mobilizing and storing savings, dealing with co-variant risk, and transforming small, short-term savings into larger loans of medium-term duration. In this way, these insights revealed an unfulfilled demand for financial services that formal institutions can address more readily than informal ones:

1. Mobilizing savings together with providing unrestricted withdrawal.
2. Short-term lending for working capital, as and when required.
3. Medium- and long-term lending for investments.

The overall conclusion was that rural households would benefit from the presence of formal financial institutions with services adjusted to their capabilities. The policy implications are twofold: (a) government policy attention for rural finance was vindicated, though not policies with the aim to provide capital, but policies to enable formal financial institutions to intermediate between savers and borrowers; and (b) policies should encourage financial institutions to participate in pushing the financial frontier to include new, low-income rural households as their clients, by tackling the information problem through innovative screening, monitoring, and enforcement procedures.

The Performance of Microfinance Institutions

The views and policies described above translate into the operations of microfinance institutions and thereafter into the assessment of their performance. The credit for target group view results in microfinance institutions that focus on providing loans, generally in specified quantities and possibly provided in kind and earmarked for a specific enterprise. These loans are provided to the defined target group, to be used to attain the specified development goals. The loans are generally at subsidized interest rates, as the target group is poor—in whatever terms poverty is defined. The assessment of the performance initially focuses on the number of loans provided, or the number of people who have received one or more loans,
because this number of people is assumed to reach the anticipated development goal. The latter assumption can be tested through impact assessment, for which elaborate methodologies have been developed. This operational approach can be summed up as “supply leading finance.” Adams and Von Pischke (1992) are among those who have analyzed this approach in detail and shown that government interference adversely influences lending and causes the basic economics of banking to be bypassed. The consequences of these failings have been that microfinance institutions incurred losses and sooner or later ceased operating—but not before destroying repayment morale in the population and giving bank staff wrong ideas about banking. Most importantly, the target group was only partly and temporarily reached, and after the demise of the financial institution was again left without financial services.

Two developments in the 1980s and 1990s changed the situation. The emerging pushing the financial frontier view showed the importance of permanent financial relationships for rural households, and thereby the permanence of financial institutions. The “cost-covering interest rates” for microfinance institutions (instead of the subsidized interest rates) advocated by Adams and Von Pischke were a major step towards achieving such permanence. Financial sustainability became part of the microfinance discussion and Yaron (1992) made this operational by devising the subsidy dependence index with two levels of achievement: operational sustainability and financial sustainability, whereby the latter indicates the total independence from subsidies. New microfinance institutions took on board the increased insight and the attention for financial sustainability and used new approaches to reach people who had previously lacked access to institutional financial services.

The emergence and expansion of microfinance institutions was greatly facilitated by a second development: financial liberalization. This meant a reduced role for government in the allocation of capital, less interference with banking, and thus new opportunities for banks and microfinance institutions to engage in the central function of financial institutions: intermediating between savers and borrowers. Less interference with banking generally meant the
abandonment of interest rate control on savings and credit, and that enabled the microfinance institutions to pay attention to financial objectives.

By the end of the 1980s, case studies had become available on microfinance institutions that had succeeded in reaching low-income households with savings and credit services (Moll, 1989; Patten & Rosengard, 1991; Yaron, 1992) and that showed a wide variety of organizational structures and operations. These case studies provided the material for comparative analyses and the emergence of “best practices” in microfinance literature. These best practices offer a wealth of experience, but as the description of the background that shaped the specific institutions is generally limited, these best practices need to be tested, assessed, and adapted to the individual circumstances.

Presently there seems to be consensus on at least the objectives of microfinance institutions: outreach towards low-income people and financial sustainability. Given these two objectives, microfinance institutions must deal with two central issues in their day-to-day operations:

(a) the information issue: how to establish borrowers’ ability and willingness to repay; and
(b) the cost issue: how to handle cost-effectively the small financial transactions with a short duration generally required by low-income people.

The first issue requires screening, monitoring, and enforcement procedures that comply with the specific circumstances of low-income people and that deviate widely from the usual banking practices. The second issue requires operating with transaction costs (including information costs and risk) that necessarily lead to interest rates that are well above commercial bank rates, but that are nevertheless still competitive and thus attractive for the microfinance institution’s clients.

Microfinance institutions generally experience a trade-off in their operations between the two objectives: a focus on the somewhat better known clients who require somewhat larger loans eases
the cost issue and brings financial sustainability closer. This, however, leaves the smaller clients outside the financial frontier. Conversely, a focus on new clients with small financial capacities who require small loans does bring new clients inside the frontier, but also brings more costs and risk due to an initial shortage of information on the new clients. The consequence is that it is more difficult to achieve financial sustainability. It is in this trade-off between the two objectives that the two views sketched in the previous section have maintained their roles up until today. The *credit for target group* view complies directly with the outreach objective, as outreach can be made operational in terms of reaching a specific target group. Successfully reaching the target group with loans, possibly measured through impact studies, may easily provide a justification for slackening the financial sustainability objective by accepting “structural subsidies” or by postponing the date for achieving sustainability. The *pushing the financial frontier* view offers more opportunity for a better balance between the two objectives, as financial sustainability is required to keep low-income people inside the financial frontier. The resulting greater emphasis on financial sustainability may, however, slow the flow of new people across the frontier.

The balance between the two objectives often remains hidden in management decisions on organization, operations, and the financial products offered. The consequences of these decisions are, however, reflected in the annual accounts; whether or not these are considered acceptable depends on the views of the governing body of the microfinance institution.

**Microfinance and Rural Development**

No studies have been done on the long-term effect of microfinance, most likely due to the relative youth of many microfinance institutions and the generally still limited coverage within their areas of operation. However, an exploration of studies on the effects of microfinance on rural households and studies on the role of finance at national level provides indications of what the long-term effect might be. As a start, an overview of the position of a
The potential demand for formal financial services by the rural population is depicted by the triangular segments. The population in the lowest income quintile has a demand for saving services and short-term credit. Higher income quintiles require more types of services and a larger volume of these services, with the volumes measured along the Y-axis. The position of commercial banks is on the left: serving the highest income groups with a range of services. Microfinance institutions focus on the population in the lower quintiles and offer a limited range of services. Over time, successful microfinance institutions will reach a steadily increasing share of the rural population and most likely will expand the range of services offered. Commercial banks may also expand their presence by offering services to somewhat less well-off people. In the long run we can envision a gradual change from complementarity to competition between the two types of financial institutions.
The effect of microfinance on individual low-income households has been studied through microeconomic impact studies. Three aspects are generally highlighted. Firstly, there is an increased capacity to deal with risk through the withdrawal of savings or obtaining credit in the case of an emergency. This may mean that productive assets (machinery, inventory, land, livestock) need not be sold during an emergency and thus that the flow of income is not interrupted. Secondly, there is an improved management of consumption requirements over the year, to maintain adequate levels of food intake (Pitt & Khandker, 1998). This is of major importance, as labor is often the main resource of low-income households. Thirdly, opportunities to invest in productive enterprises increase. These increased capabilities of rural households to produce, consume, and invest may be reflected only partly in the actual credit and savings relationships with microfinance institutions, because reliable access to microfinance forms a potential that can be tapped if and when required. This potential may, for example, mean that the household’s own resources will be utilized more fully for production, with access to microfinance being relied on if there is an emergency.

Extrapolating the effects of microfinance on individual households to rural areas in total gives some idea of the overall consequences. The increased individual capacity to deal with shocks reduces the effects of a co-variant shock for the rural population as a whole, at least when a substantial proportion of the population is within the financial frontier. Further, increased saving in financial assets means a shift away from storing wealth in assets with zero or low productivity. The financial savings become available for investment in agriculture, in agriculture-related trade and processing, and in a host of other enterprises with expected benefits for technological progress and rural employment. In a later stage, when remunerative investment opportunities in rural areas become limited and the volume of savings overtakes the volume of credit, excess capital can be channelled via microfinance institutions and the national banking system to urban areas where large-scale industries and services offer extensive investment opportunities. In this
way, rural savers will benefit from those investments and the children of the savers might find the urban jobs they are looking for.

The above process of increased saving in financial assets followed by intermediation by the banking system and investment by borrowers has been studied extensively at the national level. In their theory of financial development, Shaw (1973) and McKinnon (1973) describe this process as financial deepening. This theory was developed in the 1960s when governments used the banking system to support investment in their priority sectors (often industry), thereby bypassing efficiency considerations in many cases and neglecting domestic savings. Since the 1980s, many countries have shifted policy from financial repression towards financial liberalization, or from shallow finance to deep finance.

The relationship between financial development and economic growth at the national level has received renewed attention now that databases covering many countries over prolonged periods have become available. In a cross-country sample of 80 countries over the period 1960 to 1989, King and Levine (1993) found a positive relationship between financial depth, measured through four indicators, and economic growth. They also showed that financial development has predictive power for future growth, indicating a causal relationship between financial development and growth. Khan and Senhadji (2000) reviewed methodological issues regarding the relationship between financial development and growth and applied these insights to a data set covering 159 countries over the period 1960–1999. Their results are in line with the findings of King and Levine, and they conclude that financial depth is an important determinant of economic growth.

The analysis of the relationships between financial development and economic growth has been expanded to include poverty. Li, Squire, and Zou (1998) studied income inequality in a large data set from 112 developed and developing countries for the years 1947–1994. They found that financial deepening helped reduce inequality and raise the income of the lower 80% of the population. Honohan (2004) gives a recent overview of financial development, economic growth, and poverty and concludes that
finance-intensive growth is empirically associated with lower poverty ratios.

The discussion of financial deepening, economic growth, and poverty cited above considers these issues at the national level. However, the central tenet of financial deepening, a shift to saving in financial assets followed by intermediation by the banking system and investment by borrowers, has direct relevance for microfinance in rural areas, since providing rural households for the first time with access to savings and credit through local intermediation is the core of financial deepening. The effects of financial deepening go beyond the individual links between microfinance institutions and households, because a reduction of the capital locked up in poorly productive assets and the availability of capital for new, trustworthy clients with productive uses fundamentally affects economic relationships in rural areas. Rajan and Zingales (2003), for example, state: “a healthy financial system can be a powerful anti-monopoly tool, providing the lubrication for the emergence of competitors that can undermine the power of incumbent firms, and the means for poor households and small-scale producers to escape the tyranny of exploitative middlemen.” Microfinance thus positively affects economic life in rural areas; expanding outreach, enlarging the microfinance oval in Figure 1 to include a substantial proportion of the rural population, will make these effects more visible.

The review of long-term financial development at the national level also provides a perspective on a potentially negative side of financial deepening: the occurrence of bank insolvency. Caprio and Klingebiel (1996) give an overview of bank insolvencies in 69 countries since the late 1970s. The list includes countries from all five continents and covers industrialized, transitional, and also developing countries. A number of countries saw more than one crisis in the period covered. The crises involved government banks, private banks, savings banks, and rural banks and ranged from a few banks to the entire banking sector in a country. The costs or losses ranged from less than 1% of GDP to as much as 55% of GDP and were borne by taxpayers, savers, or a combina-
tion of both. The factors cited as reasons for the crises range from macroeconomic factors, through weak incentives for banks to act prudently, to lack of managerial skill and fraud.

The widespread occurrence of national bank crises means that viewed from a long-term perspective, financial institutions are at risk irrespective of current apparently stable situations. For microfinance institutions this risk has special dimensions. A possible collapse of a microfinance institution in a national banking crisis means a loss of savings for their low-income clients, and this is the more damaging as a financial crisis is usually followed by a period of economic recession. Less visible, but with similar grave consequences, is the loss of the relationship-specific social capital built up between the microfinance institution and clients. This social capital cannot be replaced without again overcoming the information gap and building up new confidence between financial institution and clients—a costly affair that will take years. Finally, in a national banking crisis the government’s priorities are usually with the larger commercial banks. These banks are more likely to be rescued in the name of national interest and with taxpayers’ money than the smaller, less visible, rural microfinance institutions.

The exploration of microfinance and rural development shows a potentially positive impact of microfinance institutions on rural economic life, as they are the primary vehicles for the process of financial deepening in rural areas. This process is not without risk, however, as a failure of a microfinance institution, whether induced by a national bank crisis or by the institution’s own actions, will result in a loss of both financial capital and the relationship-specific social capital built up between institution and client.

**Discussion**

The foregoing review of views and policies on microfinance and the operations of microfinance institutions vis-à-vis the position of microfinance in the long-term process of rural development leads to the conclusions given below.
First, the generally accepted objective of microfinance institutions—financial sustainability, or independence from subsidies—seems to be outdated. It was certainly relevant in the 1980s and 1990s when microfinance institutions were struggling into existence. Nowadays, many microfinance institutions are operational and the established relationships with clients deserve to be safeguarded. This is the more relevant as history has shown that bank crises are the rule rather than the exception. The financial objective must therefore be raised towards financial stability, defined as the ability to withstand financial shocks, whether the shocks come from inside due to the adverse conditions of clients or from outside, transmitted through the financial links with the national economic and financial sectors. Financial stability must be approached from two sides: diversification of the loan portfolio to minimize the negative effects of co-variant risks facing the rural population, and building up reserves. The latter means making a profit, not as an objective as such, but as a requirement for continuation.

Second, outreach in the sense of reaching a more or less narrowly defined group is, in the long run, not justified. First, a focus on one group of clients makes a microfinance institution vulnerable, thereby endangering financial stability. Second, a focus on one type of clients overlooks the indirect positive effects of wider access to financial services for the rural population as a whole. Therefore, the objective that is beneficial for all rural households in the long run is expansion towards new clients and the provision of new financial services. Profit comes in again for two additional reasons: profitable microfinance institutions are more likely to be able to draw capital from the national market for expansion, and profit is required for experiments to include new groups of clients and to develop new financial products to serve old clients better.

The two opposing views on microfinance, credit for target group and pushing the financial frontier can be united into one new perspective for policy formulation: stability and expansion. From this perspective the first priority is to achieve financial stability to maintain what has been achieved; the second is to expand towards new clients. It is interesting to note that from a long-term perspective,
there is no trade-off between stability and expansion, as financial stability is a necessary condition for an expansion of services.

Government policies that are based on stability and expansion must support microfinance institutions in two ways. First, they must pass legislation that allows microfinance institutions to mobilize savings, to provide credit, and to undertake other services, such as insurance and money transfers. This combination of services results in economies of scale and scope, which strengthens the financial position of individual microfinance outlets and thus allows geographical expansion and financial deepening in rural areas. Second, prudent regulations are required that buttress the financial stability of microfinance institutions in their specific circumstances.

Notes

This article is based on a paper presented at the International Seminar on BRI Microbanking System, Bali, Indonesia, 1–3 December 2004.

1. Impact assessment may include an assessment of the effect of credit on clients as well as a study of the appropriateness of credit services.

2. (1) The ratio of liquid liabilities (M3) of the financial system to GDP; (2) the ratio of deposit money bank domestic assets to deposit money bank assets plus central bank domestic assets; (3) the ratio of claims on the nonfinancial private sector to total domestic credit; and (4) the ratio of claims on the nonfinancial private sector to GDP.

References


Journal of Microfinance


Data Standards for Connecting to Commercial Sources of Capital

James Dailey

Abstract: The importance of data interchange between commercial sources of capital and the microfinance sector is generally acknowledged, if not well detailed. But microfinance institutions (MFIs) and commercial sources of capital often need a different depth and breadth of information. As the industry grows and accesses more commercial capital, there is a need to enable standardized reporting from multiple MFIs to multiple sources of capital, rather than a proliferation of one-to-one reporting relationships. IT professionals and managers of microfinance institutions need to recognize this need and push vendors and industry associations to agree on specific standards of data elements, quality, and transmission protocols. This paper aims to provide the reader with a grasp of the issues involved and to recommend a sample set of data standards for MFIs to use in communicating with commercial sources of capital.

Ongoing financial innovations in the microfinance market—equity investments, portfolio securitization, and credit facilities—demand comprehensive scrutiny of microfinance institutions (MFIs) to ensure that their operational systems meet the requirements of such financial instruments. In addition, careful attention must be paid to the value and the quality of the data MFIs produce.
According to an article about financial transparency published online by the World Bank’s Consultant Group to Assist the Poor (CGAP, n.d.),

Only a handful of microfinance providers currently include enough information to comply with International Financial Reporting Standards (IFRS) and industry-specific disclosure guidelines. Industry-specific disclosure requires certain information in addition to that required by IFRS to permit a fair assessment of the profitability and asset quality of microfinance operations.

The importance of enabling data interchange between commercial sources of capital and the microfinance sector has been underscored in multiple forums. The microfinance industry needs an estimated US$300 billion to grow to scale. However, this figure may be too conservative, given that approximately three billion people globally do not have regular access to financial services. That number continues to grow.

An analysis of the industry’s needs by a group of funders and microfinance practitioners shows three related obstacles (personal communication, July 28, 2004):

1. Lack of diversified sources of capital for microfinance investing.
2. Lack of sufficient market infrastructure to facilitate efficient information and resource flow.
3. Lack of business expertise and capacity among leading MFIs required to reach scale.

From these concepts, we can derive broad requirements:
• Diversification of portfolio financing by MFIs requires more sophisticated segmentation of the loan portfolio and loan servicing concepts, better data for regulatory agencies to allow

James Dailey is the Technical Project Manager for Innovations in Microfinance at the Grameen Technology Center, an initiative of GFUSA located in Seattle, WA. Email: jdailey@gfusa.org
registered deposit taking, and more customer data to enable the modeling of the risk profile of any derivative securities.

- The market infrastructure factors that will enable resources and information to flow are the ability to send information, the need for data to be understood, and the need to create norms, audit standards, and mechanisms to comply with the requirements of rating agencies.

- Organization-wide norms, expressed through systems, are a key part of operational capacity. These systems must also have the flexibility to adapt to changing conditions.

This paper proposes an overall strategy to meet the emerging need for data standards in the microfinance industry. These standards should, nominally, leverage large parts of the existing financial services standards with some important caveats. However, the microfinance industry, precisely because it deals with the non-banked, does not always have the same level of information that is found in the formal sector.

Data standards should cover the following areas:

- Financial reporting, such as those embodied in the Mix Market platform.
- Connections to commercial capital markets (e.g., the securitization of portfolio).
- The information needs of credit bureaus and regulatory players.
- Remittances and external payment systems.
- Remote transactions and third-party transactions.

The remittance market, which is currently estimated at US$150 billion annually, is particularly interesting to note as a potential source of capital.

Third-party transactions include connections to global transactional systems such as point of sale (POS), automated teller machine (ATM), credit card, or ACH transactions (an inter-bank automated clearinghouse system). Such transactional networks typically operate through agreements with regulated banking entities in each country, a fast growing market globally. Currently, these
networks are absent in microfinance operations in rural environments, but this seems to be mostly a function of connectivity.

Other reporting standards not covered in this document include those used by credit bureaus and other regulatory or standard financial documents used to evaluate an organization’s strength.

**Microfinance Open Source and Establishing Standards**

The microfinance open source project (Mifos) developed by Grameen Foundation USA focuses on integrating data standards and protocols for financial transactions into an operational system. To maximize the effectiveness of the system and to move towards common standards, input from others in the industry is critical, particularly because one effective strategy for pioneering new standards is to encourage partner institutions to adopt them.

**Intended Audience**

The audience for this paper is composed of those concerned with the technical interface between the back-office systems used by microfinance institutions and those used by banking entities. Vendors of back-office systems for MFIs and the Mifos software itself will benefit from having specifications from these important data flows.

**General Approach**

In the context of promoting financial instruments and the information requirements to enable the aforementioned financial mechanisms, the intent of this report is to look as broadly as possible. Requirements for data standards should reflect current trends away from legacy systems in the commercial sector, with their strong systems-in-isolation approaches, and toward “marketplace” approaches, where interoperability and data exchange are key drivers. There is probably little need in the microfinance sector to be backwards compatible with legacy systems in the commercial sector.
There are numerous sources which can be used to determine the information requirements for back-office systems of microfinance institutions. These include work on portfolio management systems and financial accountability funded by the World Bank. As noted by Dailey and Parekh (2003),

One of the most important kinds of information exchange conducted at microfinance institutions is basic financial reporting. Many different kinds of financial reports are needed for the effective functioning of an institution. . . . These reports can be intended for a variety of audiences, and encapsulate different subsets of data for institutional performance and operations.

The financial reports typically used by MFIs include the following:

- **Teller/operational reports** guide the teller or loan officer in transactions.
- **Portfolio reports** provide qualitative analysis of the payment performance of a loan portfolio, including such indicator calculations as loan aging, portfolio-at-risk, and credit scoring.
- **Financial statements** are the most common documents, including balance sheets and income statements.
- **Cash flow reports** provide monitoring data for actual and predicted cash flows; they are used in evaluating performance and forecasting problems.
- **Summary reports** provide aggregate reports for upper management to guide institutional strategy and planning.

While useful to specific audiences, these reports focus only on a high-level data summary. The financial instruments being considered by GFUSA and the MFIs, however, focus more on detailed portfolio transactional data.

For the commercial banking sector and other sources of capital, the format and type of data needed is dictated by its use. Whereas in equity investments, only summary data validating the
strength of the organization and transparency about weaknesses is necessary, for portfolio securitizations, more complex data is required. To date, financial deals with microfinance organizations have not demanded changes to the MFI-customer relationship. Therefore, while the financial paper corresponding to that segment of the portfolio may be traded (as in the case of ICICI Bank of India’s purchase and subsequent sale of a segment of the portfolio of a leading MFI to another Indian bank), the actual “loan servicer” does not change. The requirements for the bank in these types of deals, according to interviews conducted in August 2003 with ICICI, will involve the following components:

• Elements of risk within the portfolio by segment (identifying diverse sources of risk, such as geographic focus, industry-specific or MFI-management-specific issues, etc.).
• Determinants of that risk, including loan size, terms, and loan purpose.
• Current loan terms and loan repayment history.

These elements determine how the funding bank would ideally stratify the portfolio into risk-based segments and are thus the basics for determining the appropriate pricing for the overall loan portfolio. Until such pricing becomes outsourced to credit rating agencies and similar entities, or there is sufficient industry history, individual deals will require a willing bank to look at the risk factors and determine their pricing. Grameen Foundation USA and Grameen Capital India could have a key role to play in determining how these types of data formats are generated and evaluated.

An article in the *Deloitte and Touche Journal* (Caplan, 2001) points to three areas of data for the commercially traded loan:

1. Pedigree information—who issued the loan originally, under what facility, etc.
2. Pricing information—how one should value the loan (largely automated through algorithms in developed markets).
3. Back-office information—how a third party can service the loan and what information is transferred to enable that.
For microfinance, the third area of loan servicing is now underway in limited areas. In contrast, the second area is still unclear to the markets, and the first is relatively easy, since few deals have happened. The second area deserves the most attention because this is where the microfinance industry is the least standardized, and the availability of such transactional data sets is also unclear, at best.

With regard to loan servicing, it is generally held that only the original institution has the relationship and the operational reach to service the customer. Actual field conditions are proving otherwise. Currently it appears true that only institutions with relatively similar methodologies, rotating staffs, and similar geographic outreach can actually do loan servicing for another MFI or, through acquisition, easily absorb the other MFI’s customer portfolio. Although the industry is a long way away from offering investors clear options for loan servicing, it is interesting to note that this misconception is already giving way to the real needs of the industry.

**Reporting versus Transactions**

As noted previously, banks with a typical lender relationship with a microfinance institution are interested in standard financial statements, such as balance sheets, profit and loss statements, cash flow reports, and portfolio-at-risk ratios. They may have no interest in the transactional data that underpins the portfolio-at-risk calculations but will be interested largely in the debt-to-equity ratios and solid cash flows from external sources. These relationships do not explicitly recognize the asset valuation of the portfolio. Commercial sources of capital seeking to work with MFIs in the same manner as a typical bank should structure the deal so that either the asset of the loan portfolio is used as collateral or the asset is effectively purchased, as happens in a securitization deal.

According to Jennifer Meehan (2004), director of GFUSA’s Capital Markets Group, “In the largest individual microfinance securitization to date, ICICI paid US$4.3 million for 25% of SHARE’s loan portfolio. SHARE’s cost of funds was approximately
8.75%, below the 12 to 13% it has traditionally paid borrowing from commercial banks, including ICICI.”

It is clear that the ability to use the MFI portfolio as a readily priced asset class requires a greater degree of reliability and accuracy for the portfolio data, frequent or on-demand reporting on portfolio quality, and better transparency with regard to debt servicing by the customer. Those standard financial practices do not necessarily have to be specific to the microfinance industry, but they must exist within it. They must also be enforced via commonly accepted mechanisms, such as true ratings agencies. The rating agencies must be bonded and must be able to accurately assess the microfinance portfolio through meaningful audits and analysis.

An important step toward data standardization in the microfinance industry is the creation of a set of data standards that are universally accepted and understood by all MFIs.

**Developing a Data Standard**

The next section sets out a high level data standard. The first part is concerned with the data elements that one would expect to find, and the second part covers data protocol issues. The data standard is given from the perspective of a flat file transmission.

The rationale for this is that in most electronic data interchanges, the database is flattened out to provide a simple hierarchy of the multidimensional data, rather than sending a multitable database.

The data elements should include annotations, which are meant to magnify a particular grouping of data elements. For example, the data element “extend” is a common annotation for XML-based standards and indicates those places in the file format where additional data elements can be added. Determining optional or required elements and specifying data types are both part of the standards settings and part of the implementation.

The process imagined for setting this data standard in the microfinance industry is, briefly:

1. Determine minimum requirements of a specific bank.
2. Sketch out overall sector requirements (this document).
3. Review the document (performed by the range of institutions that may be involved).
4. Develop a prototype solution between two entities.

Borrowing from Fannie Mae's approach to data standards, the Mifos project envisions a data dictionary, a conceptual data model, and a conceptual XML schema.

**Data Dictionary**
The data dictionary will present the portfolio data standards in a list form and will build on the data list below. It will include information for each data attribute, including standard business names, screen names, definitions, data types and lengths, allowable values, and XML names.

**Conceptual Data Model**
The conceptual data model will show the relationships between groups of data, such as the recursive loan details and the client information to which those loan details relate.

**Conceptual XML Schema**
The Mifos XML schema for this data set type will consist of references to the specialized microfinance schema (groups, methodologies) and standard financial data. It will essentially capture the data dictionary in XML with attribute and element names, enumeration values, and definitions.

**Data Elements**
Data elements can be described as having four segments:

1. *Metadata*—annotations and fields describing the data set, its origins, and general information about the institution.
2. *Customer data*—basic determinants of risk with regard to the profile of the customer.
3. *Account data*—information about the product (e.g., loan) provided to the client.
4. *Account transactions*—the core of the data set, which describes the payments and relationship to arbitration values for being “on time.”
Protocols for Data

Beyond the basic data format, there are many questions about how data will be generated within the system. In the formal financial sector, the relationship between transactional data and actual accounting events is generally understood; knowledge of the microfinance sector, however, is limited. Data quality includes the concepts of reliability according to a set of financial operational standards.

Table 1. Data Elements

<table>
<thead>
<tr>
<th>Metadata</th>
<th>Customer data</th>
<th>Account data</th>
<th>Account transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Data set information:</td>
<td>Customer (recursive):</td>
<td>Loan (recursive):</td>
<td>History of loans</td>
</tr>
<tr>
<td>Number of records</td>
<td>Identifying information—may be stripped out (Name, Address, ID)</td>
<td>Loan Purpose</td>
<td>Percentage of payments</td>
</tr>
<tr>
<td>Date or report</td>
<td></td>
<td>Loan amount</td>
<td>previously on time</td>
</tr>
<tr>
<td>Annotations</td>
<td></td>
<td>Extend</td>
<td>Extend</td>
</tr>
<tr>
<td>Extend</td>
<td></td>
<td>Terms of loan</td>
<td>Payments on this current loan (recursive)</td>
</tr>
<tr>
<td>Facility information (Tanche ID):</td>
<td></td>
<td>Length</td>
<td>Date of payment</td>
</tr>
<tr>
<td>Bank deal identifier</td>
<td></td>
<td>Interest</td>
<td>Payment amount</td>
</tr>
<tr>
<td>Bank deal type</td>
<td>Age</td>
<td>Collateral (opt) -Type</td>
<td>On time? (flag)</td>
</tr>
<tr>
<td>facility amount</td>
<td>Gender</td>
<td>-Value</td>
<td>Extend</td>
</tr>
<tr>
<td>Facility start date</td>
<td>Household income:</td>
<td>-Date of value</td>
<td></td>
</tr>
<tr>
<td>Extend</td>
<td>-Household income component one (opt)</td>
<td>-Depreciation method</td>
<td></td>
</tr>
<tr>
<td>Institution information:</td>
<td>-Household income component two (opt)</td>
<td>-Verification method</td>
<td></td>
</tr>
<tr>
<td>Name</td>
<td></td>
<td>Co-guarantors (opt)</td>
<td></td>
</tr>
<tr>
<td>Primary Location</td>
<td>Extend</td>
<td>Revolving loan type?</td>
<td></td>
</tr>
<tr>
<td>National ID</td>
<td>Determinants of risk</td>
<td>Restructured loan type?</td>
<td></td>
</tr>
<tr>
<td>Banking sys ID</td>
<td>-Length of relationship with institution (e.g., group membership term)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Admin Contact</td>
<td></td>
<td></td>
<td>Extend</td>
</tr>
<tr>
<td>Technical Contact</td>
<td>Rating by</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institutional rating</td>
<td>Annotation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extend</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Portfolio information:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size of portfolio overall</td>
<td>-Type of work</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size of portfolio data in data set</td>
<td>-Type of industrial sector (e.g., farming)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extend</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
One of the successes of microfinance is the relatively high repayment rates. This has been achieved through a combination of personal touch (the officer goes to the customer), expectations management (repayment schedules are structured with minor grace periods that are not shared with the client), and group-based risk management. The group-based risk management is the most important factor and has several components, all of which are well documented in microfinance literature. The first is loan issuance, where the group operates as a kind of business plan review committee, ensuring that only the most productive business ideas are advanced for funding. Secondly, it implies, depending on the situation, that the group entity is either the loan guarantor or the loan recipient. Since these group entities are not legal entities, the individual is usually the stated borrower on the loan. Because the group may, in some institutions, be required to make up any payment shortfalls, 97% to 100% repayment rates are not uncommon. This creates a fundamental question for the data protocol: how much intra-group payment dynamics are required to accurately account for risk management?

It is at this level that the Mifos project hopes to have the greatest impact by allowing for metadata that explains the techniques utilized by the MFI to manage such risk components. The protocol for communicating such risk components will need to be further developed through surveys of existing MFIs and better understanding of the intra-group dynamics that are captured in internal back-office systems. One suggestion is to flag when individual payments are made in part or in full by the group, rather than the debtor.

**Metadata**

Capturing the unique characteristics of microfinance requires a type of metadata for the portfolio data. By structuring how those intra-group risk mitigation dynamics are described, the information system can manage the complex data and use it for risk analysis.

As detailed in the data elements section, metadata about the transaction record set allows for the data quality and integrity to be
described. Building on this, the metadata should allow for full transparency to the appropriate parties of:

- Coverage, periodicity, timeliness.
- Data access and privileged rights.
- Data integrity.
- Data quality.

Coverage refers to the data set within context. Providing the total portfolio of the organization and then the relative size of the portfolio covered by the data set provides one type of context. Periodicity of providing data can be regular or irregular, and if regular, the period should be noted in the metadata. Timeliness is a judgment as to how well the data has been provided according to the reference of the periodicity. Data integrity refers to the ability to trace the data back to data generated at the source institution, data quality refers to how well that data reflects actual occurrences. Data access and privilege rights are self-explanatory.

**Conclusions**

The global financial services industry is a very large consumer of data about customers and financial products. Microfinance, as a part of that industry with a social mission, should also be able to promote and use a set of standards for data about asset quality and profitability. This data should be both meaningful to the commercial sector and in keeping with the long-term mission to have customers of microfinance become full economic participants in society.

Secondly, data that is sorted in different ways can reveal patterns and information beyond the initial intent. At a minimum, microfinance institutions should be aware of the value of their customer database to the commercial bank, which may or may not be thinking about these microfinance customers as their next market.

Lastly, Grameen Foundation USA and others are promoting innovations in the financing of microfinance institutions to achieve greater effectiveness in serving the poorest with access to credit. Commercial data interface standards have an important role to play in terms of leveraging the exiting portfolio quality for funding.
References


Other Resources

Asia Pacific Loan Market Association, http://www.aplma.com/
Credit risk assessment services, http://www.xbrl.org/BankingLoans/
Securitization Journal,
Transactional systems,
http://www.goldengate.com/products/industry_bankingRetail.html
Commercializing Microfinance and Deepening Outreach?

Empirical Evidence from Latin America

Francisco Olivares-Polanco

Abstract: Does commercialization mean mission drift? Christen (2001) argues that commercialization, which is characterized by profitability, competition, and regulation, does not have any effect on large differences in loan size between regulated and nonregulated MFIs. I used data from 28 Latin American MFIs to conduct a multiple regression analysis to test for some of Christen’s conclusions, as well as for other factors that, according to the literature on microfinance, may affect loan size. The results of the regression indicate first that the type of institution, in terms of NGO versus financial institution, regardless of being regulated or not, has no effect on loan size. Second, the age of the institution predicts loan size in a direction contrary to that suggested by Christen. Third, competition turned out to be significant, in contradiction to Christen’s conclusion; it appears that more competition may lead to larger loan sizes and less depth of outreach. Finally, the models confirm an old belief in microfinance: there is a trade-off between depth and sustainability.

Microfinance institutions (MFIs) in Latin America are in the midst of a commercialization process. International organizations are encouraging this process and inviting NGOs to join it, while the perception of MFIs as profitable businesses has increased (Christen, 2001). In an MFI inventory carried
out by Christen in 2001, 205 MFIs were identified in Latin America. Seventy-seven MFIs (37.6% of the total) were regulated and accounted for 73.9% of a US$877 million portfolio. In general, this phenomenon has been called the commercialization of microfinance. Commercialization is characterized by profitability, competition, and regulation, but at the same time large differences in loan size are observed between regulated and unregulated institutions (Christen, 2001). While unregulated MFIs recorded an average outstanding loan size of US$322 in 1999, regulated institutions recorded US$803, which is 2.5 times larger. Assessed in terms of relative wealth, the average outstanding loan size for unregulated MFIs represented 24% of GNP per capita in 1999, versus 49% for regulated MFIs.

Do these large differences in loan size mean mission drift? Christen concludes that larger loans do not necessarily indicate mission drift, and they could simply be the function of different factors, such as choice of strategy, period of entry into the market, or natural evolution of the target group. Consequently, in the first place this paper discusses the points of view on impact assessment and the use of loan size as a “proxy” measurement for poverty level, and more important, it tests through a multiple regression analysis for commercialization factors, as well as for those factors that may also affect depth of outreach, in terms of loan size.

A preliminary sample of 30 Latin American MFIs was chosen and finally 28 were included, based on the availability of operational and financial information.¹

Some Points of View on Impact Assessment

Microfinance scholars and practitioners are divided into two fields: the welfarist and the institutionalist (Bhatt & Tang, 2001; Woller & Woodworth, 2001). Morduch (2000) refers to these two positions as the microfinance schism. Each position differs in their views on how microfinance services should be delivered (NGO versus

Francisco Olivares-Polanco is currently working as a Consultant for CANTV, the largest telecommunication company in Venezuela. Email: folivares@alumni.pitt.edu
commercial banks), on the technology they should use (financial services, or “minimalist,” approach versus an “integrated” service approach), and on how their performance should be assessed, among other subjects.

On the last mentioned discrepancy, the welfarists believe that MFI performance should be assessed in terms of the impact on the welfare of the poor. In short, the welfarist approach is not only concerned with the question of how poor the clients are, but whether or not they are less poor after they borrow the money (Cheston & Reed, 1999). Hence, their methods are aimed at determining whether the institutions are achieving their poverty reduction objective. On the other hand, the institutionalists believe that performance should be assessed in terms of the institution’s success in achieving self-sustainability and breadth of outreach. Breadth and depth of outreach, although desirable for both institutionalists and welfarists, are perceived as contradictory objectives, thus representing a trade-off for the institutions.

For the welfare-oriented practitioners, microfinance should focus on reaching the poorest and help alleviate both material and nonmaterial poverty, even with subsidized operations. On the other hand, the institutionalists foster financial broadening, where microfinance should focus on providing services to a large number of poor people and reaching financial sustainability through more efficient operations, market or higher-than-market interest rates, and economies of scale (Bhatt & Tang, 2001).

Methods, Advantages, and Disadvantages of each Approach

The methods used by the welfarists assess the impact of the program on their clients by measuring changes in dependent variables, such as the level of income, the level of production, sales, assets, or the general well being of the client (Alfaro, 1999; Bhatt & Tang, 2001). The underlying assumption is the existence of a direct causal relationship between the credit and the observed change in the dependent variable (Rhyne, 1994). The methodology to assess the impact generally consists in collecting data ex-ante and ex-post the program intervention through direct interviews, and sometimes in comparing the results against a control group.
Eventually, the advantage of this approach is that it would allow knowing whether the MFI has a positive impact in fighting poverty. However, there are diverse criticisms to this approach. Selection bias, lack of control groups, and inability to gather longitudinal data are common concerns (Bhatt & Tang, 2001). Validity of the data also seems to be problematic, because such studies “rely on the often unreliable memories of clients to determine their status before receiving a loan” (Cheston & Reed, 1999). In addition, conducting these may take time and may be too expensive to be absorbed by MFIs on a regular basis (Alfaro, 1999).

Additional fundamental problems still remain with this methodology. First, credit is not an input for the production process, but rather a financial instrument that increases purchasing power. The fungibility of financial instruments implies that establishing a causal relationship between the credit and the dependent variables would require controlling for the rest of the unit of analysis’s sources and uses of funds (Alfaro, 1999) and probably for other factors different from money that may have an effect on the dependent variables under study (i.e., the level of education of the borrower). Second, the credit does not necessarily represent an addition of 100% in purchasing power. In some cases there is financial substitution and deviation (Von Pischke & Adams, 1980; Alfaro, 1999). In addition, even though an impact analysis includes control groups, there is the problem of achieving equivalence between the control group and the group actually receiving loans. As an efficient financial system or institution should discriminate between good and risky clients, the control groups would be essentially different (Alfaro, 1999). Finally, looking for equivalent control groups may also lead to other dilemmas.

Contrary to the welfarist methods, the analysis of the institution’s performance carries lower costs and becomes more feasible to assess continually in the long run. Basically, the institutionalist approach employs two measurements of success: outreach and sustainability. Outreach is measured in two dimensions: depth, or how poor the clients are; and breadth, or how many people the program is reaching. There is no causality chain analysis, and the
indicators for depth of outreach are various measures of loan size. For international comparisons, a ratio of loan size to per capita GDP is also commonly used (Alfaro, 1999; Schreiner, 2001), and breadth is usually measured as the number of clients or the types of instruments offered (Bhatt & Tang, 2001).

The level of sustainability is measured through financial indicators such as the Subsidy Dependency Index (SDI), suggested by Yaron in 1992, or through other similar indicators such as the Explicit Subsidy Dependency Index (ESDI) or the Implicit Subsidy Dependency Index (ISDI). Other more common measures such as the Return over Equity (ROE) or the Return over Assets (ROA) are also employed, but they do not account for subsidies when they are recorded in the Profit and Loss statement. Contrary to the welfarist approach, subsidies adjustments are necessary under this approach, and they have to be reduced to a minimum level when a MFI is looking for sustainability. In addition, Rhyne (1994) recommends the inclusion of one additional measure: the quality of the service provided or quality of outreach. When an institution records high repayment rates and high growth rates in terms of clients, retains a large number of clients, and its clients are willing to pay interest rates that allow for institutional self-sustainability, then the services provided by the institution are considered of “good quality” because they are “appreciated and relevant to its clients” (Christen, Rhyne, Vogel, & McKean, 1995; Alfaro, 1999).

Due to the availability of data to carry out an analysis under the institutionalist point of view, the methodology of this study is framed within this approach. The shortcomings of the study will be addressed when explaining each variable. Consequently, the final results of this study are influenced and affected by these limitations.

**Models and Data**

The goal of the study is to test for commercialization factors, as well as for other factors that according to the literature may have an impact on the depth of outreach. I use the Ordinary Least
Square (OLS) regression method to find out which variables are good predictors of loan size.

**Dependent Variable: Depth of Outreach**

Within the institutionalist approach, reaching the poor means small loan sizes. The basic assumption is that the smaller the loan size, the deeper the outreach, or the poorer the client. Thus, loan size has been consistently used as a “proxy” for the level of poverty. In his study, Christen uses two widely used measures of loan size: average outstanding loan (AOL), obtained by dividing the outstanding loan portfolio by the number of active clients at the end of the period of analysis; and the ratio of AOL to per capita GNP (AOL/PCGNP), usually used in cross-comparative analyses. For the initial sample of 30 Latin American MFIs, the AOL from the NGOs was US$769, while financial institutions recorded US$1,026 (1.33 times the NGO loan size). This result is much lower than the ratio obtained by Christen (2.5 versus 1.33), which may be the result of a selection bias problem, which is discussed in detail in the section on data.

Schreiner (2001) critiques the use of both AOL and AOL/PCGNP because they do not take into account other aspects of loan size, especially term to maturity. Schreiner argues that AOL is imperfect, because it measures the resources held in the term of the loan but does not consider the length of the term to maturity. Since finance is the exchange of resources through time, then loan size should account for it. Additionally, in many countries, especially in poor countries, per capita GNP can be distorted by inequalities in income distribution. In countries with higher inequalities, per capita GNP exceeds both median GNP and the poverty-line income (Schreiner, 2001). Hence, AOL/PCGNP may not be a useful measure for cross-comparative analysis. Schreiner also criticizes the fact that the numerator and denominator pertain to different time frames. The numerator (AOL) is a flow disbursed in a specific moment, while the income (PCGNP) is generated in an entire year. Within a year, there can be more than one disbursement. Schreiner suggests an alternative measure to adjust for time: dollar-years of resources from loans over dollar-years of resources.
from annual income, if it were all saved (denoted as $-years loan/$-years income). Regrettably, there was not complete information on the average disbursed loan for all the institutions under study; thus, AOL substitutes this variable in Schreiner’s original formula:

\[
\frac{\text{-years loan}}{\text{-years income}} = \frac{\text{Average outstanding loan}}{\text{Average term to maturity}} \times \frac{12}{\text{Per capita GDP / 2}}
\]

I regress three measures of loan size—the two used by Christen and the third suggested by Schreiner—on 7 independent variables, but adjusting two of the measures of loan size containing income: the AOL/PCGDP, and $-years loan/$-years income. In his critique of the use of either per capita GNP or GDP, Schreiner suggests the use of poverty-line income or median income but recognizes that the first is measured in different ways across countries and that the data for the second is hard to find. Therefore, I substitute per capita GDP by per capita GDP of the 20% poorest when measuring both AOL/PCGDP and $-years loan/$-years income. Thus, the new measures are AOL/PCGDP20% and $-years loan/$-years income20%.

The average income of the poorest quintile could be a better indicator than per capita GNP in order to compare outreach among MFIs. This indicator is closer to the target group that MFIs should be serving, and probably, there are no problems of significant inequality within the group. Although there are almost no studies on income distribution aimed specifically at the poorest quintile, this study assumes that income distribution among the lowest 20% is not as unequal as for the whole population. For instance, when using AOL/PCGDP and the value of 1 as the upper limit usually used as the indicator of depth of outreach (Alfaró, 1999), 24 out of 28 institutions would be classified as having a “deep” outreach; that is, their AOLs represent less than the average income. But when per capita GDP of the poorest 20% is used, then only three institutions may claim that their AOLs were lower than the income of the average person in the poorest quintile.
This analysis suggests that most of the MFIs, whether they are NGOs or banks, are not reaching the very poor when using these adjusted measurements of loan size. Contrary to the expected result, AOL/PCGDP and AOL/PCGDP20% are highly correlated (0.924). A possible explanation is that the income share held by the lowest 20% across the ten countries included in the analysis is very similar (mean = 3.43%, standard deviation = 0.95). Similarly, $-years loan/$-years income and $-years loan/$-year income20% are also highly correlated (0.9608). In fact, and less expected, AOL/PCGDP and $-years loan/$-year income also show a high correlation (0.8374), and when adjusting by GDP of the lowest 20%, the correlation increases (0.9138), which suggests that, for this specific analysis, accounting for time should not make much difference.

Finally, the main limitation of loan size measures as a “proxy” for poverty measurement emerges when the basic assumption—the smaller the loan, the poorer the client—does not hold. This assumption is based on another assumption: people with access to traditional banking services do not find small loan sizes attractive, since they have to wait months or even years to get large loans (Woller & Woodworth, 2001). However, when access to credit is restricted in an economy, there is a possibility that the well-off will be willing to assume the high opportunity costs of borrowing small amounts of money (Dunford, 2002; Hatch & Frederick, 1998). Loan size is the only available information from most MFIs and is used for the purpose of this analysis, despite the fact that some scholars and practitioners do not recommend its use due to its weakness in accurately determining the poverty level of clients and beneficiaries (Hatch & Frederick, 1998).

**Independent Variables**

**Type of Institution.** In his paper, Christen (2001) compares the loan size of regulated and nonregulated microfinance institutions in Latin America and found substantial differences in loan size between the two groups. Because regulated MFIs are associated with increasing commercialization, Christen asked whether com-
Commercialization has drifted the MFIs’ mission of reaching the poorest of the poor. In his conclusion, Christen disregards mission drift and suggests that large differences in loan size may be caused by factors such as choice of strategy, maturity of portfolio, or client group. Commercialization, characterized by profitability, competition, and regulation, has no effect.

To assess for the type-of-institution effect, I include a “dummy variable” on whether the unit of analysis is a NGO (1) or not (0). From the initial sample of 30 Latin American MFIs, there are 11 NGOs and 19 banks or nonbanking financial institutions, a group that I called “financial institutions.” Regrettably, the sample is mainly composed of regulated institutions—only three NGOs were unregulated—and the simple dichotomy is not enough to characterize the variety of MFIs operating in Latin America. The results on the adjusted loan sizes for each group are surprising. The ratio \( \frac{AOL}{PCGDP} \) is larger for NGOs than for financial institutions (0.80 versus 0.56), and the ratio \( \frac{AOL}{PCGDP20\%} \) is again larger for NGOs than for financial institutions (5.50 versus 2.90). A similar outcome is also observed when using Schreiner’s loan size measure. Given these large differences, and despite the fact that MFIs are mostly regulated, it is still relevant to test for the type of institution.

**Age of the Institution.** As mentioned in the previous section, the differences in loan sizes found by Christen may be caused by choice of strategy, maturity of portfolio, client group, or a combination of these causes. On choice of strategy, Christen argues that “larger loan sizes could simply be the result of deliberate strategy or choice . . . all the older, more established microfinance institutions (including in their previous incarnations as NGOs) in Latin America started with an explicit objective to generate employment in the urban microenterprise sector, so that their initial mission was not reaching the poorest of the poor.” Christen mentions as a choice of strategy the choice of operating as a regulated or nonregulated institution (instead of the NGO versus financial institution dichotomy that is tested in this study), and in this case “large differences . . . may simply reflect the fact that the two groups started
out to serve quite different populations.” On the maturity of portfolio, Christen argues that “[w]hat appears to be mission drift may also be nothing more than the natural evolution of the average loan balances of NGOs that transformed themselves into regulated financial institutions . . . [t]hey all engaged in incremental lending, in which loan balances start well below the client’s ability to pay the installments and are subsequently increased through many short-term loans.” Dunford (2002), Christen et al. (1995), and Jansson and Taborga (2000) offer similar arguments.

Two of these three factors have a common element: the age of the institution. Hence, years of operation are used to control for the effect of time. In fact, Christen et al. (1995) consider that “in judging whether a given institution has achieved extensive outreach, comparisons must be made with achievements of other institutions, keeping in mind the program’s age.” In this case, the prediction would be: the older the institution, the larger the loan size.

Sustainability. Throughout this document it has been stated that financial sustainability and depth of outreach are perceived as contradictory objectives. The basic assumption is that lending small credits to the poor carries a higher cost of operation, hence the prediction would be: the larger the loan size, the more profitable and sustainable the institution. On this issue, Schreiner (2001) says, “greater loan size usually means more profitability for the lender but less depth of outreach for the borrower.” He later adds that “the drive for profits for the organization tends to improve all aspects of outreach, except perhaps depth” (Schreiner, 2002). Woller and Woodworth argue that “the unsatisfied credit demand among the disadvantaged non-poor, the not-so-poor, and the poor, together with the high costs of targeting and reaching the very poor, created an almost irresistible pull for MCIs to move upscale to wealthier and more profitable market segments.”

For this study it was not possible to find data on self-sufficiency that excluded explicit or implicit subsidies, as Yaron suggests. Hence, a measure of Return over Assets (ROA) without these adjustments is used as the sustainability variable, instead of Return over Equity (ROE), which may be distorted by the leverage or
differences in the financing structures between NGOs, non-banking institutions, and banks.

**Breadth of Outreach.** For this study, breadth of outreach is the number of active borrowers. As breadth and sustainability are positively related, then both are inversely related to depth, so the larger the number of clients, the lower the depth or the larger the loan size. However, in absolute terms, the picture can still be optimistic. As Schreiner (2001) argues, wider breadth offsets depth, when an institution reaches “as many of the very poor as poverty-oriented organization with narrow breadth,” even when recording high average loan balances.

**Competition.** According to Christen, “in regular markets, classic enterprises usually respond to competitive pressures by offering new and better products at more competitive prices and by improving productivity. As microfinance institutions increasingly find themselves operating in markets where competition abounds, their behavior more and more resembles that of classic enterprises.” Does competition increase the loan size? Christen argues that commercialization, and therefore their characteristic components, does not have an effect on loan size. Hence, there should not be any relationship between these two variables. I use the percentage of concentration of the four largest MFIs by country: the higher the level of portfolio concentration, the lower the competitive pressures. Concentration is measured as the market share held by the four largest MFIs in a country, and is calculated with data from Christen (2001).

**Gender.** Depth of outreach has been also associated with gender distribution of the portfolio (Alfaro, 1999; Navajas, Schreiner, Meyer, Gonzales-Vega, & Rodriguez-Mesa, 2000; Bhatt & Tang, 2001). Studies on women and development show that women are relatively poorer than men; therefore, any institution engaged in reaching mostly women should provide smaller loans. In this study, gender is measured as the percentage of women clients in the portfolio.

**Credit Methodology.** Two broad methodologies have been regularly used in microfinance: individual loans and group lending
(solidarity groups). Using the latter methodology, each member guarantees the repayment of every other member’s portion, which creates social pressures within the group to avoid defaulting. Christen found that the tendency of Latin American MFIs during the last 10 years is toward an increasing number of individual loans. What would be the effect of this tendency on loan size? For Woller and Woodworth, “the process of loan-group formation also can work to exclude the very poor. Lending groups typically assume joint liability for loan repayment, which can create an incentive to exclude the very poor, who are seen by other group members as poorer credit risks.” This vision, however, contradicts the generally accepted assumption that lending groups reach poorer subjects of credit who do not have enough collaterals to apply for an individual loan. An analysis of five Bolivian MFIs carried out by Navajas et al. (2000) found that “the group lenders in Bolivia reached the poorest better than individual lenders.” Besides, lending groups are mainly associated with microfinance programs aimed at women, and as it has been argued above, women are considered to be relatively poorer.

Usually, MFIs do not engage in only one credit methodology; rather, they use both. Then, in order to assess the impact of credit methodology on loan size, individual loans as the percentage of the portfolio is used, with the prediction as follows: the larger the percentage, the lower the depth of outreach and the larger the loan size.

**Sources of Data**

Information on most of the variables is drawn from each MFI and is mainly public. MFIs elaborate the primary data either for actual variables used in this study or for their construction (e.g., loan size measures and return over assets). Although sources of data were various, the majority of the information for the years 1999, 2000, and 2001 is available from the Microfinance Information Exchange Program (Mix) web page (www.themix.org), a not-for-profit private organization supported by CGAP-World Bank, the Citigroup Foundation, and other private foundations. Specifically, the data are available from those institutions with high or full disclosure of
information—rated by the Mix as 4 and 5 diamonds; however, not all the MFIs rated as 4 or 5 diamonds had complete data for the study. In total, there were 36 MFIs rated lower than 4 and 5 diamonds, but only 28 MFIs had information on most of the variables either from the Mix Market or from other sources. To fill the gaps of information, I used other sources, such as the web sites of Accion International (www.accion.org), MFIs, and banking regulatory agencies, as well as MFIs’ annual reports and audited financial statements. Most of the annual reports and financial statements were also available through the Mix Market in the form of pdf documents. Because the data are presented or have been translated from local currencies into US$ and contained in a period of four years, I did not adjust the financial statements by inflation nor restate them in a year-base currency, assuming that the statistical effect would be negligible.

Missing values on gender and credit methodology were substituted in both cases by the mean obtained from the rest of the sample. Two additional institutions were added to the original 28 MFIs; one from a case study written by the author (Financiera Calpia, El Salvador), and the other from information released by a banking regulatory agency (Bangente, Venezuela). The only data not generated by the MFIs were GDP, population, income share held by the lowest 20% of the population, and the average and year-end exchange rate. The source of this information was the International Finance Statistics (CD-ROM) from the International Monetary Fund (IMF).

Some comments on the data and the sample are relevant at this point. First, as the author constructed, fully or partially, some of the variables, there is the possibility of error. Second, although the sample represents only the 13.6% of the MFIs inventoried by Christen in 2001, there could be a selection bias problem because the sample was not randomly selected. As this is the only public information available on Latin American MFIs for the purpose of this study, and most of the information was drawn from the Mix Market database, it is possible that this sample is substantially different from the actual MFI population. The Mix Market promotes
transparency among MFIs worldwide, and the fact that only 3 out of 11 Latin American NGOs from this database are unregulated could be an indicator that most of the institutions reporting to the Mix Market are following a more commercial-oriented strategy than the actual population of MFIs as a whole. In fact, two of the three unregulated NGOs operate in Nicaragua, where, according to Christen, “commercialization has not entailed the transformation of financial NGOs into licensed banking intermediaries . . . spurred by direct competition, commercialization is beginning even though traditional profit-seeking entrepreneurs, such as commercial banks, have not yet entered the market.” For these reasons, it is possible that the results from this study cannot be generalized to the entire population of Latin American MFIs and reflects more accurately the reality of commercial MFIs in the region.

Results

OLS was conducted to determine which of the seven variables are predictors of loan size. For this study, three measures of loan size were used, resulting in three sets of models. Data screening allowed the identification of outliers, and two institutions were eliminated in each of the three sets: Compartamos and FMDR, both from Mexico. Compartamos is a regulated nonbanking institution, while FMDR is an unregulated NGO. Therefore, the final database ended up with a total of 28 observations, where only two were unregulated NGOs—from Nicaragua—and eight were regulated NGOs.

Model Containing AOL

The regression results for the model containing AOL (US$ per loan) as the dependent variable and seven independent variables do not indicate that the model significantly predicts loan size, $R^2 = 0.185$, $R^2_{adj} = -0.100$, $F(7,20) = 0.649$, $p[0.712$. This model accounted for only 18.5% (zero when adjusting for degrees of freedom) of the variance in loan size, and none of the coefficients proved to be significant, suggesting that these independent variables are not useful in predicting loan size in terms of absolute value—US$ per loan.
<table>
<thead>
<tr>
<th>Institution</th>
<th>Country</th>
<th>Year of Data</th>
<th>AOL (US$)</th>
<th>AOL/PCGDP 20%</th>
<th>$-years loan/ $-years income 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 ACODEP</td>
<td>Nicaragua</td>
<td>1999</td>
<td>291.00</td>
<td>5.652</td>
<td>24.452</td>
</tr>
<tr>
<td>3 ACTUAR-Antioquia</td>
<td>Columbia</td>
<td>2001</td>
<td>608.76</td>
<td>2.108</td>
<td>5.727</td>
</tr>
<tr>
<td>4 ADMIC</td>
<td>Mexico</td>
<td>2000</td>
<td>1,588.70</td>
<td>1.548</td>
<td>3.286</td>
</tr>
<tr>
<td>5 BancoSol</td>
<td>Bolivía</td>
<td>2000</td>
<td>1,279.70</td>
<td>6.484</td>
<td>12.238</td>
</tr>
<tr>
<td>6 Crear-Tanca</td>
<td>Perú</td>
<td>2000</td>
<td>1,433.00</td>
<td>3.126</td>
<td>13.227</td>
</tr>
<tr>
<td>7 Eco Futuro</td>
<td>Bolivía</td>
<td>2000</td>
<td>655.33</td>
<td>3.320</td>
<td>12.826</td>
</tr>
<tr>
<td>8 EDYFICAR</td>
<td>Perú</td>
<td>2000</td>
<td>599.49</td>
<td>1.308</td>
<td>5.207</td>
</tr>
<tr>
<td>9 FADES</td>
<td>Bolivía</td>
<td>2000</td>
<td>529.13</td>
<td>2.681</td>
<td>5.984</td>
</tr>
<tr>
<td>10 FAMA</td>
<td>Nicaragua</td>
<td>2000</td>
<td>433.63</td>
<td>7.980</td>
<td>37.131</td>
</tr>
<tr>
<td>11 Finamerica</td>
<td>Colombia</td>
<td>2000</td>
<td>1,032.78</td>
<td>3.583</td>
<td>10.081</td>
</tr>
<tr>
<td>12 FINCOMUN</td>
<td>México</td>
<td>2000</td>
<td>993.62</td>
<td>0.968</td>
<td>6.690</td>
</tr>
<tr>
<td>13 Génesis Empresarial</td>
<td>Guatemala</td>
<td>2000</td>
<td>442.33</td>
<td>1.396</td>
<td>4.066</td>
</tr>
<tr>
<td>14 PRODEM</td>
<td>Bolivía</td>
<td>2000</td>
<td>782.18</td>
<td>3.963</td>
<td>11.097</td>
</tr>
<tr>
<td>15 Visión de Finanzas</td>
<td>Paraguay</td>
<td>2000</td>
<td>659.47</td>
<td>5.072</td>
<td>18.876</td>
</tr>
<tr>
<td>16 WWB-Medellín</td>
<td>Colombia</td>
<td>2000</td>
<td>325.48</td>
<td>1.129</td>
<td>4.438</td>
</tr>
<tr>
<td>17 ADOPEM</td>
<td>República Dominicana</td>
<td>1999</td>
<td>386.22</td>
<td>0.719</td>
<td>2.081</td>
</tr>
<tr>
<td>18 AgroCapital</td>
<td>Bolivía</td>
<td>1999</td>
<td>2,945.07</td>
<td>14.609</td>
<td>24.029</td>
</tr>
<tr>
<td>19 Banco ADEMI</td>
<td>República Dominicana</td>
<td>2000</td>
<td>3,088.14</td>
<td>5.155</td>
<td>11.429</td>
</tr>
<tr>
<td>20 Caja los Andes</td>
<td>Bolivía</td>
<td>1999</td>
<td>919.33</td>
<td>4.560</td>
<td>12.043</td>
</tr>
<tr>
<td>21 CMAC-Arequipa</td>
<td>Perú</td>
<td>2001</td>
<td>1,001.38</td>
<td>2.221</td>
<td>7.650</td>
</tr>
<tr>
<td>22 CMAC-Maynas</td>
<td>Perú</td>
<td>2000</td>
<td>314.93</td>
<td>0.687</td>
<td>3.000</td>
</tr>
<tr>
<td>23 FIE</td>
<td>Bolivía</td>
<td>2000</td>
<td>962.51</td>
<td>4.877</td>
<td>10.876</td>
</tr>
<tr>
<td>24 FINDE</td>
<td>Nicaragua</td>
<td>1999</td>
<td>1,136.15</td>
<td>22.065</td>
<td>91.500</td>
</tr>
<tr>
<td>25 MiBanco</td>
<td>Perú</td>
<td>2000</td>
<td>636.35</td>
<td>1.388</td>
<td>2.094</td>
</tr>
<tr>
<td>26 PROEMPRESA</td>
<td>Perú</td>
<td>2000</td>
<td>1,160.31</td>
<td>2.531</td>
<td>12.469</td>
</tr>
<tr>
<td>27 Financiera Calpia</td>
<td>El Salvador</td>
<td>2000</td>
<td>802.68</td>
<td>2.311</td>
<td>6.619</td>
</tr>
<tr>
<td>28 Bangente</td>
<td>Venezuela</td>
<td>2001</td>
<td>1,412.76</td>
<td>1.832</td>
<td>10.916</td>
</tr>
</tbody>
</table>

Table 1. Database of Selected Latin American MFIs
<table>
<thead>
<tr>
<th>Institution</th>
<th>Type</th>
<th>Age</th>
<th>Sustainability (ROA)</th>
<th>Breadth of Outreach</th>
<th>Gender</th>
<th>Credit Methodology</th>
<th>Level of Competition</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACODEP</td>
<td>1</td>
<td>10</td>
<td>10.67%</td>
<td>15,073</td>
<td>62.0%</td>
<td>98.75%</td>
<td>0.632</td>
</tr>
<tr>
<td>ACTUAR-Tolima</td>
<td>1</td>
<td>14</td>
<td>-14.68%</td>
<td>3,444</td>
<td>52.7%</td>
<td>69.00%</td>
<td>0.757</td>
</tr>
<tr>
<td>ACTUAR-Antioquia</td>
<td>1</td>
<td>18</td>
<td>2.98%</td>
<td>8,913</td>
<td>57.5%</td>
<td>100.00%</td>
<td>0.757</td>
</tr>
<tr>
<td>ADMIC</td>
<td>0</td>
<td>20</td>
<td>-0.88%</td>
<td>4,424</td>
<td>90.0%</td>
<td>100.00%</td>
<td>0.793</td>
</tr>
<tr>
<td>BancoSol</td>
<td>0</td>
<td>14</td>
<td>0.89%</td>
<td>60,976</td>
<td>72.0%</td>
<td>65.00%</td>
<td>0.587</td>
</tr>
<tr>
<td>Crear-Tanca</td>
<td>0</td>
<td>8</td>
<td>4.51%</td>
<td>2,637</td>
<td>40.0%</td>
<td>95.00%</td>
<td>0.935</td>
</tr>
<tr>
<td>Eco Futuro</td>
<td>0</td>
<td>1</td>
<td>-12.00%</td>
<td>17,400</td>
<td>52.0%</td>
<td>42.00%</td>
<td>0.587</td>
</tr>
<tr>
<td>EDYFICAR</td>
<td>0</td>
<td>3</td>
<td>2.74%</td>
<td>16,451</td>
<td>45.0%</td>
<td>95.00%</td>
<td>0.935</td>
</tr>
<tr>
<td>FADES</td>
<td>1</td>
<td>14</td>
<td>0.08%</td>
<td>22,582</td>
<td>35.0%</td>
<td>80.45%</td>
<td>0.587</td>
</tr>
<tr>
<td>FAMA</td>
<td>1</td>
<td>9</td>
<td>5.34%</td>
<td>14,301</td>
<td>66.0%</td>
<td>100.00%</td>
<td>0.632</td>
</tr>
<tr>
<td>Finamerica</td>
<td>0</td>
<td>7</td>
<td>-2.87%</td>
<td>16,049</td>
<td>48.0%</td>
<td>44.50%</td>
<td>0.757</td>
</tr>
<tr>
<td>FINCOMUN</td>
<td>0</td>
<td>6</td>
<td>-1.25%</td>
<td>3,300</td>
<td>46.0%</td>
<td>100.00%</td>
<td>0.793</td>
</tr>
<tr>
<td>Génesis Empresarial</td>
<td>1</td>
<td>12</td>
<td>1.41%</td>
<td>25,217</td>
<td>58.0%</td>
<td>77.90%</td>
<td>0.908</td>
</tr>
<tr>
<td>PRODEM</td>
<td>0</td>
<td>14</td>
<td>0.29%</td>
<td>30,227</td>
<td>49.0%</td>
<td>34.43%</td>
<td>0.587</td>
</tr>
<tr>
<td>Visión de Finanzas</td>
<td>0</td>
<td>8</td>
<td>2.89%</td>
<td>34,531</td>
<td>57.5%</td>
<td>100.00%</td>
<td>0.842</td>
</tr>
<tr>
<td>WWB-Medellín</td>
<td>1</td>
<td>15</td>
<td>8.52%</td>
<td>8,883</td>
<td>5803%</td>
<td>100.00%</td>
<td>0.757</td>
</tr>
<tr>
<td>ADOPEM</td>
<td>1</td>
<td>17</td>
<td>10.70%</td>
<td>17,847</td>
<td>88.0%</td>
<td>39.00%</td>
<td>1.000</td>
</tr>
<tr>
<td>AgroCapital</td>
<td>1</td>
<td>7</td>
<td>0.04%</td>
<td>4,524</td>
<td>57.5%</td>
<td>100.00%</td>
<td>0.587</td>
</tr>
<tr>
<td>Banco ADEMI</td>
<td>0</td>
<td>17</td>
<td>9.73%</td>
<td>16,408</td>
<td>36.0%</td>
<td>100.00%</td>
<td>1.000</td>
</tr>
<tr>
<td>Caja los Andes</td>
<td>0</td>
<td>4</td>
<td>-15.74%</td>
<td>36,814</td>
<td>54.0%</td>
<td>100.00%</td>
<td>0.587</td>
</tr>
<tr>
<td>CMAC-Arequipa</td>
<td>0</td>
<td>15</td>
<td>4.83%</td>
<td>49,246</td>
<td>57.5%</td>
<td>100.00%</td>
<td>0.935</td>
</tr>
<tr>
<td>CMAC-Maynas</td>
<td>0</td>
<td>13</td>
<td>4.33%</td>
<td>14,053</td>
<td>57.5%</td>
<td>100.00%</td>
<td>0.935</td>
</tr>
<tr>
<td>FIE</td>
<td>0</td>
<td>15</td>
<td>1.59%</td>
<td>23,402</td>
<td>53.8%</td>
<td>100.00%</td>
<td>0.587</td>
</tr>
<tr>
<td>FINDE</td>
<td>1</td>
<td>6</td>
<td>13.02%</td>
<td>2,837</td>
<td>62.0%</td>
<td>100.00%</td>
<td>0.632</td>
</tr>
<tr>
<td>MiBanco</td>
<td>0</td>
<td>8</td>
<td>3.39%</td>
<td>58,088</td>
<td>59.0%</td>
<td>80.45%</td>
<td>0.935</td>
</tr>
<tr>
<td>PROEMPRESA</td>
<td>0</td>
<td>14</td>
<td>2.80%</td>
<td>3,559</td>
<td>44.0%</td>
<td>92.00%</td>
<td>0.935</td>
</tr>
<tr>
<td>Financiera Calpia</td>
<td>0</td>
<td>12</td>
<td>4.29%</td>
<td>37,621</td>
<td>60.6%</td>
<td>100.00%</td>
<td>0.867</td>
</tr>
<tr>
<td>Bangente</td>
<td>0</td>
<td>2</td>
<td>-3.93%</td>
<td>5,221</td>
<td>49.0%</td>
<td>100.00%</td>
<td>1.000</td>
</tr>
</tbody>
</table>
In these models, AOL/PCGDP20% is the dependent variable and the regression results indicate that the full model significantly predicts loan size, $R^2 = 0.57$, $R^2_{adj} = 0.42$, $F(7, 20) = 3.790, p < 0.01$. This model accounts for 42% of the variance in loan size adjusted for degrees of freedom, and three coefficients (age, sustainability, and competition) are significantly different from zero, suggesting that they do have an effect on loan size. The reduced model is a more parsimonious one: only the three significant independent
variables were included, and although $R^2$ decreased, adjusted $R^2$ increased.

Table 3. Unstandardized Coefficients from the Regression of the Ratio Average Outstanding Loan (AOL) to Per Capita GDP of the Lowest 20% on Selected Independent Variables.

<table>
<thead>
<tr>
<th>Independent Variable</th>
<th>Model 1 (full)</th>
<th>Model 2 (reduced)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of institution (NGO – Financial Inst.)</td>
<td>0.431</td>
<td>______</td>
</tr>
<tr>
<td>(0.251)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Age of the institution (years)</td>
<td>-0.347*</td>
<td>-0.334*</td>
</tr>
<tr>
<td>( -2.360 )</td>
<td>( -2.520 )</td>
<td></td>
</tr>
<tr>
<td>Sustainability (ROA)</td>
<td>0.332**</td>
<td>0.374**</td>
</tr>
<tr>
<td>(2.837)</td>
<td>(3.663)</td>
<td></td>
</tr>
<tr>
<td>Breadth of outreach (# clients)</td>
<td>-0.000029</td>
<td>______</td>
</tr>
<tr>
<td>(-0.657)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Competition (concentration)</td>
<td>-0.174**</td>
<td>-0.178***</td>
</tr>
<tr>
<td>( -3.490 )</td>
<td>( -4.123 )</td>
<td></td>
</tr>
<tr>
<td>Gender (% women as clients)</td>
<td>0.035</td>
<td>______</td>
</tr>
<tr>
<td>(0.601)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit methodology (% of individual loans)</td>
<td>0.027</td>
<td>______</td>
</tr>
<tr>
<td>(0.803)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>17.094*</td>
<td>20.977***</td>
</tr>
<tr>
<td>(2.789)</td>
<td>(5.778)</td>
<td></td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.57</td>
<td>0.531</td>
</tr>
<tr>
<td>Adjusted $R^2$</td>
<td>0.42</td>
<td>0.472</td>
</tr>
<tr>
<td>$F$-value (model)</td>
<td>3.790**</td>
<td>9.053***</td>
</tr>
<tr>
<td>(7, 20)</td>
<td>(3, 24)</td>
<td></td>
</tr>
<tr>
<td>Number of MFIs</td>
<td>28</td>
<td>28</td>
</tr>
</tbody>
</table>

Note: numbers in parentheses are $t$-values, except for $F$-value (degrees of freedom).  
* $p \leq 0.05$  ** $p \leq 0.01$  *** $p \leq 0.001$

Models Containing $\text{-years loan/income 20\%}$

The last set of models include $\text{-years loan/income of the lowest 20\% as the dependent variable.}$ For this case, the regression results indicate that the full model significantly predicts loan size, $R^2 = 0.593$, $R^2_{adj} = 0.451$, $F(7,20) = 4.164$, $p[0.01$. This model
accounts for 0.451% of the variance in loan size corrected for degrees of freedom, and again the same three coefficients from the model containing AOL/PCGDP20% (age, sustainability, and competition) are significantly different from zero, suggesting that they do have an effect on loan size. In a way similar to the previous model, the three significant independent variables were included in a separate model (2). For the reduced model, although $R^2$ decreased, adjusted $R^2$ increased, as it was observed previously. Interestingly, adjusted $R^2$ are very similar for both sets of models (0.472 versus 0.471).

**Table 4. Unstandardized Coefficients from the Regression of the ratio $\$/years of resources from loan to $\$/year of resources from per capita GDP of the lowest 20% on Selected Independent Variables.**

<table>
<thead>
<tr>
<th>Independent Variable</th>
<th>Model 1 (full)</th>
<th>Model 2 (reduced)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of institution (NGO – Financial Inst.)</td>
<td>1.349</td>
<td>____</td>
</tr>
<tr>
<td></td>
<td>(0.213)</td>
<td></td>
</tr>
<tr>
<td>Age of the institution (years)</td>
<td>-1.623**</td>
<td>-1.561**</td>
</tr>
<tr>
<td></td>
<td>(-3.005)</td>
<td>(-3.115)</td>
</tr>
<tr>
<td>Sustainability (ROA)</td>
<td>1.433**</td>
<td>1.587***</td>
</tr>
<tr>
<td></td>
<td>(3.334)</td>
<td>(4.112)</td>
</tr>
<tr>
<td>Breadth of outreach (# clients)</td>
<td>0.000195</td>
<td>____</td>
</tr>
<tr>
<td></td>
<td>(-1.154)</td>
<td></td>
</tr>
<tr>
<td>Competition (concentration)</td>
<td>-0.539**</td>
<td>-0.550**</td>
</tr>
<tr>
<td></td>
<td>(-2.933)</td>
<td>(-3.372)</td>
</tr>
<tr>
<td>Gender (% women as clients)</td>
<td>0.173</td>
<td>____</td>
</tr>
<tr>
<td></td>
<td>(0.804)</td>
<td></td>
</tr>
<tr>
<td>Credit methodology (% of individual loans)</td>
<td>0.081</td>
<td>____</td>
</tr>
<tr>
<td></td>
<td>(0.668)</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>57.401*</td>
<td>70.628***</td>
</tr>
<tr>
<td></td>
<td>(2.548)</td>
<td>(5.143)</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.593</td>
<td>0.530</td>
</tr>
<tr>
<td>Adjusted $R^2$</td>
<td>0.451</td>
<td>0.471</td>
</tr>
<tr>
<td>F-value (model)</td>
<td>4.164**</td>
<td>9.016***</td>
</tr>
<tr>
<td></td>
<td>(7, 20)</td>
<td>(3, 24)</td>
</tr>
<tr>
<td>Number of MFIs</td>
<td>28</td>
<td>28</td>
</tr>
</tbody>
</table>

*Note: numbers in parentheses are $t$-values, except for $F$-value (degrees of freedom). * $p \leq 0.05$ ** $p \leq 0.01$ *** $p \leq 0.001$
Conclusions

I assessed the effects of commercialization factors and other variables that, according to the literature on microfinance, may also affect loan size. Using data from diverse sources, the analysis on the first measure of loan size—average outstanding loan in US$—led to a nonsignificant model: independent variables do not explain any variance in loan size. Because this measure of loan size has been widely criticized, additional models with different measures of loan sizes were used.

Using the ratio of average outstanding loan to per capita GDP of the lowest 20%, the main finding was that the type of institution has no significant effect on loan size. Using a modified ratio derived from Schreiner’s formula—dollar-years from borrowed resources to dollar-years from per capita income of the lowest 20%—the results are similar. The same independent variables were the significant ones in both sets of models: age of the institution, sustainability, and the level of competition. In addition, the type of institution, breadth of outreach, gender, and credit methodology turned out to be not significant as well.

Additional research could assess other possible predictors of loan size, such as urban/rural scope (Thys, 2000), deposit deepening, importance of nonfinancial products, or business strategies for microfinance operations (i.e., downscaling, upscaling, etc.). Further studies may also include measures of average disbursed loan as the dependent variable. In this study, it was not possible to find appropriate information to test for these factors. There is also the question of whether this analysis should follow a more dynamic approach, in which changes in the unit of analysis should be assessed over time (3 or 5 years), as Schreiner suggests (2001, pp. 22). This type of analysis could be more useful in understanding MFIs’ operations, but longitudinal information for five years is even harder to gather.

Conservatively, these results should not be generalized to the entire Latin American MFI population. As I argued before, most of the information came from MFIs that seem to be engaged in a more commercial approach: they are reporting to the Mix Market,
an institution that is looking for and encouraging more disclosure of information and transparency. Part of its purpose is for investors to make the better investment decisions based on available information, and for MFIs to obtain needed resources for growth. Therefore, it could be the case that the entire population of MFIs in Latin America is different from this sample, which in fact may resemble instead the population of commercial MFIs.

The results deserve some comments, however. First, the sign of the coefficient for the age of the institution suggests a negative relationship: the older the institution, the lower the loan size; this finding contradicts two of Christen’s arguments: the target group of pioneering NGOs was not the poorest of the poor, but a higher income group, and their engagement in incremental lending. Statistically, the process seems to be the other way around: newer participants may be serving higher income clients than older participants.

Second, the sign of the coefficient for the level of competition indicates that the higher the concentration—or the lower the competition—the lower the loan size. If this variable accurately predicts loan size, then more competition in a microfinance market will also result in larger loan sizes, suggesting that institutions will probably search for more profitable clients.

Finally, the sign of the coefficient for sustainability (ROA) confirms an old belief in microfinance: there is a trade-off between profitability and depth of outreach.

Notes

1. These institutions are ACODEP (Nicaragua), ACTUAR-Tolima (Colombia), ACTUAR-Antioquia (Colombia), ADMIC (Mexico), BancoSol (Bolivia), Crear-Tacna (Peru), Eco Futuro (Bolivia), EDYFICAR (Peru), FADES (Bolivia), FAMA (Nicaragua), Finamerica (Colombia), FINCOMUN (Mexico), Génesis Empreserial (Guatemala), PRODEM (Bolivia), Visión de Finanzas (Paraguay), WWB-Medellín (Colombia), ADOPEM (Dominican Republic), AgroCapital (Bolivia), Banco ADEMI (Dominican Republic), Caja los Andes (Bolivia), CMAC-Arequipa (Peru), CMAC-Maynas (Peru), FIE (Bolivia), FINDE (Nicaragua), MiBanco (Peru), PROEMPRESA (Peru), Financiera Calpia (El Salvador), and Bangente (Venezuela).
2. For example, financial substitution occurs when a borrower receives a loan to buy two bags of fertilizer, but without the loan, the borrower would have bought one bag anyway. In this case, the loan resulted in 50% of addition and 50% of financial substitution (Adams et al., 1990; Alfaro 1999).

3. For instance, when two prospective clients are good credit subjects, then why, or under which criteria, should the institution discriminate against one of them?

4. In his article “Seven Aspects of Loan Size,” Schreiner (2001) argues that loan size depends on how the borrowers give more importance to some of the seven aspects than others. The seven aspects are: term to maturity, dollars disbursed, average balance, dollars per installment, time between installments, number of installments, and dollar-years of borrowed resources.

5. Most of the studies on income distribution are developed at the total population level.

6. MCI stands for Microcredit Institution.

References


Building Economic Self-Reliance

Trickle Up’s Microenterprise Seed Capital for the Extreme Poor in Rural India

Jan Maes and Malika Basu

Abstract: The Trickle Up Program is a US-based organization engaged in microenterprise development for very poor households in 14 core countries, including India. Because it targets the most vulnerable sections of the population, such as the rural landless, women-led households, people with disabilities, and economically disadvantaged minorities, TUP employs a seed capital grant strategy to facilitate its clients’ movement from absolute poverty toward economic self-reliance. TUP clients cannot risk taking a loan because they have no spare income to make payments if their enterprises do not generate an immediate profit. A conditional grant, in contrast to credit, exposes its recipients to less risk and allows them to grow a business with a longer payback period. This paper draws from a recent study of the Alternative for Rural Movement, one of TUP’s partner agencies in rural Orissa, India, and shows that its TUP clients moved successfully from a position of extreme vulnerability to one of significantly improved economic self-reliance.

The Trickle Up Program (TUP) is a US-based organization engaged in microenterprise development for very poor households in fourteen core countries, including India. TUP achieves its mission, to enable the lowest income people worldwide to take the first step out of poverty, by providing...
conditional seed capital, business training, and other relevant services essential to the launch of a microenterprise, by working in partnership with local organizations. These partner agencies integrate TUP’s services into their model to achieve their own context-specific approach to poverty alleviation. Trickle Up refers to the individuals selected for participation in the program as TUP entrepreneurs, even though in most cases this level of enterprise would be better described as launching or expanding an income-generating activity. Very poor TUP households commonly engage in multiple income-generating activities and use the TUP seed capital to capitalize both existing and new activities.

While a discussion among microfinance practitioners as to who constitutes the poor or very poor is ongoing, suffice it to say that TUP’s local partners target the poorest and most vulnerable sections of the population residing in the communities they serve, including the rural landless, women-led households, people with disabilities, and economically disadvantaged minorities. These people often cannot afford to take the risks associated with a loan, even though many are capable of running successful and profitable enterprises. Over the past two decades most microenterprise development and microfinance initiatives have been targeted at the so-called working poor, the majority of which are clustered just above and just below the poverty line. Most microfinance institutions that are driven by financial sustainability standards exclude the very poor, because loans to the very poor are seen as too risky and too labor-intensive. Even microfinance programs that deliberately target the very poor do not always manage to provide this target group with access to financial services, because the very poor often exclude themselves from such programs or are excluded by less poor clients.

Jan Maes is a consultant in microenterprise development and impact assessment; from 2000 to April 2005 he was a program officer and then a program evaluation officer with the Trickle Up Program. Email: janpmaes@yahoo.com

Malika Basu is a freelance consultant in the field of rural and social development, and presently a Ph.D. Fellow at the Institute of Social Studies (ISS), The Hague, The Netherlands. Email: basu@iss.nl
TUP clients, on the other hand, typically belong to the very poor living below the international US$1-a-day poverty line. Some TUP clients, including those portrayed in this study, can be labeled the *extreme poor,* as they live on less than $0.50 a day (taking into account purchasing power differences as with the international $1-a-day standard). Most microfinance practitioners would consider these extreme poor people unsuitable for microloans or any microenterprise interventions, since they are unable to provide for even the most basic daily needs or cope with frequently occurring emergencies. Although they struggle to survive in this condition of extreme vulnerability, owning little or no land or animals and suffering for long periods of time from chronic food deficits and illnesses, Trickle Up believes that even the extreme poor are capable of running a successful microenterprise. The key ingredient of TUP’s microenterprise development program is the provision of a seed capital grant, typically in the amount of $100, given in two consecutive installments, and based on certain conditions, to be explained later in this paper. Trickle Up’s seed capital poses less risk and therefore represents a more acceptable option for the extreme poor to invest in the start-up or expansion of income-generating activities.

While the use of grants as a microfinance strategy is controversial, proponents agree with the Consultative Group to Assist the Poor (CGAP) that microgrants can be “the first step in a strategy to graduate the poor from vulnerability towards economic self-sufficiency” (Parker, 2001, p 7). The research reviewed in this paper reveals strong evidence that extremely poor households can achieve economic self-sufficiency after receiving seed capital grants, and that access to a range of business and non-business support services provided by local NGOs are at least as critical for success.

The objective of this paper is to understand the effectiveness of the TUP seed capital grants in the creation of profitable and sustainable income-generating activities, and to highlight additional microenterprise program factors that facilitate progress from a situation of extreme poverty to one of improved economic self-reliance. This self-reliance can be typified by a sustainable increase
in household income and productive assets, enabling a household to continue to build up its economic strength. Finally, it should be emphasized that in its evaluation of the effectiveness of the TUP model, this paper focuses almost exclusively on the intended primary program outcome, household economic empowerment, while paying less attention to the hypothesized link between economic progress and the ultimate goal of social impact.

**Methodology: A Brief Overview**

At the time of this study in January 2005, TUP was working with 19 partner agencies in India, mainly in the eastern states of Uttar Pradesh, Bihar, Jharkhand, West Bengal, and Orissa. The findings in this paper are the result of a study conducted in rural Orissa with one of TUP’s partner agencies. Known as the Alternative for Rural Movement (ARM), this agency is one of TUP’s most successful partners in Asia in moving a majority of their TUP clients from extreme poverty to a situation of significantly improved economic self-reliance.

The objective of the study was not to *prove* the impact of Trickle Up seed capital grants on the economic capacity of the extreme poor, but rather to learn about the types of income-generating activities in which TUP entrepreneurs choose to invest their seed capital, to understand their reasons for making certain business decisions, and to assess how these income-generating activities contribute to the diversification and strengthening of the household income portfolio. Therefore, the study methodology is best described as a practitioner (as opposed to academic) approach to impact assessment. Through the use of focus group discussions and a standardized survey, the research produced cost-effective and credible information on the most important economic changes that take place when TUP is implemented. The goal was also to understand the reasons for success or failure as well as the constraints faced by TUP households when conducting their microenterprise activities, thereby offering immediate insights as to how program operations can be improved in the future. By no means does the research aim to attribute specific household changes to
certain program inputs or to distinguish between Trickle Up’s and the local partner agency’s contributions towards achieving impact. The study leaves no doubt, however, that ARM’s own development activities are at least equally as significant as its implementation of TUP’s microenterprise program for achieving sustainable impact on a household’s economic portfolio and well-being.

ARM is a local Indian NGO that targets more than 50 villages in Baliapal Block, which is part of the coastal district of Balasore in Orissa, India. In addition to its proven success in implementing Trickle Up, the primary reasons for choosing ARM for this study were the following:

1. Its long-term association with TUP, which yielded a large pool of long-term TUP entrepreneurs, thus enabling the researchers to gauge the sustainability of the economic changes believed to be facilitated by TUP.
2. The variety of income-generating activities undertaken by TUP entrepreneurs in this area, which allowed for comparing the utility of seed capital in initiating or expanding different income-generating activities.
3. The rural context in which ARM operates, which is common for most of TUP’s target populations in India and worldwide.

In addition, ARM’s excellent track record with TUP’s microenterprise development program made ARM a suitable organization for field-testing a quantitative survey on the use of TUP grants and its effect on the household income portfolio of TUP entrepreneurs. An analysis of these results is expected to provide the program staff at TUP headquarters and at the local partner agency with concrete recommendations to improve the program’s impact and cost-effectiveness. This is particularly important as partner agencies move to adapt the key program features, such as grant size and business training, to the specific requirements of different income-generating activities.

The field study started with a focus group discussion with ARM’s staff members who are directly involved in the implementa-
tion of the Trickle Up program. This consultative process allowed for taking up issues that were considered important by the staff and provided additional questions or phrasing for the questionnaires and focus group discussions for TUP entrepreneurs. The staff also provided valuable feedback for translating and adapting the field questionnaire to local conditions. Since ARM implements almost all its development programs, including the Trickle Up Program, through Self-Help Groups (SHGs), two such groups that had Trickle Up entrepreneurs among their members were selected at random. The field study consisted of two in-depth focus group discussions with these SHGs and individual interviews with their TUP members. The group discussions focused on different aspects of the Trickle Up program (selection, size of grant, and quality of training and business counseling) or issues related to their own SHGs (savings amount and frequency, loan availability, and group meetings). Immediately after each focus group discussion, individual TUP entrepreneurs were interviewed for one hour using a Household Income-generating Activities Survey, which is a set of mostly quantitative questions related to the nature and profitability of the various income-generating activities funded by TUP grants and the role they play in the overall household income portfolio. These were conducted with the help of ARM staff, who acted primarily as translators. One-third of the interviews were supplemented with further qualitative questions that aimed to provide more in-depth insights into the motivations of TUP entrepreneurs in relation to their business and investment decisions. Table 1 provides details about the sample used during the study.

Table 1. Self-Help Groups and TUP Entrepreneurs in the Study Sample

<table>
<thead>
<tr>
<th>SHG</th>
<th>Total Members</th>
<th>Number of TUP Clients</th>
<th>Sample Size</th>
<th>TUP Grant Installments Received</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kenduaria</td>
<td>18</td>
<td>11</td>
<td>7</td>
<td>1st in October 01 2nd in May 02</td>
</tr>
<tr>
<td>Rashalpur</td>
<td>15</td>
<td>7</td>
<td>6</td>
<td>1st in October 01 2nd in May 02</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>1st in January 04 2nd in August 04</td>
</tr>
<tr>
<td>Total</td>
<td>33</td>
<td>24</td>
<td>19</td>
<td></td>
</tr>
</tbody>
</table>
As is illustrated in Table 1, among the members of the two randomly selected SHGs, 11 (of 18) and 13 (of 15) were TUP entrepreneurs, of which 7 and 12 were interviewed, respectively. The entire sample of 19 TUP entrepreneurs represents 6.3% of a total of 300 entrepreneurs assisted by ARM during the last 3 years. Of these 19 TUP entrepreneurs, 13 received their seed capital grant nearly 3 years ago, while the remaining 6 received theirs 6 months ago.

**Trickle Up’s Seed Capital Approach to Microenterprise Development for the Very Poor**

Trickle Up partner agencies provide seed capital in two consecutive $50 installments to selected TUP entrepreneurs. While a grant may appear contrary to current development thinking, the TUP model does not begin or end with a seed capital grant, which constitutes only one of four cornerstones of the integrated Trickle Up approach to microenterprise development for the very poor. The other three are careful selection of participants, business training and counseling, and continued access to capital through savings or loans. While TUP provides most of the financial inputs, it is the partner agency’s role in selecting and training TUP entrepreneurs and linking them to savings and loans that ensures long-term sustainability of their strengthened household income portfolios. Moreover, before describing the four cornerstones of the TUP model in more detail, it is important to mention ARM’s own development activities, which play a vital role alongside TUP’s contribution in moving households toward economic self-reliance.

Whereas TUP’s principal input to the business is the financial capital to acquire business assets, ARM’s own programs address human and social capital limitations that extremely poor people face in their efforts to build sustainable livelihoods. Like many TUP partner agencies in India, ARM delivers the Trickle Up model through SHGs, which are also the point of entry for other programs, including group capacity building, advocacy, literacy training, nonformal education, health, and sanitation, among others. ARM focuses on human capital development through education
programs for adults and children and through a sophisticated health program that includes health awareness training, access to basic health services through a mobile clinic, and a life insurance program. This strong focus on health is uncommon among TUP partner agencies and strongly contributes to the success of ARM’s microenterprise programs, as chronic illness continues to be a very common obstacle to microenterprise success by TUP entrepreneurs worldwide. ARM also assists SHG members in building up their social capital through group solidarity and mutual help, increased negotiation power with local institutions, and linkages with business and market networks. ARM believes that a focus on the development of human and social capital of TUP entrepreneurs is vital both for improving the quality of life of the extreme poor and for improving the entrepreneurs’ ability to run successful microenterprises. ARM integrates these social safety net programs with the four cornerstones of Trickle Up’s microenterprise program that are described in the next sections.

Selection
Local partner agencies select new TUP entrepreneurs by using a poverty assessment tool that scores new applicants according to five locally relevant poverty criteria, identified by the partner agencies themselves. ARM’s poverty criteria include lack of land ownership (most TUP households are landless), illiteracy (80% of TUP entrepreneurs are illiterate), lack of access to credit at affordable interest rates, official “Below Poverty Level” (BPL) status, and rural residence. Those who receive the highest score according to these criteria (and thus experience the highest poverty) are eligible for participating in the program and receiving the seed capital. Since the poverty assessment tool selects households based on relative poverty only, Trickle Up also focuses geographically on countries with high poverty incidence according to the Human Development Index and on mostly rural areas within those countries to ensure that it reaches the very poor worldwide.

In order to promote sustainable income-generating activities, a strong preference goes to business groups of at least two people, typically adult members of the same household who designate one
among them as their business leader. Since illness is often a major obstacle to business success, having more than one person involved improves the continuity of the business. The motivation of the candidates, although assessed in a much less formal way than their poverty, is in most cases an equally strong requirement to pass the selection process.

**The Trickle Up Seed Capital Grant**

Before participating in the Trickle Up program, most households are already involved in one or more undercapitalized and usually seasonal income-generating activity, while others derive their income exclusively from daily labor. In both cases capital is often the most limiting factor to unleashing the profit potential of existing or new income opportunities. Given their very low and irregular incomes, the extreme poor cannot risk taking a loan to invest in a microenterprise activity, because, as one of the women stated, they can never jeopardize the inadequate resources required to feed their children in case the profit of the business would not be enough to pay the loan. And even if profit is ensured, many of these income-generating activities are difficult to finance with a loan because they generate unpredictable returns or need an incubation period after investing in the required productive assets. Agricultural income-generating activities require an especially long lag period before actual production, which prevents immediate loan repayments. Finally, the very poor often need to consume a significant part of their production, which leaves insufficient cash to pay back a loan.

TUP seed capital, in the form of two $50 grants, has the capacity to unlock latent profit opportunities, especially, as is the case at ARM, when preceded by training in basic business concepts and followed by regular business counseling sessions. The seed capital grant is not a handout but is conditioned on a strong commitment by the TUP entrepreneur. In order to receive the first seed capital installment, she must attend training and, assisted by partner agency staff, prepare a business plan for her intended microenterprise as well as commit to saving or reinvesting at least 20% of her profits in business. After working for at least three months and
completing a business report, a successful entrepreneur is eligible for a second $50 installment, which she can use to expand the original income activity or start a new one. The bulk of Trickle Up seed capital is used to fund the expansion of existing undercapitalized income-generating activities, but some recipients use at least a portion of the TUP grant to start a new activity.

**Business Training and Counseling**

The seed capital grants are most effective when combined with appropriate business training, geared toward mostly illiterate TUP entrepreneurs. ARM’s field personnel organize training sessions that cover immediately relevant business topics, such as conducting a simple feasibility study, estimating and calculating profits, marketing, reinvesting profits, and so on. Equally important is regularly encouraging entrepreneurs to think of their income-generating activities as businesses, many elements of which they have control over. After an initial business training in a group, subsequent follow-up counseling sessions are typically one-on-one; these sessions are vital to nurture self-confidence and to address individual and specific business issues. These sessions also enable field staff to monitor the use of the capital for productive purposes according to the business plan and to assist entrepreneurs in calculating their profits and reinvesting a portion in the business before using the remainder to meet daily household needs.

**Continued Access to Capital**

The majority of TUP clients generate a profit within the first year after receiving the first grant, thereby increasing their overall household income and strengthening their economic portfolio. Most partner agencies encourage or require TUP entrepreneurs to participate in formal or informal savings (and loan) programs. These programs can provide additional capital for new business opportunities and help to protect group members against future economic or natural shocks as well as prepare for costly life events, such as a marriage or the death or illness of one of their household members.
At ARM, TUP entrepreneurs form SHGs that pool their periodic savings to provide loans to their own members and to serve as collateral for bank loans, often three to four times the amount of their combined savings. While such savings-led microfinance approaches for the poor have been immensely successful, they tend to work less well with the extreme poor whose savings usually accumulate too slowly to provide sufficient capital to invest in profitable income-generating activities before a new disaster wipes out their savings. This study shows that the extreme poor can kick-start sustainable income-generating activities much faster if they have sufficient capital to invest in the minimum assets needed for their microenterprise activities. When microcredit is too risky or not available to them, or when their savings rates are very slow, seed

Figure 1. Trickle Up’s Seed Capital Grant Approach

New Business Assets (fixed and/or variable assets)
Improved Business Skills
Motivation, skills, business idea
Time, health

Stronger household income and asset base
Improved business capacity
Improved well-being (nutrition, shelter, clothing, healthcare, education)
Empowerment and increased self-confidence

Market, Geography, Climate
Unexpected events: conflict, natural disaster
Government policy and programs

Poverty Level: Income/Assets/Vulnerability
Other poverty dimensions: Health, Education, Literacy, Disability, Gender Inequality

External Conditions

Business Groups/ Households

Conditional Seed Capital

Business Training
Business Planning

Training:
- TUP procedures
- Business T o T
Tools: PAT, BP, BR

Technical Assistance
- BDS
- Savings (and Loans)

Administrative Support

Non-TUP program
- SAVINGS and LOANS
- Food assistance
- Agricultural development
- Education, skill training
- Healthcare and sanitation

Selection:
Very Poor

Monitoring:
- use of grant
- business progress
- savings and reinvestment

Non-TUP program
- SAVINGS and LOANS
- Food assistance
- Agricultural development
- Education, skill training
- Healthcare and sanitation

Repor ting:
- BP, BR, 1-yr update
- Evaluation
- Data Collection

Trickle Up

Grant funds

PAs

Expected Outcomes, Impact

Stronger household income and asset base
Improved business capacity
Improved well-being (nutrition, shelter, clothing, healthcare, education)
Empowerment and increased self-confidence

Household Conditions
capital grants are a more effective alternative to provide the very poor with this minimum amount of capital.

Figure 1 represents an overview of the Trickle Up seed capital grant approach. Central to this model are the acquisition of physical (productive) capital through the use of seed capital grants and the strengthening of human capital through business training. As mentioned previously, however, the role of the partner agency often extends much further than the implementation of these two TUP inputs. The quality and frequency of monitoring and counseling by the partner agency is also crucial for sustainable business success, as well as facilitating access to new markets for inputs as well as products.

**Improved Economic Self-Reliance**

This study’s findings relate mostly to changes at the individual enterprise (or income-generating activity) level and at the broader household income portfolio level. At the enterprise level, impact is seen through changes in profitability, employment, assets, and level of production, while impact at the overall household economy level becomes visible through changes in household income, labor productivity and dependency ratio, asset accumulation, and income diversification. The Household Income-generating Activities Survey focused on the uses of the seed capital grants, the underlying decision-making factors, the diversification and profitability of household income-generating activities, and the accumulation of productive assets and savings.

**Poverty Conditions and TUP Entrepreneur Data**

The study took place in Baliapal Block in Balasore District, a coastal area in the northeast of Orissa, one of India’s poorest states. This predominantly agricultural area is prone to frequent natural disasters, such as cyclones, droughts, and floods. During the last census in 2000, 74% of the households in Balasore District were below the poverty line (BPL), the official State poverty line set at 324 Indian rupees (Rs) per capita per month, which translates into approximately 10 Rs per capita per day. The better-off among
these BPL households are small farmers (12%), followed by marginal farmers (28%), and seasonal farm workers (60%) who have no land except for their homestead. While most agriculture is subsistence-based, some farmers produce cash crops, such as betel leaves and coconuts. The extreme poor in Baliapal Block are predominantly members of Scheduled Tribes\(^6\) (8%) and Scheduled Castes (23%), who constitute ARM’s main target population.

More than 500 SHGs have been created in Baliapal Block, 200 of which have been formed with assistance from ARM in 40 villages and hamlets. The majority of Trickle Up entrepreneurs selected by ARM are landless and their main source of income is daily wage labor, which pays an average of 45 Rs per day for men and 40 Rs for women and is available for fewer than 100 days each year. Even though some households manage to supplement this with paddy cultivation through leasing land or sharecropping, their harvest meets only home consumption needs for a maximum of two to four months. In this study, household income levels were estimated by combining annual incomes calculated for each of the various income-generating activities taken up by a household, including labor and the household’s own food production. These estimates suggest that before entering the Trickle Up program, the majority of the sampled households (14 out of 19) belonged to the extreme poor, with daily per capita incomes below 4 Rs, which is equivalent to 25% of the international $1-a-day poverty line.

Table 2 below shows that two-thirds of the Trickle Up entrepreneurs in the sample were women. In the case of male-led

<table>
<thead>
<tr>
<th>Category</th>
<th>Male</th>
<th>Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>6</td>
<td>13</td>
</tr>
<tr>
<td>Percentage</td>
<td>32%</td>
<td>68%</td>
</tr>
<tr>
<td>Average age</td>
<td>39 years</td>
<td>38 years</td>
</tr>
<tr>
<td>Average years in school</td>
<td>3.5 years</td>
<td>2.3 years</td>
</tr>
<tr>
<td>Can read</td>
<td>100%</td>
<td>46%</td>
</tr>
<tr>
<td>Can add and subtract</td>
<td>100%</td>
<td>92%</td>
</tr>
</tbody>
</table>

Note: \(n = 19\)
income-generating activities, female SHG members had been selected for TUP, but they used their seed capital grant to sponsor a business activity led by their husbands. The average age of both male and female TUP entrepreneurs was slightly below 40 years. Most men were literate and had attended school longer than the women, of whom less than 50% are literate. Both men and women could add and subtract numbers.

Table 3 shows that the average household size in the sample was six and had a dependency ratio (the number of income earners divided by total household members) of 0.6. Smaller families had higher dependency ratios and tended to rely proportionally more on women to provide income. Four out of five households were headed by a married couple, and the majority of households belonged to Scheduled Castes, the largest disadvantaged social group in ARM’s target area.

Table 3. TUP Household Data

<table>
<thead>
<tr>
<th>Category</th>
<th>Average</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of members</td>
<td>6.0</td>
<td>2</td>
<td>11</td>
</tr>
<tr>
<td>Dependency ratio</td>
<td>0.58</td>
<td>0.30</td>
<td>1.00</td>
</tr>
<tr>
<td>Marital status of TUP client</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Married</td>
<td>79%</td>
<td>5%</td>
<td>16%</td>
</tr>
<tr>
<td>Divorced/Separated</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Widowed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>OBC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Caste</td>
<td>58%</td>
<td>26%</td>
<td>16%</td>
</tr>
</tbody>
</table>

Note: n = 19. SC=Scheduled Caste, ST=Scheduled Tribe, OBC=Other Backward Castes

Seed Capital Grant Use and Asset Accumulation

Of all Trickle Up entrepreneurs interviewed, only two used part of the seed capital for a different purpose than investment in productive assets. One household had spent a portion of the grant to pay off a high-interest loan with a local moneylender, while another had used a portion to pay for the children’s school expenses. Even though these actions by both households might have been good long-term investments affecting their economic potential, TUP guidelines allow the use of the seed capital grant only to purchase income-generating assets or to pay for business-related expenses.
Data on ARM entrepreneurs indicate that during the past four years the most common types of businesses supported by Trickle Up grants are paddy cultivation (17%), goat raising (12%), vegetable cultivation (10%), rice processing (9%), bamboo and cane work (7%), betel cultivation (6%), fishing (4%), poultry raising (4%), and leaf-plate making (4%). The majority of income-generating activities are agriculture related (crop production and processing, fishing, and small animal husbandry), with the remainder involved in the production of simple household items, such as baskets. The participants in the survey (n=19) show a similar trend in their choice of income-generating activities for TUP funding; the most frequently selected income-generating activity is paddy cultivation (9), followed by rice processing (6), and followed in turn by basket making (3), fishing (3), and trading fruits (3).

When asked what factors they had considered when selecting a certain income-generating activity, the most common responses were market demand and profitability (18), advice from a family member (10), and familiarity with the work or an example by others (9). Given their initial condition of food insecurity, many invested at least part of the seed capital in paddy cultivation and rice processing. These households typically keep a portion of their harvest or processed product for home consumption, thus providing them with an income in-kind rather than in cash. Paddy cultivation remains popular, perhaps because of its importance for the household’s own food security, even though it is by far the least profitable of all the income-generating activities analyzed in the study. Interestingly, the majority used only the second seed capital installment, and in most cases only a portion of it, to either expand or start paddy cultivation enterprises. This seems to suggest that there are fewer profitable opportunities available to TUP households when they receive the second grant or that they prefer to address food shortages by producing rice themselves rather than buying rice from enterprise income. Rice processing (dehusking) on the other hand generates better profits than paddy cultivation and is the most common income-generating activity funded by the first seed capital installment. The fact that this microenterprise
activity can be done by women in their homes and requires few
skills probably explains its popularity.

One-third of TUP entrepreneurs used their seed capital amount
exclusively to expand existing income-generating activities, whereas
two-thirds used at least one of the two grant installments to start a
new income-generating activity. The TUP households participating
in the survey spent about 40% of the seed capital on long-term
assets (tools, means of transportation, equipment, animals) and
60% on working capital items (raw materials, inventory, agricul-
tural inputs, transportation expenses). This ratio, however,
depends strongly on the type of income-generating activity. For
instance, betel-leaf cultivation requires almost exclusively long-
term assets, while rice dehusking requires mostly working capital.

Two-and-a-half years after receiving the second grant disburse-
ment, all households still owned the fixed assets they had originally
purchased with the TUP seed capital, and many had acquired addi-
tional assets from subsequent profits and savings. This accumula-
tion of long-term assets is a significant step toward self-reliance, as
the assets not only provide a secure source of income but also
increase a household’s resilience against economic shocks, as they

Table 4. Reinvestment of Profits in Productive Assets by TUP
Entrepreneurs

<table>
<thead>
<tr>
<th>Type of Assets Purchased from Business Profits</th>
<th>Number of TUP Households</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small tools or accessories, such as cooking utensils, hoes, plow, baskets, basins, barrels</td>
<td>12</td>
<td>63%</td>
</tr>
<tr>
<td>Tools, such as stoves, equipment, machinery</td>
<td>10</td>
<td>53%</td>
</tr>
<tr>
<td>Means of transportation, such as a bicycle, pushcart</td>
<td>6</td>
<td>32%</td>
</tr>
<tr>
<td>Building or storage structure, including house improvements</td>
<td>3</td>
<td>16%</td>
</tr>
<tr>
<td>Minor investments for marketing, such as chair, table, shed, or the like</td>
<td>4</td>
<td>21%</td>
</tr>
<tr>
<td>Animals, including livestock, poultry, fish</td>
<td>9</td>
<td>47%</td>
</tr>
<tr>
<td>Land, bought or leased</td>
<td>3</td>
<td>16%</td>
</tr>
<tr>
<td>Other</td>
<td>4</td>
<td>21%</td>
</tr>
</tbody>
</table>

Note: n = 19
are typically the last assets to be sold in a crisis. Table 4 shows how TUP entrepreneurs have reinvested profits for investment in both production and household assets.

More than half of those interviewed had acquired the following asset categories from their enterprise profits: small tools, utensils, and accessories; larger tools and equipment; and animals. An average household invested in 2.7 different types of assets, and only one household was not able to reinvest any profits in new assets. These high reinvestment rates are a good indication that the new and expanded income-generating activities have sustained profits for several years since the disbursement of the Trickle Up seed capital.

**Profits and Diversification**

Since most available income-generating activities are seasonal and time is usually not a limiting factor for engaging in them, most households conduct a certain income-generating activity for as long as the season lasts. Therefore, rather than comparing daily profits of different income-generating activities, it makes more sense to evaluate their annual profits. Unlike time requirements, gender roles and the number of people required to run a business impose strong limits on the type of income activities households can choose from. For instance, fishing ideally requires three (preferably male) household members, whereas fruit vending can be done by one male household member and rice dehusking by one or more female members. A profitability analysis of the various income-generating activities selected by the TUP entrepreneurs interviewed shows that there is a significant variation in profits among different income-generating activities, but when considered on a per capita basis, annual profits for the various income-generating activities are very similar. Table 5 provides a comparison of profits for the most common income-generating activities in which those interviewed were engaged. Even though profits are annualized as explained above, they are shown as average daily profits by dividing the profit by 365 days, to better understand each activity’s contribution to daily incomes, comparable to the international $1-a-day poverty line. The reader needs to keep in
mind that these are not actual daily profits, since most income-generating activities are not conducted on a daily basis. For example, while an actual daily labor wage is 45 Rs (for men), the average daily labor wage is only 6 Rs, because agricultural wage labor is only available for an average of 50 days during the year.

When considering the profitability of each income-generating activity, regardless of the number of people engaged in it, fruit vending (34.7 Rs per day) and fishing (33.1 Rs per day) are by far the most profitable. As stated earlier, paddy cultivation provides the lowest average daily income (3 Rs per day). However, there is much less variation in average daily income for each income-generating activity when considering per-worker incomes: all but two provide average daily worker incomes between 7.5 Rs and 9.1 Rs, a difference of only 21%. This suggests that annual profits are not a strong discriminating factor for selecting an income-generating activity. Only fruit vending, at 20.8 Rs per worker per day, is significantly more profitable, and paddy cultivation, at 3 Rs per worker per day is significantly less profitable. In other words, compared to the average daily income of 6 Rs from labor, most alternative income-generating activities (except rice cultivation) generate a higher average daily income (on an annualized basis). Since most households are underemployed before they receive the TUP grant, they often supplement rather than replace their labor wages with income from microenterprise activities, at least to the extent that agricultural labor and microenterprise activities can be performed during different times. In addition to such time-management constraints, other factors, such as the composition of the household work force, caste and gender roles, and previous

### Table 5. Profit and Income in Kenduaria and Rashalpur Villages

<table>
<thead>
<tr>
<th>IGA Type</th>
<th>Fruit Vending</th>
<th>Fishing</th>
<th>Betel Leaf Cultivation</th>
<th>Bamboo Cane Work</th>
<th>Rice Dehusking</th>
<th>Vegetable Cultivation</th>
<th>Paddy Cultivation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average daily profit per IGA</td>
<td>34.7</td>
<td>33.1</td>
<td>21.6</td>
<td>21.3</td>
<td>17.1</td>
<td>15.1</td>
<td>6</td>
</tr>
<tr>
<td>Profit ranking</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>Daily income per worker income ranking</td>
<td>20.8</td>
<td>9.1</td>
<td>8.7</td>
<td>8.5</td>
<td>8.3</td>
<td>7.5</td>
<td>3</td>
</tr>
<tr>
<td>Income ranking</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
</tr>
</tbody>
</table>

*Note: IGA = income-generating activity.*
experience with an income-generating activity, are more important in the selection of a microenterprise than its expected annual profits.

The study also revealed a marked increase in the diversification of household income sources after the TUP seed capital intervention. Figure 2 shows the number of income-generating activities per household before and after TUP. The average number of income-generating activities per household before TUP was 2.1 (median = 2) and after TUP increased by 41% to 2.9 (median = 3). In other words, an average household managed to add one new income-generating activity to its household income portfolio, not only increasing overall household income, but also decreasing risk and vulnerability through diversification. On closer examination, it appears that pre-TUP households with one income-generating activity added two new ones, while those with two income-generating activities added one new one (with one exception among nine cases), and those with three or more income-generating activities before TUP added none. This strongly suggests that the combination of three income-generating activities per household

---

**Figure 2. Diversification: Number of IGAs per Household**

![Graph showing the number of income-generating activities (IGAs) before and after TUP. The x-axis represents the number of households, and the y-axis represents the number of IGAs. The graph shows a significant increase in the number of IGAs per household after TUP.]
represents an optimal number. It also suggests that household employment not only improved but perhaps reached a maximum.

All nineteen respondents confirmed that their household income had increased since receiving the TUP grants. The average increase in household income for those households who added one new income-generating activity to their economic portfolio was 113%. The average increase in household income for those households who added two new income-generating activities to their economic portfolio was 152%. See Figure 3 for a household annual income distribution before and after TUP. Before TUP, the majority of households were found in the two bottom income categories, below 5,000 Rs and between 5,000 and 10,000 Rs. After TUP, most households had moved up at least one category and all had annual incomes above 5,000 Rs. Figure 4 shows daily per capita household income data, which can be compared with the $1-a-day international poverty line, equivalent to approximately 16 Rs at the time of the survey in January 2005. Before TUP, the majority of households had a per capita daily income of less than 4 Rs. After TUP, most households were in the 4 to 8 Rs and 8 to 12 Rs.

Figure 3. Household Annual Income Distribution (Rs)
categories. After TUP, the average daily per capita income level was 7.1 Rs per day (roughly equivalent to $0.50 a day), and only one household was able to cross the 16 Rs per day equivalent to the international $1-a-day poverty line. More telling than a comparison with the international poverty line are the perceptions about their poverty shared by TUP entrepreneurs themselves during focus group discussions. During these discussions the following changes were almost unanimously cited as the most significant ones: reduced debt burden and ending of dependency on local moneylenders; increased household income, especially during the lean period; and the ability to eat three meals a day instead of one, as was the case before.

**Access to Capital**

Since capital had been a limiting factor for expansion or start-up of income-generating activities, the seed capital grants enabled most TUP entrepreneurs to reach a higher level of business activity than before. Some had been in a perpetual state of indebtedness with local moneylenders, and surpluses in-kind or in cash could never...
be realized because they were withheld by the moneylenders as payments for high-interest loans. Even without this debt burden most households never had enough cash flow to expand their working capital or to buy additional assets for an existing or new income-generating activity. As a result, the household labor force remained largely underutilized and income sources were mostly limited to daily wage labor and sharecropping, supplemented in some cases by the meager profits of undercapitalized microenterprises. In almost all these cases, the TUP seed capital injection boosted microenterprise profits by optimizing the amount of working capital needed or by providing for the purchase of new fixed assets. Also, one-third of the interviewed households bought or repaired a bicycle with TUP seed capital, and another 25% did the same with profits subsequent to the TUP seed capital injection. The resulting increased mobility enabled many to bypass middlemen and to access new markets for their products and their raw materials.

For each type of income-generating activity, a critical minimum amount of capital seemed to be necessary to jump-start the business to a level that more fully employed household labor. Some microenterprises, such as basket making and rice dehusking, require less than $50 to enable the household to produce at maximum capacity or to generate a surplus from the profits and gradually increase inventory. In the case of basket weaving, for example, $10 was enough to purchase a stock of raw materials to last for weeks. In many cases, the ability to buy greater quantities of raw materials (bamboo or paddy for instance) enabled these microentrepreneurs not only to bargain for lower bulk prices, but more importantly to buy raw materials at times when prices are low. For instance, the biggest investment to start a rice dehusking business is equipment (a large boiling pot, a tarp to dry the boiled rice, and a scale with weights) and amounts to approximately 1,000 Rs or $20. The remaining cash amount from a grant is more than sufficient to purchase adequate amounts of paddy and firewood to operate a profitable business for at least several weeks. After that, the TUP entrepreneur is able to gradually increase the inventory of paddy by reinvesting a portion of the profits.
In other instances, the $50 capital grant is insufficient, especially for start-up businesses. For instance, betel leaf growers needed more than the initial $50 to buy all the assets and betel saplings necessary to start a minimum size betel vine. Given the high start-up cost as well as the required skills, only those who were already engaged in betel leaf production before TUP used the seed capital to expand this type of income-generating activity. Moreover, one betel leaf producer borrowed additional money from her SHG to supplement the first TUP grant so as to increase her investment. She later used the second grant to pay back this loan. Finally, some income-generating activities simply require a much higher investment than $50. Operating a grocery shop and trading coconuts and bananas are good examples. None of the TUP entrepreneurs interviewed owned a grocery store, and only those who were already engaged in buying and selling fruits were able to use the TUP seed capital for expansion of this type of business.

**Conclusions and Recommendations**

TUP’s primary objective for this study was to better understand its microenterprise development process and to learn how the TUP model could be improved and adapted within each local context where the program is implemented. Therefore, rather than focusing on social impact, this paper was mostly concerned with how TUP entrepreneurs invest their seed capital grants, what types of assets they buy with the grant money, and how they are able to improve their household income portfolio. As TUP starts to better understand and systematically analyze, beyond mere anecdotal evidence, the various determining factors for success of the microenterprises it funds, it and its partner agencies can use these findings to make program inputs more fitting to the partner agency’s own development approach and more relevant to each different socio-economic context as well as more fitting to the different types of income-generating activities that are available to would-be TUP entrepreneurs. This in turn can be expected to provide recommendations for increased impact and for a more cost-efficient program.
Experience has shown that before participating in the Trickle Up Program, many extremely poor people are by necessity already involved in various income-generating activities that are often seasonal, barely profitable, and undercapitalized. Others, such as the rural landless, can only resort to labor as their source of income, but they often have the skills and interest to engage in certain income-generating activities. Capital is often the key to unleashing the profit potential of such income activities, but the high risks involved make loans unattractive to both lenders and entrepreneurs. Trickle Up’s capital grant eliminates most of these risks to the entrepreneurs who, in the case of ARM, have been able to expand existing activities and start new income-generating activities, resulting in significantly increased household incomes. That the capital grant plays a critical role in strengthening the household income portfolio is evident from the direct link that exists between the investment of the grant in productive assets and the increased profits these assets in turn have generated. Whether the capital grants are the main factor in this process, however, is less certain, since ARM, like many Trickle Up partner agencies, provides a range of additional financial and nonfinancial services that may contribute directly or indirectly to the sustainability and profitability of the income-generating activities funded by TUP grants.

In the absence of a control group and a large sample size, it is impossible to attribute impact to specific program elements. But the fact that ARM is one of TUP’s most successful partner agencies in improving the economic capacity of extremely poor households is likely to be related to the type and quality of the services it provides to its target clients in addition to the TUP inputs.

As for the role of capital itself, the study did not attempt to compare the effectiveness of Trickle Up grants versus loans taken from SHG members’ own pooled savings in improving the household income portfolio. But since it would take most SHG members years to save the equivalent amount of the TUP grant, it is easy to see that a large one-time TUP grant represents a stronger potential than slowly accumulating savings for boosting household incomes. The fact that TUP entrepreneurs are saving two to three times
Building Economic Self-Reliance

more than non-TUP SHG members also suggests that grants are capable of improving household profits faster than just savings alone. Nevertheless, it would be valuable to conduct further research to assess to what extent non-TUP SHG members, of the same poverty level as TUP entrepreneurs, are able to increase their household incomes, relying on savings as their only source of financing their income-generating activities.

When microcredit is too risky or not available and their own savings rate is limited, seed capital grants are an effective method to provide the extreme poor with a minimal amount of capital to start or improve income-generating activities. Moreover, grants provide more flexibility than loans for several microenterprise activities, especially in rural areas, as these activities often generate unpredictable returns or need an incubation period after investing in productive assets. In addition to making immediate loan repayments difficult, microenterprises that involve food production often provide the household with food for home consumption, leaving little or no products to be sold for cash to pay back a loan.

As mentioned before, ARM assists TUP entrepreneurs in various ways in their efforts to initiate or expand productive and sustainable income-generating activities. For instance, SHG membership provides TUP entrepreneurs with an opportunity to save as well as a platform to discuss their businesses with each other and to jointly sort out difficulties that may be hindering their income-generating activities. TUP entrepreneurs also found the regular business counseling sessions with ARM staff very useful, and they recommended that these sessions cater more to their needs by addressing specific issues relevant to each different type of income-generating activity. As mentioned before, ARM’s nonbusiness services, such as healthcare and education, also play a crucial role for achieving long-term economic progress by the extreme poor targeted for the TUP program.

The study points at several ways whereby TUP can increase the impact of its programs and make them more cost-effective. Given the different amounts of seed capital required by different income-generating activities, TUP should consider varying the amount of
seed capital according to business needs instead of the current one-size-fits-all approach of two $50 installments. In the case of higher capital needs for a certain business, TUP could disburse a higher amount for the first grant installment and a lower one for the second. Some of the evidence also suggests that in the current two-installment system, the second $50 grant has less potential for improving the household income than the first one. If further research confirms this, then increasing the first installment and possibly eliminating the second has the potential to make the program not only more effective but also less costly. Some microenterprise activities, as mentioned in the study, require a total investment of less than $50. Reducing the amount of seed capital for these types of business therefore is justifiable but might seem unfair to those who engage in these business types. To address this issue, TUP could consider providing all entrepreneurs with an equal amount of seed capital (for instance, $25 instead of the current $50 first installment), enough to invest in low-capital business types, and to provide access to loans (in the case of ARM, from the SHG savings pool, for instance) for those who require a higher capital investment and can take on some risk. This or similar innovations (such as matching savings with a grant amount, for instance) would not only increase the entrepreneurs’ ownership in their businesses but also offer great potential to reduce overall program cost, of which a large portion is currently allocated to capital grant expenses.

The finding that the TUP entrepreneurs at ARM were able to significantly increase their production and profits after investment of the grant in working capital and long-term assets suggests that their microenterprise activities were undercapitalized before. Moreover, since their per capita income levels were estimated to fall below $0.50 per day before TUP, they lived in extreme poverty. The TUP entrepreneurs themselves stated during focus group discussions that they had led a hand-to-mouth existence, often with only one meal a day for the entire family and virtually no cash surplus. In addition, many faced permanent debt and their money-lenders would demand any cash surplus as soon as it became
available. The seed capital grant enabled them to accumulate a critical minimum of productive assets to reach a state of economic self-reliance, characterized by a significantly increased household income and employment level. Through increased microenterprise profits they were able to improve their food security from one meal to three meals a day, pay off long-term debts, and start saving. These households were able to shift their focus from consumption and immediate survival to production and longer-term survival.

Whether these households are able to continue to accumulate wealth and invest in new profit opportunities remains to be seen. Several factors seem to indicate that their income has reached a plateau. First, almost all households in the study had arrived at a total of three income-generating activities, which seems to present an optimal household income portfolio in the given circumstances. Second, since the majority of microenterprise activities generate very similar profits (annualized) and very few households were able to specialize in only one microenterprise as their only source of income, there seems little room for expansion and improved profits unless other factors such as increased demand, skill development, or technological innovations improve the profits of their microenterprises. In order for these households to move further out of poverty, TUP and its partner agency ARM should explore the impact potential of business development services, such as business-specific training, new ways to add value to product and services, and linking TUP entrepreneurs to new markets for their raw materials and products.

Notes

1. Recent US legislation defines the phrase very poor as those households living in the bottom 50% below the nationally defined poverty line or those living on the equivalent of less than $1 per day, which is the international poverty line, adjusted for Purchasing Power Parity (PPP). While TUP does not formally measure the poverty levels of its clients, the majority of its clients in India are believed to live significantly below the international poverty line.

2. The TUP-assisted households in this study can be described as the extreme poor because they all live below $0.50 per day (per capita income) and a majority live on less than $0.25, based on poverty estimates derived from the annual income from
their entire portfolio of income-generating activities, including labor and food production for home consumption. Sebsted and Cohen (2000) distinguish among different poverty levels: destitute (the bottom 10% below the poverty line), extreme poor (the bottom 10–50%), moderate poor, vulnerable non-poor, and non-poor. In January 2005, when the study was conducted, the $1 per day international poverty line was equivalent to approximately 16 Indian Rupees, compared to the market exchange rate of 45 Rupees per $1.

3. In this study the household income portfolio is simply the set of income sources within a household, which is much less encompassing than the term household economic portfolio as defined by Chen and Dunn (1996). The household income portfolios in this study are mostly agricultural in nature and consist of income-generating activities (earning an income through selling a good or service), wage labor and employment, and production for home consumption.

4. In India, a typical Self-Help Group is a voluntary group of 10–20 low-income women who collectively save a monthly amount into a group fund. After a sufficient period of internal lending, the group is able to access bank credit for larger needs. Peer pressure is said to ensure regular repayment and accountability. Often SHGs provide nonfinancial benefits to their members, who use their meetings as a forum to discuss issues of mutual concern and resolve matters collectively. Many community development NGOs in India aim to facilitate economic and social development by targeting their programs to SHGs.

5. For the time frame of the study, which focused on incomes earned during the last 12 months before the interviews took place, the average exchange rate was 47 Rs per $1.00. Most income data in the study were either kept in local currency or converted into dollars, adjusted for purchasing power parity (PPP), which takes into account the local purchasing power of the Indian rupee.

6. The Indian constitution allows the government to compile a schedule (list) of castes (Scheduled Castes, SC) and tribes (Scheduled Tribes, ST) who are economically and socially disadvantaged and are therefore entitled to protection and specified benefits under the constitution. Other Backward Castes (OBC) are also officially recognized as being traditionally subject to exclusion, while still having a higher status than Scheduled Castes and Scheduled Tribes.

7. Since SHG membership often precedes the TUP intervention by only a few months, it would be misleading to suggest that the TUP program is solely responsible for the observed changes in the household income portfolio. It is more likely that the combined effects of SHG membership (giving members access to a range of services) and TUP facilitated some of these changes.
References


Microfinance Institutions in Transition

Fonkoze in Haiti Moves toward Regulated Banking Status

Michael Tucker and Winston Tellis

Abstract: Microfinance institutions (MFIs) established to provide the poor with access to capital have typically operated outside of their countries’ regulated banking environments. Many have relied on donor grants and low-interest funds to support loan portfolios and social programs. As MFIs mature they aspire to become more efficient and attain economic sustainability because they understand that greater numbers of the poor can be serviced by economically sustainable institutions. Many MFIs collect savings deposits but are often barred from using them for loans by their countries’ laws. Fonkoze, an MFI in Haiti, has sought regulated status, which would provide access to deposit assets and enable Fonkoze to better compete with other MFIs, some of which are regulated subsidiaries of commercial banks. In the midst of political and economic turmoil, Haiti’s Central Bank has delayed Fonkoze’s transformation. A different solution is now moving forward, with Fonkoze becoming two entities, Fonkoze Financial Services and Fonkoze Foundation.

Most microfinance institutions (MFIs) have been outside of or at least partially removed from the banking regulatory system of their respective countries. The poor also lack access to traditional forms of banking capitalization and are frequently reliant on donor organizations, typically nongovern-
mental organizations (NGOs). One such NGO is Fonkoze, which started in Haiti as an organization to help the poor and grew into an MFI. Fonkoze started with an office in Port-au-Prince, the capital of Haiti, and quickly expanded into an organization with 18 branches throughout the country to meet rising demand from the poor. From its inception in Haiti, Fonkoze has been financed by a combination of outright donations and loans at below market interest rates. As with many MFIs, adhering to the mission of providing capital to the poor was more important than profits for Fonkoze. Financing continuing and growing operations without access to depositor funds limited operations to whatever could be raised or borrowed from donors, necessitating continuous rounds of fund-raising. Like a growing number of MFIs, Fonkoze is in the process of making the transition from an MFI to a regulated banking institution legally able to mobilize deposit capital for its loan portfolio. While transformations have been successfully negotiated in other developing countries, Fonkoze is the first applicant for transformation in Haiti. Each MFI contemplating transformation is in a unique situation, but there are similarities as well as country-specific differences that illustrate the promise and pitfalls of becoming a regulated financial institution.

Larger MFIs with operating assets in place may not be able to realize economies of scale without becoming regulated institutions. Expansion of loan portfolios that could be accommodated by MFI infrastructure already in place may not be possible, due to funding constraints. Such constraints can be overcome with the establishment of or access to already existing savings deposits. Becoming a regulated bank would also mean focusing on profits. Since profits are not the focus of all MFIs, some may not be candidates for transformation to regulated institutions. MFIs with missions heavily tilted toward servicing the poor incur expenses far beyond those of banking operations that would make transformation to an operationally profitable entity difficult if not impossible. In Bangladesh

Michael Tucker is a Professor of Finance at Fairfield University in Fairfield, Connecticut. Email: Tucker@mail.fairfield.edu
Winston Tellis is a Professor of Information Systems and Operations Management at Fairfield University, in Fairfield, Connecticut. Email: Winston@mail.fairfield.edu
there was concern that a focus on profit-making could reduce service to the existing clientele, 90% of whom were women (Charitonenko & Rahman, 2002). Programs focusing on serving the poorest can at best cover 70% of operating costs (Morduch, 2000). Donors believe that as few as 5% of MFIs with a social welfare orientation may be able to attain financial sustainability. Fonkoze, with its mix of social and educational services as well as lending to the poor, has been a social-welfare-oriented MFI. Fonkoze plans to address mission drift, a preeminent issue in MFI transformation, by splitting its organization into a profitable bank with plans for becoming regulated and a foundation that would continue as a separate organization for social services. Splitting the functions and the funding sources will set up a synergistic relationship. The poor can receive rudimentary education and instruction in running small businesses, making them more creditworthy borrowers from Fonkoze the foundation and eventually move on to doing business with Fonkoze the bank.

Competition can also be a motivating factor behind seeking regulated status. In Haiti, regulated banks have created spin-offs or have directly entered microfinance. While their services differ considerably from those offered by Fonkoze, over time and with perhaps government intervention, they could become dominant players in an altered lending environment.

Regulation means stepped up reporting requirements and audited financial statements. For most MFIs receiving support from multiple donors, financial reporting is nothing new. They often need to satisfy multiple and time consuming reporting demands. Some NGOs funding MFIs have also insisted on audited statements. Transformation to a regulated institution streamlines these reporting requirements while simultaneously making those loose requirements more stringent. Regulated institutions are subject to far more scrutiny than unregulated MFIs. Regulation means higher standards, and the necessity of profitability translates into focusing on greater operational efficiencies. Regulated unprofitable banks cannot continue to function while losing money, unlike unprofitable MFIs. Improving operational efficiency can be a good
thing for clients but may move regulated institutions away from serving the more expensive clientele, the poorest of the poor. As Fonkoze moves steadily towards transformation, it has much to learn from the experiences of similar organizations around the world.

The first two sections of this paper trace the origins of Fonkoze and place it in the context of recent Haitian history. The next sections discuss and review microfinance institutions and banking in other countries and how some of these MFIs have transformed into regulated banks. The paper proceeds to examine the banking regulatory body in Haiti, the National Bank of Haiti (BRH), followed by an overview of MFI competition in Haiti. The final section and conclusion of the paper describe the impediments to Fonkoze’s transition toward transformation into a regulated bank and how these impediments were overcome, allowing the formation of a new entity, Fonkoze Financial Services (FFS), a transitional entity that is partway to achieving that transformation.

**Origins of Fonkoze in Haiti**

Fr. Joseph Phillipe founded Fonkoze in 1994. One year later it became a foundation under Haitian law. Since it is a membership organization, only other organizations, with the exception of political parties, can be members of Fonkoze. Organizations with membership in Fonkoze represent the organized poor. Governance is through a democratic General Assembly, with organizations having memberships greater than twenty-five sending two delegates and those with fewer than twenty-five sending one. The delegates elect nine members to a Board of Directors.

It was not until 1996 that funding levels began to rise and Fonkoze began making loans to the poor. In 1996 an organization of Haitians living in Canada donated $10,000, which was matched by the Canadian government as seed capital for a loan portfolio. Soon after that an organization of women in Louisiana, USA, donated funds. In 1997, the Doen Foundation of the Netherlands provided a combination grant and loan of $100,000, allowing Fonkoze to have a major impact on loans to the poor. To assist
Fonkoze in Haiti, Fonkoze USA was formed in 1997 as an independent 501(c)3 charitable organization incorporated in the United States with a separate board of directors. Sixty-eight percent of Fonkoze’s loan portfolio is financed through Fonkoze USA. Funds raised in the United States have come from three sources:

- Progressive Donors: those making tax deductible donations.
- Solidarity Investors: those who loan $1,000 or more for a period of one year at little or no interest.
- Dedicated Partners: individuals or organizations donating expertise (Fonkoze, 2004).

Fonkoze requires that borrowers maintain savings deposit accounts, but because of Haitian banking regulations, it cannot mobilize those savings for any purposes. The savings are effectively segregated from Fonkoze’s other accounts by being held in separate commercial bank accounts.

Meeting rising demand for loans had been possible with the participation of Fonkoze USA, international donors, and lenders. Political instability in Haiti in recent years, however, has increased the difficulty of maintaining donor funding. Satisfying different reporting requirement of the various NGOs has also become increasingly burdensome particularly since there is no standardization. Gaining legal access to deposits in order to minimize and possibly even eliminate the need to continue to seek outside funding, which is a time consuming and costly pursuit for management, would set Fonkoze as a bank firmly on the road to self-sufficiency.

Deposits on hand were much greater than the loan portfolio in both 2001 and 2002, reaching over 270% of the loan portfolio. Interest paid on deposits held by commercial banks in 2002 was 5% per annum. Fonkoze charged borrowers upwards of 3% interest per month. The spread between rates charged and rates Fonkoze would need to pay depositors leaves considerable room to cover operating expenses. Not all deposits would be available for loans. BRH set reserve requirements at 31%, well above the 8% standard set by the Basle Capital Accord of 1988 (Basle Committee, 1988).
Even at this level, considerable deposit funds would be available to fund a loan portfolio larger than current levels.

In 2001 and 2002 Fonkoze had net operating losses and sustainability ratios of 40% and 54% respectively. These numbers in isolation would seem to be poor indicators of the ability to survive without subsidies in the form of donations. Low sustainability margins, however, reflect both expenditures serving the poor, such as literacy and business practices classes, and a strategy of purchasing assets in preparation for the transformation into a larger regulated entity. Transformation would enable Fonkoze to utilize economies of scale by tapping deposits. With fully staffed branches throughout the country and considerable fixed assets ready to be utilized, Fonkoze in 2002 was poised for regulated status and expansion.

**Recent Historical Background**

Fonkoze was founded at one of the many turning points in Haitian history. A military coup had taken over the country from Bertrand Aristide, the first democratically elected president in Haiti's history, forcing him into exile. By September 15, 1994, having exhausted diplomatic negotiations to reinstate the elected president, the United States along with twenty other countries decided to intervene in Haiti (Ambassade d’Haïti, 2004). Four days later troops landed, and coup leaders stepped down and left the country. On October 15, Aristide returned from exile and resumed what had become an abbreviated presidency. In June 1995, former Prime Minister René Préval was elected president to succeed Aristide, who could not succeed himself.

Parliamentary elections were held on May 21, 2000. Results were delayed and then in June Haiti’s top election monitor fled the country, casting doubt on the election’s legitimacy (Associated Press, 2000). Even with this hasty departure, local and international observers expressed a willingness to accept the election results as marred but legitimate. Opposition parties were less sanguine, continuing to express outrage. They accused former President Aristide’s Lavalas Family Party of fixing the election to
ensure an overwhelming victory prior to Aristide’s own run for the presidency later in the year. Led by the United States, the international community rejected the May 2000 elections and subsequently embargoed all aid to Haiti (CIA, 2004). The Haitian economy has been shrinking since, with approximately $500 million in aid suspended only worsening the plight of 80% of the population already mired in extreme poverty (Janet Matthews, 2004).

In early 2004, unrest fomented by extremists, some of whom were convicted murderers, participants in the prior military coup, and retreads from the Baby Doc Duvalier dictatorial regime of the 1980s, led to the late-night February 29 departure of President Aristide under questionable circumstances. Chief Justice Boniface Alexandre was sworn in as caretaker president (Janet Matthews, 2004). New elections were scheduled for late 2005. The US military returned with a multinational force to restore order at least in some portions of the country. The Haitian government functions were reconstituted without Aristide and the possibility of a resumption in aid with the promise of stability seemed imminent in mid-2004.

Corruption and lack of security were rampant before Aristide’s departure. In June 2003, Police Chief Jean-Robert Faveur resigned after only a short time on the job. His predecessor had lasted only three months before he resigned after being accused of a 1991 murder. With law enforcement minimal, Haiti has become a transshipment point for cocaine to Europe and the US, with 15% of all US cocaine consumption passing through the country (Janet Matthews, 2004). In 2002 GDP was down 1.5% following a 1.7% decline in 2001. Inflation was down to 8.7% in 2002 from the 2001 level of 14.2%. There was a run on bank deposits after a rumor was spread that BRH would require forced conversion of all US denominated deposits to Haitian gourdes. While exports in 2002 held to 2001 levels, coffee exports, a mainstay of the rural economy, continued to decline from the 1995 level of $25 million to just $2.6 million. Manufacturing exports fell from $100 million to $85.9 million, although this was still considerably above 1995’s $30 million. Imports were off by $77 million to $980.2
million, seven times the level of exports. US currency reserves dropped to $45 million, barely sufficient to cover two weeks of imports. Foreign investment undaunted by political instability rose slightly in 2002 to $99.1 million, more than double the 1995–1998 annual averages (Janet Matthews, 2004).

The budget deficit rose to 3% of GDP as taxes fell to just 5.3% of GDP, covering only 50% of government expenditures. The IMF in 2003 called for privatization of telecommunications and energy along with substantial infrastructure improvements. It would be difficult to imagine where the funds to accomplish any rebuilding would come from other than foreign aid, which in 2001 had fallen to $20.40 per capita from $43.40 in 1997, significant sums in a country where average wages are $1.20 per day (CIA, 2004).

**MFIs and Banking in Other Countries**

Microfinance institutions’ ability to attract capital is in part dependent on the stability of the country’s political climate (Campion & White, 2001). Sri Lanka’s experience of political unrest impinging on commercial development (Charitonenko & de Silva, 2002) could be instructive to countries like Haiti undergoing similar disruption. Indonesia also endured sectarian violence, but the government introduced enabling measures to assist in microfinance development (Afwan & Charitonenko, 2003). In Bangladesh, creating an MFI enabling environment is not the highest priority of a government that has been faced with occasional instability. Even so, government subsidies do contribute to enhancing the 41% of loanable funds that come from donations to MFIs (Charitonenko & Rahman, 2002).

Some countries, recognizing the lack of capital and banking services available to the poor, often encouraged and assisted the establishment of institutions. In the Philippines the Rural Banking Act of 1952 promoted the establishment of rural banks. The Central Bank of the Philippines (*Bangko Sentral ng Pilipinas*, BSP) provided free technical assistance and access to loans at preferential rates (Charitonenko, 2003). The way was open to entrepreneurs or cooperatives to own rural banks. That is not to say that Philippine
rural banking was always successful or that government assistance was not without a price. In the 1970s, BSP forced rural banks to act as a conduit for unsecured loans to rice farmers by threatening to fund new competitors if they did not cooperate. The loan program was a disaster, creating economic hardship and even bankruptcy for some rural banks. Similarly, Indonesia began deregulating the financial sector in the 1980s by liberalizing interest rates. The government has tried to strengthen the Central Bank since 1998 (Afwan & Charitonenko, 2003). Sri Lanka addressed the issues across several areas: the policy environment, the legal framework, regulation and supervision, money and capital markets, and support institutions. Sri Lankan government support was not always beneficial. Government subsidization and debt forgiveness significantly compromised movement toward best business practices and sustainable viability of the microfinance industry (Charitonenko & de Silva, 2002).

The governments of Bangladesh, Chile, Sri Lanka, and Indonesia directly subsidized microfinance lending for selected institutions, sometimes causing serious harm to those outside the orbit of such aid (Charitonenko & de Silva, 2002). In Chile, the focus of the subsidies was the country’s largest banks. MFIs were bypassed even though they had built a base of 81,000 loan clients over ten years. Quickly, the three largest banks attracted 70,000 microcredit clients (CGAP, 2001). NGO-established MFIs, locked out of the subsidization program because it was open only to regulated banks, eventually closed down. Many MFI employees ended up working for banks in their microcredit departments. While profitability was not up to the standards of other sectors of Chilean banks, efficiencies achieved by economies of scale aided by government subsidies made loans more available. More of the poor may have been assisted by the government subsidized expansion of microfinance lending in the end, but the process destroyed existing MFIs.

Since MFIs are costly to operate, the ability to set interest rates high enough to cover operating expenses is crucial to survival. Government laws capping usury rates can be restricted to regulated
institutions or in some cases extend to all lending institutions in the economy. In Nicaragua, where the microfinance industry has grown rapidly in both rural and urban areas, the legislature capped all loan interest rates at such low levels, reportedly at the behest of the commercial banks in the country, that the survival of microfinance organizations was threatened. Since the cost of administering small loans is higher for MFIs than the cost of administering larger sized bank loans, MFI profit margins are particularly susceptible to the imposition of interest rate caps. In 1986, ACP Group in Peru had become the largest MFI lender in Latin America with over $5.8 million in loans and better than nine thousand borrowers (Campion, Dunn & Arbuckle, 2001). To fight inflation, the government capped interest rates at 32% in 1987, an extremely unrealistic figure, as inflation rates climbed to over 7,000%. By the following year ACP’s loan portfolio was below $100,000 and two of its four branches had closed. Fujimori’s election led to reforms that lifted the usury cap in 1990. ACP expanded its loan portfolio to $6.8 million and 19,100 clients. Though inflation was also down, ACP still had to charge an effective annual interest rate of 125%. Without the ability to adjust interest rates, ACP would certainly not have been able to expand or possibly even survive.

Progress and Challenges to MFI Transformation

Ideally a country’s political and economic climate should nurture new financial institutions. Some specific legal and economic conditions that are seen as favorable to the growth and prosperity of financial institutions include the following:

• The elimination of policies that inhibit transformation, such as rate caps on commercial institutions.
• The elimination of government sponsored loan programs that undercut private and NGO sector loans.
• A legal system that allows for the creation, registration, and repossession of claims against borrowers.
• Banking supervision that both regulates and assists in the mobilization of savings.
• The existence of both money markets for short-term credit and capital markets for longer term funds.
• The existence of institutions or the ability to create institutions that compile credit information, credit rating, and collections agencies.
• MFI trade organizations that provide training and technical support (Campion & White, 2001).

Favorable conditions did exist in Sri Lanka, so much so that microcredit saturation is reported to be around 80%. Some of these MFIs are at a fairly early stage of transformation. A few NGO-sponsored MFIs were attempting to transform, but most were economically unsustainable. There is limited involvement in microfinance by commercial banks. Government policies and interventions now discourage new entrants into microfinance and hinder the transformation of existing MFIs (Charitonenko & de Silva, 2002). Saturation of the microcredit market “Has led to many cases of over-indebtedness and appears to be undermining the primary incentive to repay . . . increasingly, clients appear willing to default . . . safe in the knowledge they can access the financial services from one of its competitors if follow on loans are not made available” (Wright, Christen & Matin, 2001). In Bangladesh, the government estimates that 45% of the population, or 12.2 million families, are poor. If this estimate is correct, the microcredit market is largely saturated, with MFIs reaching more than 70% of the poor households (Charitonenko & Rahman, 2002).

Bolivia was also fertile ground for MFIs. The number of microfinance lenders reached such high levels in the 1990s that borrowers began to obtain loans from one MFI to repay another (Rhyne, 2001). By 2002 as much as 34% of all Bolivian MFI loan portfolios were for borrowers with obligations at more than one MFI. Insolvency at some institutions and excessive debt burdens forced the government to intercede.

The tendency to subsidize interest rates to borrowers and to forgive loans during adverse weather conditions was perhaps the most inhibiting factor faced by MFIs in Indonesia as they moved...
towards transformation (Afwan & Charitonenko, 2003). Sri Lanka was also hampered by government intervention, which had a chilling effect on organizations considering transformation to regulated status (Charitonenko & de Silva, 2002).

Many MFI boards and NGO sponsors are reluctant to consider transformation to regulated status, fearing that the founding mission of serving the poor will be lost in the pursuit of profits. Focusing on profits can raise the size of the average loan, effectively locking out the poorest of the poor. By contrast, mission drift may be low in semi-formal MFIs that are content with serving a localized market on a competitive basis (Charitonenko & de Silva, 2002).

Indonesia had a sound regulatory framework, but with lax enforcement MFIs circumvented regulations banning the use of savings deposits to finance loans. Indonesia lacks deposit insurance—there is no deposit insurance institution—and public savings have reached 70% of total bank assets, which makes the lending of deposits even more dangerous without appropriate supervision and control. Indonesia also lacks a Credit Information Bureau and like Sri Lanka lacks microfinance training centers (Afwan & Charitonenko, 2003).

MFIs in Sri Lanka overemphasized the social mission, which in turn curtailed progress towards transformation. In Sri Lanka there is a legacy of ad hoc debt forgiveness that damages the repayment culture. Sri Lankan cooperatives mobilized over 1 billion Sri Lankan Rupees (US$11.2 million), but an inadequate legal and regulatory framework places customers’ funds at risk. Most MFIs in Sri Lanka consider transformation to a regulated bank as the best survival option, but the high minimum capital requirement—500 Million Sri Lankan Rupees (US$5.6 million)—is likely to be difficult to meet (Charitonenko & de Silva, 2002).

In Indonesia, transformation has allowed large scale, sustainable microfinance outreach. Indonesian MFIs are averse to the term transformation and instead invoke the phrase greater business orientation. The more “business oriented” MFIs have a good record in reaching the poor and have not experienced significant mission
drift. However, MFIs have not had to deal with competition from new entrants.

Indonesia’s Bank Rakyat (BRI) is the largest microcredit institution in the world. It is also 100% state owned. Such market dominance can inhibit other MFIs from making the transition to regulated institutions that would entail greater scrutiny and reporting requirements. Only a few Indonesian NGOs have made efforts to formalize their microfinance activities. Prohibited from mobilizing savings deposits for use in loan portfolios, they set up credit unions to circumvent the law. Moslem religious prohibitions against usury are another impediment to lending practices in Indonesia. Here government-sponsored changes in the late 1990s to banking laws have paved the way to creative lending that accommodated the ban on charging interest (Afwan & Charitonenko, 2003). In the Philippines, restrictions on MFI access to mobilizing savings are more flagrantly violated. Many MFIs regularly loan savings, effectively challenging regulatory authorities to intervene (Campion & White, 2001).

In Peru, APC faced two choices when it considered transformation to regulated status in 1994. One choice, Financieras, required capitalization of $3 million, less than the second choice of the traditional full-service bank, but Financieras was restricted from offering savings accounts and other banking services (Campion, Dunn & Arbuckle, 2001). Later in 1994 legislation created a third alternative specifically designed for MFIs, the EDPYME, with an even lower capital requirement of $256,000. EDPYME organizations were to be a first step in a transformation process eventually leading to becoming a full service bank. Mobilizing savings deposits, however, was barred until the transformation was complete. The cautious step-by-step approach appealed to APC until Fujimori, after attending a Microfinance Summit in 1997, proposed establishing a full-fledged microfinance bank in Peru. Rather than create a new MFI institution, Fujimori saw APC, the largest MFI, with capitalization exceeding the $5.6 million minimum, as the logical choice. The new entity would also be permitted to collect passbook savings.
The Haitian Banking Sector

The National Bank of Haiti (BRH) was founded in 1880 but did not assume the role of a national bank until 1934 (U.S. Department of the Army, 1989). Since then it has had multiple roles, including the issuance of Haitian currency, the gourde. Under 1979 legislation, BRH gained authority to control credit, and to set interest rates and reserve requirements. It exercised that authority in the 1980s to implement conservative monetary policy requiring high reserves and low interest rates on loans made by the country's commercial banks. This policy effectively limited credit availability, slowing the economy and curtailing inflation.

The bulk of banking profits were made on the spread between the interest rates banks could earn on their investments and what they paid out to depositors. With rates on deposits low, commercial banking was a money machine. In the 1980s imposed caps on loan rates made commercial bank lending unprofitable and undesirable, particularly when money could be made on the spread between rates paid and investment returns. Private-sector lending beyond the purview of banking regulation supplied loans at very high rates. The poor had access to loans only from loan sharks, who were often brutal in collecting overdue debts. It was not until the 1990s that NGO-sponsored microfinance institutions began making loans available to the poor. MFIs were unregulated and outside the imposed BRH rate caps, though not beyond a prohibition barring access to deposits for their loan portfolios.

MFI Players in Haiti

There are many microfinance institutions in Haiti (see Table 1) but none offers the type of services and geographical reach of Fonkoze. With branches in outlying rural areas, where 95% of its clients are located, Fonkoze serves the rural poor as a lender and as a deposit institution, though those deposits are eventually transferred and held by commercial institutions. Fonkoze's average loan size is well below average loans provided by other Haitian MFIs (Table 1) because of its dedication to serving the poor. Remittance services,
i.e., money transfers from outside Haiti done affordably, as well as foreign exchange services are not found at other MFIs.

In the early 1990s Haitian bank regulators removed interest rate caps, motivating three commercial banks to offer microfinance loans (Gonzalez, 2001). As in Chile, commercial banks were building on the success of NGO-backed MFIs, but unlike in Chile, the only help from the government was the lifting of interest rate caps to create a level playing field. With 80% of Haiti’s workforce self-employed (CIA, 2004), the market for small loans is large. The sophistication of borrowers, however, is limited, as it is in Sri Lanka or Indonesia.

Legislation that removed interest rate caps from commercial banks and lowered equity requirements opened the way for large scale commercial lending as well as the expansion of commercial banks into microfinance (Accion International, 2000). In 2000, following these reforms, Sogebank, a major commercial bank, created Sogesol as a joint stock company to be its entrant in the microfinance market. Sogesol planned to rely on Accion International for advice. Profits were to be the focus of Sogesol business—not an unusual focus for a commercial bank but somewhat different from the typical orientation of NGO-supported MFIs that emphasized social benefits (Gonzalez, 2001). Another departure from NGO-run MFIs was Sogesol’s collateral requirement. Loans would only be made to borrowers able to pledge

Table 1. Comparison of Haitian MFIs (June 2002)

<table>
<thead>
<tr>
<th>Institution</th>
<th>Outstanding portfolio</th>
<th>No. of active loans</th>
<th>Average outstanding balance</th>
<th>Interest rate (monthly)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACME</td>
<td>US$1,432 mil.</td>
<td>4283</td>
<td>US$334</td>
<td>3% flat + application fee</td>
</tr>
<tr>
<td>FHAF</td>
<td>US$1,431 mil.</td>
<td>2951</td>
<td>US$484</td>
<td>N/A</td>
</tr>
<tr>
<td>FONDEPOIR</td>
<td>US$1,126 mil.</td>
<td>3645</td>
<td>US$308</td>
<td>N/A</td>
</tr>
<tr>
<td>FONKOZE</td>
<td>US$1,128 mil.</td>
<td>10000</td>
<td>US$113</td>
<td>3% + application fee</td>
</tr>
<tr>
<td>BUH</td>
<td>US$2,349 mil.</td>
<td>3000</td>
<td>US$783</td>
<td>3% flat + application fee</td>
</tr>
<tr>
<td>SOGESOL</td>
<td>US$2,197 mil.</td>
<td>5522</td>
<td>US$366</td>
<td>3%, 5% flat + application fee</td>
</tr>
<tr>
<td>MCN</td>
<td>US$3,152 mil</td>
<td>2500</td>
<td>US$1260</td>
<td>5% declining balance + application fee</td>
</tr>
</tbody>
</table>

Source: Microfinanza Ltd. 2002 and Fonkoze
collateral, which could include appliances, beds, or other household goods. Collateral requirements have locked the poor out of capital markets in the past, i.e., commercial bank loans. Borrowers with collateral are not the poorest of the poor, making Sogesol’s clientele only slightly down market from Sogebank’s clients but unlike many of Fonkoze’s clients who lacked collateral, particularly first-time borrowers. In its first year, Sogesol had 700 clients. Sogesol’s client base rapidly expanded to over 5500 clients, with a loan portfolio just under $2.2 million. While Sogesol was effectively a regulated MFI, the fact that it attained this status because it was a joint stock company owned by an already regulated commercial bank, Sogebank, did not offer any guidance or procedures that BRH could follow in reviewing Fonkoze’s application for regulated status.

Established in 1999 as a joint stock company, Micro Credit National (MCN) is 50% owned by Haiti’s number two bank, Unibank S.A., and the remainder is held by three NGOs (IMI, 2003). Loan sizes are large by MFI measures, averaging $1,000, though MCN also has low end loans and high end loans up to $20,000. Operations are in Port-au-Prince and ten other cities, with 36 loan officers. As of 2002, MCN’s loan portfolio was over $3.5 million and its clients numbered 2500.

In 1997 with assistance of loan guarantees from USAID, Banque de l’Union Haïtienne, a commercial bank, established a microfinance subsidiary BUH to provide microcredit to the poor (USAID, 2003). By 1999 BUH had 14 branches, including 8 outside of Port-au-Prince. BUH’s loan portfolio in 2002 was over $2.3 million, with 3,000 active loans. Forty percent of BUH’s loans are in the Port-au-Prince market and the average loan is also at the higher end: $1500 in Port-au-Prince and $783 elsewhere.

Association pour la Cooperacion avec la Micro (ACME) is an NGO-operated MFI founded by a Belgian professional in 1997 (Microfinanza, 2002). Like Fonkoze, ACME is registered as an association in Port-au-Prince. Since it is not a regulated financial institution and is not owned by a commercial bank, it has limits on its sources of funds. It has managed to borrow from commercial
banks, which insist on 100% equity to back loans to ACME. With such loans composing the bulk of its funding, leverage to grow the loan portfolio is limited. Bank loans also charge interest rates of 18–24%. To make up for these high rates and the high cost of doing business, effective annual rates on ACME loans were 74–83% in 2002 (Microfinanza, 2002). Rates consisted of a flat 3% monthly rate plus fees. Borrowers seeking loans do not have to pledge collateral but they do need a fixed residence, a business that has been in operation for six to nine months, and a loan guarantor who is not an ACME client and who has an annual income at least triple the loan amount requested. Nearly all loans are for six month periods, averaging just over $500 in 2002. ACME puts a $2,000 cap on loans. Twenty-four loan officers administer loans. Loans are made on a commercial bank account from which borrowers withdraw money by ACME-issued check and to which borrowers make deposits as payments. Clients perceive ACME as being friendlier than banks and its staff as motivated and qualified. ACME provides no other services, such as training in business practices or literacy, both provided by Fonkoze. Incentives paid to loan officers succeeded in lowering an 18.7% PAR (portfolio at risk) in 2000 to just 4.48% in 2002. But the tilt of the incentives toward larger loans also resulted in 50% of the PAR being concentrated in smaller loans. Collecting on bad loans is a slow and tedious process due to inefficiencies within the Haitian court system, but ACME has managed to collect on over 20% of the loans it writes off. In 2002 ACME had a loan portfolio of $1.4 million and over 4300 active loans (Microfinanza, 2002). It has also managed to attain sustainability; revenues exceeded costs in both 2001 and 2002. ACME recognizes the advantages of becoming either a cooperative or a commercial bank but does not have plans to pursue regulated status in the immediate future.

Interest rates on loans may be stated on a rate per month basis but a hidden aspect of these loans that makes them less comparable is the principal to which the interest rate is applied. Sogesol’s 3% monthly rate appears comparable to Fonkoze’s loan rate (Table 1) but it is considerably higher. Sogesol borrowers repay principal
over the course of the loan installments but the interest they continue to pay is on the initial amount borrowed. It is not interest on the declining balance, typical of installment loans. Fonkoze borrowers pay interest only on the declining balance. For example, assuming both Sogesol and Fonkoze charge the same application fee and the total loan is $500 for six months at 3% per month, the effect of Sogesol applying interest to the initial amount borrowed for the entire six-month period and collecting equal installments results in monthly payments of $98.33 versus $92.30 for Fonkoze’s loan. Sogesol’s actual monthly rate is 4.94%, which approximates the 5% rate charged by MCN on declining balances.

The launching of a new MFI trade organization in Haiti, DAI/FINNET, is a positive development. DAI/FINNET has begun to keep track of borrower credit information. One difficulty in compiling such information is that the poor often lack proper addresses. Note that one of ACME’s requirements is that borrowers have a residence with a fixed address.

**Fonkoze: Planning a Commercial Transformation**

Making the transformation in Haiti is more of a challenge than in many other developing countries. Haitian capital markets are nonexistent, the legal system is in tatters, and BRH is largely without the means to properly supervise and regulate. In Haiti, the lack of infrastructure makes normal business decisions risky. If the judicial and supervisory agencies were functional, the governor of the Central Bank would provide a list of instructions to the applicant MFI, which would guide the process through transformation.

MFIs seeking other avenues to access savings could have considered becoming cooperative banks. In 2000, *Caisses Populaires* (CP) or savings cooperatives began expanding in Haiti. Government regulation created a boom in this banking segment with a 2001 anti-money-laundering law that forced drug money from commercial banks into less regulated CPs (Microfinanza, 2002). Competition for deposits heated up, with promised interest rate of 10–12% per month, much higher than annual rates offered by commercial banks. CP deposits reached $200 million. The pyramid
scheme imploded when the volume of savings inflow slowed after the rush to move drug money into CPs. Soon interest rate payments halted and CPs limited withdrawals. Rioting and even burning of CPs followed. The government was forced to pay off some of the deposits but the reputation of cooperatives was tarnished. This black mark against savings cooperatives effectively eliminated such a transformation alternative for Fonkoze.

With Haiti under siege internationally in 2001 and aid cut off following the parliamentary elections of 2000, just when Fonkoze began pursuing transformation, it was unlikely that Aristide could have undertaken an MFI transformation initiative. Transformation to become a regulated bank would have to be proposed and managed by Fonkoze and BRH. On May 28, 2001, Fonkoze wrote to Gustave Flaubert, Haitian Minister of Finance and Economy; Fritz Jean, Governor of the Bank of the Republic of Haiti; and Staley Theard, Haitian Minister of Commerce and Industry, proposing a transformation to a commercial bank. The new entity would be a stock company, with 40–49% owned by the foundation currently managing Fonkoze. A minimum of 51% of the stock would be owned by Haitians. Dismissing the idea of becoming a cooperative in the letter, Fonkoze proposed a gradual process. First it would become a provisional commercial bank, with $500,000 deposited in escrow. Fonkoze would seek further funding to achieve full status as a commercial bank, with $3 million in equity.

Fonkoze reorganized itself into the Fonkoze Foundation and Bank Fonkoze. There would be two distinct boards. The funds that Fonkoze USA raised for the bank were turned over to a new entity, Fonkoze LLC. Through a private offering memorandum, Fonkoze LLC would in turn invest in Fonkoze SA, a holding company that would control the regulated Bank Fonkoze. With $2.5 million in funds raised, more than any prior Haitian bank had raised at startup, Bank Fonkoze was well financed.

Fonkoze’s 2003 application for transformation to regulated status languished in the waning months of the Aristide regime. In 2004 Fonkoze management discovered that the application was dismissed in an August 2003 BRH report which questioned the
capitalization of the proposed bank. The report was never delivered to Fonkoze. The negative report revealed a basic misunderstanding of the complex structure of Fonkoze. Although Fonkoze was well capitalized, the main objection voiced in the report to moving forward with regulated status was doubt about Fonkoze’s ability to honor its obligations in the event of financial failure.

Fonkoze’s board of directors, frustrated with the lack of progress, considered an alternative strategy that would provide legal access to savings deposits. MFIs in the Dominican Republic similarly barred from using savings deposits in their loan portfolios had found a way to circumvent banking regulation. They accessed savings by creating a new debt instrument to “sell” to the public. MFIs issued notes instead of deposit slips as a form of acknowledgment of the receipt of funds. Would-be depositors became creditors loaning money to the MFIs at fixed interest rates. The MFIs could then legally use these “borrowed” funds to finance their loan portfolios.

With the departure of Aristide and the installation of Acting Prime Minister Latortue, the possibility of moving forward with regulated status was reopened. Latortue was known to be favorably disposed to MFIs—his daughter was an official with the Consultative Group to Assist the Poor (CGAP). In May of 2004 Latortue assured Fonkoze that bureaucratic stumbling blocks would be removed. However, it soon became apparent that the new administration and BRH had many other pressing issues to address, relegating Fonkoze’s application to further delay.

The board pursued the option of using a credit instrument with which to turn deposits into loans. A new entity, Fonkoze Financial Services (FFS), was created to supercede Fonkoze Bank as an interim step toward becoming a regulated bank. It was to handle the new credit instruments. There would need to be training sessions for Fonkoze employees and new forms and procedures would need to be designed. Following legal advice, Fonkoze conferred with BRH and explained their intention of using credit instruments instead of deposit slips. BRH was amenable to the change but went further with a simpler solution. Each existing depositor
was simply to sign an agreement granting permission to Fonkoze to manage their savings. The process of gaining access to deposits would not only be streamlined, it would effectively be approved by BRH.

Prior to transferring funds from Fonkoze LLC to FFS, LLC investors asked that a pilot project be run at two rural branches and at a branch in Port-au-Prince. The change would be explained to depositors and they would be asked for written approval. Rural depositors were unanimous in their approval, while 85% approved in Port-au-Prince. The lower approval rating in Port-au-Prince was mainly because some depositors were unable to consider the proposed change, due to time constraints. Fonkoze LLC authorized conversion of the MFI to FFS, which would serve as a transitional entity. The $2.5 million raised and currently in escrow in the US would be released to Fonkoze LLC and eventually to FFS. Fonkoze would effectively obviate the urgent need to transform into a regulated bank.

FFS was not required to adhere to banking regulations since it would not be a regulated bank. Fonkoze’s board, however, continued to focus on the need for best practices. Planning for a future transformation, the board mandated that the new entity act as if it were regulated and meet BRH standards as well as international standards under the Basle accords. BRH standards required 31% of deposits be held as reserves. The only exception to strict adherence to BRH regulations would be that FFS would keep the 31% reserves in dollars and deposits in US banks rather than in Haitian currency on deposit with BRH.

Fonkoze has been reconstituted into two separate entities. The first entity is a continuation of the original foundation, which will continue to provide educational programs for new borrowers and serve as an incubator for new branches by financing and operating them. A subset of the first entity will manage cooperative agricultural loans. Cooperative agricultural loans are a relatively new product in Haiti. Haitian farmers have been encouraged and given help to grow crops for export, but there was no existing entity to purchase those crops and aggregate shipments. The agricultural
cooperatives lacked funding to carry-over the several month period between buying crops from farmers and receiving payments from outside the country. Fonkoze entered into the business of providing loans to agricultural cooperatives, initially with a loan guarantee program sponsored by USAID. That guarantee program expired without any guarantees being invoked. The foundation will continue to provide cooperative loans. The second entity, FFS, will operate the established bank branches and manage savings deposits, foreign remittances, and foreign exchange. Small business loans, which are typically longer-term, for larger amounts, and with men being the predominant clientele, will be managed by FFS.

Fonkoze has used the Grameen model (Grameen, 2004) in organizing its borrowers into solidarity groups of four or five clients. Under the Grameen model between 1996 and 2001 there were 601 NGOs operating as MFIs in Bangladesh. The loan recovery rate had reached over 95% in 2001. There were over 8 million borrowers and over 11 million active members in Bangladesh (Charitonenko & Rahman, 2002). Fonkoze clientele lack collateral; relying on solidarity groups for social collateral, as Grameen does, creates incentives to make payments. Solidarity groups centralize contact between credit officers and clients. The ability of loan officers to meet with large groups of clients makes for greater efficiency. Currently loan officers service 320 clients. Postregulatory projections anticipate that experienced credit officers could oversee thirteen centers consisting of a maximum of 520 clients. Fonkoze’s fully operational small branches typically include a manager, two credit officers, two cashiers, two security guards, and one custodian. Managers are expected to handle up to 200 clients in addition to other tasks.

Banco Solidario in Bolivia was an MFI that employed group-based lending exclusively prior to becoming the first MFI to make the transition to a regulated institution. Bolivian MFI lending quickly evolved toward individual loans, which in 2000 composed 78% of loans, up from just 41% in 1997 (Rhyne, 2001). Fonkoze began with group loans and until recently they composed 90% of lending activity, mainly to groups of entrepreneurial women.
Solidarity groups went through education and literacy programs together and borrowed together, albeit for different individual needs. Graduates from solidarity groups were eligible for individual loans. Graduates have successfully completed the second phase of Fonkoze’s business training program and have previously repaid all their loans on time. It is likely that individual loans will make up an increasingly greater portion of Fonkoze’s portfolio.

Becoming a regulated bank can often mean larger, more profitable loans and mission creep away from an emphasis on serving the poor. Fonkoze’s strategy to avoid this is to leave the more charitable, not-for-profit operations to the Foundation. The poor will continue to be served and perhaps served even better. One new Foundation-based program will provide loans to poorer women not currently served by Fonkoze. The requirement for a savings account will be postponed and dues will be paid over the course of time. Loans will be made to solidarity groups in smaller sums and the women will receive basic literacy and educational services.

**Conclusion**

The following continuum describes typical MFI progress toward transformation:

- Adoption of a professional, businesslike approach to MFI administration and operation.
- Progression towards operational and financial self-sufficiency.
- Use of commercial sources of funds.
- Operation as a for-profit formal financial institution subject to regulation and supervision (Afwan & Charitonenko, 2003).

Fonkoze has attained a professional and businesslike approach. It has been hampered from moving toward the second phase of transition, sustainability, because of a lack of access to savings deposits and the need, defined by its mission, to provide social welfare programs. To continue to provide social welfare programs and attain profitability, Fonkoze’s board came up with a plan to divide Fonkoze into two entities: the original foundation that would
focus on welfare programs and seek funding through donations and a bank that would eventually attain regulated status.

Turmoil in Haiti and a lack of understanding of the complexity of Fonkoze’s tiered structure resulted in delay and denial of the initial plan to become a fully regulated institution, even though funding requirements were met. Fonkoze devised another plan that would create a transitional entity, Fonkoze Financial Services (FFS), which would circumvent the government ban against non-regulated institutions loaning savings. FFS was approved by BRH. Savings would be considered “loans” to Fonkoze by depositors and as such would then be legally available for its loan portfolio. Not only did BRH approve of the plan, it suggested speeding up the process by simply obtaining approval from current depositors to allow FFS to manage their money.

FFS is a transitional vehicle which will conduct business as if it were already a regulated institution while preparing for the final transformation into a commercial bank. That final transformation will be delayed until a more stable political situation develops in Haiti. While this is not a predictable and smooth progression toward attaining transformation, as has been accomplished in other countries, Fonkoze has taken the first step to move through the transformation continuum as quickly as the political situation allows. FFS will for all intents and purposes function as if it were a regulated bank.

References


Wright, G., Christen, R., & Matin, I. (n.d.) *ASA’s culture, competition and choice: introducing savings services into a microcredit institution* Retrieved from http://www.ids.ac.uk/cgap/satic/2182.htm
Microentrepreneurship and Job Creation
A Multiple-Case Study of HUD Microenterprise Development Assistance Programs in Upstate New York

James O. Bates

Abstract: This multiple-case study explores local government’s use of HUD-funded microenterprise development assistance for job creation and self-employment of low-to-moderate-income individuals. Respondent information was reviewed and then supplemented with document analysis and interview materials from earlier research on HUD microenterprise development assistance programs in upstate New York. Because the number of local government respondents who self-identified as providers of microenterprise development assistance was small, it was not possible to generalize research findings to the overall public microenterprise development sector. However, the study of this phenomenon, although limited, does have implications for government microfinance instrumentalities and intermediaries and for future research on public-sector microenterprise development efforts. Based on the participants’ self-report, it appears that both urban and rural HUD-sponsored microenterprise development assistance programs create jobs and self-employment opportunities for low-to-moderate-income persons using a myriad of strategies.

Since the end of World War II, the industrial economies of the northeastern United States have undergone a fundamental structural change. Where automotive and manufacturing industries were once dominant employers, today’s urban economies
in the Northeast are now driven by growth in the service sector. With the change from a manufacturing-based economy to one that is service oriented, many “living wage” employment opportunities have all but disappeared.

These changes, coupled with high unemployment and a shrinking tax base, have compelled public-sector administrators to develop local policies and programs that link business lending, on-the-job training, education, and training programs to their community development processes. These programs, albeit nascent, have created many noteworthy economic opportunities for low-to-moderate-income persons.

The Upstate New York Context

Job creation for and self-employment of low-to-moderate-income persons is an important policy option in New York State because New York, like other states, has been experiencing an increase in the number of unemployed persons and working people earning low wages. Prospects for such programs are particularly important in upstate New York, where poor economic conditions continue to exacerbate local social, economic, and political problems. New York’s poor economic conditions are evidenced in the notably high unemployment figures and poverty levels of non-New York City areas like western New York. In recent years, the weak upstate economy has been a political rallying cry for national and local officials seeking political office. The Center for Budget and Policy Priorities (2002) indicates that for the past two decades, the gap between high-income and low-income New York State families is significantly wide. The report, “Pulling Apart: A State-by-State Analysis of Income Trends” (Economic Policy Institute, 2002), shows that in New York State by the late 1990s,

- The richest 20% of families had average incomes that were 12.8 times as large as the poorest 20% of families.
• The richest 20% of families had average incomes 3.1 times as large as the middle 20% of families.

The Economic Policy Institute’s estimate of the average income of families, expressed in 1990 dollars, shows that the average income of the bottom fifth of New York state families was $13,433 from 1978–1980, $12,871 from 1988–1990, and $12,639 from 1998–2000. The top fifth of New York state families earned $105,046 from 1978–1980, $134,061 from 1988–1990, and $161,868 from 1998–2000. From these figures it can be observed that the bottom fifth of New York state families has grown relatively poorer over time while the top fifth’s income has experienced nearly a 54 percent increase between 1978 and 2000 (p. 67). The increased income gap is partially due to the downsizing and outmigration of many defense and manufacturing industries and to increased job separations in low-wage retail and service sectors—job quits, layoffs, and firing.

Why HUD Microenterprise Development Assistance

There are two reasons for using microenterprise development as a community development policy tool: first, it is a method of optimizing the use of indigenous resources for economic stabilization and growth; and second, it is a method of wealth generation for groups that have historically been economically isolated—welfare mothers, youth, unemployed persons, and immigrants. As “supply-side” economists and planners have learned from the economic growth periods of the 1980s, “universal policies” fail to redistribute income toward the poorest in our nation (Wilson, 1996). While this failure may be partially explained by the skill mismatch between laborers and available jobs, it is also a function of social behaviors and practices like racism, social exclusion, the crowding of the labor force in low-wage service jobs, the indifference of multinational corporations to local social problems, and the absence of full-time work for the low-skilled. A targeted microenterprise development program may be one of the few viable vehicles—in addition to a few innovative job training
programs—for overcoming some of these challenges and increasing employment opportunities for many low-income persons.

Although state and local governments must play a part in designing and implementing a public-sector microenterprise development strategy, they are generally not able to pursue such a strategy on their own. There are several reasons for this, including staffing constraints, the large amount of financial resources required to overcome macroeconomic and human capital barriers faced by the poor in the formal economy, and the inability of local governments to garner sustainable, broad-based political support for means-tested programs targeted at the poor that may create few jobs, have a potentially high failure rate, and provide limited tax benefits. For this reason, many U.S. microenterprise development programs are administered by not-for-profit organizations using a variety of funding streams (the Community Reinvestment Act; community foundation funding; Individual Development Accounts; religious, social, and economic justice funding; and government grants). In some instances these agencies may act as the main instruments of local governments and community foundations, directly responsible for carrying out a multitude of publicly authorized community development activities.

In 1992, the Housing and Community Development Act of 1974 was amended to include microenterprise development as an allowable activity under the Community Development Block Grant (CDBG) program. While this provision did not create a de facto set-aside for federally sponsored microenterprise development assistance, it did codify microenterprise development as an eligible CDBG social and economic development activity. CDBG funds could now be used for microloans, technical assistance, transportation, and child-care in support of entrepreneur training. HUD allocates CDBG funds to each state on a formula basis to support community development activities in support of low-to-moderate-income households whose incomes are less than 80% of the area median family income. Based on published information from the Consolidated Federal Funds Report (U.S. Bureau of the Census, 2002), national CDBG obligations have exceeded $3.4 billion for
the past five years. From this information, it seems that CDBG is a viable, accessible, and practical source of funding for microenterprise development programs.

**Microenterprise: Toward a Definition and Initiative**

There is no general consensus about what constitutes a federally recognized microenterprise. The definition depends on the granting agency and its objectives. For example, two agencies within the federal government, the U.S. Agency for International Development (USAID) and the U.S. Department of Housing and Urban Development (HUD), define microenterprise differently. USAID has defined microenterprise as a business with a low level of assets that has fewer than ten employees (USAID, 2002). HUD on the other hand defines a microenterprise as any form of business that employs five or fewer employees, one or more of whom owns the enterprise (HUD, 2001). With the lack of consensus in mind, this assessment will follow the HUD definition of a business that employs five or fewer employees, including the owner.

HUD regulations for microenterprise development programs, as codified under the 2002 Federal Code of Regulations 24CFR 570.201 (o) state that municipalities can provide microentrepreneurs (HUD, 2002):

(i) credit, including, but not limited to, grants, loans, loan guarantees, and other forms of financial support, for the establishment, stabilization, and expansion of microenterprises;

(ii) technical assistance, advice, and business support services to owners of microenterprises and persons developing microenterprises; and

(iii) general support, including, but not limited to, peer support programs, counseling, child care, transportation, and other similar services, to owners of microenterprises and persons developing microenterprises.
Thus, there are three classes of activities that are eligible for CDBG funds: (1) microenterprise establishment, (2) microenterprise expansion, and (3) microenterprise stabilization. Microenterprise establishment activities are designed to integrate disadvantaged groups and nontraditional borrowers into the small business sector. These programs assist low-income and nontraditional borrowers to form viable businesses that will be owned and operated by entrepreneurs who otherwise have limited or no access to capital markets.

Microenterprise expansion activities attempt to increase an entrepreneur’s sales and income through extending credit or various forms of technical assistance to him or her. Technical assistance may include marketing, bookkeeping, legal, managerial, and tax assistance. The objective of an expansion program is to create employment opportunities by affecting employers’ long-range demand for additional labor.¹

Microenterprise stabilization activities attempt to improve the managerial capacity of the entrepreneur or provide short-term credit to help increase sales and revenues. It is assumed that an increase in sales or revenue will enable an entrepreneur to retain or create jobs. Local governments are compelled by HUD regulation to direct microenterprise development assistance exclusively toward establishment, expansion, or stabilization. In addition, HUD regulations require that microloan borrowers create or retain jobs for low-to-moderate-income individuals.

Conventional public and quasi-public microenterprise development programs supported by CDBG focus activities on credit enhancement and lending. With regard to lending, four categories of loans have been commonly made to microentrepreneurs: working capital loans, business development loans, purchase order financing, and inventory and equipment loans. Working capital loans allow an entrepreneur to pay suppliers and buy equipment. Business development loans are used for site acquisition, capital improvement, asset purchases, and working capital. Purchase order financing is made available to businesses to make up for shortfalls in production. Inventory and equipment loans are for the purchase of fixed assets in support of production.
<table>
<thead>
<tr>
<th>Name of funded community</th>
<th>Mission statement summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cattaraugus County</td>
<td>Offer a comprehensive support program in response to the diverse needs of the growing number of entrepreneurs in Cattaraugus County.</td>
</tr>
<tr>
<td>Cayuga County</td>
<td>Provide financial assistance to small new and existing businesses in the county, with emphasis on proposed new or retained job creation.</td>
</tr>
<tr>
<td>Columbia County</td>
<td>Strengthen the city and county tax base through economic development and job creation, and assist businesses small and large with training and financial assistance.</td>
</tr>
<tr>
<td>Elmira Heights</td>
<td>Educate individuals on the opportunities that exist in the village and allow them to utilize the available resources to make Elmira Heights a more desirable community in which to live and work.</td>
</tr>
<tr>
<td>Greene County</td>
<td>Provide training, technical assistance, and low-interest financing to support the start-up and expansion of microbusinesses.</td>
</tr>
<tr>
<td>Lewis County</td>
<td>Create and retain jobs within Lewis County.</td>
</tr>
<tr>
<td>Little Falls</td>
<td>URA plans, applies for, and administers community and economic development projects on behalf of the City of Little Falls.</td>
</tr>
<tr>
<td>Village of Mayville</td>
<td>Provide sub–market rate low-interest financial assistance to microenterprises as well as additional business assistance as may be required.</td>
</tr>
<tr>
<td>Niagara County</td>
<td>Assist low-to-moderate-income entrepreneurs in starting or growing their microenterprises (defined as having 5 employees or less) by providing education, technical assistance, and access to a low-interest loan fund.</td>
</tr>
<tr>
<td>Oswego County</td>
<td>Establish and implement sound economic development strategies in order to enhance the economic vitality of Oswego County’s businesses, industries, and citizens, leading to an overall better quality of life.</td>
</tr>
<tr>
<td>Village of Saranac Lake</td>
<td>Improve quality of life by providing state- and federal-funded economic development supported by village residents.</td>
</tr>
<tr>
<td>Wayne County</td>
<td>Provide technical and financial assistance to start-up or expanding small businesses (5 or fewer employees) where low and moderate income jobs will be created or retained.</td>
</tr>
</tbody>
</table>
Lisa Servon and Timothy Bates (1998) have noted that providing a small business loan to a microentrepreneur will not by itself remove the barrier for small business creation. Entrepreneurs benefit from a combination of programs, including neighborhood planning, leadership training, business related training, access to capital and a high quality labor pool, and labor training programs. This is not to say that microlending programs do not have their merit. Servon and Bates (1998) point out that, “when well-targeted and clearly focused, . . . it [microlending strategy] can be a critical vehicle for helping some low-income people to achieve economic self-sufficiency” (p. 437). As Servon points out, by their very nature, microlending programs act as a conduit for linking neighborhood residents and businesses to banks, business development centers, community-based organizations, and state and local government agencies (Servon, 1996, p. 336). This study reinforces the importance of non-lending activities in microenterprise development.

Research Questions

In the following section I lay out the research method used to review microenterprise development assistance projects in upstate New York.

Table 2: Microenterprise (M.E.) Development Program Characteristics

<table>
<thead>
<tr>
<th>Name of funded community</th>
<th>Number of staff</th>
<th>Program start-up date</th>
<th>Value of all loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cattaraugus County</td>
<td>2</td>
<td>1996</td>
<td>$1,687,579</td>
</tr>
<tr>
<td>Cayuga County</td>
<td>0*</td>
<td>1993</td>
<td>$816,000</td>
</tr>
<tr>
<td>Columbia County</td>
<td>1</td>
<td>1996</td>
<td>----</td>
</tr>
<tr>
<td>Elmira Heights</td>
<td>1</td>
<td>1996</td>
<td>----</td>
</tr>
<tr>
<td>Greene County</td>
<td>0*</td>
<td>1998</td>
<td>$332,998</td>
</tr>
<tr>
<td>Lewis County</td>
<td>1 p.t.</td>
<td>1995</td>
<td>$852,000</td>
</tr>
<tr>
<td>Little Falls</td>
<td>0*</td>
<td>1990</td>
<td>$357,829</td>
</tr>
<tr>
<td>Village of Mayville</td>
<td>0</td>
<td>----</td>
<td>$354,200</td>
</tr>
<tr>
<td>Niagara County</td>
<td>4</td>
<td>1995</td>
<td>$1,340,600</td>
</tr>
<tr>
<td>Oswego County</td>
<td>5*</td>
<td>1998</td>
<td>$195,000</td>
</tr>
<tr>
<td>Village of Saranac Lake</td>
<td>1</td>
<td>1996</td>
<td>$189,500</td>
</tr>
<tr>
<td>Wayne County</td>
<td>1</td>
<td>1994</td>
<td>$584,000</td>
</tr>
</tbody>
</table>

*Respondents report that the program is supplemented by municipal department staff.
York. Next, I describe the missions of microenterprise development assistance programs. I then outline some specific program characteristics and performance indicators that address the following research questions:

• Who is the program serving?
• How many people have been served?
• How are clients performing?
• Are there any recognizable patterns or themes among upstate microenterprise development programs?

**Methodology**

The scope of the review included an examination of provider agency program documents and a structured survey. The survey was faxed to upstate New York municipal government grant recipients under the HUD Small Cities CDBG program. As the universe of active HUD-funded microenterprise development programs is not easily identified through available information systems, municipal government grant recipients were asked to self-identify themselves as operators of a Small Cities CDBG subsidized microenterprise development program. Service providers were asked to supply informa-

**Table 3: Performance of Microenterprise Development Program**

<table>
<thead>
<tr>
<th>Name of funded community</th>
<th>M.E. start-ups since program inception</th>
<th>Existing M.E.s served</th>
<th>Number of loans issued</th>
<th>Number of jobs created</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cattaraugus County</td>
<td>35</td>
<td>68</td>
<td>103</td>
<td>180</td>
</tr>
<tr>
<td>Cayuga County</td>
<td>14</td>
<td>21</td>
<td>38*</td>
<td>120</td>
</tr>
<tr>
<td>Columbia County</td>
<td>65</td>
<td>65</td>
<td>-0- indeterminable</td>
<td></td>
</tr>
<tr>
<td>Elmira Heights</td>
<td>14</td>
<td>---</td>
<td>14</td>
<td>60</td>
</tr>
<tr>
<td>Greene County</td>
<td>35</td>
<td>-60</td>
<td>14</td>
<td>30</td>
</tr>
<tr>
<td>Lewis County</td>
<td>15</td>
<td>15</td>
<td>40*</td>
<td>82</td>
</tr>
<tr>
<td>Little Falls</td>
<td>10</td>
<td>5</td>
<td>15</td>
<td>43</td>
</tr>
<tr>
<td>Village of Mayville</td>
<td>14</td>
<td>24</td>
<td>14</td>
<td>64</td>
</tr>
<tr>
<td>Niagara County</td>
<td>70</td>
<td>157</td>
<td>64</td>
<td>265</td>
</tr>
<tr>
<td>Oswego County</td>
<td>10</td>
<td>5</td>
<td>15</td>
<td>25</td>
</tr>
<tr>
<td>Village of Saranac Lake</td>
<td>-0-</td>
<td>12</td>
<td>12</td>
<td>39</td>
</tr>
<tr>
<td>Wayne County</td>
<td>45</td>
<td>50</td>
<td>24</td>
<td>84</td>
</tr>
</tbody>
</table>

* In some instances, microentrepreneurs applied for and were issued multiple loans.
tion about the loans issued, clients served, program accomplishments, and ancillary technical assistance provided to microentrepreneurs. The survey consisted of approximately 34 open-ended questions. It was modeled on a questionnaire used by the Aspen Institute’s 1999 Directory of U.S. Microenterprise Programs. This information was then supplemented with earlier unpublished original case-study research on this topic. The earlier research was in the form of structured interviews and documentation analysis of 15 HUD microenterprise development program operators.

Research and Discussion

Twelve municipalities responded to the survey. All respondents identified themselves as practitioner agencies. Practitioner agencies are defined as active agencies that provide loans, training, or technical assistance directly to microentrepreneurs. Most practitioner agency microenterprise development programs were established in the mid-1990s.

They operate with few staff people specifically dedicated to microenterprise development program operations. In some instances, programs are carried out by existing government community and

Table 5: Characteristics of Microenterprise Development Program Clients

<table>
<thead>
<tr>
<th>Name of funded community</th>
<th>Percentage of AFDC/TANF assisted clients</th>
<th>Percentage of low/mod* assisted clients</th>
<th>Percentage of unemployed assisted clients</th>
<th>Percentage of female assisted clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cattaraugus County</td>
<td>N/A</td>
<td>56</td>
<td>N/A</td>
<td>---</td>
</tr>
<tr>
<td>Cayuga County</td>
<td>---</td>
<td>50–55</td>
<td>---</td>
<td>23</td>
</tr>
<tr>
<td>Columbia County</td>
<td>N/A</td>
<td>61</td>
<td>1</td>
<td>50</td>
</tr>
<tr>
<td>Elmira Heights</td>
<td>---</td>
<td>100</td>
<td>---</td>
<td>50</td>
</tr>
<tr>
<td>Greene County</td>
<td>10</td>
<td>60</td>
<td>10</td>
<td>50</td>
</tr>
<tr>
<td>Lewis County</td>
<td>---</td>
<td>90</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Little Falls</td>
<td>---</td>
<td>13</td>
<td>7</td>
<td>13</td>
</tr>
<tr>
<td>Village of Mayville</td>
<td>0</td>
<td>100</td>
<td>25</td>
<td>21</td>
</tr>
<tr>
<td>Niagara County</td>
<td>---</td>
<td>58</td>
<td>---</td>
<td>41</td>
</tr>
<tr>
<td>Oswego County</td>
<td>N/A</td>
<td>55</td>
<td>30</td>
<td>10</td>
</tr>
<tr>
<td>Village of Saranac Lake</td>
<td>0</td>
<td>80</td>
<td>20</td>
<td>---</td>
</tr>
<tr>
<td>Wayne County</td>
<td>0</td>
<td>72</td>
<td>---</td>
<td>39</td>
</tr>
</tbody>
</table>

* Low/Mod: persons whose incomes do not exceed 80% of the Median Family Income.
economic development staff. Annual microenterprise development program operating budgets (survey question 14) ranged from $10,000 to $100,000. Program performance, as measured by reported major agency achievements (survey question 32), varied among programs. This may be partially explained by the fact that program divisions and departments in respondent municipalities had different program missions and operating requirements. Respondents listed the following types of activities as major agency achievements:

- Program funding allowed the only grocery store serving the remote, rural community to remain open.
- The microenterprise program has filled empty stores, increased local employment, and educated individuals while improving the overall community.
- The program has generated $1.6 million in leveraged loans.
- The program has enjoyed eight years of continuous success. Nearly 300 individuals and businesses have been assisted. Forty-six loans have been made, for a total of over $1 million, with an acceptable charge-off rate for a high-risk portfolio.
- A county-wide program has been developed to train and support small business and microbusiness development in rural areas.
- There are 12 new businesses in town!!

The mission statements in Table 1 show that job creation is merely one objective of microenterprise development. Filling vacant storefronts, keeping essential services in communities, and introducing new business opportunities into the area are also important achievements for local governments. While the distinctions between reported major achievements are subtle, they represent significantly different paradigmatic approaches to development—social planning and development versus economic development. This finding is reinforced by the fact that a number of respondents consider improving the quality of life of residents to be their mission while others consider job creation and job retention to be their mission.
All respondents with active microenterprise development programs indicate that their programs have created or retained jobs. Most respondent communities currently operate a revolving loan fund (RLF) concomitantly with training and technical assistance programs. RLFs are locally administered, flexible debt instruments that are capitalized by public and quasi-public entity grants and low-cost loans. RLFs provide affordable capital to microentrepreneurs and nontraditional borrowers in the form of seed capital, bridge loans, and gap financing. An entrepreneur uses a seed capital loan for business start-up needs like real estate and equipment purchases. A bridge loan is a form of short-term debt that is assumed by an entrepreneur until permanent financing is put in place for such activities as the development of new commercial properties or the renovation of existing properties for leasing and speculative development. The currently available dollars in the RLFs of respondent communities range from $25,000 to $866,000, and the total value for all loans issued across each RLF ranged from $189,500 to $1.6 million. The aggregate dollar value of loans distributed for all respondent microloan programs since the inception of their programs is $9,815,206.

The primary forms of technical assistance are:

- Business training courses
- Business planning assistance
- Individual business counseling.

One quarter of the respondents indicate that peer support and exchange, mentoring, and other forms of technical assistance are provided to entrepreneurs. The majority of the respondents indicate that they use a collaborative process for carrying out their microenterprise development program. Only a small percentage of the respondents indicate that their program is being carried out by a single government agency. Examples of collaboration cited by respondents are:

- We are the only agency in the county that offers training and technical assistance to small business; therefore banks and other loan funds in the area refer their clients to us. The Department of Labor even uses our classes as a requirement for their self-employment program.
• We work with borrowers to secure local bank funding; local planning staff assists with land use and environmental issues, business groups, and real [sic] to help promote programs.
• A 30-hour course is developed through Corning Community College Small Business Development Center. The Small Business Administration (SBA), local law firms, and local insurance agencies supply guest speakers.
• Some borrowers use the Small Business Development Center (SBDC). The Urban Renewal Agency (URA) works with local banks to meet business needs.
• The village microenterprise program interacts with other lenders to provide additional funding for qualified applicants to ensure access to conventional lending sources.
• Niagara County Community College coordinates classroom curriculum and provides some technical assistance. Business skills gained by program participants make their businesses more bankable, and several participants have obtained bank financing in addition to microloan fund financing.
• The Industrial Development Agency (IDA) provides 25% of each loan, using the HUD Microenterprise Program (MEP). IDA works for bank participation where possible. State University of New York (SUNY) Oswego SBDC contracted for microenterprise training.

Respondents were responsible for assisting 327 business start-ups and 482 existing businesses. As a result of this, 1,237 persons have been employed by microenterprises served by the program since its beginning. The number of loans issued by microenterprise development agencies ranges from 12 to 103, and the number of jobs created ranges from 25 to 265. Applicants were not requested to convert positions to full-time equivalents; therefore, nothing further can be inferred from this description. Because these developments are not concentrated in a specific city within the region, it is difficult to gauge the regional impact or macroeconomic implications of this change—despite the fact that they are noteworthy.
The microloan programs’ general characteristics appear to be convergent. Average loan amounts are in the $20,000 range. The average rate is approximately 5%. Loan terms range from one to seven years. Interest rates ranged from 3% to 5%. The majority of microenterprise programs reported income in the range of $30,000 to $50,000. Most respondents report an 89% to 90% business success rate (survey question 22). One third indicated a success rate that is less than 70%. Additionally, most respondents indicate that less than 10% of the loans are delinquent (survey question 24).

The respondent programs primarily serve low-to-moderate-income clients, including unemployed individuals. In three of the respondent communities, unemployed individuals account for nearly 20% of the clients served. Most beneficiaries of microenterprise development program assistance are Caucasian. Between 95% and 100% are Caucasian and 50% to 90% are male.

**Conclusion**

The results of this study appear to suggest that microenterprise development assistance is being used not only as a vehicle for general job creation but also as an employment strategy for low-to-moderate-income persons. Several microentrepreneurs were receiving some form of public assistance (unemployment benefits, TANF etc.) prior to program participation. Most beneficiaries of HUD microenterprise development assistance in respondent communities are Caucasian, and several business start-ups were in rural areas. It seems that there is a large need for entrepreneurship programs and community development services for microbusiness development in rural areas. Research involving framework development would be required to investigate this issue further. Respondent communities that view themselves as using microenterprise development programs to address quality-of-life issues implement and evaluate their programs slightly differently than municipalities that view themselves as merely operating a loan pool. This is evident in the way the programs are staffed, coordinated, and self-evaluated in terms of achievements. Finally, municipalities that operate stand-alone programs cannot be
evaluated in the same manner as municipalities that offer assistance as an adjunct service in an existing institution. Scale, operating procedures, organizational systems, and staff capacity cannot be captured by some of the standard measures of efficiency and program performance (average loan per staff, loan as a percentage of overall costs, etc.). Although many intangible benefits of microenterprise development have not been directly addressed through a limited survey of provider agencies and focused interviews such as this, it does raise the question “to what degree can microenterprise development be used to integrate low-income and the under- and unemployed into our economy?”

Today, we are only able to measure that (1) HUD-assisted programs have increased employment opportunities for low-to-moderate-income persons; and (2) these programs have produced some achievements that are consistent with the diverse interest of the sponsoring local governments. In the future, more research must be done to understand this phenomenon and to refine the social role the public sector should play as these programs evolve in the future.

Responses to Select Survey Questions

**Question 9:** For the purposes of this questionnaire, please select the response that best describes your agency:

Assessment: All 12 respondents indicated that they were practitioner agencies, which are agencies that provide loans, training, and technical assistance directly to microentrepreneurs.

**Question 10:** Number of microenterprise development staff:

Assessment: Agencies had one or fewer microenterprise development program staff each. In a few cases, microenterprise development activities were carried out by municipal government staff that also carried out other duties.

**Question 11:** Date of agency start-up:

Assessment: Two thirds of the agencies had started up operations by the mid 70s.

**Question 12:** Start-up date of HUD-assisted microenterprise development assistance program:

Assessment: Three fourths of the HUD-assisted microenterprise development assistance programs started between 1990 and 1996.

**Question 14:** Microenterprise development annual operating budget:

Assessment: Annual operating budgets for microenterprise development programs vary from $10,000 to $100,000.

**Question 15:** Is your program still operational?
Assessment: All 12 respondents indicated that their programs were still operational.

**Question 16:** Dollar amount of loan capital fund:
Assessment: Loan Capital fund values range from $150,000 to $866,000.

**Question 17:** Sources of funding:
Assessment: The primary source of Loan Capital is the Community Development Block Grant, followed by program income from Community Development Block Grant loan repayments. The primary source of operating dollars is the Community Development Block Grant, followed by program income from Community Development Block Grant loan repayments.

**Question 19:** Target population:
Assessment: The target populations served by the program are low-to-moderate-income individuals.

**Question 20:** (b) Number of business starts, (c) Number of existing businesses served since the program start-up, and (d) Number of persons who have been employed by the microenterprises you serve (including owners) since program start-up:
Assessment: (b) 327 business start-ups by programs, (c) 482 existing businesses assisted by program, (d) 1,237 persons employed by microenterprises served by the program since its beginning.

**Question 22:** What is the business success rate for your HUD-assisted microenterprise program?
Assessment: Most microenterprise programs report an 89% to 90% business success rate. One-third indicated a success rate that is less than 70%.

**Question 23:** What is the business failure rate for your HUD-assisted microenterprise program?
Assessment: Most microenterprise development programs report a business failure rate less than 15%.

**Question 24:** What are the loan repayment histories?
Assessment: Most respondents indicate that less than 10% of the loans are delinquent.

**Question 25:** Who are the beneficiaries by race?
Assessment: Most beneficiaries by microenterprise development program are white (between 95% and 100%).

**Question 26:** What are the percentages of beneficiaries by gender (% male, % female)?
Assessment: Most microenterprise program beneficiaries are male (between 50% and 90%).

**Question 27:** How much income is being generated annually?
Assessment: The majority of the microenterprise programs reported income in the range of $30,000 to $50,000. Two respondents had income in excess of $150,000.

**Question 29:** What type of technical assistance do entrepreneurs receive—what type
Today’s microfinance industry is stepping beyond charitable subsidies toward commercialization, from dependency towards self-reliance. To speed and systemize the eradication of poverty, private capital has become more crucial for microfinance institutions (MFIs). In their book, *The Private Sector in Development: Entrepreneurship, Regulation, and Competitive Disciplines*, Michael U. Klein and Bita Hadjimichael encourage practitioners and policy makers to enhance the private sector’s role in a broad range of areas that impact development.

At times, the public has characterized private capital in poverty eradication as opportunistic, exploitative, even immoral. Klein and Hadjimichael concede some abuse has occurred “by powerful groups” (p. 2). Yet, the recipients (the poor) feel that private firms are important and more effective than alternatives. Klein and Hadjimichael attribute this superiority to burgeoning ideas, competition, and best practices. Reminiscently, private sector industrialization in the 19th century in the United Kingdom doubled average worker incomes in 60 years (p. 5). Likewise, in the last decade private sector technical and organizational progress *doubled*
average worker incomes in countries like Botswana, Chile, China, Ireland, Japan, Korea, and Thailand (p. 5).

The authors contend that the private sector’s role in the development agenda is to complement the efforts of the public sector to meet the needs of poverty’s many dimensions. There is enough money in the world today to eliminate poverty (pp. 9, 15). The challenge we face in eliminating poverty is not money but delivery systems and incentives that ensure intended beneficiaries are serviced (p. 9). Combining social, political, and economic influences and resources to eliminate poverty would enhance our ability to create the infrastructure needed to reach the poorest of the poor.

*The Private Sector in Development* uses microfinance as an example of facilitating access to financial markets for the poor. MFIs are highly capable and proven delivery systems of financial services to the poor internationally. The authors note, “The effect of microfinancing is likely to be greatest when sensible, market-friendly reforms create a good business environment” (p. 84). MFI ability to scale up is questioned when the authors observe,

Most people served continue to rely on subsidies, and risks of excessive subsidy dependence are clear. . . . The greatest challenge is, thus, how to scale up the provision of microfinancing on a sustained commercially viable basis. . . . Large scale solutions are, however, unlikely to be sustained unless larger financial institutions are able to downscale their operations and serve the market for small credit and financing on a commercial basis—indeed independent of continued subsidy. (pp. 84, 85)

Technology based solutions (credit cards and prepaid electronic cards to create credit history for the poor) and governmental solutions (improve property rights to create collateral options for the poor) are suggested as vehicles to scale up microfinance.

Throughout the eight chapters of *The Private Sector in Development*, Klein and Hadjimichael measure the success and failures of a large mix of poverty-eliminating approaches. These
measures are substantiated by empirical research from the World Bank and independent sources. The findings are well presented, with dozens of statistics, graphs, tables, and charts strategically placed every few pages to enhance reader understanding.

To illustrate the need to alleviate poverty through effective delivery systems, market disciplines, and wise use of resources, the authors draw conclusions from “Where Has All the Education Gone?” a research project conducted by Lant Pritchett in 1996. The study identified the correlation between education and per capita gross domestic product (GDP) growth from 1960 through 1985. The research shows that educational capital growth in Asia was about 2.7% and per capita GDP growth was about 4.1%. In contrast, during the same time period Sub-Saharan Africa educational capital growth was about 4.2% while per capita GDP growth was only .6% (p. 7). The authors conclude that although adequate education is required for developmental growth, strong performance is best achieved when (1) human capital, (2) infrastructure, and (3) institutional frameworks are capable, with capability defined as a function of these three components combined in market operations.

Further, “studies on the effect of foreign direct investment [FDI], the most powerful mechanism to transfer best practice across borders, suggest that its contribution is most significant when domestic capability is high” (pp. 7, 18, 19). Capability is shown to be high when competitive market approaches are practiced. The private sector market approach facilitates innovation and creates jobs and improvements in service-delivery and economic performance—investment follows these conditions and per capita GDP rises. Thus, education alone will not alleviate poverty. Effective market-like delivery systems must be set in place to scale the eradication of poverty.

Throughout the book the authors emphasize job creation and the investment climate in development models. They point out that simply creating jobs is not enough to solve the world’s poverty epidemic—enterprises need to use best practices and jobs need to be productive and raise standards of living. Research provides that
“State-owned enterprises or subsidized private firms have generally failed to deliver sustainable productivity growth” (p. 17). At the same time, merely investing money into a developmental project has not proven to alleviate poverty. A firm’s capability and investment must go hand-in-hand to ensure resources are used wisely and improve economic performance. “The potentially biggest hope for poverty reduction comes from mechanisms that transmit best practice to areas where the poor live and work. The private sector development agenda emphasizes the crucial contribution of competition in this regard. . . . Special assistance to fledgling entrepreneurs through microcredit or business development services may help speed up the diffusion of best practice” (pp. 127, 128). Klein and Hadjimichael are deliberate in repeatedly reporting that competitive markets create the key drivers and incentives that encourage organizations to become efficient, use best practices, innovate, invest, create productive jobs, and raise standards of living.

The discussion of competition and investment in development markets leads the authors to examine the pros and cons of financial subsidies. At times, pro-poor intervention may require subsidies, and subsidies are in demand by both non-profit and for-profit organizations as well as the beneficiaries of subsidies. In the case of microfinance, subsidies assist institutions in reaching the extremely poor where, historically, other organizations have been unsuccessful. The authors explain, however, that cost-benefit analysis should be set in place when subsidies are used, as certain challenges arise when subsidies are granted. Although the cost of capital to organizations or individual beneficiaries appears to be less, donors, taxpayers, or investors absorb the true cost of capital. The authors present evidence that long term subsidized debt among private firms “results systematically in net negative economic outcomes” (p. 74). Further, other challenges like waste, inefficiency, and diverting funds for private gain sometimes occur when subsidies are issued. These challenges can be avoided if monitoring systems are set in place.

To remedy financial subsidy challenges, Klein and Hadjimichael suggest that information systems should be implemented to create
transparency and to assess credit opportunities. Regarding information systems the authors submit, “Informational problems make it hard to recognize and assess credit opportunities and, thus, lead to some good deals being left on the table. If one can overcome these information problems, the additional deals that would be concluded can be expected to earn the full, unsubsidized cost of capital” (pp. 74–75). Moreover, “Transparency is further enhanced when subsidies are unbundled, as they would be in private competitive markets. Then the subsidies provided for a particular activity could be calculated with some precision. In addition, results could be assessed” (pp. 164–165). Ultimately, The Private Sector in Development argues, “Subsidies can be designed to be compatible with the market solution” (p. 129). Market solutions for subsidies include establishing performance output goals, auctioning off the right to serve certain people of competing providers to the lowest subsidy bidder, and allowing information to flow so donors can choose the most deserving charities to provide subsidized funding. The authors also specify that “best practice appears highest if such support measures are delivered in ways that are consistent with market principles and that do not create unsustainable dependence on subsidies” (p. 128). Some approaches taken to promote development in the lives of the poor produce self-reliance while others lead to dependence.

The authors conclude, “The role of entrepreneurs and markets is critical for poverty reduction, because the key to rapid poverty reduction lies in transmitting advances in technology or organizational improvements across the world” (p. 167). The book outlines methods for market mechanisms to be introduced where competition will improve poverty reduction. The last chapter recognizes again the question of whether or not the for-profit motive will undermine development work. The authors establish that evidence proves for-profit market mechanisms are an integral part of the solution, yet stress that in order to create sound markets, for-profit motives need to be balanced between cooperation and competition. In sum, competition and market mechanisms transmit best practices to create effective poverty-eliminating delivery systems.
The Private Sector in Development: Entrepreneurship, Regulation, and Competitive Disciplines holds true to its title. This work thoroughly explores the private sector’s historical role in development with hard evidence of the successes and failures of a variety of poverty-eliminating approaches. Klein and Hadjimichael’s suggestions for how the private sector can complement efforts under the development umbrella—for now and the future—are well articulated and provide practitioners and policy makers a platform from which to discover effective ways to employ market mechanisms within their respective areas of influence. Though the book does not focus primarily on the microfinance industry, the principles highlighted make brilliant, practical contributions to support the commercialization of microfinance.

The strongest poverty-eliminating principle in The Private Sector in Development is clear: The private sector eradicates poverty and increases the quality of life of the poor. The eradication of poverty is a macroeconomic challenge and necessitates the cooperation of many moving parts from both the public and private sectors influencing the social, political, and economic environment. If we are to halve poverty by 2015 (Millennium Development Goal [MDG]), the public sector should continually allow more opportunities for the private sector to participate and play a larger role in development.

Notes

1. “One perspective is provided by data from the annual Human Development Report (HDR) published by the United Nations Development Programme (UNDP). For some years, the report has presented estimates of the additional resources it would take to meet all basic needs in the world. The HDR for 2000 puts the number at US$80 billion per year (UNDP 2000). That figure translates to US$1,400 for each of the richest 1 percent of people in today’s world.”