The Application of Microcredit Technology to the UK:

Key Commercial and Policy Issues

by Rosalind Copisarow

ABSTRACT: This article addresses the following issues: who needs microcredit in the UK, what is the extent of the unmet demand across the country, what are the precise terms and conditions required by microentrepreneurs, how repayment rates of at least 95% can be expected, and how an institution making microcredits can become self-financing within six years. The article also describes the main barriers faced by microcredit institutions in the UK and offers solutions to obtaining funds from the private, public, and voluntary sectors and to operating within a legal and regulatory framework that permits microcredit institutions to serve their clients with the products that they need. Finally, the article examines the social and economic impact that can be expected from microcredit, at an individual client level, at a local community level, and at a national level.

In the UK, there are approximately 500,000 microenterprises. These are tiny businesses which have no more than five employees. Only about 3% to 4% of them, however, are able to obtain credit from all the commer-
cial, government, and voluntary sector sources combined. Microfinance provides such enterprises with access to capital for as long as they need it. It thereby acts as a financial “partner,” supporting their development into mainstream banking. This is achieved through a series of incremental loans for working capital or investment purposes.

The UK is not alone in being so underserved. Microfinance in the whole industrialized world is at present hardly existent, and certainly not in a way that is capable of making a significant impact on an affordable, long-term basis. Yet for millions of people, it is a more appropriate tool to help them become self-sufficient and move toward mainstream bankability than any other means of support currently offered. If it is to become more widely available, it needs to be provided by financially self-supporting institutions.

The worldwide microfinance industry currently comprises about 7,000 to 10,000 institutions, out of which no more than 100 to 200 are both profitable and serving tens of thousands of clients, and none of these are in any industrialized country. Out of the 300 to 500 programs currently operating in industrialized countries, Fundusz Mikro in Poland has come considerably closer to profitability and scale than any other, with 30,000 loans having been extended over the past 3 to 4 years, by 90 staff working in 33 towns and cities. Since 1999, Fundusz Mikro has been fully self-supporting. An independently commissioned study of Fundusz Mikro shows, inter-alia, that every loan increased the borrower’s income by about 20% over an average term of nine months. For example, clients who started borrowing in 1995 now have two to three times more income and assets. Also, approximately 47 new jobs were created by every 100

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clients over three to four years. With 15,000 clients having borrowed from Fundusz Mikro since 1995, this implies 7,000 new jobs have resulted from the program.

A simple recommendation for the creation of many Fundusz Mikro-style organizations across the industrialized world is not, however, the answer. This is because there is no one in whose interest it entirely falls to take up such a recommendation. The social rates of return that the industry can offer in the wealthier countries require a partnership approach to be taken by financial institutions, the government, and the voluntary sector. In addition, a whole set of legal, regulatory, and institutional organization changes must accompany these partnerships in order to make them truly effective.

If this can be achieved, the rewards will be immense: for individuals, microfinance improves psychological, social, and financial well-being; for communities, it strengthens ties of mutual support and reaches out to the most needy; and for the country as a whole, microfinance can create tens of thousands of real and permanent jobs in only a few years, increase the survival rates of microbusinesses, improve the skill base of the workforce, and support a whole segment of society into the financial mainstream.

**Introduction**

How many people are lucky enough to be offered US$24 million of starting capital to design and create an entirely new financial institution, especially one dedicated to a market generally considered unbankable? I will always be grateful to the Polish-American Enterprise Fund for giving me this exceptional opportunity. Not only did it push me into rethinking from first principles what banking really ought to be about, but it also allowed me to test in practice the validity of some growing
convictions that had gradually taken root in my mind over the course of my career in commercial lending.

It is now only four short years since Fundusz Mikro made its first microloan. Nevertheless, during that time we disbursed over 25,000 loans worth US$25 million and not only obtained a consistent 98% repayment rate but also built a scale of operation large enough to fully cover its running costs and become a self-sustaining institution. Although these results are hardly sufficient to draw any generic conclusions about the legitimacy of the Fundusz Mikro approach across the whole of Europe, I hope they do at least indicate the need to re-evaluate the widely held view that microfinance cannot work in the industrialized world, however successful it may be in developing countries.

I firmly believe microfinance can work in the wealthier countries but, to do so, it must be approached with quite a different attitude from that adopted by either charitable community loan funds or commercial banks. Not only do the operating companies’ attitudes need to be radically different but so also do the community’s at large. The concept of giving people a hand-up instead of a hand-out is much talked about but has yet to be widely adopted in concrete action. Also, the legal and regulatory environment, including tax and accounting issues as well as definitions of charity and business, all need urgent review and reform if the microfinance industry is to be encouraged to develop on the one hand and protected from failure on the other.

These are all issues, however, which, though difficult, can be addressed, for they may all be regarded as externalities in relation to the two central issues of (1) whether or not microenterprises in industrialized, richer countries need lesser-developed country microfinance, and (2) whether or not they have similar propensities to repay unsecured loans to the levels seen in the best microfinance institutions worldwide.
If there is indeed the demand and the repayment basis is sound, then surely we have a secure foundation for the building of an industry.

In this article, I will try to address some of the underlying principles of microfinance that make it just as appropriate in the richer as the poorer countries and to show how here, too, there is every reason to expect high demand and repayment. (These are what one might term “client issues.”) Next, I will discuss some institutional design issues which are crucial to achieving, at minimum, financial sustainability. Third, I will look at the implications of these issues for the wider environment: What are the current obstacles, how might they be addressed, and what specifically can the public, private, and voluntary sectors each do to help build a healthy microfinance industry? And finally, I will address the potential rewards of microfinance, that is, the social and economic impact it has already made in Poland, as well as its likely impact in the UK. To begin, however, it is worth reflecting on why and for whom we need a microfinance industry in the industrialized world.

The Case for Microfinance in the Industrialized World

The developing country view is clear: Microfinance is a very important tool for poverty alleviation and in many countries it is needed by the majority of the citizens, because unbankability is the norm, not the exception. Nevertheless, it should be stressed that not one microfinance institution that I have ever visited in a developing country serves the absolute “poorest of the poor.” Below a certain threshold of energy, determination and morale, a person cannot make proper use of a commercial interest rate debt instrument. He or she first needs relief-type help, such as counselling, food, shelter and donations, as well as other financial instruments for risk-protection purposes.
The same is true in the industrialized world. Thanks to a welfare system, relief programs are available and appropriately provided to the needy. Relief programs are also, however, provided (in the form of soft loans and grants, income support, counselling and training), where funds permit, to people who do not qualify as “mainstream” but neither do they need to be candidates for relief. What they really need is a hand-up, but it is generally not available. In the meantime, as commercial financial institutions demutualize and merge and as globalization has created higher minimum thresholds of profitability for credit transactions to be deemed worthwhile, the community of potential bank clients who do not qualify has increased substantially over the past decade. This has stretched the public purse to the limit and has left the majority of the potential microfinance market in a no-man’s-land: too rich to qualify for relief, too poor to qualify for mainstream credit.

Some microenterprises may be able to take personal bank overdrafts or borrow on credit cards. But this practice often creates more problems than it solves because the unstructured nature of the debts is inappropriate for inexperienced borrowers and leads them frequently into default. The majority borrow from family, friends, loan sharks, or they do without. Again, this comprises unstructured, one-time assistance, and is very expensive and/or totally inadequate for the needs of a growing business. A small proportion obtain public sector- or voluntary sector-supported soft loans or grants for start-ups. These do little, however, to ensure their transition into the financial mainstream if they cannot be supplemented by further “development” capital. Many microenterprises operate in the gray market because the bureaucracy and tax regime create too high a threshold for them to cross in one step into officialdom. What these businesses need is transitional support enticing them into the formal economy.
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The microfinance market in the industrialized countries therefore encompasses start-ups, gray market activities, and fully registered small businesses that still lack the collateral for mainstream credit. This may not be as large or as poor a market as in the developing countries, but it is nevertheless substantial; it is largely hidden from measurement by appearing to be served by other means or by being outside of the formal economy; and it could well grow in the future if minimum thresholds for mainstream credit continue to rise. What microfinance offers in the industrialized countries is not so much classic poverty alleviation as a means of supporting small business survival and development, encouraging start-ups, motivating people out of welfare who have the desire and capacity to become financially independent, stimulating in an organic, unsubsidized way the creation of thousands or even millions of jobs, and reattaching to mainstream society a whole segment of unnecessarily excluded people.

Client Issues

Let us look first at what microenterprises actually need from their financial institution:

1. *Small amounts of capital* (on average US$1500 for a first-time borrower in Poland; likely to be US$4500 in the UK); this should be the amount structured by an expert to match precisely what they can afford without undue risk of default, i.e., to protect as well as to support their development.

2. *Minimal waiting time* for the loan to be approved. The fragility of the business might not survive the cashflow consequences of a one-month processing period. Also, minimal bureaucracy and time taken to complete the application process.
3. **A high probability of receiving a loan.** The reason banks do not have higher rejection rates is that people do not bother to apply for a loan if the chances of success relative to the processing time and the paperwork involved are too low. It is therefore essential to maintain high acceptance ratios in order to encourage people to apply.

4. **Reasonable interest rates.** These do not need to be below standard bank lending rates to small business clients, but they cannot be anywhere as high as money lending rates.

5. **Immediate subsequent loans** for the further development of the business, assuming timely repayment of the previous loans.

6. **Friendly, professional lending officers** who understand the client’s business, can advise where required, treat the client truthfully, efficiently, fairly, and with respect, and who are therefore, in turn, respected by the client.

7. **Clearly pre-explained terms and conditions,** including all costs, all small print in the loan agreement, all requirements, which, if met, will ensure the client’s future access to larger loans, etc.

8. **Other tailored financial services,** especially including a bank current and deposit account with lower transaction charges in reasonable proportion to the (small) average balances.

9. **No training requirements in order to obtain a loan.** Training, consulting, and mentoring services should be available for purchase by the client at reasonable cost.

10. **Opportunities to network** with other microenterprises for mutual support purposes, as well as to explore business development opportunities.

These requirements may be simply summarized as the strong likelihood of receiving quickly and at reasonable cost appropriate, uncomplicated, structured loans that can be increased upon repayment.
This list may look obvious, reasonable, and not too difficult to respond to; that is, until one examines the extent to which existing financial institutions are in fact failing to meet them. Table 1 (see p. 22) summarizes the extent of this market failure.

Banks fail on many points. As mentioned earlier, unstructured credit is fatal for inexperienced borrowers. Banks do not structure it (in the form of a business, cashflow-based loan as opposed to a personal loan or overdraft) because it is more labor-intensive, and therefore theoretically less profitable. A low probability of having the loan application accepted discourages a large proportion of the market from even applying, just as the high transaction costs on bank accounts keep a considerable potential deposit base from being brought into the financial system.

Most credit unions also fail to provide loans tailored to the businesses’ cashflows. They are also unable to support a microenterprise’s growth if the loan requirement exceeds their fairly restrictive limits. Further, with credit limits related to the deposits first made by a client, the waiting time for a first loan can be months, and the deposit requirement may exclude many potential borrowers. In addition, marginal and excluded populations may not be eligible to join a credit union.

Money-lending companies such as Provident Financial, Cattles, Scottish London, etc., score well on many points. However, their biggest problems for microenterprises are the 40% to 160% per annum interest rate that is prohibitive for businesses, and (again) consumer loans that are neither structured to the businesses’ cashflows nor likely to be big enough for their future development.

Finally, public-sector and voluntary-sector loan schemes, though well intentioned, are frequently poorly designed with unstructured loans, have a low probability of application acceptance especially for the better (i.e., less disadvantaged) clients, possess low or no chance of any further loans, sometimes require pretraining, and, worst of all, send a confusing
### Table 1: Inability ("X") of the Market to Serve Microentrepreneurs’ Needs

<table>
<thead>
<tr>
<th>Feature</th>
<th>Commercial Banks</th>
<th>Credit Unions</th>
<th>Money-Lending Co's</th>
<th>Public/ Voluntary Sector</th>
<th>Credit Card Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appropriate Amount</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>X</td>
<td>—</td>
</tr>
<tr>
<td>Repayments Structured Against Business Cashflow</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Speed of Processing</td>
<td>—</td>
<td>X</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Likelihood of Approval</td>
<td>X</td>
<td>—</td>
<td>—</td>
<td>X</td>
<td>—</td>
</tr>
<tr>
<td>Reasonable Interest Rate</td>
<td>—</td>
<td>—</td>
<td>X</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Subsequent Loans in Increasing Amounts</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Inviting, Empowering, Professional Culture</td>
<td>X</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>X</td>
</tr>
<tr>
<td>Clearly Pre-explained Terms and Costs</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Other Financial Services at Reasonable Cost</td>
<td>X</td>
<td>—</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>No Compulsory Training</td>
<td>X</td>
<td>—</td>
<td>—</td>
<td>X</td>
<td>—</td>
</tr>
<tr>
<td>Mutual Support Network</td>
<td>X</td>
<td>—</td>
<td>X</td>
<td>—</td>
<td>X</td>
</tr>
</tbody>
</table>
message that undermines a loan instrument with a “grant culture” that does not press delinquent cases nor encourage timely repayment.

Although Fundusz Mikro was modelled after the leading microfinance organizations in developing countries, in terms of what it represents in the industrialized world, it is a response to the microenterprises’ needs described previously, in that it encompasses the relevant elements of many different kinds of already existing financial institutions.

Microfinance therefore has a similar mission and focus on nonfinancial support to those of public- and voluntary-sector programs; its personal risk assessment methodologies are more like those of credit unions (i.e., based on mutual trust); its business risk assessment methodologies are adapted from those of banks for larger companies (i.e., based on cashflow); it has a highly mechanized back office like that of a credit card company; its organization structure is similar to that of a money-lending institution (combining the best of bottom-up grass-roots loan officers with top-down financial systems and economies of scale); and its financial objective lies roughly between the most grant-dependent and the most profit-seeking. Its goal is, at minimum, to be fully self-supporting, i.e., to cover its total operating costs and maintain in real terms the value of its loan capital. Whatever return it can achieve above that should then be subservient to its strategic goal to offer credit as widely as possible. Figure 1 (see p. 25) shows the elements of its composition.

Regarding client issues in general, three key points should be emphasized:

1. There is nothing fundamentally new or untested about microfinance in the industrialized world; it has all been done before, though in bits and pieces within different segments of the financial services industry. Therefore, microfinance should not be treated as simply the newest fashion in development economics, a fashion that could well be discarded within a decade. Rather, it should be
understood as a revival of a centuries-old system of trust-based lending. In fact, the derivation of the word “credit,” which is *credo* or *credere* meaning to believe or trust, which, together with the equally important concept of mutuality, is at the very root of lending.

Microfinance works because it taps into the natural predisposition of all animal species to cooperate with each other for reasons of enlightened self-interest. Benefits and obligations must be balanced to produce a water-tight system of “metaphysical” collateral. Defaults generally arise from poor program design or implementation, not from any essential problems with the borrowers.

2. It is important to remind ourselves of why trust-based lending is no longer the norm in many industrialized countries. This is due not to repayment problems but to the need of financial institutions for both profits and year-on-year growth in profits. This objective precludes small transactions, however safe, from being attractive. (Those institutions still using a trust-based methodology, such as credit unions and money-lending companies, still have excellent repayment results.)

What has happened therefore is a shift in the meaning of the word “creditworthy,” from “being able to repay the loan” to “being able to offer a minimum profit to the lender.” Muhammad Yunus, Managing Director of Grameen Bank, has declared credit to be a human right, i.e., a universal right. I would disagree—I believe one must be creditworthy to take on credit. However, my definition of creditworthy is the original one and includes anyone who can repay a reasonably priced loan, however small a profit it may generate for the lender.

3. The upper and lower limits of microfinance need to be recognized: At the upper end, microfinance breaks down when the
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Figure 1: Key Microfinance Elements in Existing UK Financial Institutions

- **Credit Unions**: Personal Risk Business (Cashflow-Based) Risk Assessment Methodologies
- **Commercial Banks**: Objective to be Fully Self-Supporting but not Profit-Maximizing

- **Public/Voluntary Sector Programs**: Mission to Support the Financially Excluded, Focus on Skill Development, Mechanized Back Office
- **Institutions Pursuing Sustainable Development**: Bottom-Up/Top-Down Organizational Structure

- **Credit Card Companies**: Money-Lending Companies
loan sizes reach the level at which, with all the will in the world, borrowers are unable to raise the sums needed to repay the loan from their own savings, as well as from all their friends’ and family’s contributions, if their businesses collapse. Peer group guarantees are better than physical collateral only when the combined resources at the group’s disposal can provide an effective back-up repayment source. After that, physical collateral-based lending should take over.

At the lower end, microfinance stops short of helping the poorest and most destitute. The financial instruments most suitable for such people may include savings and cash management instruments, such as emergency funds, pensions, and disability/life insurance schemes.

Where credit is granted, there must be a business, however tiny, which generates net cashflow surpluses. Some public-sector and voluntary-sector programs incur large defaults because they do not observe this rule when they finance start-ups. When interest-bearing debt is used as a substitute for seed equity, it inevitably puts a huge burden on fragile, uncertain cashflows. Fundusz Mikro will lend to any microenterprise with at least three months’ net cashflow surplus, however tiny. This is our definition of a creditworthy start-up, and we have found that while it does not preclude anyone with a serious idea from starting and returning in three months, it does effectively screen out businesses that people are only prepared to try with someone else’s money—most failures are from this latter group.

**Institutional Issues**

If we approach the institutional requirements of microfinance organizations by reviewing the main obstacles to be overcome, the two problems
most frequently cited by banks (as to why they do not engage in microfinance) are high credit risk and high transaction costs. I hope the previous section has sufficiently addressed the credit risk issue to conclude that just as it is not a problem in the developing world, neither should it be one in the industrialized world. It just needs a specific approach.

As regards transaction costs, these have been addressed in developing countries partly by highly streamlined procedures, partly by vast economies of scale, and partly by charging substantially higher interest rates than bank rates (although still significantly lower than those of money lenders). In industrialized countries, it is equally possible to streamline the procedures and to create economies of scale. For example, in Fundusz Mikro we had three loan-processing clerks looking after a 1,000 client portfolio in 1995, and now, with 10,000 clients, we still need only four. Interest rates, however, are another matter.

Rates of Return

The interest rate affordable by a microenterprise is a direct function of its gross profit margin. The poorer the country, the higher this margin is likely to be, especially on exported products. In industrialized countries, not only are markets tougher and more competitive but so also are microenterprise owners’ expectations of what constitutes a fair interest rate on a loan. Whereas in developing countries bank rates are not considered a relevant marker, in the industrialized countries they are. Hence microfinance organizations in industrialized countries can only partly address the transaction cost issue, but in Fundusz Mikro we have shown that this can be done sufficiently to become, at least, self-sustaining. Comparing some example interest rates being charged today in the UK throws further light on the potential levels of profitability of microfinance organizations in industrialized countries (see Table 2, p. 28).
Table 2: Examples of Current Interest Rates in the UK

<table>
<thead>
<tr>
<th>Lender/Borrower Interest Rate (example APR)</th>
<th>Nature of transaction costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structured bank loan to small business</td>
<td>Tailored business risk assessment</td>
</tr>
<tr>
<td>Personal credit card to individual</td>
<td>Computer-driven, credit-scoring assessment</td>
</tr>
<tr>
<td>Money-lending company making consumer loans</td>
<td>Tailored personal risk assessment/collection process</td>
</tr>
<tr>
<td>Credit union consumer access loan to member</td>
<td>One-time personal access loan; costs frequently subsidized by volunteer/donated administrators</td>
</tr>
<tr>
<td>Fundusz Mikro interest (zloty) (average Polish inflation during period charged: 15%)</td>
<td>Tailored business risk rate assessment</td>
</tr>
<tr>
<td>Potential UK micro-finance institution</td>
<td>Tailored business risk assessment rate</td>
</tr>
</tbody>
</table>

What we see is that in order to maintain their required rates of return, banks can charge only 12% to 14% if the transaction size has a certain minimum value. Below that, they have to offer cheaper products such as personal overdrafts where no business assessment is involved. Credit card companies and money lenders both offer microsize loans, and their rates show what needs to be charged in order to obtain a commercial rate of return involving, respectively, computer-based and tailored/manual assessment processes. Credit unions’ rates are neither fully costed nor intended to provide a commercial return to investors. In comparison with these institutions, if we agree that business risk assessment involves more work than personal risk assessment, which is in turn more work...
than a computer-driven process, Fundusz Mikro’s (real) rate looks cheap, even after taking into account the low rate of return to investors. The reason for this lies in the simplification and elimination of administrative procedures.

In the UK, though the nominal interest rate needs to be lower than Poland’s, the real rate may be similar, indicating that investors in the two countries can expect a similar rate of return as each other. Since the Polish and UK rates reflect their respective countries’ typical gross profit margins for microenterprises, they are probably the maximum rates generally affordable. This then more or less caps the returns the industry can generate in industrialized countries, barring some further streamlining of procedures in the future.

Therefore, though commercial banks should bear some social responsibility, microfinance cannot be the responsibility of the banks alone. This is both because of its low potential returns in industrialized countries and because of the quite distinctive nature of the business which suggests that it is far better undertaken by specialist institutions. These reasons are also to some extent connected in that asset-driven lending methods (used by banks), minus the assets, are bound to create default problems.

On the other hand, microenterprises represent the next generation of small business clients for banks and an additional market for noncredit products. Banks should therefore have an interest in supporting their development. Also, though their lending approach may be completely different from that of microfinance institutions, commercial banks have a great deal of experience that they can share quite cheaply with microfinance organizations, for example, in the areas of governance and supervision, asset and liability management, internal financial control and audit systems and software programs to fully integrate the treasury,
and accounting and loan administration records. (These are areas in which most microfinance organizations are particularly weak.)

What is therefore needed is a partnership approach which enables banks to contribute funding and know-how on a wholesale basis, i.e., to independently managed (retail) microfinance institutions with grants and/or low cost financing from the public and voluntary sectors to cover a major portion of the shortfall in banks' rates of return. The principle of partnership is, of course, already familiar and accepted amongst UK banks, government, and the voluntary sector. However, it has yet to result in any really large-scale programs of this type.

**Development Methodology**

So far I have reviewed the key institutional issues only with respect to full-grown microfinance institutions. Another set of institutional issues, however, revolves around the optimal method of growth and development for a brand new microfinance institution. If financial sustainability is the goal, one of two alternative approaches can be taken: to minimize costs, or to maximize revenue. The cost-minimization approach may be seen in those local community loan funds and credit unions which are volunteer-run or have part of their operating costs donated in kind. Their advantages are that they require low investment and can rapidly become self-financing. On the other hand, because their outreach is small, their impact is limited, and growth beyond the local level is prevented by both the vision of those involved and the lack of contractual agreements against which to secure funding for growth.

The revenue-maximization approach, which makes impact and outreach the top priority, involves building a large organization in order to benefit from economies of scale. Most people taking this approach have done so by starting small and gradually adding local branches as each one in turn becomes profitable. This strategy has enabled the initial loan
capital investment to be kept as low as possible. However, it has created a much longer lead time to sustainability (i.e., the point at which there are enough branches to fully cover the central overheads as well as the local costs), and until that point is reached, the institution has remained grant-dependent. Grameen Bank took at least 20 years to reach this point and Banco Sol (in Bolivia) 11 years.

The challenge we set for ourselves in Fundusz Mikro was to find a way of combining the best of both approaches—i.e., the speed to sustainability of the cost-minimization model with the outreach and impact of the revenue-maximization model. If we could achieve this, we felt it would ultimately be the cheapest (i.e., least draining on grants during the years of operating deficit), as well as provide financial support to the maximum number of microenterprises within the shortest possible timeframe. To achieve these objectives, the method we adopted was to design the full-scale institution upfront, to hire the future senior managers immediately, and, after an initial pilot testing period of a year, to open as many branches as possible. While this involved greater financial exposure by creating higher short-term operating deficits, over a five year period it was a much cheaper, shorter, and surer way to the sustainable state we have since achieved. For future microfinance institutions in the industrialized countries, I now feel convinced that this is the optimal development route for anyone whose goals are wide outreach and rapid impact at the cheapest ultimate cost.

Wider Issues

In the course of my efforts to promote the Fundusz Mikro model for the UK, I have come to experience firsthand the main obstacles that such a project must overcome and therefore I feel uniquely qualified to write about them! First, let me list them:

- A problematic definition of charity under British law.
The lack of any public-sector or voluntary-sector commitment to the concept of “optimal project funding.”

The lack of an internal organization structure in today’s financial institutions, companies, charities, and government bodies capable of evaluating and responding to proposals that fall between profit-maximizing and being charitable in the conventional sense.

The difficulty for commercial banks to fund the start-up phase of a lending business which uses alien methodologies to its own and potentially serves a market that they themselves have rejected or with which they have incurred high defaults.

The lack of fully integrated welfare-to-work incentives.

The lack of any appropriate legislation, regulation, and supervision for the microfinance industry.

The following section will examine each of these issues more closely.

Definition of Charity

The story is told of a father who was trudging home through the forest with his young son. The son says to his father, “Father I am tired. Please carry me.” The father replies, “Walk on as far as you possibly can, and when you can go no further, then I will carry you.” Most people hearing this story nod wisely and agree with the father’s response. According to the law, however, “self-help” and “charity” are placed in diametric opposition to each other, such that if people do something for themselves, they cannot by definition be recipients of charity. Unemployed persons may need a large amount of external support but can still manage to do something for themselves. Similarly, employed or self-employed persons with a lower than subsistence income, though mostly self-reliant, still need some external support.
At an institutional level, a school for disabled children, for example, may be able to raise some revenue from parents’ contributions, while the rest must come from charitable sources; similarly a sustainable microfinance organization may be able to generate enough income from its lending operations to cover its operating costs but not enough to also cover the commercial cost of its capital. The point here is that if we agree with the father-son basis for helping people or institutions which help people, then “gap-filling” support should become eligible for charitable status and for tax-exemptions for the donor. This could be achieved, for example, in the UK, by making it an eligible activity under the Enterprise Investment Scheme and by enabling it to qualify for corporate tax-exempt bonds.

**Optimal Project-Funding Concept**

In the same way as we think about how best to help people by first requiring, encouraging, and empowering them to do whatever they can by themselves, so too may we think about how to appropriately allocate public or donor funds to charitable projects. Microfinance has been criticized rightly, in my opinion, for “using up precious grant monies” intended for poverty alleviation, thus leaving the hungry, sick and destitute with inadequate support. If one assumes that pure grant-funding is the most limited form of funding available and commercial capital the most unlimited, the concept of optimal project funding is simply about allocating funds with the highest affordable cost of capital to any given project.

This means that if a project needs only partial grant-funding and the rest can be equity or debt, then it should not take grant-funding for the whole. It also suggests the need for a measurement tool to help investors/donors equate (e.g., a low yield 10-year loan to a commercial 10-year loan plus a grant in present value terms) and obtain a tax-
exemption for the grant-equivalent provided. Projects requiring funding would then be evaluated and compared along a “subsidy spectrum” for any given funding level, as well as in relation to their goals, achievements, or outputs. As a result, much more “socially-directed” funding should become available, requiring rates of return ranging from partgrant, part-capital-retention to “ethical” investment rates a few points below pure commercial rates.

**Internal Organization Structures**

At present, neither the British government, nor the European Commission, nor commercial financial institutions, nor companies, nor charities are set up to properly evaluate and respond to requests for “intermediate” funds. Private sector organizations either seek to maximize their profits or to “minimize” them (i.e., give them away in the form of charitable donations). There is therefore no proper value ascribed to a sustainable project. Whatever does not generate commercial returns will fall into the charity department, and with charitable funds being strictly limited, no high-impact, sustainable project requiring economies of scale, and therefore larger investment amounts, is likely to be within their budgets.

As regards government money, only grants are, so far, possible for microfinance. Within the charity sector, a few institutions do make investments or loans but this needs to be much more widespread. (The Program-Related Investment Model pioneered by the Ford Foundation in the U.S. is an excellent reference point.) As for other potential providers of intermediate funds, I believe, both at an institutional level (e.g., the Church of England’s investment portfolio) and at an individual/community level, there is a vast, untapped market of would-be investors in socially directed projects who understand the superior value of recycling their funds again and again, versus
making one-off donations, but they are not encouraged by the charity and tax laws to do so.

Specific Difficulties for Commercial Banks

In respect to microfinance specifically, what we are asking of commercial banks is quite a tall order; not only are they required to admit to the scale of population they are failing to serve, but also to agree that a brand-new organization, with no track record and a set of intended practices in direct opposition to their own, is more likely to succeed than they are. So much so, that they are willing to fund its start-up, conditionally commit future success-based funds for its development, and agree to a social rate of return.

If microfinance were not about an activity (i.e., lending money) at which banks feel they ought to be the experts, it would probably be easier to approach them for funds, as they would not be tempted to assume at least as high a level of industry knowledge as the applicants’ own. Even then, however, as the funding required in the first instance would really be for start-up venture capital, it should rather be requested from socially directed venture capital funds. Banks could then lend or invest the major portion of the loan capital in the post-pilot phase, once a track record had been created from the pilot loans.

Welfare-to-Work Incentives

At present, anyone on welfare who starts a business (officially) will immediately start to lose their benefits, despite the lack of subsistence level profits from the business. This clearly needs to change, but, in the meantime, if there is an implicit understanding that a reasonable amount of gray-market income fulfills an important role in helping people through the transition phase to the formal economy and is a necessity until the laws change, then microfinance can act as a useful tool to
encourage the transition process. In Fundusz Mikro, we do this by tying the loan amounts for which borrowers are eligible to the percentage of their undeclared income, which will be recognized in the cashflow calculation. The higher the loan amount, the lower the percentage of undeclared income that will be recognized. Thus the borrowers always have the choice of how much to declare but the less they declare, the smaller the loan for which they are eligible.

**Microfinance Legislation, Regulation, and Supervision**

What kind of license does a microfinance institution need to properly serve microenterprises?

1. The ability to use up to 100% of its loan capital on unsecured lending.
2. The ability to start lending with a very small capital base.
3. The ability to take client deposits.
4. The ability to lend out of borrowed funds as well as out of its own capital or grant monies.
5. The freedom to make loans or take deposits without the restrictions imposed on institutions such as credit unions or mutual credit societies.

If such a license were created, what measures could be taken to protect the health and safety of the microfinance industry?

1. The deposits of microenterprise owners need to be safer than those of average (richer) bank depositors. There should therefore be a lower cap on the microfinance institution’s capital: asset ratio, and perhaps a graduation policy such that, for brand new organizations, it is lowest and then rises with the track record of consecutive years’ lending with a minimum repayment rate.
2. There should perhaps also be separate ratio requirements in relation to client deposits (only) vs. total risk assets, based on the size and track record of the organization.

3. The national deposit insurance scheme covering bank clients should also include clients of microfinance organizations, or a separate scheme should be established.

4. An industry-specific set of institutional risk-assessment measures should be formulated.

5. Standardized definitions of terms, such as delinquencies, defaults, operating, and financial sustainability, should be created.

6. Standardized performance measures to compare asset quality, operating efficiency, etc., between different institutions, should be introduced.

7. Incentives should be provided for banks to offer their know-how to microfinance organizations, to strengthen areas such as governance, internal control functions, and back office systems.

8. There should also be incentives for insurance companies to develop an institutional insurance product for microfinance organizations to protect them from systemic risks in the portfolio. Whereas banks tend to collapse because of problems in or overexposure to a particular industry sector, this is much less likely to happen in a microfinance institution, unless it is badly managed. The main risks in (well-managed) microfinance institutions are that of flood, drought, acts of war, etc. If they occur, they can affect a substantial proportion of the total loan portfolio. This, however, should be insurable and must become so if the industry is to survive.

Several lesser-developed countries, including South Africa and Peru, and industrialized countries, such as Bosnia, have enacted or, at least
drafted, specific microfinance legislation. Both the legislation itself and the practical experience of operating within it should be very useful to other countries considering the introduction of similar legislation.

Social and Economic Impact

The impact of microfinance is visible at many levels. For individual borrowers, these loans first and foremost directly affect the chances of survival of their business and therefore the continuation of their livelihood. In particular, loans provided for working capital during times of cash shortage are crucial. Second, these loans psychologically boost borrowers’ self-confidence and self-esteem by giving the borrowers greater control over their lives and expanding their options. Third, since the loans are accompanied by frequent interactions with the loan officers, borrowers enhance their business skills, particularly in the areas of risk assessment and risk management, cashflow and inventory management, the optimal use of debt, and the maximization of return on long-term investment. Fourth, microentrepreneurs borrowing under group-lending schemes derive considerable benefit from the mutual support (albeit accompanied by joint and several liability) provided by their group members. This increases their security and morale and helps strengthen their local communities. Fifth, microloans have a rapid effect on borrowers’ incomes and wealth. In Fundusz Mikro, every loan has increased a borrower’s income by about 20% over an average term of 9 months. Businesses that started borrowing in 1995 are now 2 to 3 times bigger in terms of income, assets, and employment.

At a community level, in addition to strengthening the bonds between people through group-borrowing, microfinance programs have also, without excluding others, particularly benefited women and minority groups whose self-confidence to apply for a loan may be lower than average. They have also had a particularly strong impact in smaller towns
and rural areas where financial institutions are absent or less prevalent and the social bonds between people are greater and enable easier adoption of the group-lending approach.

At a macroeconomic level, the benefits of microfinance include substantial job creation through increases in employment of businesses that would otherwise have been stable, survival of businesses that would otherwise have folded, and graduation into the formal economy of businesses that would have remained gray-market activities.

A recently commissioned social impact study on Fundusz Mikro’s clients shows, despite only four years of lending, a significant increase in the survival rates of client businesses over those of similar, nonclient businesses. In Britain, the Department of Trade & Industry (DTI) estimated that 500,000 new businesses were established in 1997 while, in the same year, 480,000 businesses ceased trading. By contributing to a major reduction of the latter figure, microfinance can significantly improve the level of net new business creation. The Fundusz Mikro study also shows six times the proportion of clients who have grown to employ five or more people as the proportion in the Polish microenterprise population as a whole. This equates to 47 new jobs created by every 100 clients over 3 to 4 years. With 15,000 clients having borrowed from Fundusz Mikro since 1995, the study estimates that 7,000 new jobs have been created.

Two other macroeconomic impacts that have been visible from microfinance are, first, the increase in long-term capital investment rates in microenterprises. Among Fundusz Mikro’s clients, over six times the proportion made annual investments of over US$22,500 as the proportion in the Polish microenterprise population as a whole. Second, the informal training and skill-building received by clients have provided commercial banks with a greatly improved stream of new (graduating microfinance) clients, which has lowered their default rates on small business lending.
Overall, therefore, microfinance makes a very important contribution to the psychological, social, and financial well-being of microentrepreneurs. It strengthens the bonds of support between people and it reaches out to the most needy communities. It creates long-term, unsubsidized jobs in an organic way, increases the skill base of the workforce, increases the capital investment rates in small businesses, and offers mainstream financial institutions an attractive pool of new business clients.

Conclusion

Microfinance in the industrialized world is at present hardly existent, and certainly not in a way that is capable of making a significant impact within a short period of time on an affordable, long-term basis. Yet for millions of people, it is a more appropriate tool to help them become self-sufficient and move towards mainstream bankability than any means of support currently offered. If it is to become widely available, it must be affordable. This means that it needs to be provided by financially self-supporting institutions.

The worldwide microfinance industry currently comprises about 7,000 to 10,000 institutions, out of which no more than 100 to 200 are both profitable and serving tens of thousands of clients, and none of these are in any industrialized country. Within the 300 to 500 industrialized country programs, Fundusz Mikro has come considerably closer to profitability and scale than any other, and it is for this reason that its methodologies are described to such an extent in this article.

A simple recommendation for the creation of many Fundusz Mikro-style organizations across the industrialized world is not, however, the answer. This is because there is no one in whose interest it entirely falls to take up such a recommendation. The social rates of return that the industry can offer across the industrialized world therefore require a partnership approach to be taken by the banks, the government, and the
The Application of Microcredit Technology to the UK voluntary sector. In addition, a whole set of legal, regulatory, organizational, and attitudinal changes in the wider environment must accompany these partnerships in order to make them truly effective.

If this can be achieved, the rewards will be immense: for individuals, microfinance improves psychological, social, and financial well-being; for communities, it strengthens ties of mutual support and reaches out to the most needy; and for the country as a whole, microfinance can create tens of thousands of jobs in only a few years, increase the survival rates of microbusinesses, improve the skill base of the workforce, and support a whole segment of society into the financial mainstream.