

# **Attacking Poverty through Microenterprise Financing**

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**A**ddressing the poverty issue in *World Development Report 1990*, the World Bank (1990:4) concluded that:

To be truly cost-effective, interventions must be not merely well targeted but also carefully designed to meet the specific needs of poor people. This means developing technologies suited to the risky environment that confronts small farmers, devising credit schemes to serve small borrowers, combining feeding programs for especially vulnerable groups with education on health, nutrition, and so on.

Commercial financial institutions designed and established specifically for the purpose of lending to microentrepreneurs in developing economies and that are able to mobilise the necessary funds from markets on commercial terms would, if self-sustainable, meet the dual policy objectives of attacking poverty and engaging the private sector in doing so. By providing the right sort of financing, such institutions would help release the considerable potential of the poor for productive activity.

## **The Role of the Informal Sector**

In most developing economies the poor undertake much of their economic activity in the informal sector, which provides them with both employment and the necessities of life. It makes sense, therefore, to direct programs designed to promote the productive use of the labour of the poor towards the informal sector. Not only do most productive enterprises operate in the informal sector, but jobs can be created in much larger numbers and at much lower cost than in the formal sector. In the Philippines, for example, the Department of Trade and Industry estimated in 1990 that whereas it cost P224,000 in capital investment to create a job in the 'modern sector' (Medalla, 1990), the programs of the Philippines non-government organisation Tulay sa Pag-unlad Inc. were thought to be creating on average one job for about every P10,000 lent to microentrepreneurs. In Zimbabwe, at a conference on job creation held in Harare during 1994, the Ministry for Employment Creation, National Affairs and Cooperative Development estimated that in 1990 small-scale

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enterprises in the informal sector created jobs for only Z\$4,000 of investment, while Z\$75,000 was needed to create a job in the formal sector. (This is not to suggest that the 'jobs' created in the informal sector are substantially comparable to those created in the formal sector.)

Informal sectors are extremely important — yet frequently overlooked — employers of labour and contributors to the national product in developing economies. In Bolivia, it has been estimated that 5.2m people out of a population of 6.4m rely on the informal sector, which is said to generate about 30 per cent of the economy's GDP and supply 60 per cent of urban jobs and 90 per cent of rural jobs (PRODEM, 1993). The World Bank (1990:63) estimates that the informal sector accounts for 75 per cent of urban employment in many economies in sub-Saharan Africa and 85 per cent in Pakistan. According to United Nations Development Programme (UNDP, 1993:41), in some Asian economies, including India, the Philippines and Sri Lanka, wage employment in the urban informal sector has been growing faster than in the formal sector. In India, twice as many jobs have been created in the unorganised manufacturing sector compared with the organised. In Tanzania, the 'second economy' accounts for more than 40 per cent of GDP (Bagachawa & Naho, 1994:20). There is little doubt that informal sectors play a significant role in most developing economies.

### **Characteristics of Microentrepreneurs and their Enterprises**

The informal sectors of developing economies differ greatly in their organisation, composition, productive capabilities and income structures. Nevertheless, the patterns of activity within them are remarkably similar. The 'firms' to be found in these sectors range from the individual sidewalk vendor and tenant farmer to quite substantial and advanced business undertakings that employ many people and produce large volumes of goods and services. In most developing economies, such firms produce goods of all kinds, ranging from consumables for sale within the informal economy itself to cash crops and consumer goods to supply the formal sector. Individuals and firms of informal sectors provide a comprehensive range of services for the day-to-day purposes of clients both within and beyond informal sectors.

Microentrepreneurs and their enterprises likewise display considerable similarity across developing economies.

- The vast majority of microentrepreneurs are poor.<sup>1</sup>
- They have very few assets — mostly their own labour and the labour of those they can afford to hire, and possibly minimal pieces of capital equipment required to produce their particular wares or render their particular services.

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<sup>1</sup> See Remenyi (1991) for a discussion of the hierarchy of poverty as it relates to this issue.

- They frequently operate outside the purview of government business regulation, sometimes intentionally (though they may be subject to some local official supervision such as licensing, limitations on scope and nature of activities and formal and informal taxation arrangements).
- Their sources of finance are limited to their own savings or those of their families and friends, or, where available, the informal sector money lenders who usually charge rates of interest considerably higher than those charged in the formal sector.
- They do not have acceptable forms of collateral to support borrowing from the formal banking system.
- Their financing requirements are usually relatively very small, entailing relatively high administration costs to their lenders.
- Initially, they require mainly working capital (to buy stock for work in progress), but if they are given the opportunity to grow they also require capital for plant and equipment.
- They are usually located in poorer urban communities.

Financing programs designed to meet the needs of such people and their business undertakings obviously need to take account of these characteristics.

### **Financial Markets and Informal Sectors**

Most developing economies are served by banks and other financial institutions operating along relatively advanced lines. They tend to operate almost exclusively within the formal sector and to lend only to those clients who can meet their standards of security and accountability, which standards are usually adopted from financial practices in industrial economies. One consequence of this is that financial intermediation in developing economies tends to divert the savings of the relatively poor into the activities of the relatively rich.

In most developing economies, the businesses of the informal sector are catered for by a separate, informal financial system. The enterprises and individuals making up these informal systems are largely either traders who extend credit to their clients on the basis of anticipated crop or other production, or money lenders who specialise in extending secured or unsecured credit to those who cannot meet the formal system's standards. Typically, interest rates are much higher than those charged in the formal sector and security is guaranteed by often unsavoury means. An example of the sorts of credit terms available from informal lenders of the Philippines is the 5/6 system under which loans of five pesos made in the morning are to be repaid at six pesos at the close of business each day.

The two groups of financial organisation described above are not interlinked in any significant way. Severe discontinuities exist, not only in the terms and conditions on which funds are lent, but also in the flow of funds to the respective sectors. The institutions of the formal financial system prefer to ration credit by selecting borrowers who are the best credit risks and require the least supervision. Smaller businesses, traders, and farmers, as well as poorer households, are thus rationed out of the formal credit market. Instead, they rely on local money lenders, traders, and others who can acquire local knowledge at a reasonable cost and find it profitable to serve smaller, low-income borrowers at interest rates well above those in the formal sector (Roemer & Jones, 1991:8).

### **Credit Programs for the Poor**

For many years now, official development programs have included credit schemes of one kind or another directed at the poor. These have been mostly designed to support poor primary producers in the form of rural credit cooperatives and revolving funds. Generally, these have fallen well short of expectations, since they have reached only a minority of their target groups, or have been utilised by relatively wealthy minorities for whom they were not intended. Many such programs have been very expensive to administer, have suffered severe losses and have been a heavy drain on state budgets. In the worst cases, programs have retarded the establishment of efficient financial markets and have impeded the development of other sectors of the economy, mainly by depriving institutions of loanable funds and increasing their borrowing costs (Yaron, 1994:51).

Yaron (1994) examines the performance of four 'successful' institutions operating largely in the rural credit field. These are the Bank for Agriculture and Agricultural Cooperatives in Thailand, the *Bandan Kredit Kecamatan* and the *Bank Rakyat Indonesia Unit Desa* of Indonesia, and the *Grameen Bank* of Bangladesh. These institutions do raise some funds from commercial sources, and lend funds and take deposits from clients at commercial rates. However, they remain highly dependent on the continued support of their own governments, as well as on donor and concessional funding support from bilateral and multilateral aid sources.

In more recent years, some non-government organisation (NGO) programs have ventured into the financing of urban microenterprises on strictly commercial terms. Many of these programs also provide technical assistance of some sort to their clients, largely by 'training' potential borrowers in their responsibilities or even in simple business principles. Some of these programs have become quite large, supported by grants from bilateral and multilateral official sources, as well as from funds mobilised by their sponsors from private sources.

The *Grameen Bank* of Bangladesh has provided a model for many of these NGO programs. Initiated in 1976 by Professor Muhammad Yunus, then of Chittagong University, *Grameen Bank* now has almost one million members (borrowers) and about 900 branches operating in nearly 40,000 centres in Bangladesh. In the year ending June 1991, it disbursed some US\$300m to borrowers and held almost US\$20m in deposits of member groups (Getubig et al., 1993:26).

One estimate suggested that, by 1990, 18 credit projects around the world were based on the Grameen Bank approach, supporting over 10,000 members (Getubig et al., 1993:40). This number of projects can, however, be considerably expanded if a slightly broader definition is adopted than that based on the operational methods of the Grameen Bank. For example, the Opportunity Network — a voluntary association of supporting NGOs in Australia, the United States, the United Kingdom and New Zealand, and 42 autonomous implementing NGOs operating in Asia, Latin America, Africa and Eastern Europe — had a worldwide loan portfolio of over US\$13m in 1993 through 42 partner agencies in 20 countries (Opportunity Trust, 1993). And the World Council of Credit Unions reported that at the end of 1989 there were more than 17,000 credit unions in Asia, Africa, Latin America and the Caribbean, with approximately 8.7m members. The annual microenterprise loan volume was estimated to be around US\$200m (Otero & Rhyne, 1994:144).

There is no available comprehensive survey of the number and location of the privately sponsored microenterprise financing programs found in developing economies. But the actual number of programs in operation probably runs worldwide into the hundreds, if not thousands. Even so, in aggregate, they probably have only a relatively insignificant impact on the overall poverty situation, as most of them are very small, focusing as much on social service as on financial support.

### **The Effectiveness of Existing Microenterprise Financing Arrangements**

The record of official and unofficial poverty credit programs is not particularly impressive on the whole. Most poverty focused NGO credit programs share a number of features. They attempt to subsidise the credit receiver (that is, lend on conditions much easier than commercial terms); they tend to associate credit facilities with a range of relatively costly 'support services'; and they have had to rely on grant or concessional funding from public subscription or sympathetic donor government programs for their continued existence. The vulnerability of these programs, as well as that of their members, to the uncertainties of public fund raising and the policy shifts of government donor agencies can be overcome in only one way: by putting them on so sound a commercial basis that they can draw on money markets on commercial terms at will in order to sustain their lending programs. This means providing their services to members or clients on a full cost-recovery basis and operating in a manner that will ensure continued investor interest and financial market confidence — that is, profitably.

The impact of lending on reasonable commercial terms on the business income (and presumably also the living standards) of poor microentrepreneurs can be quite dramatic. One study undertaken by the Asian and Pacific Development Centre, and based on data of six Asian Grameen Bank replicators, indicates that returns on capital, labour and management of representative projects undertaken by borrowers range from 23 per cent for the least profitable to 638 per cent for the most profitable (Getubig et al., 1993:63). The increases in borrowers' household income generated by the same programs ranged from 33 per cent to 414 per cent, over

three years (Getubig et al., 1993:65). Other studies and anecdotal evidence suggest that such results are not unusual.

Furthermore, supporters of such programs claim that they yield additional benefits. According to Getubig et al. (1993:64),

These include empowerment of the poor, especially the women, who begin to look at their groups and centres as a source of strength as they support one another in their struggle for survival, including assisting them in family conflicts or conflicts with other more powerful members of society. These groups also inculcate positive development values which are incorporated in the pledges that they make during their weekly meetings, or in their code of ethics . . . many of these decisions promote the value of education, sanitation, nutrition, health, family planning, and the practice of justice, discipline and hard work.

It is important to bear in mind that these institutions are business enterprises, not welfare organisations. They simply cannot afford to provide services where the costs are not covered by those who utilise them. It is therefore necessary for such institutions to focus on those people and their businesses that have the capacity to utilise such finance productively and to service their debts on commercial terms but that do not have access, for a variety of reasons, to formal sources of finance. Commercial programs of this kind need, therefore, to focus specifically on the informal sectors of developing economies and, within these, on active — or at least potential — microentrepreneurs.

A broader focus that includes the poor who do not have the capacity to use and support debt on commercial terms would, by definition, no longer be 'commercial' in nature, but welfare oriented. Poverty levels without such minimal capacity need other forms of assistance beyond the scope of commercial microenterprise financing.

### **Banco Solidario S.A.: Microenterprise Financing on a Commercial Scale in Bolivia**

Banco Solidario S.A. (BancoSol) of Bolivia<sup>2</sup> is possibly the best example of a financially viable private-sector venture into microenterprise financing. It is a profitable commercial bank that is successfully raising funds on national and international money markets on commercial terms, for on-lending to poor microentrepreneurs.

BancoSol was created in 1986 by an NGO, Fundacion para la Promocion y Desarrollo de la MicroEmpresa (PRODEM). It began operations in Bolivia in February 1992 as a private commercial bank established specifically to provide financial services to microenterprises in a developing country. Two banks supplying such services predate BancoSol — the Grameen Bank in Bangladesh and Bank Rakyat Indonesia — but these are government-supported undertakings. At the end

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<sup>2</sup> This discussion of BancoSol draws on Agafonoff (1994).

of June 1994, BancoSol had about 57,000 client borrowers and a loan portfolio of almost US\$27m, returning over 20 per cent on equity capital and 3 per cent on total assets. BancoSol is already operating profitably.

The Deputy General Manager of BancoSol is Hermann Krutzfeldt, Sub-Gerente General, a professional Bolivian banker with many years of experience in North American and Bolivian commercial banking. He claims that BancoSol is in the final stages of transition from its NGO origins to a fully fledged commercial banking operation. Thus, enough has been achieved by BancoSol to provide a reasonable basis for judgment on its future as a self-sufficient and profitable financial intermediary. The essential features of a possibly replicable model seem to be in place.

The bank's objectives are consistent with the Bolivian government's new economic policy of encouraging private-sector development, including that of the informal sector. The government has recognised the considerable productive potential of the informal sector, and understands the limitations placed on its activities by the concentration of existing commercial banking services on the relatively (numerically) small formal-sector economic entities.<sup>3</sup> The government is currently reviewing laws and regulations pertaining to the financial sector in order to facilitate the creation of a wider range of credit institutions capable of catering to the financial needs of individuals and small business enterprises in Bolivia. It has been very informally estimated that these reforms could double the economy's private-sector credit base, currently around US\$2 billion.<sup>4</sup>

The informal sector in Bolivia has grown very rapidly in recent years partly because of the migration of rural population to the cities, and partly because of the decline of employment opportunities in the mining industries that have been severely affected by declining commodity prices. One estimate is that 5.2m Bolivians rely for their livelihood on the informal sector. The same source suggests that 60 per cent of the economically active urban population is employed in the informal sector, and 90 per cent in rural areas, while the informal sector generates about 30 per cent of Bolivia's GDP (PRODEM, 1993). The potential market in which BancoSol and other microcredit providers are operating in Bolivia has been roughly estimated at between 500,000 and 750,000 enterprises.

### **Reasons for BancoSol's Success**

What has contributed to the success of BancoSol?

The first and most obvious factor is that there is an effective demand for its services, in terms of both market size and social attitudes. Microentrepreneurs are willing and able to take the necessary investment decisions to maintain and even

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<sup>3</sup> About 57 per cent of commercial bank deposits are held in 6,800 accounts (owned by about 3,500 individuals), while 29 per cent of commercial bank lending is concentrated in 300 loans and a further 24 per cent in 830 loans. This information is from Central Bank data, interpreted for the reviews by Ing. Herbert Muller Costas, Economic Consultant, La Paz.

<sup>4</sup> This view is based on discussions with Fernando Paz, Intendente de Bancos y Entidades Financieras.

develop their small enterprises. Such a venture might not succeed where markets are very small and very dispersed, or where social attitudes to commerce are not well developed.

Second, official policies are at least permissive of such undertakings. The authorities seem to recognise the need for the services being provided, are willing to make the necessary adjustments to regulations to accommodate the process, and are even considering encouraging the development of a wider range of financial institutions catering for small and micro business enterprises. The criticism that bureaucratic intervention and delays make it difficult to establish new institutions is often well taken; at the same time, there is need to have regard for processes that ensure financial prudence and client security. An associated factor in BancoSol's success is the very politically influential nature of the members of the Board of Directors.

Third, the Bolivian government has adopted a set of macroeconomic policies that facilitate the process. The reforms of 1985 (designed by the first President of BancoSol, Fernando Romero Moreno, as the then Minister for Planning and Co-ordination) and the subsequent move to an open economy, including notably the liberalising of foreign-exchange markets, have enabled the private sector — even the informal one — to move ahead confidently in developing business undertakings, and have given foreign investors (including NGOs interested in fostering small business) freedom and confidence to move capital into the country in pursuit of their legitimate business activities. It is doubtful that BancoSol would have achieved its success had macroeconomic policies been inimical to the free flow of capital into and out of Bolivia. The open economy enables BancoSol to lend and borrow freely in US dollars, thereby considerably reducing the problems of managing for the effects of domestic inflation.

Fourth, the bank has uncompromisingly adopted and applied sound commercial standards to its activities. BancoSol, and PRODEM before it, have not succumbed to the temptation of feeding the poor for short-term relief; rather, they have enabled the poor to help themselves in a disciplined and commercially fair way. Of course, the target group is not the absolutely poor, but those who have already demonstrated a minimum capacity for attempting to help themselves. Nor does the bank devote any effort to the kind of costly 'technical assistance' and 'training' of its borrowers that is provided by the traditional NGO approach.

Fifth, the bank had a head start by being able to acquire a ready-made, established portfolio of loans from PRODEM. PRODEM had, over five years of pioneering effort, developed lending practices appropriate to the market it served, and conditioned borrowers to the 'solidarity group' lending arrangements (a technique designed to overcome the target clients' inability to provide collateral in support of borrowing from the formal sector). A BancoSol might have been able to start from scratch, but shareholders would have had to wait for any returns on their investment considerably longer than they will have to now.

Finally, the bank is succeeding because it is completely professional in its approach to the business of banking. It has high professional standards of manage-

ment, and an obviously highly motivated staff, who are recruited on merit and trained in the conduct of the business of the bank. The institution displays none of the well-meaning amateurism that is sometimes seen in non-banks undertaking similar activities in other places; even at the shop-front agencies, business is conducted briskly and efficiently. Nevertheless, there is no lack of vision and idealism among staff members, supported no doubt by the obvious success with which the institution is pursuing its goals in a new, receptive and challenging market.

There seems to be no reason why, in developing countries where such conditions are found, similar institutions should not establish and thrive. To improve chances of success, however, it might be necessary to build, where possible, on an established NGO base of activity that has effectively mobilised a critical mass of client borrowers and already introduced the market to the concept of disciplined borrowing on commercial terms.

### **Conclusions and Policy Implications**

Efforts have been made in a number of developing economies, primarily in the area of rural credit, to engage existing banks and other institutions of the formal sector in providing credit to the poor. The Foundation for Development Cooperation (1992) has developed proposals for the systematic involvement of formal banking institutions, supported by NGOs, in lending to the poor.

The research undertaken in this case has been concerned with an alternative approach — the creation of specialist commercial banking institutions — and suggests the following conclusions. First, BancoSol appears to provide a successful model for a commercial bank specialising in microenterprise financing and would be worth replicating if, and where, the political, economic and social environment is conducive to its successful implementation. Second, while it might be possible to set up such banks from the outset, investors are likely to regard the area as high risk; a better road to success may therefore be for NGOs to work directly in their communities with poor microentrepreneurs, and develop the necessary critical mass of clients required to ensure the financial viability of new banks.

The sources of funds for the formative stages of such projects are the traditional ones: public subscriptions, national official and multilateral aid agencies, especially international financial institutions (IFIs). Organisations involved in establishing microenterprise financing NGOs are experienced in raising funds by public subscription and through national official aid agencies — the latter showing increased interest in such enterprises over recent years. Funding support from IFIs would help the program to high levels of achievement.

Many proposals for new enterprises would no doubt emerge if the World Bank and/or regional banks were to announce policies and financial arrangements supporting the development of microenterprise financial facilities on a private commercial basis. The real problem for the providers of funds then would be to ensure that funds are used effectively, efficiently, reliably and for the purposes specified. This is a continuing problem in development assistance programs generally, and can be overcome by dealing with reputable agencies that have a good record and by

undertaking projects based on well thought-through development plans. It is important that such plans cover the formative NGO and commercial bank stages, with strong commitment from implementing agencies.

One possible consequence of these conclusions is that resources currently being channelled into potentially bankable microenterprise development will be available to concentrate on areas of poverty that may, with the additional effort, also become bankable. This study, considered against the basic policy objective, suggests possible lines of action that might facilitate the flow of commercial money from the private (formal and informal) sectors to informal sectors of developing economies through newly created banks. A possible subsequent effect might be that, through the demonstration of their commercial success, such specialist banks may encourage imitation by financial institutions not primarily concerned with development assistance, thereby adding to the flow of commercial resources into the informal sector. This, after all, is one of the important aims of economic development.

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