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MICROCREDIT IN TRANSITIONAL ECONOMIES

LEED
THE PROGRAMME ON LOCAL ECONOMIC AND EMPLOYMENT DEVELOPMENT

TERRITORIAL DEVELOPMENT SERVICE

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FOREWORD

Microenterprise credit, or the provision of short-term loans to very small businesses, is a proven, effective development instrument to reach high numbers of beneficiaries and microentrepreneurs in the developing countries of Asia, Africa, and Latin America. By contrast, in the highly developed economies of North America, microcredit has filled small and targeted geographic areas and market niches. The potential impact of microcredit for the economic development of central and eastern European countries (CEECs) and the New Independent States of the former Soviet Union (NIS) may be high. Economies in transition represent a hybrid of the environments in developing countries and North America. Access to credit and capital is limited, and there appear to be viable business opportunities for microenterprises.

The intended audiences for this report are development professionals and policy makers operating in CEECs and in the NIS. This report provides practical tools for new and experienced microcredit practitioners as they design and manage their programmes for long-term viability. In transition economies, the small business environment presents unique features that are different from those in either developing or first world countries. While there has been a surge of microbusiness ventures in these countries to fill market gaps for local goods and services, few potential entrepreneurs have had the personal savings or financial resources to invest for capital formation in a new business. Few have a grasp of markets, competition, and pricing, and a high proportion operate in the informal sector to avoid high taxation or other obstacles. Business management skills are also lacking.

There is a unique opportunity in the CEECs and NIS to use microenterprise finance as an additional tool to foster the production and distribution of local goods and services and to help new entrepreneurs gain experience, earn income, and build capital. This report identifies the opportunities for microcredit in the transition economies and presents the experience of microcredit programmes in developing countries and North America.

The project was undertaken on the initiative of the LEED Programme of the OECD's Territorial Development Service and the Charles Stewart Mott Foundation of Flint, Michigan, as part of the programme of the OECD Centre for Co-operation with the Economies in Transition (CCET). The authors of this report are Ms. Janney Bretz Carpenter, Managing Director of Shorebank Advisory Services, and Ms. Julia Vindasius, Executive Director of the Good Faith Fund.

Salvatore Zecchini
OECD Deputy Secretary-General
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INTRODUCTION

As a handbook for new microcredit programme managers, this report summarises the key building blocks of programme design and current experiences in efficient programme operations. It is organised into the following sections: Chapter 1 provides an introduction to microenterprise credit, summarises the experience of programmes in both developing countries and North America, and discusses the potential role of microcredit in transition economies.

Chapter 2 focuses on the economic environment of the transition economies and its implications for the design of microcredit programmes. The chapter describes the business and development infrastructure currently available to support these programmes and microentrepreneurs, and it indicates opportunities for the development of microcredit in transition economies.

Chapter 3 describes four existing micro and small-scale credit programmes and how they have operated successfully in their respective contexts, given their different development objectives and target customers. These four programmes highlight the challenges facing microcredit programmes in transition economies and the main factors for success.

Chapter 4 reviews main components, that can lead to the design of an effective, local programme. These building blocks concern context, mission, customers, and resources. This chapter details the steps in developing a clear programme mission and a strategic plan as well as appropriate institutions in making an assessment of local customers and markets; and in defining the credit and non-credit products and services to be offered.

Chapter 5 reviews the fundamentals of programme operations, including effective lending methods, technical assistance delivery, credit and portfolio management, financial and cash flow management, and staff training and development.

CHAPTER 1. WHY MICROENTERPRISE CREDIT

This report explores the potential for microenterprise finance, or microcredit, in transition economies and shares how to design and run an effective microcredit programme in this context. The focus of this report is the micro and small-enterprise sector, or MSE sector, as a distinct segment of small and medium-sized enterprises (or SMEs) that have been the focus of economic development efforts in these countries. As a frame of reference, SMEs are defined by the Organisation for Economic Co-operation and Development (OECD) as businesses employing more than 50 people. These small businesses have been recognised as an engine of economic growth and sustainable economic development. In developing economies, SMEs are key actors because they are more likely to participate in export markets, can contribute to Gross Domestic Product, and can employ a significant number of employees.

Very small businesses, or microenterprises, can also be engines of growth and development, particularly in environments facing high unemployment, and high poverty rates, or in highly fragmented, cash-based economies. Although the SME sector may create more full-time jobs per firm and more disposable income per employee to be spent in the community, the MSE sector generates additional household income, creates wealth for individuals, and builds service and retail firms that provide local goods and services. The focus on MSEs also stems from their potential for growth. Perhaps 2-5 per cent of all microenterprises grow into SMEs; however, nearly all SMEs began as microbusinesses.[1]

This chapter summarises the current state of microenterprise finance as a development strategy and the experience gained in developing countries and in North America. While this report focuses on MSEs, it also looks at the lower end of the SMEs as part of the overlapping continuum of small enterprise development.

A. Definitions and Underlying Premises

Since its emergence in the 1970s and 1980s, microcredit has become a development strategy with adaptations in Latin America, Africa, Asia, and North America. Most microcredit organisations have one or more of three objectives:

- To provide seed capital to small-scale businesses that can create jobs and economic growth in the future;
- To provide income-generating opportunities and services to alleviate poverty; and
- To provide credit and financial services to micro and small businesses run by entrepreneurs who do not have access to conventional financial resources because of a lack of physical access or social barriers to women, disadvantaged groups, or informal businesses whose links to the conventional banking system are weak.

A wide range of microcredit institutions and programmes have emerged to pursue one or more of these objectives. In Latin America, Africa, and Asia, microcredit programmes have pursued poverty alleviation strategies in very poor countries or supported self-employment and the unbanked sectors of the economy by providing basic financial services for the very poor. In more developed countries like the United States, microcredit has targeted narrower market niches as a poverty alleviation or business formation strategy.

Definition of Microenterprise:

Definitions of microenterprise vary widely, usually based on the size of the business (by numbers of employees or sales volume) and its need for small amounts of credit. For this report, a microenterprise or microbusiness is defined as:

- A sole proprietorship or family business with fewer than 10 employees (most often owner-operated); and

- Requiring relatively small amounts of capital or credit financing (less than US$25 000).[2]

- In addition, microenterprises include part-time or self-employment activities to supplement family income.

The MSE sector includes a spectrum of businesses, ranging from high growth potential firms in infancy to small-scale firms that may never achieve significant growth but regularly employ one or more persons.

Most importantly, many microenterprises, perhaps the majority, are operated by the owner alone, although they may have part-time employees.[3] These businesses vary widely in size and sophistication, but almost always lack access to conventional sources of credit and capital because of their modest size, lack of collateral, insufficient equity, and management inexperience. An additional factor in limiting access to credit are less developed financial sectors that do not serve smaller businesses and social prejudice against certain populations.

As an economic development strategy, microcredit (defined as loans of less than US$25 000) provides financing and assistance to the smallest businesses. These programmes encourage income-generating activities, help entrepreneurs stabilise existing sources of income, and assist microbusinesses to grow into small businesses.

Regardless of their geographic location, most small-scale entrepreneurs face three fundamental gaps between their needs and existing resources: an information gap, a management skills gap, and a financing gap. The specific nature of those gaps varies with business contexts, socio-economic groups, and available resources. In rural Bangladesh, for example, landless women have no savings, and thus seek part-time income-generating activities. These women need small amounts of short-term working capital, basic market information, and life skills training, which are not commonly available in the Bangladesh marketplace, especially to women. In the United States, microentrepreneurs need medium-term working capital loans and management help to navigate the complex American regulatory business environment. In Russia, entrepreneurs may need market information, cash flow management skills, and small equipment financing. Although each microcredit programme might serve a different group of entrepreneurs, their common goal is to promote economic opportunity for individuals and to provide access to resources that entrepreneurs need to generate income or expand their businesses.

As noted earlier, microenterprise is one of several strategies in economic development and has found a niche in certain economic conditions and contexts. Although microenterprises are the smallest businesses and generate fewer full-time jobs than SMEs, microenterprise credit and/or support services have become an additional tool for alleviating poverty, promoting economic independence, providing alternative employment options for low- and moderate-income people, and fostering the creation of new small businesses.

This report reflects several values and lessons that the most mature and successful programmes have concluded through their experience. These premises are stated below, and are developed fully in the remaining chapters.

- **Microenterprise finance achieves social good through poverty alleviation, small business formation, and small business growth and transformation**

  Microcredit fills a particular niche among financial and development tools and balances social good with the business of lending. As a result, microcredit organisations find themselves balancing financial viability with development goals. In transition economies, the market opportunity for microcredit is at least two fold: small business formation and supporting the growth and emergence of small enterprises. These may also be a viable niche for microcredit as a poverty alleviation strategy. Those organisations with a clear development vision and a commitment to becoming permanent resources have proven their ability to achieve their mission successfully.

- **Successful organisations plan for permanence**

  Because entrepreneurs cannot grow a business by depending on a temporary programme for their financing needs, successful microcredit organisations have an aura of permanence and usually have a strategy for long-term sustainability. Dependence on philanthropic funding alone is short-sighted. Strategic planning should include long-term capitalisation and institutional development, as well as effective products and services. Institutional structures might include: a new stand-alone organisation, a programme within a permanent institution, or the strategic use of existing delivery systems (e.g. the banking system). There will always be a continuing gap between the need for alternative sources of credit and capital and the formal financial system.

- **Organisations should strive for financial self-sufficiency and scale**

  Most developing country microcredit institutions have reached financial viability by achieving scale in their operations. They usually operate in high density markets with a high demand for microcredit, and have relatively low operating costs. Not all programmes will achieve the large scale most often associated with financial self-sufficiency. Those that cannot achieve either scale of operations (a high number of beneficiaries) or financial self-sufficiency must demonstrate results that merit continued subsidy.

  These programmes will not survive unless they master effective use of subsidy and can merit continued investment based on the benefits generated and a reasonable subsidy cost per unit.

  Organisations that strive for self-sufficiency and scale are more likely to steadily reduce their subsidy requirements and increase the number of clients they serve than programmes that do not set those goals.

- **Although the definitions of success vary among microcredit organisations, cost-effectiveness is paramount**

  Each organisation identifies its goals, objectives, and performance measures. For stand-alone microcredit financial institutions, financial self-sufficiency and number of beneficiaries may be key success measures. For a smaller programme focused on poverty alleviation in a certain geographic or customer market, the number of participants who achieve economic self-sufficiency may be the best success measure. Whatever the goals of the microcredit programme, those that relentlessly pursue cost-effectiveness often achieve the most development impact because they are focused on meeting the credit demand from their customers while maintaining efficiency in operations.

- **Clients are best served by a business-like microcredit programme**

  Small-scale entrepreneurs are drawn to and better served by organisations that they perceive as businesses rather than government programmes or charities. The lender has more credibility as a reliable business partner and can speak more convincingly of business planning and financial management if it operates in a business-like way.

Microcredit programmes must both demonstrate social good and deliver those results cost-effectively. Achieving scale and determining reasonable costs are part of the debate. The opportunity for microcredit in transition economies is the potential to achieve both goals successfully. The development benefits are substantial, and the high demand for microcredit may allow programmes to achieve full or near financial self-sufficiency.

As a development strategy, the following microcredit has been most effective in economies distinguished by five characteristics:

- **Structural change or a persistently negative condition** in an economy creating declining wage rates, growing unemployment, and a high proportion of “working poor.”

- **Limited employment options** due to the closure or lack of large employers or industries that were the main source of local jobs.

- **An ethnic culture of entrepreneurial activity** and a high proportion of the population interested in self-employment and entrepreneurship.

- **Economic opportunities with low barriers to entry** into the marketplace that require small amounts of start-up capital.

- **A significant credit gap** between the need for financing and the availability of personal resources (such as savings) or formal credit (such as bank loans).

B. International Microcredit Experience

Starting in the mid-1980s, microenterprise finance organisations began shifting their focus from experimentation in programme development to more highly cost-effective and professional operations.

Out of the investments in microcredit organisations, a handful of permanent financial institutions serves millions of poor entrepreneurs while covering their annual operating costs with interest income and service fees paid by their customers. These institutions cover all operating costs (operations, loan loss reserves, inflation) except the market cost of capital.[4] The BRI Unit Desa System in Indonesia covers all of its costs. The Grameen Bank in Bangladesh, Bank Rikiyat Indonesia (BRI) Unit Desa programme in Indonesia, and Banco Sol in Bolivia are all chartered financial institutions under national banking laws. They operate in countries with high population densities and with high demand for credit and financial services and have been able to achieve large scale in their operations. These programmes recognised that microentrepreneurs want and need liquidity -- not just credit -- and developed the capacity to mobilise large amounts of savings from their customers, as well as provide them with loans. In addition, their successes have spawned a large number of small, village-based microcredit programmes in developing countries around the world.

With a primary focus on the very poor in society, the successful institutions in Asia, Latin America, and Africa share several traits:[5]

- **They know their markets: entrepreneurs seeking a source of income are willing to pay for access to credit**

  The major service need of microentrepreneurs in these environments is credit for working capital, with loan terms of less than one year. Most programmes do not try to direct capital to specific uses. They charge market rates for loans, understanding that access to credit is more important than the cost. Interest rates are high relative to the formal financial system, but low compared with typical informal sources (e.g. money lenders). Programmes lower transaction costs by locating lending branches near the clients (in rural or urban areas), providing simple application processes, and disbursing loans quickly.

- **They streamline lending and monitoring processes to slash administrative costs**

  The simplest procedures are used for the smallest loans. Loan applications are often no more than one page; loan terms are standardised; and credit decisions are based on eligibility rather than on business appraisal.

- **They use special techniques to motivate borrower repayment**

  Lenders use negative sanctions (such as group guarantees and pressure from social networks) to replace collateral and other traditional loan security such as quick access to larger loans in the future. Although programmes dealing with large microbusinesses often require collateral, many do not.

- **They are designed for cost-effectiveness and sustainability**

  All of these institutions are striving for long-term financial viability. The handful of large-scale institutions that have reached full financial self-sufficiency for their branch operations may still benefit from a below-market rate cost of capital or funds. Many programmes, however, remain heavily subsidised and dependent on funders for both capital and annual operating funds. Successful programmes are steadily improving their cost-effectiveness and are designed to be sustainable.

In Latin America, Africa, and Asia, microenterprises are often existing small businesses in the informal or cash sectors of the economy that require small amounts of short-term working capital and minimal technical assistance. In a developing country context, microcredit has been a highly efficient development strategy due to the high level of interest in microenterprise, the need for income sources, and a significant credit gap combine to create strong demand for small amounts of credit. For example, ACCION International affiliates in Latin America focus on lending to street hawkers and market vendors who know their market well but need small amounts of working capital to boost their profits and income. The Grameen Bank and BRAC, both in Bangladesh, make very small loans to rural, landless women who need to buy a milk cow or raise a small flock of chickens to supplement family income.

For the handful of programmes that have emerged as permanent financial intermediaries specialising in providing financial services to the poor, the population density when combined with high demand for loans generates substantial interest income revenue. Because operating costs (labour costs and other transaction costs) are relatively low, financial viability is compatible with their poverty alleviation or microbusiness growth development goals. As noted earlier, these programmes have demonstrated several key methods to streamline operating costs and reach the poor. Because of the poverty and lack of resources among their customers, these programmes use group lending methods and cross-guaranties among borrowers in place of traditional collateral. Most developing country microcredit programmes streamline their loan disbursement, monitoring, and collection procedures through weekly or biweekly loan payment meetings. In addition to a monitoring system that tracks payments, these meetings provide a forum for informal information-sharing or training.

As discussed in the next section, microcredit has found demand in small and targeted niches in the highly developed economies of North America. These economies have localised pockets of limited employment, but the population is generally less entrepreneurial and the barriers to entry are much higher for small businesses.

C. North American Adaptations

Although microcredit practitioners in transition economies can benefit from experiences in both least and most developed countries, the adaptations of microcredit in the United States and Canada may be more directly relevant: like transition economies, the markets are more competitive; the development goals are more often small business formation and job creation; the public assistance safety net for the unemployed can dampen entrepreneurial interest; and microcredit is only one of many economic development efforts.

In most cases, the North American markets for microcredit have been:

- Those left unserved by conventional financial institutions because of the high cost, perceived higher risk, and limited profit potential of making small loans.

- Those that are relatively weak and hence do not attract market-based capital or investment; or

- Those in which people have few personal financial resources and therefore cannot qualify for existing resources.

North American microcredit programmes are almost always non-profit organisations that extend credit through a revolving loan fund and provide management assistance to the owners of microenterprises. Loan volumes are much lower than those in developing countries for several reasons:

- A relatively small proportion of the overall population engages in self-employment or entrepreneurial activity (often estimated at

- 8-10 per cent of the population nationally, compared to as much as 80 per cent in developing countries, such as Bangladesh).

- The financial system is well-developed and banks and other credit institutions reach many small businesses with both commercial and consumer credit products, leaving a relatively narrow credit gap;

- The public assistance "safety net" poses disincentives for low- and moderate-income individuals to engage in self-employment; and

- The regulatory and legal costs of establishing a formal small business in the U.S. can be high.

American microcredit programmes have adapted the developing country microenterprise models to fit certain market gaps within a relatively sophisticated credit and business development environment. Programmes focus on rural or urban disadvantaged populations, or fill the narrow credit gap with very small loans.

The Spectrum of North American Microcredit Programmes

Microcredit programmes in the United States have a broad range of development objectives from poverty alleviation to business formation to business growth.

They fall into three general categories:

- **Poverty alleviation programmes** that use microcredit as one of many tools to help individuals increase their economic independence and overcome social and financial hurdles. These programmes aim to alleviate poverty and develop human capital by helping poor people develop additional sources of income.

- **Self-employment programmes** that help microbusinesses become stable sources of employment for one person or a family.

- **Growth and emerging microbusiness programmes** that help microbusinesses to increase sales and employment and to transition into small businesses with access to banking system resources.

As shown in Table 1 on the following page, these programmes provide different products and services depending on their objectives and the needs of their target customers. For example, those programmes with a poverty alleviation mission focus on life skills and social development as well as the opportunities to increase income through microenterprise. Programmes targeting existing microentrepreneurs or those with growth objectives usually provide more specialised business assistance that is specific to each entrepreneur and his or her industry.

Table 1: North American Microloan Programmes Vary By Mission and Target Market

Types of Programme	Objective/Mission	Customer Characteristics	Typical Financing Needs	Typical Technical/Assistance Needs
Poverty Alleviation Programmes	Improve self-sufficiency and welfare of entrepreneur	• Disadvantaged entrepreneur • Informal, part-time, home-based activity • entrepreneur is beginning to think of an income-earning activity as a business	• Loans generally less than \$5 000, usually starting at \$1 000 or less. • Terms of 12 months or less. • Non-traditional or partial collateral due to lack of assets • Short-term working capital.	• Pre-credit counselling • Basic business and cash flow planning. • High level of continued personal support. • Verbal “action plan” for business and understanding of break-even requirements.
Small business Formation and Self-Employment Programmes	Develop a stable source of income and full-time employment	• Full-time venture for the entrepreneur (existing business or start-up) • May have part-time employees • Early stage expansion or stabilisation stage	• Loans from \$2 500 to \$15 000. • Terms of 1-2 years. • Secured by business assets and personal guarantees (sometimes of group members). • Working capital and equipment purchase.	• More specialised, less general TA • Financial/cash flow manage-ment. • Product and market develop-ment. • Production processes.
Microbusiness Growth and Transformation Programmes	Help microbusinesses expand and grow to next stage	• Expansion or growth stage • May have full-time employees • entrepreneur beginning to dele-gate business decisions • Market-tested product/services	• Loan amounts of \$10 000 to \$25 000. • Terms of 1-5 years. • Secured by business assets, personal guarantee. • Medium-term working capital, fixed-asset financing (up to 3 years).	• Sector-specific TA, knowledge • Working capital and cash management • General financial mgmt. • New market development • Production processes • Hiring and managing employ-ees • Advisory Board

Although individual programmes vary widely, most microcredit programmes share five elements:

- **Targeting of particular market niches**

  Most North American microenterprise programmes target a certain group of entrepreneurs (women, minorities, low-income individuals) or businesses (start-ups, existing microbusinesses that want to expand, businesses in particular sectors, or businesses located within a geographic area). Programmes screen out those entrepreneurs who have access to other sources of credit by above-market pricing or other screening criteria.

- **Delivery of credit through a disciplined lending methodology**

  The most common lending methodologies are direct lending (a loan to one individual with collateral), peer lending (loans to a small group of individuals or members of a group whose shared obligation replaces traditional collateral), and modified group lending (lending to the individuals within a community).

- **Provision of some pre-credit technical assistance**

  Pre-credit technical assistance is provided either as formal, mandatory training (for start-up businesses) or as assistance in completing the loan application or a business plan. Training can be a series of meetings or a formal, 6-10 week training programme for start-up businesses which imparts basic business knowledge and screens out those who are not ready to start a business or repay a loan.

- **Provision of ongoing business assistance for borrowers**

  To improve chances of success and loan repayment, most programmes provide ongoing business advice and problem solving to their borrowers. This is usually structured as part of regular loan monitoring, separate advisory services, or a peer-based support system.

- **Development of programme operations**

  In North America, most programmes have developed systems for approving and documenting loans, monitoring the loan portfolio, financial and cash management, and staff development and training. These are designed as management tools to control cost inefficiencies, monitor loan loss rates, and prevent rapid staff turnover, any of which can quickly render a programme ineffective.

  In the U.S., a few programmes at the poverty alleviation end of the spectrum also provide a savings component which enables their customers to build a financial cushion (personal liquidity).

Lessons from North American Adaptations

As North American programmes have adapted the developing country microenterprise experience, they have created modifications to make microcredit an effective tool in a financially complex and sophisticated economy. The lessons that may also be applicable to microcredit programmes in CEEC and NIS contexts include:

- **Most credit needs among microbusinesses are for either short-term working capital or small amounts of asset or equipment financing**

  To minimise lengthy underwriting, most programmes use a standardised regular loan product that can effectively meet these credit needs. Short- to medium-term loans (6 months, 12 months, or at most, 36 month loans) impose the discipline of frequent payments, monthly or quarterly monitoring (usually with a site visit to the business), and a set repayment schedule, reducing the risk to both the lender and the borrower. Furthermore, loan standardisation streamlines costs.

- **"Stepping loans" that start small and gradually increase in amount with subsequent loans minimise business risk for both borrower and lender**

  When lending to start-ups or new, unproven businesses, many programmes test their customer by making a smaller loan at first (sometimes as low as $500). Once the borrower has demonstrated his or her ability and commitment to repay, a series of gradually larger loans capable of meeting additional microbusiness needs can be disbursed. Access to larger amounts provides strong incentive for repayment.

- **Lending is a business: borrowers must be selected on the basis of rigorous assessment of business viability and character, not need**

  No one benefits by supporting a poor business idea or an individual not ready to be a successful entrepreneur. Screening and self-selection techniques have helped programmes find the most "entrepreneurially ready" customers. Unlike the developing country context, the competitive retail and service markets in North America have made business viability a more important component in credit decisions than client need or eligibility.

- **Microentrepreneurs need three things: financing, market information, and management skills**

  Entrepreneurs everywhere need access to credit and capital, information on how to access markets, and both skills and a network of peers and mentors for management guidance and support. Access to information and management skills are needed by all microentrepreneurs, however, programmes that link those to the individual business provide the greatest value to the entrepreneur.

- **Linking access to credit with business assistance is an effective way to change entrepreneurial behaviour**

  While high quality assistance is an excellent resource in and of itself, it is those programmes that provide both credit and business assistance that have the highest quality services and most affect borrower behaviour. By controlling the purse strings, a microcredit programme can encourage a customer to improve certain elements of his or her business plan or get assistance in certain weak areas. Once the credit is disbursed, that leverage must be maintained through constant loan monitoring.

- **Investments in staff development and training pay off**

  In the US, most early practitioners had little lending experience or business management experience. Over the past few years, more programmes are hiring experienced staff (e.g. former lenders and business-owners) and investing in staff training to improve lending and financial skills.

- **Management information systems and internal control procedures should be developed early**

  Managers need reliable and timely information on their development outputs and financial performance to assess programme methods and evaluate the effectiveness of programme elements.

Perhaps the most important lesson has been that microcredit is not a "cookie-cutter" formula that can be easily applied from one situation to the next. Individual programme design, development goals, and financial objectives are determined by four factors: context or macro environment; mission or development goals; target market; and available resources. These four factors will be explored further in Chapter 4.

Continuing Challenges

The most important continuing challenge for microcredit organisations is to balance development goals with financial sustainability. After more than five years of experimentation and adaptation, North American microloan funds began to be pushed by funders and policy makers to:

- Better demonstrate a measurable impact on their client base;

- Achieve those development goals at reasonable cost; and

- Steadily improve their cost-effectiveness and move toward financial sustainability.

In response, the microenterprise field has better identified its goals and objectives, and focused on identifying those models that appear most effective. Individual programmes are developing performance measures and operating plans that strive for sustainability. In addition, they have been developing relationships with banks and other financial institutions to develop additional resources and improve their cost-effectiveness.

In addition, the contextual limitations on loan volumes cited on page 9, microcredit is expensive to deliver in developed countries because:

- Transaction costs per loan tend to be high as a percentage of the amount loaned;

- Business assistance and other support services are staff-intensive and costly;

- Small loan sizes generate small average outstanding balances and low interest earnings; and

- Many programmes incur higher than acceptable loan losses in their early years (loan losses are a cost of lending and must be maintained at reasonable levels).

Only in a few developing countries are a handful of microcredit organisations reaching financial self-sufficiency (excluding the cost of capital). They are operating in high-density and high-demand markets, generating large loan volume, and fully covering operating costs with loan interest income.

Currently, no North American microcredit organisation is earning a profit or covering all of its costs. However, several are striving for self-sufficiency and are continuously improving their operations to earn an increasing percentage of their operating budget from internally generated funds.

For microcredit programmes, several key variables influence financial viability:

- **Pricing of credit**

  The most successful programmes charge "market" rates on loans. Although government and other funding sources often prefer to subsidise interest rates, microcredit programmes generally do not. For borrowers, access to credit is usually more important than the cost of credit because the cost to the borrower is low compared to the return from investing that credit. A high interest rate on a small loan significantly increases the revenues of the loan fund. The net interest margin that can be earned (the difference between interest earned on loans and the cost of loan capital) varies with the local market rates: in Latin America, programmes charge as much as 15-20 per cent above inflation rates; in the United States, interest rates range from a few points above conventional bank commercial interest rates to credit card rates of 15-16 per cent.

- **Targeting customers**

  The intended customer base determines the size range and structure of loans. Self-employment and start-up microbusinesses will tend to have small average loan sizes and short maturities (up to 12 months). Existing and growth-oriented microbusinesses will tend to need larger loans with maturities of 1-3 years. Disbursements, shaped by the number of loans made and the average size of loans, drive the size of the loan portfolio. As with conventional banks, the interest income of microloan programmes is determined by average loans outstanding multiplied by the interest rate. To expand their portfolios and to meet the growing credit needs of their customers, most programmes will allow experienced borrowers who have proven their creditworthiness with small loans to obtain loans in larger amounts. In this way, the programme grows with its customers.

- **The amount of technical assistance provided**

  A key cost variable is the level of pre-credit technical assistance to be provided and the amount of monitoring or post-credit business assistance needed. This variable is also driven by the choice of target market, whether that be first time entrepreneurs who need help applying for a loan, or existing business owners who are able to benefit from credit with minimal business assistance. These services can be delivered directly by programme staff, through partnerships with existing organisations, or by tapping private business services providers such as accountants, lawyers, and marketing experts.

- **Sound management and operations**

  Like any business, a microloan fund needs good management and careful planning to maximise its cost-effectiveness, including leveraging resources where possible, standardising loan products and procedures, and streamlining the delivery of credit. A strategic plan for long-term cost-effectiveness also requires clear performance measures and periodic self-evaluation.

Most programmes, especially in the early years, will need annual loan operating support because their operating costs will exceed the revenues generated from interest income or fees. The level of operating support should steadily decrease as the programme builds its loan portfolio and meets the credit demand of its customers. As noted earlier, the appropriate performance goals for achieving self-sustainability will vary among individual programmes based on their mission, customer base, and resources.

Some programmes will achieve self-sufficiency; some will never cover their costs and must steadily reduce their subsidy requirement. Successful programmes, however, strive to do two things:

- **Clearly identify development outputs and the associated financial costs; and**

- **Steadily increase the proportion of operating costs that are covered by internally generated funds**

Chapters 4 and 5 share many of the operational strategies that microcredit programmes have used to manage the above variables and achieve these objectives.

D. Opportunities for Microcredit in Transition economies

The potential economic and development impact for microenterprise finance programmes in CEECs and the NIS is high. The transition economies of the CEEC and NIS share characteristics with both developing countries and North America that create unique opportunities for microcredit as a tool to encourage self-employment or help launch new entrepreneurs and businesses. Choosing the target customer base is one of four key factors that drive programme design and affect the challenges for microcredit programmes. The interplay between the four key design factors -- **context, mission, target market, and resources** -- determines the development and business strategies of an individual microcredit programme.

Context

Microcredit opportunities in these countries may be much greater than in North America because of their economic context. Structural change creates new market opportunities, unemployment in rural areas is high, interest in entrepreneurship runs strong, and the gap between current credit resources and needs is relatively wide.

- **First, the dramatic market changes from centrally-planned economies to various forms of capitalism have created new market opportunities**. Market gaps are being capitalised on by MSEs and SMEs in manufacturing, retail, and services. Structural change in the economy and the dependence of many rural areas on single employers or industries have created a need for discovering new ways to generate income, employment, and a high interest in entrepreneurship.

- **Second, the institutional infrastructure has not yet adapted to support the emergence of the small-scale private sector.** The credit and information gaps for MSEs remain quite large. The banking system has not yet adapted to meet the needs of small businesses and the credit gap is relatively wide. The multinational economic development assistance from OECD countries has focused mainly on targeting resources to SMEs. Most aid has been in the form of large-scale credit, technical assistance, and management training with the goal of improving the survival rates of new SME firms and accelerating the economic transformation of these transition economies. Foreign aid and local policy-makers have focused on SMEs because:

  a) They can cushion the unemployment that results from the closing or scaling down of large, economically non-competitive state-owned enterprises by creating new jobs;

b) The proliferation of SMEs can improve the quality, efficiency, and distribution of consumer goods and services, and contribute to Gross Domestic Product through exports.[6]

Conventional wisdom has been that MSEs have neither the market knowledge nor capacity to significantly increase exports quickly and efficiently. As a result, few resources have targeted this segment of the enterprise spectrum. In transition economies, however, microbusinesses both provide consumer products and services in local and smaller urban areas, and allow new entrepreneurs to build experience and capital. Home-based businesses, petty traders, local retail storefronts and service firms, and nascent manufacturers are important sources of employment, supplemental income, and local goods and services.

- **Third, the slow rate of change in much of the regulatory and legal framework continues to contribute to the growth of informal small-scale entrepreneurship outside of the regulated business realm.** High tax rates, expectations for continuing high inflation, and required registration of all private business have given many entrepreneurs disincentives to make the transition into "formal" regulated and taxed businesses.[7] Local experts in Poland and Hungary estimated the percentage of informal microbusinesses as 20 per cent and 50 per cent of total firms, respectively.[8]

Mission and Customers

Development mission and choice of target customers are inextricably linked. A programme seeking to assist low-income individuals will by necessity serve first-time entrepreneurs needing significant business assistance. Transition economies comprise several levels of entrepreneurs, nearly all of whom are constrained by their lack of personal savings, lack of assets, and lack of access to bank credit or capital. This presents a diverse spectrum of microentrepreneurs and presents many opportunities. The volume and density of entrepreneurial activity is high as shifting markets create opportunities, and the economic viability of microbusinesses appears to be strong.

According to interviews, latent entrepreneurs are emerging to meet the private sector opportunities. As noted earlier, microbusinesses, both family-run storefront enterprises and single-owner start-ups, are a vibrant and essential part of local economies, particularly in rural and smaller urban areas. In several markets, microenterprise is the only alternative for people facing closure of a city's sole or major state-owned employer. This demand for credit and the financial viability for microbusinesses are discussed further in Chapter 2.

In contrast to North America, microenterprises in transition economies have a strong potential for financial viability. Microcredit programmes can focus on entrepreneurs who have technical skills and market knowledge, but lack basic business management skills. The most skilled microbusiness owners have a strong probability of growing into viable contributors to economic growth and exports. Less skilled microentrepreneurs may create stable sources of self or family employment. The diversity of entrepreneurs who need access to credit gives microcredit programmes a wide range of market opportunities and may allow them to reach financial sustainability more easily than their American counterparts.

Resources

The level of financial and human resources currently available for enterprise development is a unique trait of these economies. Relative to the United States, OECD donor countries and development institutions have been making significant financial and human resource investments into these transition economies. The financial resources from foreign donors and financial institutions provide an opportunity for microcredit programmes to raise capital and operating funds, gain operating experience, and at the same time plan for self-sufficiency. In addition, the generally higher education level of the population and the strong motivation among local development professionals suggests a strong local management capacity for microcredit programmes.[9] There are a wide range of professionals with technical skills (engineers, attorneys, lenders) who can develop the market-oriented management skills necessary to run effective programmes.

Opportunities

Given the market characteristics of transition economies, microcredit may be a highly effective development strategy in these environments. Based on the above, there are at least three potential market niches for microenterprise credit:

- **First-time entrepreneurs and the unemployed**: For those poverty-stricken or unemployed individuals, self-employment provides an alternative or additional source of income and may potentially be a source of self-determination. In transition economies, where a significant number of people are losing jobs that previously offered lifetime security, microenterprise is a way to smooth their transition into the private sector. Several western countries currently include microenterprise as an alternative for the unemployed.[10]

- **Existing, stable microbusinesses**: According to interviews, family-or individually-owned retail and consumer product and service businesses form the backbone for the distribution of goods and services outside of the capital cities. They often need small amounts of equipment or working capital financing to stabilise the business, meet demand, or expand their ventures.

- **Emerging growth microbusinesses:** These are start-ups or existing businesses with high growth potential but no access to capital or credit. They are often run by technically-proficient or market-savvy owners who lack business management experience. Most often, these businesses appear to need equipment financing to grow the business, and can often use their own resources for small working capital financing.

Microcredit organisations have become an important strategy for poverty alleviation in developing countries. Microcredit has also been adapted to particular market niches in North America to support income-generation among the poor and small business formation. In the unique context of economies in transition, microenterprise finance can play an important role in cultivating new entrepreneurs and promoting the emergence of the private sector.

CHAPTER 2. THE BUSINESS ENVIRONMENT

> Much of the advice given [about small enterprise development] is based on previous experience in the donor or other richer countries, or in far poorer "developing countries" in Africa, Latin America, and Asia. Often it fails to take account of the special history or of the educational standard and significant industrial development previously attained in these countries in transition…
>
> The result, to say the least, has been confusing. It would be more effective not to recommend a model or approach from another country, but rather to analyse the needs and the prevailing situation and then use judgement as to the suitable way forward.
>
> Harper and Levitsky[11]

Enterprise development grows out of local entrepreneurial capacity and is supported by a broad development infrastructure. This infrastructure includes banks and other sources of capital, the labour force, business support services and technical assistance programmes, as well as the overall qualities of the economies in which these businesses take root. While many of the ingredients for successful enterprise development are common to all countries, local development professionals are the best judges of which models, approaches, and methods are most appropriate for their particular context or environment.

As stated in Chapter 1, the business context in transition economies offers a very high potential for microcredit programmes because:

- There is a high volume of diverse, small-scale entrepreneurial activity and high demand for small amounts of credit;

- The existing business infrastructure has not yet adapted to meet the needs of very small businesses, creating a significant credit gap between demand and available resources;

- Substantial economic development resources are flowing into these countries to grow the nascent private sector; and

- A well-educated, motivated population provides a strong pool of talent as microentrepreneurs and as potential managers of microcredit programmes.

To set the context for microenterprise opportunities in Central and Eastern Europe and for other economies in transition, this chapter presents a brief overview of the current business environment in these transition economies and the opportunities for microenterprise development. Although the market conditions described are not shared by all transition economies, the underlying similarities may help new programmes identify their niches more clearly. Specifically, this chapter reviews entrepreneurial activity in these markets, the current state of the banking system and other components of the business infrastructure, and the channelling of current economic development resources.

A. Overview of Economic Conditions

Current Economic Conditions:
Czech Republic

The Czech Republic has maintained low inflation (10.0 per cent in 1994),[12] has kept low unemployment (3.3 per cent in 1994),[13] and has a relatively well-developed legal and regulatory environment for private sector businesses. The Czech government privatised most state-owned enterprises in two waves by distributing vouchers that entitled citizens to bid on shares. Most Czechs have entrusted their vouchers to one or more of the 600 or so investment funds run by the country's major banks.[14] Unlike in Poland and Hungary, privatisation has not yet resulted in dramatic restructurings and increased unemployment. Based on interview findings however, unemployment in rural areas and certain towns may be as high as 10-15 per cent. Although the Czech Republic is often seen as more similar to Western Europe than to other CEECs, local enterprise development experts interviewed believed that in small cities and rural areas outside of Prague, the emergence of small-scale private enterprise remains slow. Under the previous regime, privately-owned businesses were not permitted.

Although each CEEC and NIS comprises a unique set of economic, political, and social conditions, they share certain general characteristics as transition economies that are relevant to the design of microcredit programmes. Beginning in 1989, the Soviet republics and Eastern Bloc countries broke away from the centrally-planned economic policy and business practices of the previous regimes and headed towards private and free markets. These transitions have taken time and progressed to varying degrees as the banking systems and legal and regulatory frameworks are being rebuilt. Many state-owned enterprises have closed or contracted, resulting in the loss of jobs, reduced availability or certain goods, and an influx of higher priced imports; and individuals and families have had to adjust to rapidly changing job markets with high levels of uncertainty. Each country has struggled to balance the restructuring of state-owned firms with maintaining employment options for the population. A key objective in these economic transitions is to hasten the emergence of a private sector economy to create new jobs.

Current Economic Conditions: Hungary

The legal private sector economy began in 1982 with the Act for Economic Association and was broadened in 1988 with the Second Act for Economic Association. The first Act allowed professionals to establish small businesses as a sideline to their primary jobs. In 1988, the regulations loosened further and allowed small-scale private enterprises to incorporate, borrow, and grow into full time businesses (and broadened the pool of eligible Entrepreneurs). Hungary attracted more than half of the foreign investment into Eastern Europe from 1989 through 1993. In 1993 and early 1994, however, burgeoning government deficits and imports exceeding exports have created an economic recession. Inflation reached 22.5 per cent in 1993 and fell to 18.4 per cent in 1994; unemployment leapt to 12.8 per cent in 1993 before dropping to 11.3 per cent in 1994.[15] Privatisation nearly stopped in mid-1994 with the election of Socialist Party leadership. According to more than one person interviewed, most microbusinesses are worse off now than they were in 1990 because of high inflation and economic uncertainty. However, new small firms are emerging at a relatively rapid pace in both rural and urban centres, often out of fear of unemployment rather than perceived economic opportunity.

Despite their similarities, each country has unique conditions based on its implementation and response to market reforms. The Czech Republic, Poland, Hungary, and the Slovak Republic are probably the furthest along in their introductions of market-oriented reforms.[16] Others, including those further east and the NIS, are in the early or middle stages of economic transition, depending on their access to foreign markets, monetary stability, infrastructure, and entrepreneurial business activity.

In this context, microenterprise finance may be an additional strategy for producing and distributing local goods and services, creating jobs in rural areas and smaller cities, and providing additional income sources. Microenterprise allows new entrepreneurs to accumulate experience and capital. It will permit some of those entrepreneurs to launch larger ventures in the future.

Although only Hungary, Poland, and the Czech Republic were visited in researching this report, the observations and conclusions drawn from those interviews have parallels to other CEECs and the NIS for several reasons:

- The macro-economic environments in transition economies share many similar characteristics regardless of the stage of their economic transition.

- Interviews with Eastern European experts suggest that microbusinesses play an essential role in the production and distribution of consumer goods and services in all rural and small urban areas. Whether part-time, informal, legal, or well-established, microbusinesses are an important source of jobs and supplemental income for people.

Current Economic Conditions: Poland

The largest of the three countries, Poland posted 4.5 per cent growth in GDP during 1994, exceeding even that of the Czech Republic. The radical "shock therapy" approach to economic reforms that Poland adopted in 1990 is now bearing fruit in terms of high productivity and foreign investment. However, high turnover in the Polish political leadership has resulted in a stop-and-go pattern of change and frequently changing laws. Poland has privatised about 30 per cent of its state-owned enterprises; unemployment was about 16 per cent nation-wide in 1994,[17] but reportedly up to 30 per cent in agricultural areas that depend upon a single plant or state-owned enterprise for employment. Managing the balance between market reforms and unemployment has been unusually sensitive. The early reformist zeal has been replaced by a government seeking to placate the union workers, elderly, and other labour-based constituencies. Inflation has fallen steadily, from 45.3 per cent in 1992 to 33.2 per cent in 1994,[18] but remains high.

There is a very active market economy among small businesses in rural areas because farming was never collecturized in Poland. Poland’s physical proximity to and high trading volume with Germany has also fuelled the emergence of an industry of small-scale traders and merchants, most of whom exist as informal, illegal businesses. This phenomenon may have been accelerated by the fact that 800 000 of the estimated 1.3 million recent emigrants from Poland are in Germany.[19]

Poland’s current regulatory or legal framework can not support small-scale private enterprise. Finally, there are many disincentives for microbusinesses to enter the formal sector, including high taxation rates, income and payroll taxes, and required registration with the government.

Furthermore, the principles for the design and sound management of microcredit programmes apply in a wide range of contexts; individual practitioners in each country can best determine the models most appropriate for that particular context.

Although these three countries may be farther along in their economic transitions, they share common general market conditions that are seen throughout CEEC and NIS countries:[20]

- **Inflation and currency devaluation risk**

  Although inflation has remained quite low in the Czech Republic, the risk of high inflation affects business decisions in Hungary and Poland. microentrepreneurs are concerned that high inflation will make debt repayment difficult, as few businesses can quickly earn such high returns. According to interviews, the expectation of higher inflation inhibits investment by individuals and raises uncertainty for small-scale businesses, even in the Czech Republic where many people believe the low inflation rate cannot last.

- **High effective tax rates on formal businesses**

  Although tax laws change frequently, as of March 1994, the income tax rate in Poland was 50 per cent and the payroll tax (based on number of employees) was 47 per cent, resulting in an effective tax rate of 97 per cent for all registered businesses.[21] In Hungary, the combined burden of a 44 per cent corporate tax rate and a 49 per cent payroll tax convinces many small businesses to remain informal or keep multiple sets of books.[22] All three countries also require complicated licensing and registration of small businesses, providing disincentives for microbusinesses to leave the informal sector.

- **Cash economy with a poor payments system**

  The banking sector does not yet function as an efficient national payments clearing system. Nearly all transactions occur in cash rather than through credit, checks, or electronic funds transfer. Such a cash-based economy facilitates business and tax fraud because there is little record-keeping and no "paper trail" of transactions, but businesses have little choice. In Hungary, for example, it takes eight days for a check to clear within Budapest and much longer in rural areas.

- **The commercial code and basic business laws have not yet evolved to protect non-bank creditors or shareholders**

  According to interviews, the legal and regulatory framework does not yet sufficiently protect investors and creditors from fraud and bankruptcy. This limits the amount of additional capital and liquidity pumped into the system and restricts the growth potential of smaller firms which must rely on cash terms for all suppliers and buyers. In Poland, for example, the bankruptcy laws essentially require liquidation rather than reorganisation. There is no central registry of liens or ownership, so the same asset might be pledged to multiple creditors without their knowledge. At present, banks have preference over other creditors and are the only entities that can foreclose on pledged collateral without going through the unwieldy and time consuming commercial courts.

- **Lack of reliable communication and market information**

  As one experienced manager opined, "The lack of reliable communication is the single biggest impediment to doing business in Poland."[23] Telephone communication is not consistent and travel is time consuming. In addition, the lack of reliable and accessible market information makes business planning and assessment difficult. For example, no credit histories are available, making the selection of business customers and partners difficult. This environment makes owner-operated, local microbusinesses more prevalent, as relatively few surmount the hurdles for SMEs are more significant.

All of these conditions suggest that opportunities exist, but microentrepreneurs must be street smart and savvy to solve problems and detect shifts in their markets and competition. In this context, microcredit lenders must base loan decisions on the character and resourcefulness of the borrower and the viability of the business and market niche, as opposed to need or eligibility as in developing countries.

It is in this environment that microcredit and support can be a useful development tool, as the demand for such services appears to be high.

B. Demand for Microcredit

Although the level of small-scale private sector activity in any of these countries is difficult to measure, microbusinesses are a vibrant part of these economies. In 1994, the percentage of Gross Domestic Product that is private-sector output ranged from 40 per cent -- 65 per cent for Hungary, Poland, and The Czech Republic.[24] However, these figures can be over or understated for several reasons:

- They include the privatisation of state-owned enterprises which creates large shifts all at once;
- According to interviewees, much of the private sector activity in Poland and Hungary occurs in the informal sector and is therefore not captured as registered private businesses; and
- Finally, interviews also reported that a high proportion of small, private businesses under-report their sales and incomes to reduce or avoid taxes.

As a result, reliable quantifiable data was difficult to find and the best information was anecdotal. Based on interviews in the three countries visited and conversations with experts on CEECs and NIS, the micro and small business sector appears to be very active in all of these countries. As the state-owned, centrally-planned production and distributions systems have ground to a halt or slowed, private enterprise has jumped in to fill the market gaps. In Poland, for example, small, independent bakeries appeared in almost every town and city to fill the gap left by the uncompetitive contracting state-owned bakery.[25] Medical doctors and dentists have been establishing private offices and clinics. These small-scale enterprises have been particularly important for providing goods and services to rural and smaller urban areas away from the capital cities.

According to Professor Peter Szirmai of the Small Business Research Institute at Budapest Economic University, there were approximately 180 000 registered private companies in Hungary in early 1994, only 13 000 of which were share-owned companies. The rest are partnerships and limited partnerships. In addition, there are about 700 000 craftspeople and family-owned businesses that require only a license rather than full, private incorporation and registration. Of all the private businesses, Professor Szirmai estimates that 95 per cent have fewer than 20 employees. In Poland, according to recent research by Dariusz Stola, there are 1.7 million private registered businesses and the average size is only 1.8 employees.

Based on interviews and the available written information, small-scale entrepreneurs tend to have limited capital (private savings), few assets, and insufficient access to bank financing due to the high collateral requirements. Shorebank Advisory Services drew the following observations about microenterprise in these transition economies:

- **Microbusinesses include informal businesses, the self-employed, and family-owned businesses. While microbusinesses may have up to 10 employees, the owner-operator does all management tasks and sales**

  Some interviewees, such as Eva Bakonyi in Budapest, made sharper distinctions between micro and small-scale enterprises based on the management capacity of the owner-operator. In a microbusiness, the owner-operator may have employees to help with production tasks, but does not delegate any of the management tasks (such as production, financial management, sales, buying inventory). The MSE sector is a larger economic segment in these economies than in western or developing countries because of (1) the rapid emergence of private enterprise in such a short time, and (2) the economic viability of microbusinesses appears to be high.

- **There are three tiers of potential microentrepreneurs in CEEC economies: latent entrepreneurs, potential entrepreneurs, and the under-employed**

  As one development professional stated, "the goal is to develop a private economy by encouraging entrepreneurs to come out of the woodwork."[26] In all three countries, the first tier comprised those latent entrepreneurs who come out of the woodwork when there is access to credit and information and a sense of business opportunity. They typically need minimal technical assistance. The second tier is the layer of potential entrepreneurs who need access to credit and information plus some basic coaching, support, and additional skills to manage their businesses. The third tier includes the poor, the unemployed, and under-employed who need to develop alternative sources of income. These entrepreneurs may need more handholding and support, and more extensive basic business training, than the second tier.

  In the three countries visited, the first tier has already emerged and the second tier is gradually emerging where resources become available. A few programmes appeared to target the third tier (such as the Foundation for Polish Agriculture and the Polish Ministry of Labour). In many other CEECs, experts suggested that the first and second tier are just beginning to emerge as market opportunities become more evident and resources become more available (see Existing Resources section in part D).

  Although the economic transitions of individual countries are driven by their unique context, the emergence of microentrepreneurs is likely to follow the general patterns seen in Poland, Hungary, and/or the Czech Republic. Although there is very little data on Polish firms with fewer than 5 employees, the pre-1989 private sector was comprised of subsistence farming, small craftsmen, and retail food kiosks. After the old regime, the first wave of new entrepreneurs were people who had some capital and could become importers to meet domestic consumption demand. The second wave were professionals or those with market connections who established private businesses to compete with poorly-functioning government-owned operations.[27] In Hungary, the newcomers since the 1988 law have included (1) experienced professionals who can use their market knowledge and contacts to compete with government-owned businesses, and (2) individuals choosing self-employment for survival in the face of increasing job uncertainty. Most start their businesses with savings and funds borrowed from friends and family, just as in the United States.[28]

Characteristics of Microenterprises in Transition Economies:

- **Entrepreneurs tend to focus on short-term profit opportunities rather than building long-term sustainability.**

  Many western business experts with experience in CEECs observed that entrepreneurs tend to focus on or seek out the best possible one-time deal, regardless of its long-term implications with a customer or supplier. Described by one person as a deeply ingrained instinct to survive by "beating the system," this can limit the growth of microbusinesses to a series of one-time transactions rather than supplier/customer relationships that build a base for future growth. This also reflects entrepreneurs' uncertainty about whether the government policies will change to limit future long-term business potential, such as currency devaluations, new taxes imposed on small businesses, or regulatory constraints. Overall, the lack of management experience constrains the number of microbusinesses that can grow into SMEs.

- **As an alternative source of income, microenterprise is particularly important in rural and small urban areas, where labour mobility is very limited**

  The economic need for entrepreneurship is particularly high because (1) people cannot move easily to find jobs and (2) structural changes are occurring in agriculture and industry. Most people live in rent-controlled housing co-operatives or large apartment buildings with long waiting lists. Moving to an urban centre is difficult because of the shortage of housing. In Poland, for example, there were about 2 million people on waiting lists for a flat or apartment in 1994.[29] The shortage of supply has driven up the market price of those flats to levels too high for most people to afford. In Hungary, an average apartment now costs 19 times average pay.[30]

  Rural areas are also facing structural change in agriculture and traditional rural employment. In Poland, for example, the percentage of the population supported by agriculture will fall over the next several years. The rural population is typically older than in urban centres and the average farm size is quite small. As competition increases, small scale farming may well become less viable. In 1993, approximately 24 per cent of the population of Poland was engaged in agriculture. The highest proportion among European Commission (EC) countries was 10 per cent in Portugal; it is only 3 per cent in the US.

Microbusinesses need 3 things:
Access to market information
Access to financing
Management skills

- **Microbusinesses in transition economies face common obstacles, many of which are shared by microbusinesses in the United States**

  As noted earlier, microbusinesses around the world tend to need three things: access to information, access to financing, and management experience. In CEEC and NIS economies, rapidly changing markets and inefficient communication systems make information on markets, competitors, or customers difficult to gather. Current and former insiders often have market connections that provide advantages over outsiders. Buyers and sellers are not always visible and there is little public disclosure of transactions.

Common obstacles for microbusinesses include:

a) **Limited information complicates market assessment**. This provides significant opportunity for entrepreneurs who have market knowledge and can see a way to capitalise on market gaps, but also makes assessing the changing market more difficult and profit margins can quickly erode.

b) **Few incentives to become formal businesses**. A high percentage of microbusinesses see little incentive to become formal, registered businesses due to the high tax rates and distrust of government.

c) **Limited access to credit and capital**. There is limited access to credit or capital due to insufficient personal savings and few credit resources. Many people have accumulated few assets and therefore have no collateral for borrowing from banks (banks in all three countries required high collateral to loan ratios -- about 200 per cent). Few have direct management experience in the business they are starting, and therefore fail to qualify for the few development programmes that offer credit. Finally, many businesses do not even try to borrow from banks due to mistrust or perceived ineligibility. The high cost of credit (due to inflation) and risk of higher inflation also makes many entrepreneurs cautious about borrowing.

d) **Lack of managerial skills and market knowledge**. This lack of experience among entrepreneurs inhibits the growth of many microbusinesses, as owners have less experience with the pricing, competition, and customer service orientations of market economies.

Business assistance programmes to date have emphasised business planning and management skill development, with little focus on credit provision.

C. Availability of Credit

As noted above, most CEEC and NIS governments have been trying to balance two objectives: (1) promoting the emergence of the private sector while dismantling inefficient state-owned enterprises, and (2) preserving the health and stability of their financial systems while minimising unemployment. Under central planning, the government distributed funds to state-owned enterprises via the national banking system; the banks were not required or expected to make lending judgements. With privatisation, the banks are left with a large proportion of loans to now-faltering state-owned enterprises (SOEs). Without government assurances, if the government allows the SOEs to fail, the banks will also fail. Yet, the health and efficiency of these institutions is vital to the success of broader economic reforms.

- **Conventional Resources**

To survive, banks are privatising and are seeking new revenue sources to boost their earnings. The typical preferred revenue earners are investing in government bonds (as a hedge against inflation) and other low-risk activities not making new loans.

Hungary: Almost all of Hungary's banks remain state-owned and all have a high proportion of questionable assets. The state has spent more than $3 billion (nearly 10 per cent of GNP) to purchase bad loans and boost the capital of banks, yet the banks' loan portfolios remain shaky.[31] According to interviews, the practical result is that banks "are unwilling to make less than ironclad loans" and prefer to invest the majority of their liquid funds in government bonds. "Banks are not making loans," said one business assistance provider. According to her, the preferred lines of credit that are nominally targeted for small businesses are also not readily available.[32]

Czech Republic: All of the retail Czech commercial banks are privately-owned, despite being deemed technically insolvent in 1990. To keep them afloat, all bad loans (about 20 per cent of total bank loans) were transferred to the state-backed Consolidation Bank (Konsoli Banka) and the performing loans remained in the private banks. Most banks were privatised in the mass privatisation in 1992 and have been recapitalised. Although an estimated 10 per cent -- 20 per cent of bank assets still look shaky, the Czech banks are in relatively good health. Banks are most concerned with making profits, focusing on large commercial loans well-supported by collateral and management of investment funds of privately owned equity shares. Komercni Banka is the largest Czech commercial bank and has a partnership with the Czech-American Enterprise Fund to focus lenders on small businesses, however loan volume under the programme has been extremely low (discussed below under alternative sources.)

Poland: In Poland, bad debts have troubled both the big state-owned banks and the newer private ones. In 1994, the country had 9 state-owned commercial banks and 80 private banks (not including the 1 600 agricultural co-operative banks). The nine commercial banks were created by the division of the National Bank of Poland (NBP) into nine regions, leaving the NBP to act as the central bank. Two of the nine have been privatised. Although the number of private banks and joint ventures with foreign ownership has grown rapidly, there have been several highly visible bank failures where private banks have been absorbed by the state-owned banks. Only the nine commercial banks have access to deposit insurance and therefore have a greater ability to attract local deposits more than foreign-owned banks. The agricultural banks are reportedly near insolvency, but the government is likely to make continued capital infusions due to politics and partisan concerns.

Although banks can narrow the credit gap with time, they are unlikely to become a source of microcredit finance in the near-term.

- **Alternative Sources of Credit**

Few alternative sources of credit and capital exist. Most CEECs have followed the bank-dominated financial system used in Germany rather than the more segmented financial services approach seen in the United States. In the former, banks have a wide range of powers to take deposits, make loans, make equity investments, raise capital, and manage investment funds. Several countries have agricultural banks that make only agriculture loans, however, experts believed few of these would be privatised due to their need for continuing government subsidy (they typically do not accept deposits and rely on the government or central bank for funding). Credit unions appear to be in the development stage in a few countries, led by the World Association of Credit Unions. In Poland, there were 51 credit unions registered as of November 1993, of which 26 were operational with $4.6 MM in assets.[33]

The primary focus of the CEEC banks appears to be to build their capital bases by ensuring high interest spreads between their cost of funds and lending rates. Given the high rates of inflation, banks in Poland and Hungary have preferred investing in government securities over lending. In all three countries, banks rarely lend, and when they do, it is usually to state-owned enterprises and on a short term basis. Most private-sector growth has been financed so far out of retained earnings.[34] In-country interviews confirmed that banks do not make credit readily available to smaller firms. Typically loan requirements are 200 per cent collateral coverage, co-guarantors, high interest rates, and relatively short maturities (less than two years). Although the World Bank and other intermediaries have made loans to the banking system (to the NBP, for example), the banks do not on-lend those funds to small businesses. Two reasons were most often cited: (1) the banks do not want to incur any credit losses; and (2) staff do not know how to evaluate and monitor small business loans and therefore rely solely on collateral coverage.

For the reasons given above, credit is not distributed effectively through the banking system. However, non-conventional credit resources have to rely upon the banks' transactional abilities to deliver credit. Banks are the only payment system, for example, and banks have legal power to foreclose on collateral without going through the civil courts. The existing range of alternative resources are described in Section D: Existing Resources for MSEs, that follows.

For the most part, institutions are not reaching the smaller or micro businesses in the economy, nor are the banks seen as service institutions. For this reason, many smaller or micro businesses will not approach banks for lending assistance.

D. Existing Resources for Micro and Small Enterprises

In addition to the emerging culture of entrepreneurship and the banking, legal, and regulatory infrastructure to encourage small enterprise development, the enterprise development landscape in CEECs and NIS has also been shaped by a large infusion of foreign economic development assistance to encourage the transition to a free market economy. This aid from OECD countries has focused on three types of support for the emerging private sector, with particular focus on SMEs:

- **Liquidity** into the banking system to encourage the distribution of capital and credit through on-lending by the banks;

- **Technical assistance centres and programmes** for existing businesses and managers of new enterprises to improve the success rates for SMEs; and

- **Management training** for managers of existing SMEs; usually in the form of business management courses, seminars, and libraries of translated business literature.

The majority of resources are delivered through bilateral agreements between governments or through the EC to the recipient government. Most are in the form of grants or soft loans to government agencies or to donor-designated programmes that operate within the countries.[35]

The privately-funded and privately-managed alternative sources for credit and capital are few. Notable exceptions in the three countries visited included:

The American Enterprise Funds*:* Established and capitalised by the U.S. Government to support the emergence of the private sector in transition economies, American-Enterprise funds operate in several CEEC and NIS countries. While each develops its own lending and investment products, most provide some combination of small business lending and risk capital investment, usually with a focus on the SME sector. The oldest of these funds, the Polish-American Enterprise Fund, established in 1990, is the largest fund and has an admirable track record in both small business lending (through the Enterprise Credit Corporation described in Chapter 3) and venture capital investing.

The CARE Small Business Assistance Corporations: CARESBAC-Polska is the oldest of these programmes established by the CARE international charity to provide risk capital financing and business consulting services to SMEs. In Poland, the programme is also funded by the European Bank for Reconstruction and Development. CARESBAC makes investments of US$50 000 to US$400 000 in Polish zlotys under typical venture capital return requirements and terms.[36]

BISE, TISE, and FISE: Capitalised by the French government, these three Warsaw-based institutions provide complementary products and services to Polish SMEs. The Bank for Socio-Economic Initiatives (known by the Polish acronym BISE) can make loans like other private banks; the Society for Socio-Economic Initiatives (TISE) can make equity investments in SMEs; and the Foundation for Socio-Economic Initiatives (FISE) provides business planning assistance to new and existing SMEs through its network of Agencies for Local Development. Designed to offer co-ordinated and complementary resources to SMEs, the three entities have reportedly grown to serve distinct markets with little customer overlap.[37]

The Foundation for Small Enterprise Development (SEED): Based in Budapest, the SEED programme is a small programme that wanted to make small loans to start-up and microbusinesses. Although operations were mostly technical assistance in 1994, SEED hoped to combine credit with hands-on technical assistance with loans for a small group of borrowers.[38]

In addition to these, the Agriculture Foundation and Foundation for Polish Agriculture are two private organisations described in Chapter 3.

Most of the privately-managed and governed organisations have received small amounts of financial support from Western philanthropic sources (foundations, religious organisations, or individuals). Few qualify for direct investments by EBRD or The World Bank, although there have been exceptions.

The financial and human resources for economic development flowing into transition economies have been relatively substantial. Based on interviews and published information, the following observations can be made:

- **The magnitude of the resources is significant and presents an opportunity**

  Unlike in the United States, the scale of resources flowing into alternative sources of technical assistance and credit is significant and has developed into its own business sector. It has brought both financial resources and human talent (in the form of advisors) into these countries to provide the new private sector with information and credit.

- **EC resources have emphasised technical assistance provision for both existing and new SMEs, although the number of credit programmes has been increasing**

  In almost every country, the EC-PHARE programme has financed the creation of regional technical assistance centres that provide generalist business planning assistance for new businesses and varying degrees of technical support to existing businesses. Most technical assistance centres target

SMEs with growth or export potential and are located in smaller urban areas outside of the capital cities.

- In Hungary, the PHARE programme funds the Hungarian Foundation for Enterprise Promotion, a quasi-governmental organisation which operates 20 regional Local Enterprise Agencies, or LEAs, and runs a microcredit programme (described in Chapter 3). The LEAs emphasise technical assistance, although the microloan fund is becoming more popular. This programme targets start-ups as well as existing businesses. The Hungarian programmes are notable because they were created through a stand-alone intermediary, the Hungarian Foundation for Enterprise Promotion, that can continue on after foreign funding ceases.

- In the Czech Republic, the EC-PHARE programme funds two types of programmes run directly by the government: (1) advisory schemes that are run through 19 Regional Advisory Centres (small business planning assistance located in 19 rural towns) and three Business Innovation Centres (where entrepreneurs can find help in commercialising technology, new product development, and marketing); and (2) financial schemes that provide direct loans for amounts less than Kcs 1 million or provide 75 per cent guarantees on below market-rate bank loans up to Kcs 10 million. The cumulative loan volume on the financial schemes has been below expectations in part due to the programme's reliance on the banks to originate the loans.[39] The loan programmes target businesses with more than 100 employees and 50 per cent of loan proceeds must be used for manufacturing. The goals are to build the SME sector and export growth. The RPICs and BICs must earn fee income to pay salaries of their staff and are independent organisations not aligned with any host or sponsoring entities.

- In Poland, the EC-funded Co-operation Fund targets three primary programmes at SMEs: (1) Business Support Centres focus on existing businesses and provide general business planning assistance and legal and taxation advice; (2) Regional Chambers of Commerce to encourage local business development, such as promotion of tourism; and (3) Skills Development and Training programmes which provide business management training in universities and business schools. The Polish Business Advisory Services programme trains entrepreneurs in several regions of Poland, for example. The focus is on entrepreneurs, primarily existing business-owners. There is no training for bankers or lenders because "banks are not interested in lending to SMEs."[40] In Poland, the Business Support Centres were formed with existing institutions (mostly universities) so the programme would not die when EC funding ended.

- **Most resources tend to flow to the top of a bureaucracy, are centrally-planned, and allow little local adaptation**

Local programme managers often have little control over centrally planned programme products and services designed by foreign consultants.

> The richer countries differ in their approach to support for small enterprises. In the U.S.A., membership in associations and chambers of commerce is voluntary and government works through federal agencies and centres in universities. Germany lays great stress on vocational training, and government support is provided through craft chambers to which small firms are obliged to belong. In the UK, enterprise agencies have developed based on help from large businesses to smaller ones. In some countries in Eastern Europe, such as Hungary, advisors have arrived from different donor countries, each advocating their own specific approach.[41]

The most dynamic development professionals interviewed seemed to think like entrepreneurs and developed programmes that meet local needs and conditions. Well-educated and intellectually curious, most local staff appeared to be very capable of running innovative programmes if the incentive and accountability systems were in place.

In general, there appeared to be little sharing of information among programmes within or between countries. In the spring of 1994, EC-PHARE brought the managers of its programmes in CEECs together for the first time, as few officials interviewed were familiar with their sister programmes in other countries. Even within a particular country, there is little communication or knowledge of programmes sponsored or funded by different organisations, particularly within the EC-PHARE programmes. For example, the Polish EC-PHARE staff were unfamiliar with PAEF, World Bank, and other programmes operating in Poland. As well, they knew little of the experience of their colleagues in Hungary or the Czech Republic.

- **The major operational focus is to spend grant money; access to resources is not linked to performance or results.**

  Although there are some very good programmes in place, the management orientation is for a grant-funded programme rather than of a business. The RPICs in the Czech Republic are an exception -- they have autonomy over their business planning and are forced to earn their own revenues by the quality of services they provide to their customers.

- **Most credit programmes target SMEs, rather than MSEs, or rely on the banks for distribution and credit approvals.**

  One expert in Hungary estimated 35 development loan programmes in that country, but few businesses could access these funds due to (1) use of proceeds restrictions (most often to manufacturing), (2) large loan sizes aimed at firms with high growth potential, or (3) insufficient personal equity to invest in the business or insufficient collateral to qualify for a loan. Other programmes that rely on bank lenders to originate and monitor loans to micro or small businesses often have low loan volumes due to (1) the high credit risk standards applied by banks, (2) unfamiliarity of lenders with small businesses and cash flow lending, and (3) lack of incentives or accountability to make these small loans (it is not their main business purpose).

- **There are few privately-funded or privately-managed technical assistance or credit programmes in each country.**

  Most formerly centrally-planned economies do not have a history of private ownership, much less private philanthropic organisations. Those that exist are often created from foreign funds and in partnership with foreign investors or managers, but the most effective have local staff. Examples of such private organisations noted earlier include the Polish-American Enterprise Fund's Enterprise Credit Corporation (now managed by Polish nationals), CARESBAC-POLSKA, (a seed capital investment firm), the Agriculture Foundation (established with the Catholic Church and Western donors), the Foundation for Polish Agriculture in Poland, the Entrepreneurship Centres operating in the Czech Republic and the Slovak Republic and the B'nai B'rith Foundation in Hungary. These organisations are managed by dedicated and talented staff with clear vision and purpose. These organisations often compete for resources. However, most enterprise development resources are flowing to governments or to EC designed and managed programmes.

  The few effective programmes that are EC or government-funded have attracted strong management talent and have given autonomy to local staff and managers. Examples of these include the Hungarian Foundation for Enterprise Promotion, the Local Initiatives Programme in Poland, and the three interrelated institutions in Poland capitalised by the French government. The Local Initiatives Programme is a new initiative within the PHARE programme that is responsible for day-to-day management of a Ministry of Labour programme making loans of up to $4 000 to the unemployed. It also works with nine local, gmina-level governments in a Community Development Programme in which each community has a local board of directors. After a guided planning process, all nine cited self-employment and resources for microbusinesses as an important need for their community, asking that 60 per cent of programme resources be allocated for small-scale credit.[42]

As discussed under alternative sources of credit and capital, the French government capitalised three institutions that could co-ordinate their efforts: BISE, a regulated bank that makes business loans; TISE, which invests equity in SMEs, and FISE, which provides business advisory services to entrepreneurs. According to FISE staff, the three are separately managed and do not co-ordinate closely. FISE serves start-up and smaller SMEs and MSEs through urban and regional centres, while BISE and TISE serve SMEs only. However, the three are privately capitalised and privately managed, and each has a clear mission with development and financial objectives.

Overall, the current enterprise development resources are overwhelmingly channelled to the SME sector, with an emphasis on business planning assistance rather than on credit. Few programmes provide both. While the investment in SMEs makes sense for these emerging private sector economies, there is also a clear need and market opportunity for credit and support services to MSEs.

E. Conclusions

Based on the information above, the transition economies within CEECs and the NIS present the following market opportunities and challenges for microcredit:

- **Transition economies are seeing burgeoning demand for alternative sources of credit and information by micro and small-scale entrepreneurs.**

  The structural shifts within the economy, the high demand for income-generating alternatives in rural areas, the minimal credit resources available to MSEs, and the entrepreneurial energy and capacity of the population have created strong demand for microenterprise credit.

- **The scale of enterprise development resources flowing into these countries provides an opportunity to build permanent, privately-managed organisations with a long-term focus on development and accountability for performance results**.

  Single purpose organisations that are privately capitalised and managed and have a clear development mission can (a) find market niches that facilitate self-sustainability or a steady reduction in the level of operating funds needed each year, and (b) have the local market knowledge and operational flexibility to develop products and services that leverage both grant-funded programmes and private financial institutions or organisations.

  The MSE sector provides a significant opportunity to address income-generation among the poor, job creation in rural areas, wealth creation among a broader range of people, in addition to creating the pipeline for future SMEs. However, the best way to meet these market opportunities is through local, private institutions and organisations that can shepherd capital, invest in staff and institutional development, and remain focused on long-term development objectives. If these organisations can become financially self-sustaining, they are even better positioned for long-term development and market impact.

- **The most significant market gaps in these transition economies appear to be (1) small amounts of seed or risk capital for start-up and expansion stage businesses, and (2) small loans for working capital and equipment financing.**

  Although loans of less than $20 000 are rarely available, local programme managers agree that small amounts of credit are needed by entrepreneurs. Staff for the Polish Business Support Centres all cite a need for small amounts of credit, but it is not delivered through the EC-funded programmes in Poland because it is not part of their mandate. Similarly, staff of the Hungarian Foundation for Enterprise Promotion also cite the need for working capital financing and other credit for microbusinesses that may not have high growth potential. Both the Enterprise Credit Corporation in Poland and the Opportunity International programme in Bulgaria have unleashed high loan demand by providing loans of $10 000 -- $25 000 for equipment financing.[43]

- **It may be easier and more effective to set up new organisations with permanent staff than to work through an existing bureaucracy.**

  Currently, there are few models of entrepreneurial creativity within these countries' larger bureaucracies. Private organisations are held accountable to both investors and customers for their financial and development performance. To ensure that these resources build a new infrastructure that can continue to meet the needs of small businesses in the future, private institutions with the capital, talent, and monitoring systems to ensure focus on their customer and market are important additional tools in the development of a healthy market economy.

- **The potential for microcredit will be realised only if programmes are well designed and professionally managed.**

  Microcredit organisations must think like businesses -- they must consider market opportunities, identify and development and financial objectives, and efficiently manage resources. While several existing microcredit programmes in CEECs have a strategic direction, they lack the operational and management tools to manage programmes for long-term effectiveness and sustainability.

As noted above, good design and strong management are essential for programmes to reach their potential. The building blocks for designing microcredit programmes are explored in Chapter 4. Chapter 5 discusses the management and operational tools for sound management of microcredit organisations.

CHAPTER 3. SUCCESSES AND CHALLENGES IN TRANSITION ECONOMIES

> "Gaps? There are only gaps! It isn't a matter of a land with 'gaps'...we are a sea with islands!"
>
> Dariusz Stola, Poland.

A. Overview

In Hungary, the Czech Republic, and Poland, interviews were organised with SME sector professionals involved in business training and technical assistance, venture capital, loan guarantee schemes, and small business lending (see list of interviews in Appendix A). All these professionals shared useful insights about the macroeconomic environment, their work as business development professionals, and the challenges and opportunities faced by MSEs in the transitional economy. Their opinions and anecdotes affirmed the conclusions noted in the previous chapters: the structural changes in the economy have diminished wage employment options and spawned the emergence of an entrepreneurial class, but owners of micro and small businesses have limited or no access to credit. The formal banking system in some instances, is orienting their business toward private SMEs, but a significant credit gap remains for very small and start-up businesses.

Out of the 20 SME programmes interviewed in these three countries, only four effectively reached microenterprises with small amounts of credit. Three of those four also served larger businesses, but made a concentrated effort to reach microenterprises as part of their portfolio. This chapter profiles those four programmes that are reaching smaller businesses and highlights their design characteristics, strengths, and challenges in serving microenterprises.

These four credit programmes are noteworthy for new or existing microcredit practitioners in transition economies for their programme design, operating experience, and effectiveness. One is in Hungary: the Hungarian Foundation for Enterprise Promotion (HFEP). The other three are in Poland: the Agriculture Foundation, the Foundation for the Development of Polish Agriculture (FDPA), and the Polish-American Enterprise Fund's (PAEF) wholly-owned subsidiary called the Enterprise Credit Corporation (ECC). Although programmes in the Czech Republic include many SME programmes and several successful technical assistance programmes, no interview took place with credit programmes there that served microenterprises.

The four programmes stand out because they are striving to become permanent institutions rather than temporary interventions to fill a credit gap. Although the programmes started after 1990, they appear to be well-established. Each programme illustrates how microcredit programmes can build upon the four cornerstones of good programme design identified in Chapter 1: context, mission, target group, and resources. The local programme managers have designed each programme's mission and organisational structure based on a flexible assessment of their economic, market, and institutional context, the specific needs of their target customers, and the funding resources available.

Although the four programmes exhibit a range of goals and development objectives, they share common traits that illustrate how microcredit programmes can be effective development strategies in the central and eastern European context. The four programmes vary in the strength or emphasis placed on each of these common traits; each programme is exceptional in one or two aspects. Each programme:

- Responds to the unique CEEC context with a clearly defined mission, target customer, and strategy;
- Makes good use of the current supply of foreign financial and human resources to build lasting institutions;
- Ties credit delivery to the existing banking infrastructure;
- Focuses services in small cities and rural areas where the need is the greatest;
- Continues to develop distribution systems that maintain a local connection with the borrower; and
- Has strong, committed leadership able to clearly articulate its development objectives and mobilise resources.

Section B profiles the four programmes. Section C reviews these characteristics as strengths of these programmes. Section D discusses the continuing challenges the programmes face in the CEEC environment. Whether these challenges can be met by design or the result of changes in macroeconomic policy, the ways in which these four programmes currently operate offer insights about the fundamentals of developing microcredit programmes for Central and Eastern Europe.

B. Profiles of Four Notable Credit Programmes

The **Foundation for the Development of Polish Agriculture (FDPA)**, a private, non-profit organisation supported with financial assistance from OECD countries, was established in 1988 to provide and support a variety of agricultural and rural economic development activities. The FDPA provides expert technical assistance to agribusiness ventures, fosters innovation in sustainable farming, invests capital to privatise agricultural ventures, and, specifically promotes job creation through microenterprise and rural tourism programmes. Of the four programmes, the FDPA microloan programme (Women's Rural Economic Development Programme -- WRED) has the smallest capital base with US$350 000 in equity capital.

The microenterprise training and credit programme is explicitly targeted to women-owned start-up and very small rural businesses. Led by founding manager, Elzbieta (Ela) Dec, WRED saw a need for encouraging and helping low-income rural women start micro-businesses as an alternative and supplemental source of household income. While FDPA serves fewer customers than the other programmes noted here, it provides greater depth of service including mandatory business plan training courses and one-on-one technical assistance. WRED is similar to many US-based microloan funds which lead with a training component. Demand for entering the training programme is high, with 600 women participating in 1994. Participants who complete the intensive business management training programmes develop a realistic and positive cash flow projection, and do not have any other liabilities or outstanding taxes are eligible for a US$5 000 loan on a one-year term. Manager Dec estimated that approximately one out of nine trainees become borrowers.

The **Hungarian Foundation for Enterprise Promotion (HFEP)** is an EC-PHARE funded entity that was established in 1990 to study and serve the SME sector in Hungary. The Foundation was capitalised with US$42 million and its principle programme is a network of twenty.[44] Local Enterprise Agencies (LEAs) and LEA sub-agencies in small cities and towns across the Republic. These provide business assistance and information to small business owners, many of whom are microentrepreneurs.

HFEP's microcredit programme, funded at US$9 million in 1994, is a component product offering of the LEA's. Fourteen of the twenty LEA's marketed the microloan programme in their service offerings in 1994. The Chief Executive Manager of HFEP, Dr. László Székely, and the Programme Manager for the Microloan Programme, Mr. Tibor Hári, are the management team that oversee the LEA enterprise and credit activities. While the LEAs are set up to provide technical assistance to small businesses defined as having fewer than sixty employees, the HFEP microcredit programme is targeted toward even smaller businesses that meet the following criteria:

- No more than 10 employees;
- Not older than 2 years;
- No more than $60 000 in annual sales; owner-entrepreneur has no more than $200 000 of net worth.

To date, the microloan programme is in high demand. Eighty to ninety per cent of the LEA sub-agency clients are interested in a microloan. In March of 1994, the HFEP staff estimated that they had made about 1 000 loans totalling approximately US$3 000 000 making the average loan size about US$3 000. Since the criteria excludes businesses that are more than two years old, the loans appear to be going to microbusinesses started by the unemployed or new entrepreneurs and to existing business owners who are starting an additional business activity. The microcredit programme is meant to fuel the transition from micro to small enterprise, but the staff reports that the microloans are helping small start-ups survive and stabilise. According to programme management, the HFEP funds are filling an important credit gap by helping to launch new enterprises that banks perceive as too risky to justify the high transaction costs and low revenues.

The **Agriculture Foundation** is a government-sponsored foundation established in 1991 to promote economic development initiatives in villages and small towns of Poland. The Foundation funds rural initiatives and businesses in three programme areas: alternative energy, improvement of small hydro-electric power stations, and development of small businesses to stimulate a spirit of enterprise and create off-farm employment opportunities.

With loan capital of $14 million borrowed from the Polish Ministry of Agriculture and Food Economy, the Foundation operates two loan funds:

- The Foundation started the small loan programme in 1991 for loans of up to US$50 000. Requirements include a business plan, 20 per cent equity from the entrepreneur, and a partner bank to review, disburse, close, and administer the loans. Since the beginning of the small loan programme, the Foundation has received 1 883 applications, committed 328 loans, disbursed approximately $6 million, and created an estimated 7 012 jobs.
- In partnership with the Ministry of Labour and local governments (gminas), the microloan programme was launched the following year to provide loans of up to US$3 500 for businesses started by the unemployed who complete 40-100 hours of business training. As of March 1994, 700 participants graduated from the training programme and 54 microloans were made.

Both loan programmes have equity and collateral requirements, but the microloan programme applies the rules and requirements less strictly. The Foundation's Board of Directors makes the preliminary and final recommendation for the loans, but it has carefully orchestrated its partnerships with local governments and banks to provide training and/or business planning assistance and ensure more accountable repayment. Demand for the programme appears to be high, but the Foundation has purposefully slowed the pace of the application process to encourage screening of applicants through customer self-selection, and more thorough loan reviews. These steps should help the programme maintain a well-performing loan portfolio.

The **Enterprise Credit Corporation (ECC)** is the small business lending programme established in 1990 by the Polish-American Enterprise Fund (PAEF), the non-profit corporation set up in 1989 by the US Government to promote the development of the Polish private sector. ECC started by partnering with Polish banks to make loans to small and emerging businesses through small business loan "windows" located at selected bank branches of the eight national Polish banks. ECC trained its own staff and two or three bank staff in each location in small business lending. PAEF provides 100 per cent of the loan capital, but each bank shares 50 per cent of the loan losses on loans made from their "windows." While ECC is not exclusively focused on microenterprises, a significant percentage of its portfolio is in loans of less than $15 000. ECC tries to ensure that microbusinesses represent a portion of the loan portfolio.

PAEF set up ECC to not only provide credit to small businesses, but also to build the capacity of Polish banks to undertake small business lending. This dual purpose requires its portfolio target to be more conservative than the riskier credits typical of HFEP's start-up portfolio. Not explicitly a microcredit programme, ECC targets its credit services to existing businesses in the SME sector to provide financing primarily for equipment and fixed assets. It started by providing credit to existing entrepreneurs who were springing up in 1990 to fill the market gaps left by the failing state-owned enterprises such as bakeries, doctors and dentists, and other small production and service businesses. From 1990 through 1994, the programme successfully made 3 500 loans totalling more than US$90 million to existing small business owners at an average loan size of about US$28 000.

C. Shared Characteristics of the Four Programmes

> ...(T)he management team's ability to articulate the organisation's goals clearly and develop a plan on how to reach them is the single most important factor in a programme's effectiveness.
>
> Judith Tendler[45]

These four programmes share certain traits that have contributed to their effectiveness. While some are shared by all successful microcredit programmes, others are unique success factors for the context of transition economies.

Each of these is discussed in more detail below:

1. **Clearly defined mission, market, and strategy.**

All four programmes have a clear mission, well-articulated programme goals, and a defined target market. The result is that each programme works to put credit "on the street" in high volume and has developed a highly structured and disciplined delivery system. Programme staff know their customer and have developed credit and business service products that meet the needs of their targeted customer. In most cases, the demand for products and services is high due to a combination of hitting the right target market and creating attractive services or credit products. The programmes find and screen entrepreneurs quickly and efficiently using clear, standardised criteria and a streamlined loan approval process. In this way, credit is extended prudently so as to ensure high repayment.

For example in the emerging business environment of the formerly centrally-planned economies, there are few effective legal controls to help lenders collect bad loans or foreclose on collateral. Each of these programmes are designed so that borrowers go through a rigorous application process that will prove their ability and willingness to repay and lessen the programmes' reliance on collateral.

To meet their goals, these programmes have developed various lending methodologies to deliver credit effectively. Examples of these mechanisms include:

a) **Some equity infusion by the borrower.** Most require 20 per cent to 30 per cent, although the programmes are somewhat flexible in determining the form of the equity investment. For example, for its farm-based businesses, FDPA will consider farm assets as part of the borrower's equity contribution.

b) **A co-signer or guarantor**. Several programmes require a co-guarantor in addition to a personal guarantee from the borrower, to gain a commitment from an additional source of repayment.

c) **Rigorous or multi-stepped application process.** Each programme has outlined a series of steps for the borrower to take as he or she applies for the loan to pace the decision process and to screen out impatient and less qualified borrowers. The loan application itself serves as a screening mechanism, or programmes can require new entrepreneurs to participate in formal business planning to test their ideas. Three of the programmes (HFEP, the Agriculture Foundation, and FDPA) require the borrower to submit detailed business plans and/or receiving training and technical assistance in order to be considered for a loan. At the ECC, loan officers recognise the need for technical assistance and help applicants fill out rigorous loan applications. The application results in a "mini-business plan" that helps guide borrowers and screens out those unwilling to accept guidance. ECC staff also provide market information, help negotiate supplier connections, and review financial statements from borrowers who are interested in applying for credit.

d) **Structure loan to minimise risk.** The loans are structured tightly to ensure that loan proceeds are used properly. ECC's loans are almost always made for equipment (rarely for working capital) and funds are disbursed directly to suppliers. Borrowers at the Agriculture Foundation sign a loan agreement with the bank itself and only 80 per cent of the proceeds of the loan are disbursed at the start of the project. The final 20 per cent is disbursed to the borrower only when the business project is completed as planned and to the satisfaction of the Foundation Board of

Directors. At FDPA, applications are first reviewed and analysed by the programme's local credit officer before the programme's loan committee in Warsaw makes the final decision. Borrowers sign the loan contract, an IOU, and a co-assignment lien form in local Fund offices before cash is transferred from Warsaw to the borrower's bank account locally. HFEP also uses the institutional influence of the local banks which close the loans, disburse the funds, and monitor repayment.

All of these measures reinforce the business nature of the agreement with the borrower and thereby enhance the performance and sustainability of these credit programmes.

2. Effective Use of Outside Resources to Build Permanent Institutions

The four notable programmes reviewed here were designed and established with Western funding and/or consulting assistance in combination with like-minded local managers who saw the credit programme as integral to their organisational mission. Although the programme structures and ongoing partnerships vary, the Western and local planning alliance for each programme demonstrates their commitment to creating a permanent source of small-scale credit to new entrepreneurs.

The HFEP is a continuing partnership between the EC, the Hungarian Government and local management. EC-PHARE maintains an active role in the ongoing governance of HFEP's LEA programmes, requiring each LEA office to submit an annual business plan which must be approved by both the HFEP and EC-PHARE management. In addition to setting up and staffing the Programme Management Unit or headquarters, the EC-PHARE provided access to information about other country credit models and encouraged each LEA office to engage a Western consultant to help develop their business plans.

ECC began as an agreement between PAEF and Shorebank Corporation, supported by the National Bank of Poland, all of which were committed to developing a small-scale credit system that would work through existing banks and, in the course of time, influence the banks to become more market driven. This Western-local partnership went beyond the planning stages of the programme. Shorebank consultants managed the programme for three years and played a critical role in training local staff on site and in the US prior to transferring control to Polish nationals. While the programme was capitalised with American dollars, Polish banks share 50 per cent of any loan losses and provide local staff who receive loan applications, monitor loans, and control collections. ECC staff make loan approval decisions, control portfolio quality, and manage problem loans.

FDPA, whose programmes are supported by private Western foundations--several with an interest in microenterprise--found a local champion for the concept in the programme manager, Elzbieta Dec, who is manager of the FDPA is WRED credit program. The donors supported her initial study-tour to the US to solidify funding relationships and study US-based microcredit programmes. FDPA's Women's Rural Economic Development programme secured US$250 000 in capital from the Polish-American Enterprise Fund delivered via the Polish banks and US$100 000 from a German foundation, Caritas. FDPA continues to have strong Western private donors. The microcredit programme is an affiliate of Women's World Banking. Headquartered in New York, this organisation provides access to training and learning contacts with women's credit programmes in both North American and developing countries.

Although the Agriculture Foundation had little or no contact with a Western partner during the planning or implementation stages, their capitalisation by Western funding sources has influenced the programme's structure and financial goals. The Foundation's two loan funds were capitalised with a US$14 million, 3-year, low-interest loan from the Polish Ministry of Agriculture and Food Economy, monies created by Public Law 480 that collected the proceeds of sales of agricultural products donated by the US government to Poland. The Agriculture Foundation's loan must be repaid in US dollars starting in 1999, substantially increasing the need for a low loan-loss rate on the portfolio. (Note: This topic is discussed further in Chapter 4 under Capitalisation.)

Among other small-scale credit programmes in the region that have been less successful, often one or more of the partners were not committed to the concept or fully engaged in designing the details of the programme, and therefore, not driven for its long-term success. The Czech-American Enterprise Fund (CAEF)/Komercni Banka Microcredit Programme in Prague serves as an example. The CAEF staff, for the most part, was disappointed with the outcomes of the programme through 1994. The original structure required Komercni Banka to provide 50 per cent of the capital (a risk the bank may not have been comfortable with) and invested minimal training for bank staff on how to make these loans. Furthermore, there were no dedicated staff for this specific programme, and therefore no one to drive it forward. Although CAEF and Komercni Banka had each committed $6 million and substantial talent to this project, these external resources alone were not sufficient for successful implementation. As a result, the programme staff were not able to make the programme a priority, the purpose and target customer remained unfocused, and the resulting strategy was ineffective.

Institutional permanence is both a characteristic of these programmes as well as a likely outcome of all the other common traits described here. The four notable programmes reviewed here operate as permanent institutions, not temporary grant-funded projects that will fade away when funding stops.

The four programmes share <u>two</u> characteristics that will lead to a permanent source of credit for small enterprises.

a) **The programmes are organised around or integrated into a permanent institution or an organisation that is likely to become permanent.**

The credit programmes noted here enhanced the possibility of their longevity by integrating into existing, credible institutions. For example, both the Agriculture Foundation and FDPA's credit programmes are housed within foundations that consider the programme integral to their overall mission. Similarly, the HFEP programme, a quasi-governmental foundation, designed its microcredit programme to be delivered through its existing and expanding network of LEAs which are strongly supported by EC-PHARE funding. And PAEF, as noted above, wanted a programme that would increase the availability of small-scale commercial credit through the banks. Independent, small loan "windows" were set up in local banks and bank staff was trained to build the institutional capacity and motivation for the programme. PAEF's ECC programme serves a wide range of micro- and small-sized businesses and has seen increased interest among the banks to serve MSEs. As of 1994, several banks have "spun-off" from the core programme, expressing interest in independently offering credit to small businesses. Importantly, ECC has been able to demonstrate the self-sustainability of small business lending and provide the skills to local bankers to do it well.

b) **The programmes have committed partners who made long-term investments with performance standards to ensure the accountability of all parties.**

Each loan fund noted here was designed to be revolving, with a high expectation of recycling the capital pool permanently. HFEP, ECC, the Agriculture Foundation, and FDPA were all capitalised by the Western partners with commitments to provide annual operating funds during the start-up phases of the programme. Most importantly, the programmes and resources are managed in a business-like and efficient way which heightens the potential for more deal flow and development outcomes. As noted in Chapter 1, programme effectiveness and efficiency can generate interest among funders to make additional investments.

Many SME resources in the CEECs and NIS are capital pools set up as “one-shot” grant programmes or with the expectation that funds would be distributed without any mechanism to replenish the pool. Alternatively, funds from the World Bank, IMF, or the EC have been lent to banks for distribution as small business loans or grants. These banks have little incentive to undertake high transaction costs, small loans, and prefer not to lend to or rely on their larger, current customers to absorb the funds. This practice not only fails to reach small businesses, but also fails to create a permanent institutional source of credit for MSEs.

By contrast, the four programmes highlighted here designed revolving loan funds from which credit continues to be available to new and repeat borrowers over time. Loans made to microentrepreneurs in the four programmes are, generally, small loans up to US$25 000 that do not extend past three years, with many smaller, one-year loans. These short-term loans allow the revolving loan fund to replenish itself and continue to meet credit needs for working capital and asset financing.

3. **Credit-delivery is Tied to the Banking Infrastructure.**

In an adaptation to local context, all four programmes overcame the operational hurdles of poorly developed financial sectors by finding ways to use the banks’ payment systems, administrative systems, and legal and executive powers even while the banks undergo tremendous reforms. These programmes do not rely upon the bank’s capital or loan origination capacity; rather these programmes craft partnerships that circumvent the banks' bureaucracy and risk-averse lending practices while they act as emissaries to the much-maligned banking sector to demonstrate the potential of small business credit.

PAEF’s Enterprise Credit Corporation is the most bank-based programme with a clear objective to not only provide capital for small business growth, but to improve the capacity of Polish banks to do small business lending. The programme was set up in eight local banks initially; PAEF provided the loan capital and each bank agreed to guarantee 50 per cent of all loan losses incurred by the ECC in return for 25 per cent of gross interest income. In addition, the bank provided trainable lending staff, office space, furniture, equipment, telecommunications and other support services, and supplies to operate the programme. While there was no explicit timeframe for the original programme design, the design did specify that the programme’s operations would ultimately be handed over to Polish nationals, a transition that occurred three years after inception.

The other three programmes had less explicit goals for transforming the banking sector, but recognised the value of using bank systems, powers, and expertise to enhance programme success because:

a) **Banks have the capacity to check credit history and prior liens and have greater legal powers to foreclose on loan collateral**.

In Poland, Hungary, and the Czech Republic, banks held broader legal powers than other commercial firms to investigate personal credit histories and to foreclose on loan collateral ahead of other creditors. Ela Dec, at FDPA, reported that the local banks are more likely to have credit history information about prospective borrowers. Development professionals in all three countries affirmed the role of banks in the development of the countries' Uniform Commercial Code and centralised systems to record liens on assets.

b) **Banks are responsible for disbursement and collection of payments.**

Each of the four programmes uses a bank's payment system to disburse and collect loans. The Agriculture Foundation deposits their loan capital in the local bank and the borrowers sign notes with the bank. At the Foundation and HFEP, the banks are responsible for monitoring and collecting the loan. The FDPA uses the bank to transfer funds at the time of loan disbursement from the loan fund to the borrower's account in the local community. If FDPA's programme expands to make larger loans to larger firms, Ms. Dec predicts that FDPA will contract with the banks to administer and collect the loans since most people will view the bank as having more credibility and power to effectively and efficiently collect.

c) **Local bankers can help microcredit applicants develop their business plans.**

The Agriculture Foundation requires its borrowers to use a local banker to help produce a business plan that can be used as a loan application. Moreover, the process of developing a business plan and loan application with a banker is an opportunity for an "unbankable" customer to develop a relationship with a bank. HFEP also recognises the importance of their customers developing business relationships with local banks. Although LEA staff prepare the loan application and go with the applicant to the bank, HFEP uses the banks to disburse and collect loans.

A key factor in the success of these bank partnerships is that, although bank payment systems are used, the four programmes provide the capital to lend. As noted in Chapter 2, few banks in the CEECs have the lending experience or risk appetite to make loans to very small businesses. While the partnership is essential to delivering credit, maintaining control over credit decisions is critical to making loans in any volume or to creating a permanent resource for credit to microentrepreneurs who are always seen as high risk borrowers. Even when a bank partnership appears to be formalised, without a designated and separately managed pool of capital, the results can be disappointing. For example, a business training programme in Poland that partnered with its affiliate development bank to make loans to its graduates was beginning to see their referrals denied credit at the bank. In spite of the partnership agreement, the bank controlled its own credit decisions.

With the exception of FDPA, the four programmes were not focused on the most disadvantaged microentrepreneurs, per se, but emphasised small loans that the banks would not be interested in making, i.e., loans under US$25 000. Despite their successes, these programmes are unlikely to convince the formal banking sector to serve microbusinesses. The motivation and commitment of an independent organisation ensures that loans reach the target market. For example, although ECC could make loans of up to US$25 000, individual loan officers were committed to seeking out loans of less than US$10 000.

4. **Focus on Small Cities and Rural Areas.**

Unlike the most successful microcredit programmes of the developing world that tend to focus on high density rural markets or urban centres, the existing programmes in Central and Eastern Europe are concentrated in smaller cities and rural areas. It is in the rural areas where employment options and access to resources by a highly immobile workforce are more limited--where the need appears to be greater and the demand more predictable.

In most third-world countries, microenterprise programmes typically have achieved high volumes in high-density markets. In Latin America, for example, ACCION International typically starts programmes in urban market centres to achieve scale and cost-effectiveness before expansion to less populated, rural areas. However, the market development opportunity for microenterprise credit in CEECs and NIS economies has evolved differently because of the past 40 years. As noted in Chapter 2, microenterprise may be particularly appropriate in rural and smaller urban areas because:

a) **The economic history of rural areas in the CEECs has maintained an entrepreneurial culture.**

   In Poland, for example, agriculture was never nationalised and small farms remained independent and viable. Observers feel this history correlates to Poland's extremely rapid development of an indigenous entrepreneurial sector. Similarly, Hungary was the first country in the region to allow private ownership of small businesses. Yet unemployment has remained very high, especially in the rural areas, which makes enterprise development and entrepreneurship an attractive and familiar option for rural residents.[46]

b) **The population in rural areas of the CEECs is highly immobile.**

   During the previous regime, rural settlements were often built around what seemed to be randomly placed industrial sites and while many industrial plants are closed or are contracting, the residents who worked there cannot afford to leave their still relatively inexpensive dwellings. Unlike third-world countries where rural-to-urban migration is dramatic, residents of rural areas cannot afford to move to the cities where housing shortages drive up housing prices. Economic opportunity is sorely needed in these former industrial, rural settlements.

c) **Corruption and organised crime is less prevalent in rural areas and smaller cities.**

   According to interviews, organised crime has created legitimate fears of starting a small business successfully and subsequently being threatened with extortion. Some practitioners also cite concerns of being undermined by organised crime intervention. In Vilnius, the capital city of Lithuania, where a microenterprise programme was started in 1993, a Western consultant reported that the programme has had some success but is afraid to grow or market the availability of credit since organised crime poses a serious challenge to its success.[47]

d) **Poor infrastructure and long distances create a greater need for locally-produced goods and services.**

   Microentrepreneurs are more likely to provide local goods and services, filling the supply gaps that are left by contracting state-owned enterprises. For example, during ECC's early days, many loans were made to bakeries that sprang up when the inefficient and subsidised state-owned bakeries shut down. Similarly, one of the Agriculture Foundation's financings was to a small brick factory situated in a rural area to meet the demand for rural building supplies.

Only HFEP has chosen to locate in an urban setting. It has opened an LEA office in the capital city of Budapest, after successfully operating 19 LEAs in remote towns around the country. Even so, choosing to "learn the ropes" in safer areas with greater need and no less demand may be the right approach for microcredit programmes in these contexts.

5. **A Local Connection with the Borrower.**

   Modelling successful microcredit programmes around the world, these four micro-credit programmes all deliver credit at a local level and maintain a local connection with the borrower. Since microenterprise lending is considered "character-based" lending, a local, person-to-person relationship is more effective than a relationship with a faceless, distant organisation. A local connection enables the deals (the loans) to be struck between people as well as institutions. A personal or familiar connection with a staff person or local proxy makes a difference in both attracting viable borrowers and businesses as well as improving the likelihood that the loan will be repaid.

   Among the four programmes, local connections were made either with explicit business plan training held locally or through the one-on-one learning relationship that ensues between a borrower and a lender during the credit application process. Examples follow:

   a) Hungary's HFEP microcredit programme delivers the programme throughout its many Local Enterprise Agencies set up across the country. LEA staff help borrowers prepare business plans, complete the credit application, and then work with the local banks to help disburse and collect the loan from the borrower.

   b) ECC's strategy works with local banks in smaller cities by opening "loan windows." Initially, eight loan officers from headquarters developed a "circuit rider" system of meeting with applicants in their local communities to review the application and conduct site-visits at the applicant's place of business. Eventually, local loan officers were trained in the "window" sites to receive and review applications.

   c) The Agriculture Foundation operates two branch offices outside of Warsaw and sends staff out to the sites of the business owners to assess the viability of the deal. Once the borrower passes a preliminary screen, the loan is referred to a participating local banker for further development of the business plan. However, the Agriculture Foundation staff person continues to monitor the loan through site visits.

   d) In addition to sending out their own staff to the rural sites in which they work, FDPA has a working partnership with a government institution that helps FDPA promote the programme and lend it credibility. The FDPA relies heavily on the network of well-staffed agricultural extension centres of the Ministry of Agriculture and Food Economy. FDPA field agents hold the required trainings in rural sites where the extension centres help promote the training programme and provide the facility, accommodations, and meals for participants.

A local presence and personal relationship with the borrower has several advantages:

a) **Both lender and borrower can more easily become mutually acquainted.**

   An experienced lender once said that there are only three rules to lending: "know your customer, know your customer, and know your customer". Getting to know the borrower is easier when the lender lives and works in the local community. Similarly, potential borrowers are more likely to abide by any contractual arrangements when they know the lender personally.

b) **Local lenders who are familiar with the community and its needs can best assess the market demand and competition and make better credit decisions based on a local knowledge of the market place.**

A local lender is more likely to remember critical details about how many shoe repair businesses are operating, why certain locations are undesirable, or whether rent and utility projections are realistic. At ECC, the loan officer's market assessment "often consists of simply walking around the neighbourhood or business district in which the proposed business will be established. This allowed the lenders to get a sense of the demand for the good or service as well as the competition."[48]

c) **A local presence—or simulation of a local presence with partner organisations—allows for closer monitoring of the loans and quicker response time in case problems arise in the portfolio.**

Several programmes, as noted above, rely on local banks and branches to close and monitor the loans. At HFEP, the local banks that are responsible for collecting payments also maintain the documentation and loan monitoring reports on the HFEP portfolio.

While all programmes require borrowers to commit some personal equity and the loans are secured with collateral or guarantees, the programmes place a strong emphasis on the viability of the business by assessing cash flow projections, market feasibility, and the character and business experience of the borrower. In Central and Eastern Europe, where there is little access to credit history and no centralised security filing procedures, careful character assessment of the borrower is even more important. Local staff or connections with local institutions and communities make character lending more viable, even while sustainability remains a challenge.

6. **Strong Leadership.**

As in any business, strong leadership provides the vision, resourcefulness, and determination to build an organisation to its full potential. The management teams of the four notable programmes reflect these strengths. Whether their purpose is to lend money, grow businesses, create jobs, alleviate unemployment, or some combination of those, the managers are able to balance their business purpose and development goals. They can clearly articulate their vision, motivate staff, and mobilise resources.

Balancing business purpose and development goals is an intuitive process among successful managers and is most evident in how they can identify their target customer both in quantitative and qualitative terms. At HFEP, Programme Manager Tibor Hári listed the written eligibility criteria for microborrowers, but described the programme as helping start-up businesses survive. Mr. Andrej Kuliszewski, President of the Agriculture Foundation, identified his customers as those who had experience building a rural business, employing and managing others, and who possessed resources to invest in their dream. Ela Dec was able to describe her customers as rural women, but felt that those with some wealth and access to resources were not her target customer. Without imposing any restrictive means tests, Ela distinguished her customer base with a "you know-it-when-you-see-it" logic that is common among successful microcredit managers.

Staffs for the programmes are carefully recruited and, once hired, devote their energies to the programme in exchange for intensive training and professional development opportunities. Mr. Kuliszewski of the Agriculture Foundation attributed the success of the credit programme solely to the committed staff. A hallmark of the ECC programme was the extensive training given to bank lenders. Both ECC staff and partner bank loan officers went through a multiple-week credit course and received on-the-job training through small loan committee meetings using the "Socratic-method" to discuss and approve the loans. In each case, the founders surrounded themselves with talented staff who clearly understood the mission and objectives of the programme.

Finally, these managers themselves had influence or built connections with influential authorities to enhance the credibility and status of their programmes. Ela Dec created a prestigious Advisory Board of influential and political women to lend credibility to the programme and keep the profile of their work at high levels. Although the Agricultural Foundation has experienced both of the advantages and disadvantages of its historical connections with the Catholic Church, the manager's ability to draw upon the influence of the most powerful institution in the country is overall an important resource. The resources and reach of the EC-PHARE and Polish American Enterprise Fund connections for HFEP and ECC respectively have enabled local managers to market the accomplishments of their programmes at high levels.

While these managers made good upfront design decisions, their strength lies in their ability to react, adapt, and modify as needed. They have tried to figure out what works through experimentation and react with appropriate programme refinements and changes.

The four programmes highlighted in this section—the Foundation for the Development of Polish Agriculture, the Agriculture Foundation, the Hungarian Foundation for Enterprise Promotion, and the Enterprise Credit Corporation—all stand out as effective microcredit organisations that could be models for other microenterprise programmes in transition economies. Their goal has been to respond to the significant market gap for small-scale business credit; they have operated as local and flexible intermediaries. They have planned their operations to be permanent sources of credit for entrepreneurs and have pursued self-sufficiency strategies.

Still, these programmes face challenges to their future success

D. Challenges in Transition Economies

Two underlying assumptions shape the long-term challenges that microcredit organisations, including those in transition economies, must face and overcome:

- **First**, programme services should be delivered in a manner that matches the realities of the economic, social, and institutional context in which the potential customers work and live.

- **Second**, programmes that provide credit and related business services to the micro-sector should be cost-effective and sustainable over time.

In other words, it is assumed that these programmes are interested in developing institutions, not demonstration projects. Like hospitals, schools, and financial institutions, there is a symbiotic and accountable relationship must exist between the customers or clients and the microcredit programme so that client needs are met in ways that insure the survival of the institution.

As stated in Chapter 1, the overarching challenges facing microcredit programmes involve balancing financial viability and development. Microenterprise rarely achieves the scale required for financial self-sufficiency and usually requires continuing grant support for operations. However, the various programme design and implementation tools and techniques described in the following chapters can help managers balance these complex, often competing, objectives every day.

The specific challenges faced by microcredit programmes include:

- Maintaining vision and commitment in the face of obstacles;
- Balancing development impact with financial sustainability;
- Identifying clear outcome goals and relevant performance measures;
- Defining the role and cost of technical assistance; and
- Developing efficient programme operations.

The following section includes a discussion of each challenge. Chapters 4 and 5 provide some practical tools and techniques to address these challenges.

1. **Maintaining vision and purpose in the face of constraints and obstacles**

   The four microcredit programmes studied above are pioneers, remarkable for their successes in light of some of the constraints that the programmes face in the transitional markets of the CEECs. Each has built new, private organisations to deliver microcredit in spite of significant environmental and macroeconomic obstacles as discussed in Chapter 2.

   As in any business, programme success is closely related to management clearly defining the programme purpose and objectives. Fortunately, early planning by local managers focused on researching their target customers, defining the appropriate services and credit products to deliver, and creating methodologies for delivering those products and services. Each organisation clearly identified the role of microcredit in their range of activities. In the three “foundations”--FDPA, the Agriculture Foundation, and HFEP--separate entities or names for the credit programmes were created so that there was little chance for conflicting programme objectives to surface. Similarly, PAEF created a separate subsidiary, the Enterprise Credit Corporation.

   In large measure, the decision to start or grow a microenterprise programme flies in the face of rationality. Every successful microenterprise programme manager can recall being told “it will never work.” Similarly, microcredit programmes starting out in the transition economies will struggle against several of the obstacles identified in Chapter 2 that will inhibit the feasibility of the programme:

   a) **There is no “non-profit” organisational status to accommodate developmental, charitable—and usually unprofitable—activities of these organisations**.

      With no legal status for their activities, programmes are challenged by moving boundaries of the law in conducting their lending and service activities. The organisations must question their legal rights in raising funds, extending credit, and charging interest and fees for services. The programmes highlighted in this report have pushed ahead with their agenda in spite of these legal and regulatory obstacles.

b) **Banks dominate the payments system.**

Programmes' ability to place liens and foreclose on collateral is dependent on banks that are, themselves, struggling to re-invent themselves for the new market economy and create accountable systems. While FDPA and the other programmes wisely forecast the legal and cost advantages of using bank systems as the programme grew, the trade-off can be a loss of institutional identity as the lending decision becomes separated from the control and monitoring capacity of the programme. HFEP, for example, has arranged for the banks to close and collect all of their microcredits, but as a result, the banks keep all of the data relating to collections, defaults, and portfolio performance.

c) **Macroeconomic instability and inflationary pressure are ever-present concerns.**

Several of the microcredit programmes reviewed for this study are further challenged by the interest rates charged for loans, how rates are managed, and the cost of capital. The spread earned between the cost of funds (the cost of capital) and the rates charged to customers is a key source of programme income. To reach financial viability or sustainability, microcredit programmes have to forecast loans outstanding, income streams, and funding needs, a difficult task even in a stable economy. Furthermore, programmes may have to absorb currency risk if the capital is from foreign sources. Both ECC and the Agricultural Foundation have US dollar-denominated capital.

d) **Private institutions may have difficulty accessing the resources coming into the CEECs since most of those resources flow to government programmes.**

Resources are a key building block of programme design and the current inflow of foreign development aid presents an opportunity. Yet, new and private organisations may have difficulty distinguishing themselves to foreign donors, or may not be eligible to directly receive EC or other foreign aid funds. The programme managers interviewed feel time pressure to make use of foreign economic assistance and money while it is available, recognising that the resources may dwindle in the future.

FDPA pursued an aggressive strategy to attract foreign, private grants. Through direct contact with foreign foundations and organisations, the executive director became linked into a global network of technical assistance organisations and funding opportunities. Another way to capture government funds is to adapt the programme to meet the developmental goals set by government agencies. For example, the Agriculture Foundation received funding from Poland's Ministry of Labour to provide microloans to unemployed persons who complete a business training programme. The local partner is the town or gmina government. A year after they started the partnership, the Foundation saw 700 participants go through the programme and made 54 loans. The Agriculture Foundation built upon its already strong connections with government and seized an opportunity to make more microloans with government funding support.

e) **There is little exposure to new approaches or models.**

While there is a thirst for information, there is a lack of access to information in the system. In some respects, the thirst for new ways to do things is compounded by a lack of confidence among CEEC professionals in their own common sense. Ela Dec at the FDPA took the initiative and took advantage of the opportunity to make world-wide connections which have continually exposed her to new models and allies in the field. FDPA has partnered with international intermediaries such as Women's World Banking as one way to find new ways to do things and network more broadly. Similarly, the BB Foundation in Budapest was discussing an affiliation with SEED in order to develop a microcredit programme based on successful models and experiences elsewhere. There is a vibrant international network of microcredit leaders and organisations; they will respond creatively to additional interest from CEEC and NIS credit programme managers.

Currently, there are few microcredit programmes operating in transition economies, although there is an emerging recognition of the MSE sector's needs. Microcredit programmes in CEEC and NIS environments are taking on the difficult task of building organisations against "conventional wisdom" and obvious constraints. As pioneers, they can learn from the experience of microcredit programmes elsewhere, build professional capacity, develop innovative methodologies, and create new institutions that will become additional role models in the unique context of transition economies.

2. **Balancing Development Impact with Sustainability**

The most important challenge for microcredit programmes in transition economies is to develop a long-term strategy for financial sustainability. The emerging definition of success is the ability of a microcredit programme to effectively balance development impact objectives with long-term sustainability.

a) **Sustainability:**

Definitions:
Sustainability is the ability of the microcredit programme to maintain its operations and continue to provide service to its customers or clients. A programme is sustainable when a combination of external grants, loans, and internally generated revenues are sufficient to cover all programme expenses over the long term.
Self-sufficiency occurs when the microcredit programme can cover all of its operating expenses (including loan losses and the cost of capital) entirely with internally-generated sources of income.

As noted in Chapter 1, self-sufficiency has been achieved by only a few large microcredit institutions, many of which have benefited from significant past subsidies or may receive capital at no cost. An increasing number of microcredit institutions are steadily reducing their dependence on philanthropic sources to better balance the goal of sustainability with their development objectives.

Chapter 4 discusses the factors that affect sustainability, including:

- interest rates and the cost of capital;
- availability of funding sources;

- types of services provided — training and technical assistance and other non-revenue generating services can be more costly to provide;
- administrative structure, especially staffing structure;
- service delivery methodology and partnership maintenance;
- demand for services and the scale that can be achieved;
- loan fund repayment performance.

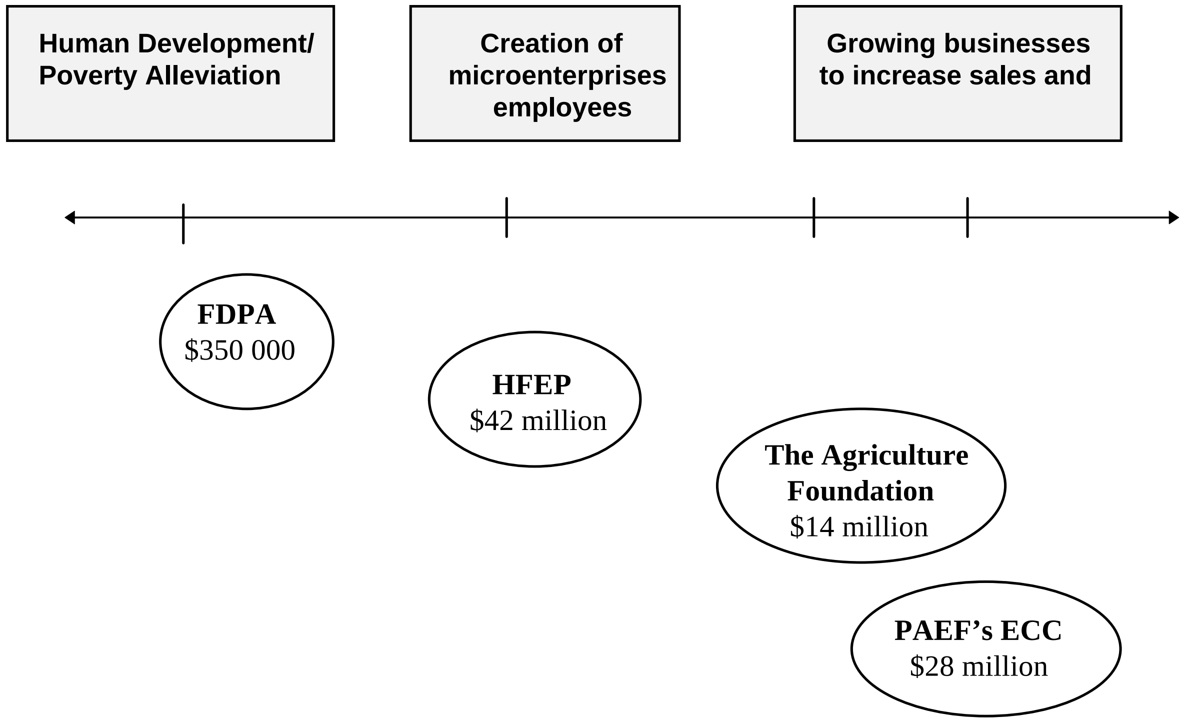
b) **Development Impact:**

The philosophical underpinnings of microcredit have to do with providing access to credit, and in turn, to opportunity. Programmes vary in the levels of support they provide to help entrepreneurs take advantage of this access -- some target more "credit-ready" customers; others emphasise human and social development to enable new entrepreneurs to try self-employment. Yet, all must clearly articulate their impact goals and how they will measure their effectiveness. Whether broadly defined (rural small businesses that create jobs) or narrowly defined (home-based businesses in Lodz for unemployed women), clearly defining the target group will help determine who has access to programme services (clients) and who will benefit from programme services (beneficiaries). For example, at FDPA, rural women are the programme clients who attend the training programmes, but the beneficiaries of the services include the households and children of the women who succeed in their income-generating activities. Understanding the target group of the programme enables the programme to articulate what the outcomes and impacts are that it expects to see from the interventions.

The four programmes highlighted in this chapter are shown below on the continuum. The programmes near the left of the continuum are more focused on achieving social and human development objectives; those closer to the right are more focused on profitable economic and enterprise development objectives. The level of training, technical assistance, and other support provided for microentrepreneurs decreases as one moves to the right, while the average loan size and importance of management assistance grows.

The key to balancing development and sustainability is that, regardless of where they are on the continuum, programmes must operate in a business-like fashion to meet those dual goals. If a programme goes out of business, it cannot achieve any of its social goals. The context of transition economies provides microcredit programmes with an opportunity to have significant impact through small business formation and development, but may also be compatible with financial viability. The demand exists, but the challenge lies in managing the programme effectively and delivering credit and services efficiently.

Continuum of Development Missions
The Missions and Capital Resources of the Four Programmes



3. **Setting Clear Goals about Outcomes and Identifying Performance Measures**

While programmes in transition economies have a strong business and economic development agenda, the social objectives and commitment to serving disadvantaged entrepreneurs are less clear-cut. First, practitioners need to define both their financial and social goals and objectives. The second challenge is to identify performance measures that capture the less easily assessed progress on social objectives. The challenge for the microcredit programmes which have dual goals of impact and sustainability is (1) to set clear goals about outcomes, and (2) monitor progress and avoid being influenced by external pressures.

Loan demand for the entire range of SMEs appears to be high in transition economies. Microcredit programmes seeking to achieve self-sufficiency will find it easy to respond to the higher range of demand which will bring in higher earnings. Anecdotal evidence suggests that programmes which aim for sustainability are more likely to achieve higher performance in all parts of the programme.

However, the challenge to microenterprise programmes in CEECs that are focused on self-sufficiency—a form of sustainability—is to balance the need for higher returns with the programme's mission. To do so, programmes need to balance several pressures:

a) The phenomenon of "creeping upward" averages. To boost internal revenue sources, there is a tendency and pressure to serve the larger, more prepared, less risky, and more profitable-per-deal businesses. As programmes develop and find it more profitable to make larger loans, the programmes favour larger loan requests, make unintentionally larger loans, and the average loan size for the programme's portfolio creeps upward. Along the continuum of micro to small business owner, the very smallest microenterprises with the smallest credit needs will be left out. If microenterprise programmes have a mission to reach the more disadvantaged borrowers with the smallest loan requests, the programme with creeping upward averages will not be complying with their mission which could upset some donors interested in development outputs.

b) The need to grow with your customers. Most programmes find that microbusinesses will return to them for larger loans as the businesses grow and thrive. Those credit needs will be smaller than bank and SME sources of credit are willing to provide.

c) The need to maintain entry-level customers. To avoid the unintentional creep upwards, programmes need to actively pursue the smaller microbusinesses as first-time customers. ECC staff, for example, have pursued loan applicants needing less than US$10 000 to ensure that they continue this segment of the market despite their self-sufficiency goals. One way to ensure this is to set ceilings on loan sizes, especially for first loans.

Programmes must make explicit choices about the range of programme services that will be provided and the methods used to deliver those services. Clear objectives and performance measures help define programme goals and avoid unintentional shifts due to funding, market, or self-sufficiency pressures. Financial and lending objectives are quantifiable and easily tracked with good reporting systems. Development impact is much more difficult to monitor, but critical for development programmes to achieve their goals and satisfy funders. Impact is defined as the extent to which the programme affects the clients and the local economy in terms of jobs created, skills gained, increases in business sales, changes in income and assets, even attitudes and behaviours. While it is easier to measure performance and achievement by quantifiable measures like loan volume and amount of funds disbursed, it is important to develop similar measures for the softer, less quantifiable development outputs. Careful planning and vigilant and regular review of the programme services, the delivery, performance, and costs will enable managers to measure effectiveness and efficiency and make informed judgements about whether the programme is meeting its goals and mission.

4. Defining the Role and Cost of Technical Assistance

In the formerly centrally-planned economies, the most common "social objective" is bringing people unfamiliar with a market economy actively into the marketplace as producers or service providers. As a result, the emphasis of business development initiatives and funds to date has been on training and technical assistance to new entrepreneurs across a spectrum of income, gender, education, rural or urban residence, and experience. Serving unemployed labourers to PhDs who want to commercialise newly-developed technologies, training and technical assistance programmes are well-funded and in demand.[49] Many of these technical assistance programme managers complain of the shortage of micro and small business credit.

As noted in Chapter 2, there is no shortage of training and technical assistance programmes available for an entire range of entrepreneurs from micro-business start-ups to large industry privatisations. Most of the aid available to grow and serve the SME sector is focused on delivering assistance to entrepreneurs to help them write and develop business plans. While some assistance providers try to focus on developing business plans for entrepreneurs to use as a management tool, most business plans are, in fact, used as applications for financing from banks or SME credit programmes.

The challenge to microcredit programmes in transition economies is to combine access to credit with access to market information and management skills in a way that increases the entrepreneur's chances for success.

The challenge to microcredit programmes in transition economies is to combine access to credit with access to market information and management skills in a way that increases the entrepreneur's chances for success. Although microcredit programmes in developing countries provide minimal technical assistance, most programmes in North America believe business assistance to be a critical component of microlending because the business environment is more competitive and complex. Transitional markets are more similar to North America; many people do not have the entrepreneurial and managerial skills to grow competitive businesses in a market economy.

However, technical assistance affects microcredit programmes in two ways:

a) The intensity of technical assistance or training needed is often inversely proportional to the experience level of the entrepreneur (and the size of the loans);

b) Technical assistance is staff-intensive and costly to provide, thereby affecting a programme's prospects for financial viability

As a result, programmes use many different approaches to technical assistance and training depending on their target customers, their financial performance goals, and the available resources. Examples include:

a) Extensive pre-credit training: For example, FDPA's WRED programme has an intensive training programme that all borrowers are required to complete before becoming eligible to borrow. Their targeted customers in the rural areas are the rural poor who want to start the smallest businesses, mostly start-up, cottage businesses. These customers may have no previous business management experience and limited confidence in their ability to develop a business. The training programme raises their awareness of their skills and talents, teaches essential financial and marketing concepts, and motivates many to embark upon an entrepreneurial venture. The training, which develops a business plan, links directly into the loan fund.

b) One-on-one consulting to prepare for a loan: Many programmes help entrepreneurs prepare or refine their business plans so they may qualify for a loan but have no ongoing role with the borrower. For HFEP, for example, the Local Enterprise Agencies offer consulting assistance to entrepreneurs who are interested in starting a small business or in applying for financing. Because of their local connections with borrowers, the technical assistance is linked with potential borrowers applying for a loan at a local bank. Yet, the LEA staff do not monitor the loans once they are made.

c) Loan application assistance and ongoing loan monitoring: Alternatively, staff may provide technical assistance directly as part of the loan application process and ongoing monitoring. This technical assistance is provided by loan officers, not separate staff. PAEF's ECC programme links technical assistance to the loan application and loan monitoring. There is no formal technical assistance or training component beyond the completion of a rigorous loan application. Since this technical assistance is direct and immediate, it allows the lender to better evaluate the prospective borrower. However, ECC staff acknowledge that they cannot invest too much time per applicant without jeopardising programme self-sufficiency. Therefore, staff might refer less ready applicants to other technical assistance providers.

Microcredit programmes that aim to meet the needs of the smallest businesses and the most disadvantaged entrepreneurs must acknowledge the symbiosis between training and lending.

Microcredit programmes that aim to meet the needs of the smallest businesses and the most disadvantaged entrepreneurs must acknowledge the symbiosis between training and lending. Microcredit loans are often made less on the strength of the business plan than on the strength of character and experience of the borrower. Providing training or technical assistance to the borrower paces the application process so that a relationship can develop and the lender can better understand the borrower's needs and capacities. Similarly, the performance of the microcredit portfolio often is linked to the quality and depth of the training and technical assistance borrowers receive.

Therefore, microcredit programmes in this context must match the non-credit support service to the needs of their customers. Providing business assistance directly provides the most control and ensures quality; using partnerships may reduce operating costs and improve long-term sustainability. The key issue is to design a system that works -- if local technical assistance resources are too generalist in nature (business planning, loan applications), they may not be useful to the programme's clients and will not achieve the programme goals. Furthermore, programmes that delegate loan monitoring to the banks will lose their local connection to the borrower, and their ability to influence an entrepreneur's behaviour, unless the partnership relationship and responsibilities are clearly defined otherwise. Once the entrepreneur is passed along to the financing entity, very little is known about their success in getting financing, implementing their business plan, or the performance of the business over time.

Effective methods of technical assistance are discussed further in Chapter 5. Most microlending programmes that provide business assistance and control access to credit have been able to change entrepreneurial behaviour and increase the chances of business success.

5. **Developing Efficient Programme Operations**

Thoughtful, strategic planning and good programme design will only go so far; microcredit programme managers also need good reporting and monitoring systems to give them the information for sound management decisions. Programme design is never static: it must be adapted and refined to changing market conditions and to continual efforts to find ways to deliver service more cost-effectively. Most of the programmes in CEECs have focused on establishing and meeting the demand for microcredit. Over time, however, funders and partners will be curious about more than demand—they will also be interested in development impact and portfolio performance.

The ECC programme has been successful in its small business lending because of its close attention to and regular documentation of portfolio performance. Systems have been designed to measure programme outputs such as number of loans, portfolio size, and rates for delinquency, default, repayment, and return. ECC also has the advantage of managing and administering its own portfolio. By contrast, when asked about portfolio performance and outputs, HFEP microloan fund managers were unable to give specific answers because the loans were being administered and monitored through a bank that did not report this information. No clear agreement had been drawn between the participating bank and HFEP for what information to report about performance or how frequently to report.

Although an additional expense, microcredit programmes benefit from setting up management information systems that can accommodate both portfolio performance as well as customer data. Portfolio reporting is especially critical, as it allows managers to make informed judgements, as discussed above, about programme services, effectiveness, and efficiency. In addition, creating one's own portfolio monitoring systems provides an opportunity to "be a player" in setting standards for performance rather than waiting for an outside agency with little practical experience to set standards.

While some programmes hesitate to ask too many questions in the application period as it takes time, adds costs, and may appear to be too intrusive, programmes should develop a simple strategy for collecting customer data and an explanation for why it is important. Some programmes may track the types of businesses being financed; others may track changes in household income as a measure of impact. The application or intake period is the best opportunity to ask for information since borrowers are eager to do whatever it takes to get their loan approved.

Creating detailed intake and application forms that capture the development indicators about the borrowers and the beneficiaries is the simplest way to begin collecting such data. The data must be stored in a way that makes it easy to compile and report. Creating simple computer databases that codify the information is the next step. Finally, since impact is usually measured by "change over time," programmes need to find ways to update the preliminary data on a regular bases. Updating the information when a borrower pays off a loan or returns for a subsequent loan are logical data collection points.

This discussion is not intended to underestimate the difficulty or cost of developing sound and effective management information systems and efficient programme operations. This challenge is faced by microcredit programmes world-wide. Yet, good management information is critical for effective management of the microcredit programme as a business and for the monitoring and evaluation of the programme's development strategy. This information should be included in annual and periodic strategic planning to steadily improve the programme's effectiveness and efficiency.

CHAPTER 4. BUILDING BLOCKS FOR PROGRAMME DESIGN

This section reviews the framework for designing new microcredit programmes, with particular focus on the design and operational challenges in transition economies. Careful planning by programme managers is a key factor in the success of microcredit programmes, as is the ability to continuously adapt and strengthen the programme's operations and management. Based on experience of international models of excellence, microcredit programmes in the United States, and programmes currently in place in Poland, the Czech Republic, and Hungary, the most effective microcredit programmes draw upon the strengths of several models to (1) reach the intended client base, (2) adapt to the local environment's needs, resources, and political and social nuances, and (3) continuously seek more cost-effective ways to operate.

This chapter reviews the key elements in programme design and strategic planning and shares the experiences of notable programmes from many contexts.

A. Principles and Building Blocks

As discussed in Chapter 1, the framework for designing or refining new microcredit programmes is based on the four building blocks of programme design:

- **Context:**

  Programmes need to be designed and products and services delivered in a manner appropriate to the economic, institutional, and business environment of the local community or region.

- **Development Goals or Mission:**

  The products and services offered by a programme are driven by its development and financial goals, the needs of the target customer base, and the resources available to the organisation. The most effective programmes strive for a balance between development and financial goals because (1) financial goals impose an internal discipline to improve cost-effectiveness and use resources wisely, and (2) organisations that strive to become self-sustaining are more likely to achieve institutional permanence.

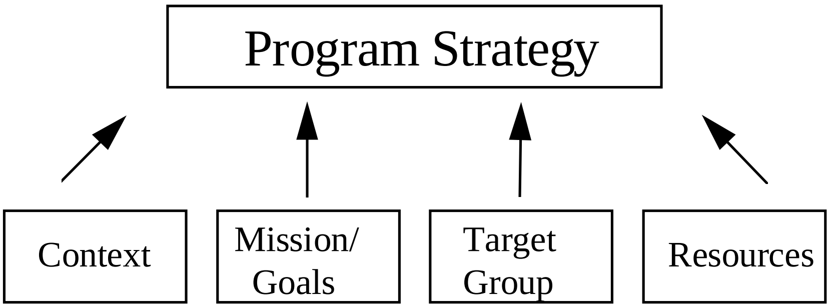
- **Target Customers:**

  Programmes should be designed based on a clear understanding of the intended client base or beneficiaries, their business and development needs, and the opportunities and constraints they face in their business environment. A microcredit programme is driven by its ability to meet its customer's needs, and market demand is the best way to evaluate the appropriateness of products and services.

- **Resources:**

  The business and operations planning of the organisation must be grounded in the financial and human resources available, their compatibility with the mission, and their performance requirements. Leadership and core staff must be able to marshall resources; institutional excellence is driven by the ability to manage those resources effectively.

All of these factors combine to determine programme strategy and business planning.



As seen in Chapter 3, the business and operating context in which a microcredit programme operates drives both the products and services to be offered and the delivery system design. A programme manager should have a good understanding of the following:

- **The business and credit environment:**

  What businesses currently exist and what legal and regulatory obstacles do they face? What legal structures or forms do they adopt and why? How available is credit today, and what are the bank and non-bank credit resources? If there are gaps among existing resources, those are potential market niches for the microcredit programme. If there are very few resources, then the microcredit programme may need to offer a wider range of loans and grow with its customers until they can access other forms of credit. The existing resources also determine whether the programme might partner with existing organisations or delivery systems (such as using the banks to administer loans, using partial guarantees of bank loans) or needs to create a new delivery method.

  Knowing the cost and terms of other financing alternatives is important to understanding which business needs remain unmet. For example, banks may only offer 12-18 month loans, which are not appropriate for financing fixed assets and equipment or long-term working capital. In these transition economies, inflation expectations are a critical variable. These expectations determine the maturity of loans the banks are willing to offer, the interest rate, and the bank's interest in lending versus investing in government bonds. For the borrower, inflation expectations also affect the financial risk of the venture due to the higher borrowing costs and the minimum investment returns that must be earned with the loan proceeds.

- **The obstacles or opportunities presented by the urban or rural context:**

  Urban and rural markets affect both the opportunities and constraints facing borrowers and the resources available to the programme itself. In urban areas, for example, there are typically more technical assistance resources and sources of credit and capital available to entrepreneurs. A programme might strike a partnership with another organisation to provide business planning assistance or advisory services rather than provide those services directly. Although need for alternative income-generating sources and new business formation is greater away from the capital cities, there are several advantages to operating in urban or centrally-located markets. They are more cost effective for programmes to serve because each staff person can spend more time with customers than on travelling great distances.

  For microbusinesses, an urban market allows easy access to customers and the potential for high volume. Although urban microbusinesses can more easily find customers and have higher potential volume, they also face higher competition and usually higher labour, space, and raw materials costs.

  Microbusinesses in rural or smaller urban areas may face several challenges: (1) the time required and expense of transporting raw materials from suppliers and finished goods to customers; (2) poor communications systems (e.g. telephone or fax lines) increase the cost of doing business in a large area, as managers and staff spend great amounts of time between locations; (3) smaller local markets may limit the size of the business or allow it to face little competition (although those conditions can change quickly with improved transportation or communications).

- **The existing resources for technical assistance and the quality of those resources:**

  Although high-volume programmes in developing countries provide minimal technical assistance, North American practitioners believe technical assistance to be an integral part of microlending. The level of technical assistance needed depends on the skill levels and experience of the target customer base, however, nearly all programmes have included some business assistance to help improve the business prospects of their customers. Technical assistance closely associated with securing approval of the loan and with solving particular problems that affect loan repayment is usually provided by the microcredit organisation. However, more general business planning, marketing, new product development, and financial assistance might be provided by outside sources or the programme itself. Programme managers should know the existing resources available and whether entrepreneurs value their services before deciding which services might be delivered through a partner organisation. Lenders or small business owners may think highly of certain providers and less highly of others. For example, the FISE small business centres in Poland and the Entrepreneurship Centres in the Czech Republic both appeared to be well-regarded by lenders.

- **Government, political, and legal constraints or opportunities:**

  Programme managers must understand the business issues facing their customers to be able to give them sound advice. If staff cannot provide value to their customers, the customers will seek help elsewhere.

- **Social environment issues, such as the role of gender, language, or ethnicity:**

  If serving a particular sub-population or a diverse population, programme managers should understand the issues and sensitivities relating to the above as they design the programme and consider what non-credit support systems may be needed. There may be unique sets of obstacles for particular groups within the general population.

Market information is often difficult to assemble in most emerging market economies. The best information is usually gathered through interviews with micro and small business owners, lenders, and technical assistance providers. In the United States, ACCION International interviews 100-150 micro and small-scale entrepreneurs before establishing a new programme.[50] In conducting this research, however, it is important to remember the viewpoint of the person you are interviewing and how it might affect their opinions. Nearly all small businesses, for example, think they need more financing and that they have been denied credit unfairly.

Programme managers must make several key decisions about their development mission and goals. The key questions for management and other stakeholders (such as board members and funders) include:

- **Strategic purpose:**

  What are the broad goals of the organisation? Microcredit organisations need to develop the same clarity of business definition and strategic direction that they expect from their most sophisticated customers. What business is it in? Does the fund seek to provide sustained credit to microenterprises as a stepping stone to growth and the conventional banking sector? Does the fund seek to increase the financial self-sufficiency of the entrepreneur? Does the fund provide a comprehensive approach to poverty-alleviation that uses loans as one of its tools, or is the fund a financial intermediary that provides access to credit to those best able to use it? If their goal is a small business development strategy, microcredit organisations must plan for permanence to be a reliable source of capital and sustained support. As a more direct poverty alleviation approach, microcredit programmes must offer customers the comprehensive support services they require to overcome obstacles to increased economic independence.

- **Desired Impact:**

  What performance measures will capture the programme's desired impact and accomplishments? Some of these measures should be quantitative (such as number of businesses created, sales growth of existing businesses, number of loans made, number of jobs created, and loan repayment rates) and some may be qualitative measures of wealth creation, income generation, and community and leadership development.

- **Financial viability:**

  What are the financial objectives of the organisation for cost-recovery, self-sufficiency, and long-term sustainability? Financial viability is determined by revenues (or resources) and operating costs. In general, programmes serving less educated or "disadvantaged" borrowers make smaller and fewer loans and provide more technical assistance. They have lower revenues (driven by small average loan sizes and fewer loans per staff member) and higher costs (low borrower to staff ratio and staff-intensive technical assistance). Programmes serving more "entrepreneurially ready" borrowers can usually provide a standardised loan product with minimal technical assistance. They will usually have higher revenues (higher number of loans per staff, larger average loan size) and lower relative costs (less technical assistance).

Mission and strategic direction should be determined by all four principles of programme design because they are mutually dependent and reinforcing. The mission and target market of each type of fund (whether it serves new entrepreneurs, stable existing microbusinesses, or growth microbusinesses) drives the products and services offered and prospects for financial viability.

Enterprise development is a continuum -- individual resources fit within a larger spectrum of enterprise development efforts and leverage those other resources where possible. A common mistake for new programmes is to try to be all things to all microentrepreneurs. Successful programmes share two characteristics:

a) They focus initially on a certain market and then expand their customer base once programme operations are established and running smoothly; and

b) They grow with their customers needs rather than always seeking to "graduate" them to another source of financing. In transition economies, the credit gap is relatively wide and the needs of customers may grow substantially before they are eligible for bank financing. For example, the average loan size of the ECC has steadily increased, in part due to the larger loan requests of repeat borrowers.

In assessing the market potential for microcredit, programme managers must identify the range of microentrepreneurs who exist and their needs. The factors to be considered include:

- **The types of economic activity and microbusinesses:**

  Are the microenterprises retail, services, or light manufacturing? Home-based and part-time businesses or full-time enterprises with storefront offices? Do they need equipment financing or small amounts of working capital? Of the many existing businesses, how many need credit; of businesses needing credit, how many might be start-ups?

- **The client's objectives:**

  Client objectives vary; the programme cannot push small-scale operations to expand. Does the entrepreneur want to expand a potentially high-growth venture, maintain a part-time business to supplement income, or stabilise a family-run retail operation?

- **The types of resources or services they want:**

  Based on the market assessment, what credit needs make sense? In CEECs, these appear to fall primarily into equipment or asset financing, small amounts of short-term working capital, and possibly start-up financing.

- **Skills or resources they lack to borrow money and use it effectively:**

  Around the world, microentrepreneurs typically face three gaps: market information, financing, and management skills. The extent of these gaps determines how much technical assistance individual borrowers require before they are ready to receive a loan. In CEECs, many borrowers have the market knowledge and operating skill to expand an existing or start a new business. However, most typically they lack the business management skills. Many programmes operating in CEECs or the NIS have found a need to ensure that borrowers are very focused on their market, the competition, and the business's cash flow before they receive the loan.

- **Targeting:**

  Programmes may target a geographic region (and all businesses within it), certain type of businesses, or certain entrepreneurs. If the programme targets a particular sub-set of the general population, what social descriptors and criteria relating to gender, ethnicity, or income level designate them as the target group? Targeting is a debated topic in international microenterprise development. One school advocates targeting the "poorest of the poor" or the "disadvantaged" to right past wrongs and provide economic opportunity to groups denied access to the conventional banking system. The other school advocates providing credit to anyone who cannot access other sources. As discussed under Section C below, these programmes use "market pricing" to screen out those customers who could access other sources of credit to ensure that credit goes only to those with no other alternatives. In this Report, the phrase "target customers" refers to those customers the microcredit programme is trying to reach, not any particular subset.

Non-credit support services may be needed to assist disadvantaged or less confident entrepreneurs, or they may be focused solely on improving the repayment success of the business. They can include business technical assistance, a savings plan, child-care or family support services for the unemployed, or co-ordination of marketing or purchase orders to reduce costs to individual businesses. Each programme must carefully evaluate the importance of such services to the programme's mission and their additional cost.

There are several types of resources that should be considered when designing a programme:

- **Institutional Structure:**

  Will the organisation have access to more resources as a stand-alone entity or as part of a larger institution (such as a university or foundation) with multiple programmes? Does any particular legal structure make fund-raising more successful? To date, there is no non-profit legal status in CEEC economies that would facilitate fund-raising. An independent institution with a strong, apolitical board of directors may have more autonomy, but affiliation with an existing institution may provide better access to funding resources. Local managers can best assess their options.

- **Management and Leadership:**

  As noted in Chapter 3, management’s ability to articulate the organisation’s goals clearly and develop a plan on how to reach them is a critical success factor for microcredit programmes. By identifying goals and objectives, management can develop a business plan that follows the strategic direction of the organisation and can continuously improve upon programme design and execution. Furthermore, management's ability to articulate that direction ensures that all members of the staff work toward the same vision and unleashes the creativity and innovation required to meet those goals.

- **Staff Availability and Capacity:**

  The education, experience level, motivation, and commitment of staff are key ingredients in a programme's success. In transition economies, there appear to be well-educated and committed professionals who want to assist microbusinesses and the transformation of the economy. The only weak points are in lending experience and skills. Some of the most effective programmes have brought in foreign bankers or financial experts to help them learn about cash flow and small business lending or investing.

- **Potential for Partnerships:**

  There may be potential partners to help deliver the credit or technical assistance components of the programme. Careful evaluation of each partner's values, goals, and operating style are important since partnerships may require relinquishing quality control over key elements of the programme. Partnerships with banks, for example, have worked well for some programmes due to the lack of any other payments system and the inability of non-banks to foreclose on collateral without a long civil courts process. Unless the partnership gives the programme control over problem loans and collections, however, the programme loses its ability to influence borrower behaviour.

  Using partners in the delivery of non-credit assistance is another way to lower costs to the microcredit programme. Passing along pre-credit training and specialised technical assistance responsibilities to an existing organisation is a particularly effective tactic to reduce programme expenses. In theory, each partner will streamline the delivery of its “specialty”, lowering the overall cost. However, a programme must evaluate the trade-off between less control and lower costs.

- **Funding Resources:**

  Nearly all grant-dependent programmes are in part driven by the parameters given by their funding sources. The feasibility of the best programme design depends on management's ability to raise financial resources. In CEECs, there is a high proportion of European Commission and bilateral funding, but less from private foundations and more flexible sources. Funders should encourage experimentation within microenterprises in transition economies to determine what models are most effective and how they can be replicated.

These principles should drive programme design for any new microcredit programme. But once operations have begun, it is equally important for programme managers to constantly adapt, refine, and revise the programme design to improve its effectiveness and efficiency. Like their most sophisticated customers, programme managers must constantly react to market changes and new information to run viable and effective programmes. The application of these principles to loan fund management is discussed below.

B. Strategic Planning

A strategic plan guides the organisation’s long-term goals and short-term business decisions. As a process, strategic planning builds a shared vision and common language for staff and managers about their work, and cultivates commitment and motivation through group participation. As a product, the strategic plan provides a rationale for funders, and a road map for management and staff. A programme may choose to exit this road in the future, but this process helps identify and define the organisation's current path. Programme strategy guides the action steps and operational plan for staff during the year.

Programme managers must make several key decisions in strategic planning:

- Define a mission and strategic goals;
- Identify products and clear performance objectives;
- Set measurable performance benchmarks;
- Develop an operations plan; and
- Identify a capitalisation and funding strategy.

As described in Chapter 1, microcredit organisations cover a wide spectrum of development objectives and institutional structures. Most seek to balance social benefits with a profit (or cost-recovery) objective to ensure that the programme continues to move towards financial viability and can continue to provide social benefits in the long run. This requires microcredit programmes to operate like a business -- they must have a clear business purpose, specific objectives guiding their operating plan, a good understanding of market niches and customers, and clear performance measures by which to track their progress. The strategic planning process helps stakeholders --- programme managers, funders, and core staff -- move from broad goals to specific operational decisions.

Each factor affects the other and all decisions should be grounded in market context, mission, customers, and resources.

Step 1 Define a Mission and Strategic Goals

The mission and strategic goals of the organisation should be grounded in market context and be broadly stated rather than tied to specific strategies. Specific strategies may change over time to best achieve the programme mission in changing conditions. The mission should be informed by the market context issues discussed in Section A. For a new organisation, this may require identifying existing needs, resources, and market gaps to define the role the microcredit organisation might fill. For an existing programme, this involves defining the road it is currently on: its products, customers, and the strategic directions of its markets. The mission should be easily articulated to customers, funders, investors, and staff, and capture the main purpose of the organisation. An organisation's strategic goals are the guiding principles that further refine how the organisation will approach its mission. Strategic goals shared by many effective microcredit organisations include:

- **Provide resources for the long run:**

  Programmes that plan for permanence and financial viability are far more likely to achieve it. Those organisations that have become sustainable institutions have balanced the business requirements of running a microcredit programme with the development activities and advocacy of a development mission. This entails (1) prudent financial management, (2) credit and portfolio management to maintain reasonable loan losses, and (3) investment in staff skills and training to ensure the programme provides information, credit, and technical assistance that is valued by entrepreneurs. The discipline of financial viability varies widely. For example, ACCION International affiliates must reach full cost-recovery within two years of operations, and therefore charge high interest rates on highly streamlined loans. The RPICs in the Czech Republic must earn salary costs of staff personnel through fees paid for technical assistance. Other programmes set a target level of self-sufficiency that steadily increases.

- **Operate the microcredit programme as a business:**

  Business operations attract staff talent, partners, entrepreneurs, and capital; movements and social programmes attract crusaders and the well-intentioned. Businesslike operations require professionalism, working with customers in a business-like manner, and accountability and efficiency in programme operations.

- **Tailor products and services to the target customers:**

  The wide range of products and services that can be offered by microlenders were hinted at in Chapter 1 and earlier in Chapter 4. No one organisation can or should attempt to provide all of them. To be effective, an organisation must focus its resources on particular types of customers and tailor the product and service offerings to meet their needs. Defining products and services is discussed under Step 2.

- **Maintain the highest ethical standards:**

  Microcredit managers and staff must be above reproach. Loan funds are not regulated lenders and need to impose the highest standards of ethical behaviour to ensure that resources are not diverted or given to those customers with particular connections or influence. Customers must be confident that they are dealt with fairly and rationally rather than through a system of favouritism or graft.

Step 2 Identify Customers, Products, and Performance Objectives

Broad goals must translate into products and services to be offered and operating performance objectives for the subsequent two or three years. These objectives may change, but they provide clear direction for the near term and for the Operations Plan. The Operations Plan addresses “how" these steps will be achieved and includes the market assessment and research needed to answer key questions. These objectives should include:

Key Tasks of Step 2:

1. Identifying markets and target customers;
2. Defining products and services;
3. Forecasting scale and loan volume; and
4. Identifying an organisational structure and staffing needs.

- **Identify the customers to reach and the obstacles they face.**

  Like any business, a microloan programme should be market- and customer-driven, rather than product-driven. As described under "Context" in Section A, staff must assess the market in which they operate and identify the microentrepreneurs they want to reach. Understanding the challenges and obstacles faced by the target customers allows programme staff to:

  a) Identify the credit and non-credit products needed;

  b) Forecast loan capital requirements; and

  c) Set performance objectives.

  To assess the market, programme staff can interview technical assistance providers about their customers, meet with local business leaders, and interview microentrepreneurs. Because many microbusinesses are informal or home-based, they may be "invisible" to the casual observer.

- **Define the types of credit products to be offered.**

  This may include 6-12 month working capital loans or 24 to 36 month equipment financing loans, depending on the target customers and their needs. It is important to allow some time for a microcredit programme to develop its loan product(s). The initial design often requires tinkering, and programmes should be flexible. The Foundation for the Development of Polish Agriculture targets the most needy, for example. But to kick off the programme, it had to make larger loans to a business owner not in their target group, but who would be an attractive and credible promoter of the programme. The Enterprise Credit Corporation has combined working capital with some asset financing to minimise risk on its 1-3 year loans. Managers must determine what loan loss rate is acceptable for the programme in its early years and what are its expectations for loan volume and demand.

- **Identify the non-credit services to be offered.**

  What level of technical assistance is needed for the target customer base and how will it be delivered? Will the organisation create partnerships and a referral network for pre-credit business planning assistance? How will it provide the ongoing technical assistance and "trouble shooting" needed to help borrowers avoid problems and repay their loans? Are there additional services that its clients need to be successful?

  These are many of the questions programme staff must ask to determine what other support services they will provide. Many start with minimal technical assistance and focus on (1) screening applicants through the loan application process, and (2) providing ongoing business assistance as part of loan monitoring. This minimises cost and allows the programme to broaden the technical assistance component to meet identified needs.

- **Determine the approximate costs of delivering the above services.**

  What implications does this have on the level of financial resources required by the organisation? The operating budget and financial resources needed to operate can be estimated compared with available resources. If there is an approximate fit, the budget and staffing can be refined in the

Operations Plan. Issues to consider include (1) the portion of costs to be paid by the borrowers, (2) the target self-sufficiency ratio, and (3) the organisational structure options.

- **Decide on the scale to be achieved in the first two to three years: Simply defined, scale is enough activity to justify being in business.**

  Several factors will influence what volume of activity a programme should reach in its early years:

a) Funder expectations regarding the project funding and the term of the initial commitments will drive the target of scale. Scale has a relation to unit costs and the nature and availability of funding sources will determine how quickly a programme must generate significant internal sources of income.

b) Market expectations and how quickly a programme's reputation will be established as a credible resource of financing and business assistance.

c) Capacity of the organisation to build the systems and staffing to handle a volume of transactions and monitor a loan portfolio. Careful planning and learning from the experience of other programmes can help programme managers prepare for the second and third factors.

- **Consider staffing requirements and the skills needed by various staff levels:**

  The quality and motivation of management and staff is perhaps the most important variable in the success of a new venture. For new microcredit programmes, this is important because of the unique balance they strike between seeing development possibilities and recognising unacceptable lending risk. Microcredit managers are either "bankers with hearts of social workers" or "social workers with the minds of bankers." It is a rare breed. Staff training and development will be very important to instil lending judgement in staff and build their capacity as knowledgeable business advocates. The estimated salary levels for managers, credit officers, technical assistance staff, if needed, and support staff are all key assumptions for the Operating Plan budget.

Step 3: Set Measurable Performance Benchmarks

As part of a focused business direction and operating plan, management must identify specific performance measures and benchmarks to track the programme's success in meeting its objectives. These measures are an internal management tool for understanding when projected performance is different from expected and for measuring the impact of programme design changes or refinements. Considerable debate has been joined on the most appropriate measures for microcredit programmes, as they are a hybrid between risk/return-driven financial intermediaries and subsidy-driven development programmes. They do not fit the standard performance measures of either conventional banks or traditional development efforts.

Over the past few years, microcredit organisations have developed greater consistency in performance measures, allowing for performance comparisons between organisations and a better understanding of an organisation's lending and development activities. Most organisations set initial performance objectives and then revise them based on operating experience and changes made in response to evolving market conditions. Clearly defined performance measures have become increasingly important, however, as global funding sources focus on development impact and more effective use of subsidy.

In response, microcredit organisations have gradually developed quantitative measures to better evaluate performance in two areas: in development impact, and financial condition of the organisation or institution. These measures focus on the market tests of demand, or the clients willingness to pay for credit or services, and the market test of financial soundness for the organisation.

Key Performance Evaluation Areas:[51]
The Client Relationship: • Number of clients and degree of market penetration; • Quality of service and market test of demand; and • Impact on clients and/or microbusinesses. **Institutional Viability or Financial Condition:** • Operating efficiency; • Financial and portfolio condition; and • Future capital or subsidy requirements.

The more sophisticated organisations have adopted a set of easily measured, quantifiable ratios that capture some of the key operating relationships of their microcredit programmes. Many of these measures have served as a framework or set of evaluation tools for funders. This section and Chapter 5 emphasise the identification of ratios as management tools for programme staff.

North American managers and regulators evaluate and measure five key areas of bank management and financial condition.

Commonly known by the acronym "CAMEL", these key measures include:

C **Capital Adequacy**, or whether the institution has sufficient capital to unexpected losses and to protect depositors and investors.

A **Asset, or loan portfolio quality**, which measures the exposure of the organisation to loan default risk.

M **Management,** a qualitative assessment whether management depth and skills recommensurate with the operating needs of the institution.

E **Earnings,** or whether the institution is sufficiently profitable to continue building its capital base and whether accrued earnings are of high quality.

L **Liquidity**, or whether there are sufficient available funds to ensure liquidity or depositors who may want to withdraw their funds.

A similar set of financial condition measures for microcredit institutions and organisations might fit the acronym SCALE and include the following quantitative measures:

S **Self-Sufficiency Ratio:** The percentage of operating costs (including loan losses) that are covered by internally-generated sources of income (including loan interest, income, investment interest income, and fees)

C **Capital Adequacy:** This measures capital (equity and debt) as a percentage of total assets. As noted above, this measures the level of capital to support future growth in the loan portfolio and the organisation’s ability to absorb unexpected losses.

A **Asset, or Portfolio Quality:** The delinquency ratio and loan ageing report indicate a programme’s exposure to default risk on loan principal outstanding.

L **Liquidity:** For microlenders that do not accept deposits, this ratio should be the amount of unlent or liquid funds, loan capital divided by total assets. It measures how much loan capital is invested and the organisation’s ability to respond to new demand.

E **Earnings Quality:** Because most lending organisations use accrual accounting methods (where interest income is booked as revenue each month regardless of when the cash is received), management should periodically evaluate the quality of earnings to ensure that the accounting methods match reality. This is best measured by the delinquency measures that indicate whether a high proportion of payments are not being received.

Unlike conventional banks, microcredit organisations also need measurement tools to track development performance. Although these measures must be tailored to individual programmes, they might fall under the acronym “OSI”:

O **Outreach:** The number of clients served and measures of market penetration.

S **Service Quality:** As the market test for meeting client demand, these measures might track demand for credit and technical assistance services and the cost of delivering each unit of service (unit cost).

I **Impact:** The most difficult to measure, these tools might include changes in client incomes or sales, number of jobs created, or number of businesses formed.

Two important challenges for microcredit programmes are:

a) Defining how many customers constitute "scale" and what cost per client constitutes "reasonable cost."

   Both practitioners and funders accept "achieving scale" and "reasonable cost" as prerequisites to large-scale investment in microenterprise. However, the number of beneficiaries that constitute scale or reasonable cost has not been defined. The number of customers per professional staff person and the cost per programme participant varies widely.

   ADEMI loan officers in the Dominican Republic serve 70-80 customers (through individual lending) and visit each client once every one to four weeks. In high density, urban microcredit markets, loan officers may service up to 500 customers, a scale permitted by the physical proximity of their clients, the programme's emphasis on minimalist credit, and the solidarity group lending methodology.[52]

In the United States, loan volume and the ratio of customers per staff member have been much lower, due to the higher technical assistance needs of borrowers and the lower volume of borrowers. The highest client/loan officer ratios in the US are in minimalist credit programmes that offer very little or streamlined technical assistance.

b) Quantifying the costs of lending vs. technical assistance.

Microcredit organisations that separate the costs of running the fund from the costs of delivering technical assistance can better measure the costs of providing each type of service. This breakdown of costs and resources can lead to accurate cost/benefit comparisons with alternative programmes. Self-sufficiency funds can then be compared to the cost of continued welfare maintenance or to the cost of programmes to reduce welfare dependence, rather than to other lending programmes with business development goals.

Identification of lending and technical assistance allows programmes to target their fund-raising to different sources, as some funders prefer investing loan capital and others prefer operating grants to cover staff costs. As noted earlier, technical assistance can be a time-intensive allocation of staff resources. Some programmes have separated lending and technical assistance completely to better track costs and develop alternative funding strategies. Others have only separated the costs of customer outreach and pre-credit technical assistance. An increasing number of programmes consider technical assistance given after the loan has been disbursed as part of loan monitoring, reducing the risk of the borrower failing to repay the loan. Such measures also help educate funders about the implications of targeting decisions (an exclusive focus on low-income clients, for example) for financial performance and achievable levels of self-sufficiency.

These ratios track relationships between variables. Monthly comparisons of these ratios reveal trends and signal changes for management to investigate. Table 2 presents some of the performance measures currently used by microcredit organisations as examples. The recommended performance measures are presented in Table 3 and described in greater detail in Chapter 5.

Table 2: Sample Performance Measures

Category	Quantitative Measures	Performance Evaluation
Degree of Market Penetration	• Active Borrowers • Conversion Ratio (loans as a % of applicants or outreach contacts) • Percentage of staff time spent on outreach and group formation	Number of contacts needed to find, screen, and yield clients, or the efficiency of staff outreach and marketing
Development Impact	• The number of clients served • Percentage increase in customer incomes • Number of businesses created, maintained, or grown • Jobs created (including self-employment) • Qualitative gains/personal development	Whether the intended results are being achieved and whether they remain appropriate.
Operating Results	• Total costs per average loan • Revenues per average loan • Clients per loan officer/staff person • Staff expense as a percentage of average assets • Net Interest Margin • Unit Cost Ratio • Cost per dollar lent*	Whether annual volume of clients is increasing and whether costs are decreasing per loan
Financial Condition	• Average portfolio outstanding • Liquidity Ratio • Delinquency and Loan Ageing Reports • Ratio of losses to average portfolio outstandings	Portfolio credit risk and financial health of the organisation
Required Subsidy	• Self-Sufficiency Ratio	The percentage of total operating costs that are met from internal revenue sources (interest on loans, interest on investments, and fee income)

Source: Originated by ACCION International

Table 3: Recommended Performance Measures

S	**Self-Sufficiency Ratio =**	$\frac{\text{Internally Generated Income}}{\text{Total Expenses}}$
C	**Capital Adequacy =**	$\frac{\text{Capital (equity and debt)}}{\text{Total Assets}}$
A	**Asset Quality =**	• Delinquency Rate = $\frac{\text{Principal Balance of Loans with any Missed Payment}}{\text{Total Principal Balance of all Outstanding Loans}}$ • Loan Loss Rate = $\frac{\text{Annual Loan Loss}}{\text{Average Balance of All Outstanding Loans}}$ • Loan Ageings Report
L	**Liquidity =**	$\frac{\text{Liquid Funds (unlent loan capital)}}{\text{Total Assets}}$
E	**Earnings Quality =**	(Based on delinquency)
O	**Outreach =**	• # of clients served • Market penetration measures • Characteristics of clients, as appropriate
S	**Service Quality =**	• Demand for loans and technical assistance • Unit Cost = $\frac{\text{Total Costs for a Service}}{\text{Total Units (or \# clients)}}$
I	**Impact =**	• Changes in client incomes • # jobs created • # businesses formed • increases in sales

Step 4 Develop an Operations Plan

Just like their entrepreneur customers, many microcredit organisations avoid writing a business plan despite its undisputed benefits. The process of writing the plan helps management identify operational issues and solutions, raise alternatives, and plot action steps. The written document provides a guide for management and staff for the interim period and can be sent to funders or investors as a fund-raising tool. Most business plans are revised on a periodic basis as the organisation evolves and market conditions change. Note that a business plan does not need to be long or extensive -- it should capture the essence of the operating plan, whether in bullet points, tables, or text.

The Operations Plan should address the core elements of programme operations and how they will be structured and operated. It should also summarise the goals, market assumptions, objectives, and action steps for the key areas of programme operations. Those key areas include:

a) **Markets and customers:**

- What are the trends in the market context?
- Who are the target customers and what obstacles do they face? What are the opportunities?
- What are existing resources, needs, and market gaps?

b) **Products and Services:**

- What credit products will be provided (direct or group loans, average size, term, use of proceeds)?
- What technical assistance will be offered and why?
- How will products be marketed and customers outreached**?**

c) **Programme Operations:**

- Loan approval process, pricing, documentation, and disbursement.
- Loan monitoring, servicing, and payment collection.
- Loan collection policies and procedures.
- Flow of funds, internal control and financial monitoring.

d) **Organisational Structure:**

- Institutional Structure (part of a larger institution, a stand-alone organisation or programme)
- Governance (Board of Directors, oversight by larger organisation)
- Management (Managers, their qualifications, and management accountability)
- Capital Structure (sources of initial loan capital, terms, cost, goals)

e) **Staffing and Staff Development:**

- Primary staff priorities and what staff should be able to produce or do.
- Staff development and training.
- Staff performance reviews and evaluation.

f) **Budget and Financials**:

- Projected operating budget for next 2-3 years.
- Sources of funding and desired terms.
- Financial performance benchmarks.

The key to effective strategic and business planning is to build frequent review and revision into the process so the strategic plan becomes a useful management tool rather than a stale document. Many organisations, both philanthropic and for-profit, conduct an annual review each fall to assess progress on strategic objectives, revise targets and action steps, and project the next year's measurable objectives. That meeting, usually including managers and staff, forms the basis for the next year's operating budget.

A sample business plan outline is presented on the following page.

Sample Business Plan Outline

1. **Programme Mission and Goals**
   - Development impact (poverty alleviation, self-employment, small business growth)
   - Financial performance
   - Institutional Strategy

2. **Medium-Term Objectives**
   - Customers and loan disbursements
   - Development impacts
   - Staff training, skill development
   - Fund-raising
   - Programme operations/systems

3. **Markets and Customers**
   - Market needs, resources, and existing gaps
   - Target customers and market depth
   - Marketing and Outreach Strategy

4. **Products and Services**
   Lending:

   - Loan types, terms, and amounts (direct or group loans, guarantees, or lease financing)
   - Loan underwriting and approval process
   - Loan pricing (interest rates and fees)
   - Loan monitoring and servicing
   - Loan collection policies

   Technical Assistance:
   - Pre-credit training or screening
     Business assistance to borrowers (sector, topic specific)
   - Costs and user fees

5. **Programme Operations**

6. **Organisational Structure**
   - Institutional form
   - Governance
   - Management
   - Capitalisation

7. **Staffing and Staff Development**

8. **Budget and Financials**
   - Operating budget for two years
   - Funding sources
   - Performance measures and benchmarks

Step 5 Determine an Institutional and Capitalisation Strategy

To plan for long-term viability, microcredit programmes should develop a strategy for both its institutional structure and long-term capitalisation.

The appropriate institutional structure may vary with the programme's mission and origins. The path to sustainability can be realised through a number of institutional arrangements. This section discussed four alternatives that can evolve into financial sustainability or self-sufficiency.[53]

Capitalisation strategies include funding for long-term loan capital and funding for annual operations. Capitalisation strategies may evolve as an organisation grows older and its needs and resources change. At the outset, managers should project a three to five year funding horizon.

In the early years of operations, a microcredit programme will depend heavily on grant funds from foundations, philanthropic organisations, and/or government sources (given the small number of private philanthropic organisations in transition economies, the primary funding sources are probably foreign and local foundations and government-relayed sources). The loan portfolio is very small at this stage and earns little revenue, but operating costs are already incurred. In later years, as the programme increases in size, internally-generated interest income on loans and investment income should become more significant. Some funding sources provide loan capital (investment) and operating grants (subsidy); other investors are more likely to provide only one kind of funding. The section below discusses key issues for programme managers, the types of funding, and possible sources.

The key issues for programme managers to consider in developing a capitalisation strategy include:

- **Establishing an independent organisation with linkages to the conventional banking system:**

  A private microcredit organisation that cannot achieve financial self-sufficiency is not in the position to become a financial institution. It may also face limited access to capital resources or be prohibited from accepting deposits competitively. These programmes can be effective financial intermediaries if they forge relationships with the conventional banking sector. The alternative is to leverage programmes capital by borrowing from commercial institutions and on lending those funds to microentrepreneurs. To merit attractive borrowing rates and to assure banks of their credit worthiness, programmes may use guarantees or credit enhancements from

  Third parties (such as ACCION's Bridge Fund)[54] or maintain 10-40 per cent of loan losses. Three of the four credit programmes profiled in Chapter 3 had relationships with the conventional banking system to ensure a delivery mechanism for credit.

- **Establishing a deposit at the bank to absorb the first programme within a larger, permanent institution:**

  This alternative may be more feasible to microcredit programmes in transition economies because existing, permanent institutions may have (1) greater access to financial resources, and (2) more political insulation from changing government policies and regulation. For example, a programme within a larger foundation may have competitive advantages over a fledgling, start-up organisation through the early stages of institutional development. Once financial viability has been reached and a track record established, the organisation may choose to become a separate non-governmental, private organisation if there is an appropriate legal structure under local law.

- **Transforming into a specialised financial institution:**

  Organisations that are striving for self-sufficiency may decide to become formal financial institutions and thereby be able to both accept deposits and extend credit (accepting deposits is an important funding source for most financial institutions). To achieve sufficient scale for financial viability, these organisations typically expand into a branch office network to deliver credit and collect deposits. Legal considerations and local government regulation about deposit-taking and extending credit are a key factor in determining the right institutional structures. As a self-sufficient credit operation, the Enterprise Credit Corporation could evolve in this direction, for example.

- **Developing a specialised operation within a commercial financial institution:**

  Although only a handful of banks have explored this option, a microcredit operation could perceivably be housed within a larger commercial bank. The best known models for this approach are the BRI Unit Desa Programme in Indonesia, and the Enterprise Credit Corporation's "loan windows" approach. The latter "borrows" bank locations to deliver credit and is not a division within a larger financial institution. To work, these models require autonomous and separate management within the banking institution. Such an arrangement is possible, as demonstrated by the BRI Unit Desa system, which is run by a large government-owned bank and serves over eight million savers and two million borrowers. The major advantages of placing microcredit organisations within commercial banks include, access to the existing infrastructure of a branch network, access to capital and liquidity, and association with a commercial institution to reinforce the business nature of microlending.[55]

- **Projected loans outstanding:**

  To adequately capitalise the programme, managers must project their capital requirements by forecasting loan demand and the amount of loans that will be outstanding on average each year. The amount of capital required depends on (1) how many loans are disbursed, (2) average loan maturities, and (3) repayment rates. For example, if loan repayment is slow, loans are not repaid as quickly and more capital remains outstanding for longer time periods, requiring a larger capital base. If the maturity of most loans is only 12 months, they will be repaid quickly and replenish the capital of the loan fund.

- **Projected annual operating budgets for up to three years:**

  In the start-up phase, programme managers should ideally secure sufficient operating grants to finance three years of programme operations. Thereafter, programme staff will need to anticipate funding shortfalls and raise money each year to cover any operating gaps. As a rule, only grant funding should be used to finance annual operating expenses.

- **The cost of capital:**

  Some sources will provide grants at no cost while others will lend capital that must be repaid in the future. The cost of capital is the interest rate charged by the investor of funder, or the cost to the programme of borrowing those funds. The cost of capital is usually a blend of several sources at different costs, as shown in the following example.

Source	Amount	Annual Interest Rate	Annual Cost
Foundation	$ 500 000	0% (grant)	$0
Private Investor	$ 200 000	5%	$10,000
Government Programme	$ 500 000	10%	$50 000
Total	$1 200 000	$60 000	
Effective Cost of Capital			5%

- **Inflation and Currency Risk:**

  In high inflation business climates, inflation is a significant additional cost. If investors seek protection against high inflation, it is usually built into the interest rate. This would require the programme to reinvest funds at high enough rates (either in investments or in loans) to earn a rate of return that equals or surpasses the inflation rate, such a requirement limits a programme's flexibility.

  The risk of currency devaluation, or exchange rate risk, poses an additional cost to the programme. For example, both the Agriculture Foundation and the Enterprise Credit Corporation are capitalised with US dollar-denominated capital. When the zloty loses value against the US dollar, the amount of zlotys that the programme must earn to repay the same amount of dollars increases. ECC lends to borrowers in US dollar-denominated loans at in interest rate of 12 per cent, passing the currency risk on to the individual borrowers. The Agriculture Foundation lends in zloty-denominated loans and absorbs the currency risk itself to insulate its customers from currency swings. The Agriculture Foundation needs a strategy for repaying the dollar-denominated principal beginning in 1997.

- **Self-Sufficiency Goals:**

  To reach a target level of internally-generated income, programmes should consider (1) how many loans need to be outstanding to earn a certain amount of interest income, and (2) how much investment capital is needed to earn significant investment earnings. Many sophisticated programmes often raise large amounts of capital upfront, before they really need it, so they can earn investment income and defray some of their operating costs. This is difficult to achieve unless the programme has a clear track record and strong credibility with funding sources.

  Preservation of capital is of paramount importance to microcredit organisations because any lost capital must be replenished. Therefore, most programmes invest in short-term government securities that can protect against inflationary losses but not involve too much risk.

To the extent that microlenders are providing a social benefit that the free market would not find profitable to provide, subsidy (grant funds that do not need to be repaid) is required to make up the shortfall between operating costs and revenues. Operating costs include all recurring expenses, loan losses (which is an expense on the programme's income statement), and currency or inflation losses (if some expenses, such as cost of capital, is in a difficult currency).

If private investors cannot earn a return from this investment, philanthropic and government development funding must also play an important role in capitalisation. Because their motivation is the social benefit, these funders need to see a clear development benefit to the programme's strategy and understand how their subsidy commitment is providing a social good that would not otherwise be available. These may be the most readily available sources of funding in a programme's early years.

Dependence on these sources alone, however, is short-sighted. Although these may be the most readily available resources at present, most philanthropic funders begin to require higher standards of performance and reduced dependence over time. In addition, the priorities of government programmes and of private foundations often change and may shift away from microenterprise.

Equity is the grant-funded or permanent capital for a microloan programme. Capital refers to both equity and any borrowed, long-term debt used to fund loans. Programmes need an equity-building strategy as well as sound management of any borrowed principal. Capital usually refers to (a) loan capital that is lent to borrowers and then repaid, or (b) any capital required to finance permanent investments, such as in fixed assets (usually a very small amount). In the United States, loan capital is more easily available to microcredit programmes than operating grants because funders anticipate that the money will be repaid at some point. The cost of capital is usually at a below-market rate to improve the self-sufficiency ratio of the programme and reduce its annual interest expense. The most effective organisations husband their capital prudently, leverage it whenever possible, and maintain a significant cushion to protect the programme against unforeseen funding shortfalls or expenses. This is conservative financial management and helps ensure that the programme can provide credit to its customers over the long-term. Many programmes maintain a "liquidity ratio" of 20-30 per cent (unlent funds as a percentage of total loan capital) to ensure that they can always meet new loan demand. However, it is very difficult to raise capital unless you can demonstrate sufficient need for additional amounts.

Capital is eroded by operating losses incurred by the programme. Operating expenses and loan losses must be held at reasonable levels to preserve capital prudently.

Although sources of subsidy or capital will vary within each country, several general sources may be available to organisations operating within CEECs and the NIS. Those include:

- Western foundations with an interest in international microcredit programmes (including The Charles Stewart Mott Foundation, The Ford Foundation, and others);

- Religious organisations or foundations (associated with the Catholic Church, for example);

- The EC's PHARE programme, which provides multilateral funding to support economic development in most of these countries;

- Other institutional lenders, such as The World Bank, and the European Bank for Reconstruction and Development (EBRD), which have channelled large amounts of funding into local governments for general relending for small enterprise development. EBRD has financed several private microcredit initiatives in the former Soviet republics, and the World Bank has established a microenterprise lending initiative.

- Private firms and financial institutions with a philanthropic interest (for example, Citibank recently committed $10 MM to microcredit programmes around the world, including several eastern European markets);

- Government programmes for the unemployed, for education and job training, and small business development may also make some resources available for microenterprise development.

In many cases, policy changes are needed to provide more direct access to funding for privately-managed programmes that can innovate and experiment with alternative strategies for enterprise development. Dependence on centrally planned and administered programmes is almost always less effective in promoting creativity and innovation.

In conclusion, strategic planning can be a highly effective way for microcredit organisations to chart their futures and to identify the management decisions that will guide their path to organisational permanence. The goal is the process by which vision is established and communicated, markets are assessed, the capacity to deliver products and services is developed, and resources are mobilised to achieve the goals. Strategic planning requires executive leadership, staff commitment, and board participation. Finally, institutional development is a dynamic process that requires constant reaction and adaptation to changing market conditions. This is especially important for those operating in fast-evolving, transition economies. Programme managers cannot become wed to a particular programme design or method, as the market needs may continue evolving and require new innovations or refinements.

C. Strategies and Tactics for Sustainability

As part of strategic planning, microcredit programmes need to constantly balance long-term financial viability with the programme's mission and development objectives. A programme that fails to meet either of those dual goals will ultimately fail -- it will either gravitate to more conventional lending and not achieve its social mission, or achieve the social goals in the short-term at the cost of survival. As defined in Chapter 3, sustainability is the ability to cover all operating expenses from a combination of internally-generated earnings and subsidy.

To be sustainable, a programme needs to consistently demonstrate sufficient development results to be able to reliably attract continued investment of subsidy from donors. As noted in Chapter 1, dependence on external funding is short-sighted. It limits the programme's independence and flexibility, and consumes a large portion of management time. Although many programmes will not attain financial self-sufficiency, they should constantly strive to increase their cost-effectiveness and reduce the amount of outside subsidy needed. A USAID study of developing country microcredit lenders concluded that those programmes that strive to become self-sufficient, even when the goal is unrealistic, generally perform better than those that are managed with the expectation of continuing support.[56] A management orientation that pursues self-sufficiency sharpens skills, hones efficiencies, and earns credibility with business and philanthropic partners.

Definition: Financial Self-Sufficiency Financial self-sufficiency is the ability to generate sufficient cash flow from internal sources to meet recurring operating expenses, including capital written off to loan losses and any capital value lost to inflation. **Definition: Sustainability** Sustainability is the ability to cover all operating expenses from a combination of internally-generated earnings and subsidy.

To merit continued support from funders and donors, microcredit programmes will need to:

- Clearly articulate their development goals and their cost/benefit performance relative to alternative means of reaching those goals;

- Successfully reach their intended customers and steadily increase the number of customers served;

- Increase revenues per loan, net of loan loss provisions; and

- Reduce total costs per loan, and therefore the level of subsidy required.

1. **Factors That Affect Sustainability:**

Several revenue and cost factors affect the degree of financial self-sufficiency that a microcredit programme will achieve:

- **Average Loans Outstanding:**

  Revenues are driven by two factors -- the amount of assets earning a return and the spread earned on those assets. Loans outstanding is the primary source of interest income for most microcredit lenders (although interest income on idle funds also contributes income, the margin is typically much lower). Loans outstanding, or the size of the loan portfolio, is driven by three factors: (1) the rate at which loans are disbursed, (2) the average term or maturity of those loans, and (3) the rate of repayment. If an organisation makes larger or longer term loans, the average outstandings increase; if the average loan is small and has a maturity of one year, average outstandings remain lower because half of the loans are repaid each year. If the repayment rate is slow, average outstandings increase but the risk of loan losses increases.

- **Net Interest Margin:**

The second revenue factor is the interest margin earned on loan assets, or average loans outstanding. The gross interest margin is the difference between interest rates charged on loans and the cost of capital. As shown in the example below, the net interest margin is the gross interest margin less the cost of loan losses.

Calculating the Net Interest Margin

	Dollars	% of Assets
Average loans outstanding	$300 000	100%
Interest Income on loans	48 000	16%
Less: Cost of Funds*	18 000	6%
Gross Interest Margin (spread)	30 000	10%
Less: Loan loss rate**	10 000	3%
Net Interest Margin	20 000	7%

Total revenue equals the interest margin multiplied by loans outstanding (plus other sources, including interest on idle funds and fees). Therefore, a programme that earns a spread of 12 per cent on $100 000 in loans will earn the same revenue as a fund earning 5 per cent on $240 000. The Net Interest Margin can be used to determine the amount of earning assets needed for a programme to reach financial break even. To break even, a loan fund must earn an amount equal to its total operating expenses. Using the example above, a fund with an interest spread of 10 per cent and a loan loss rate of 4 per cent, would earn a Net Interest Margin of 6 per cent. If average operating expenses are projected at $180 000, the fund would need $3 million in assets to reach break-even.[57] If the Net Interest Margin was 4 per cent, the break-even asset size would be $4.5 million.

- **Programme Operating Expenses:**

  Operating expenses are driven by several factors: (1) the types of services provided (the extent of technical assistance and other non-credit support services), (2) the administrative structure and staffing pattern, and (3) the service delivery methods and use of partnerships. If an organisation provides a significant amount of technical assistance directly to customers, the staff expense will increase. In contrast, if a programme can shift some of the pre-credit preparation and screening to another organisation, a higher proportion of staff will be generating revenues through loans. Organisational structure affects the amount of overhead and other indirect costs the organisation bears. If part of a larger institution, the programme might share its overhead expenses (such as space, financial and accounting, and human resources) and reduce costs ; conversely, it may be required to absorb some of the costs of the larger organisation.

  Several organisations have tried to share overhead with local, existing organisations to reduce their total operating costs and improve their self-sufficiency ratio. The Enterprise Credit Corporation, for example, was able to reach financial break-even in 1992 because expenses were relatively low due to the sharing arrangement negotiated with local bank offices.[58] A US programme shared its staff with local community development organisations that already had office space in smaller communities, reducing both salary expense and overhead.

- **Loan loss rates:**

  Although already reflected in the Net Interest Margin calculation as an expense, loan loss rates are mentioned separately because of their importance. Loan losses must be held to a reasonable level to maintain manageable operating costs. Another balancing act for programme managers is to balance the desire for a larger loan portfolio (higher outstandings) and the increased risk associated with larger loans. Larger and longer term loans can be higher risk to the lender because: (1) the default of one large loan creates a bigger loss than that of a small loan, and (2) longer maturities are higher risk because the uncertainty of repayment increases with the length of time forecasted.

2. **Ways to Increase Self-Sufficiency**

   In designing or refining a microcredit programme, managers and staff can consider the following methods to increase revenues and/or reduce costs of the programme:

- **Maximise the net interest margin** by negotiating low costs of capital and charging unsubsidised interest rates;

- **Target a range of customers** who do not all need significant amounts of technical assistance, or find partner organisations to provide business planning and other support services (but retain control of loan disbursements and monitoring);

- **Share overhead expense** and staff costs where possible through alternative organisational structures, such as incorporating as a subsidiary of an existing institution or as a programme within a larger, permanent organisation;

- **Standardise loans** as much as possible and streamline the delivery system to minimise costs;

- **Use group lending methods** where possible to streamline loan payment and collections, cultivate peer group business assistance, and simplify loan administration and servicing; and

- **Diversify the loan portfolio** among types and stages of business to reduce exposure to certain sectors and to start-up businesses; this includes cultivating repeat borrowers who need larger loans yet require minimal additional staff time.

As new and existing programmes strategically assess their markets and opportunities, they could continually ask themselves two questions: How does this affect the organisation's development goals and ability to fulfil them; and how does this affect the long-term financial viability of the programme.

D. Overview of Microenterprise Lending Models

This section summarises the primary lending and technical assistance models that are in use by microcredit programmes today. As noted in Chapter 1, microcredit programmes vary by their intended customers or beneficiaries, lending models, and emphasis on technical assistance. The purpose of this section is to provide practitioners in transition economies with additional information about microcredit programmes in both developing countries and in North America so they might pick and choose the methods and techniques most appropriate to their local context. Specific elements of effective lending and technical assistance are addressed in Chapter 5.

Microlenders in developing countries and in North America use several different lending approaches, depending on the customers they are serving, the rural or urban context, and the business environment in which they operate. The most prevalent models being used today are direct individual lending and various forms of group lending, several of which are described below.

- **Peer Group Lending:**

  Developed by the Grameen Bank of Bangladesh to serve rural, landless women, "the poorest of the poor" to finance income-generating activities and alleviate poverty. Peer groups of 5 members are organised within a village and screened through attendance at weekly meetings and mandatory weekly savings contributions. Loans are made to individuals within the group by the local branch, however, only two members can receive loans at any one time. These programmes typically provide pre-credit orientation, but minimal formal technical assistance.

- **Solidarity Group Lending:**

  Refined by ACCION International in Latin America, in this form of group lending the programme makes loans directly to 6-10 members of a group. The members cross-guarantee each other's loans to replace traditional collateral. Customers are typically informal sector microbusinesses, such as merchants or traders, who need small amounts of working capital. Payments are made weekly at the programme office. This model also incorporates minimal technical assistance to the borrowers.

- **Village Banking:**

  Pioneered by the Foundation for International Community Assistance (FINCA), village banks are community-managed credit and savings associations established to provide access to financial services in rural areas. The lending operation involves a sponsoring agency lending seed capital to newly established village banks, which then on-lend the money to their members. All members sign a collective guarantee for the loan to the village bank. The bank then makes small, short-term working capital loans to individual members.[59]

- **Direct Lending:**

  The most common approach among North American programmes, direct lending is most similar to conventional bank lending. Programmes lend directly to a single entrepreneur or microbusiness, usually one with some operating history rather than a start-up. Loans may be small and for 12 month maturities to finance working capital, or larger and for 24 to 36 month maturities to finance fixed assets. Unlike most group lending programmes, loan underwriting is usually based upon the potential of the business and the character and skills of the entrepreneurs. The extent of technical assistance varies widely. Some programmes provide minimal business assistance and respond only to borrower needs as they arise (demand-driven technical assistance). The loan officer receives helps applicants complete the loan application or refine their business plans. Once the loan is made, loan officers perform loan monitoring and may provide additional business assistance as needed to improve the chances of full repayment on the loan. Direct lending programmes that target start-up businesses typically include a more formal training or technical assistance component.

- **Transformational Lending:**[60]

  A sub-category of direct lending, transformational lending refers to programmes that target microbusinesses with the intention of helping them increase their sales, income, and number of employees (effectively transforming them from micro to small enterprises). These programmes are distinct because they combine access to credit with more comprehensive business assistance services to help microentrepreneurs address the challenges of operating a larger enterprise. The technical assistance may focus on general topics, such as cash flow management, personnel, market development, and production technology. Alternatively, it may focus on the market information and technology needed to develop particular business sectors.

Based on these models, many programmes have tailored a lending methodology to meet the specific challenges of their operating context. For example, in the United States the Rural Enterprise Assistance Project in Nebraska modified the group lending concept to fit rural Nebraska. The interested members of a small town form an Association. The Association must raise a certain amount of money as the loan loss reserve for all the loans made to its members. This "local match" demonstrates the community's interest in the programme and insulates the microcredit organisation from the first tier of loan losses. If a loan defaults, all members must contribute an additional amount to the loan loss fund to maintain it as a percentage of total loans outstanding. This mechanism encourages peer support and assistance to solve problems, but a default by one member does not make the entire group ineligible for future loans.[61]

Under this method, the microcredit programme provides a partial guarantee to a bank making a loan to a microbusiness. The guarantee is necessary because the bank would not make the loan without it. The programme usually helps prepare the borrower for the loan and then receives a small fee for providing the guarantee. Underwriting criteria are similar to conventional bank lending: the potential of the business, collateral value, and credit worthiness of the entrepreneur.

The primary advantage of this method is that a microloan programme can rely upon banks to make and service the loans, and can leverage its own capital. However, the disadvantages are numerous: (1) the programme incurs the costs of preparing the borrower for the loan and incurs the risk associated with the guarantee, but earns only a small fee rather than interest on the loan; (2) the microcredit programme has no control over credit decisions or the future relationship with the borrower; (3) without close monitoring and business assistance from the microcredit programme, the borrower has fewer resources to draw upon to avoid problems.

Table 4 compares the lending models described above. The specific element of effective lending and the provision of technical assistance are addressed in depth in Chapter 5.

Table 4: Comparison of Selected Microlending Models

Model	Customers	Credit Delivery	Technical Assistance	Examples
Peer Group Lending	• Poor rural women. • Lending to households, not businesses.	• Programme lends to individuals in groups. • 6-12 month working capital loans of up to US$175. • Weekly payments at group meetings. • Groups of 5-6 to screen borrowers and create peer pressure for repayment; no traditional collateral.	• Minimal business assistance. • Mandatory participation in weekly meetings and weekly savings. • Peer support. • Self-esteem building activities.	• Grameen Bank • BRAC
Solidarity Groups	• Poor urban microbusinesses usually in formal sector, who form groups of 6-10 members.	• Programme Lends to group. • Working capital loans of 6-12 months. • Weekly payments at local programme office. • Groups cross-guarantee loans and are collectively responsible for repayment.	• Minimal business assistance. • Peer support.	• Prodem • Banco Sol
Village Banking	• Poor rural women. • Households, not micro-businesses.	• Sponsoring agency provides capital to village bank to lend to members. • Collective guarantee by all members for loan to Village Bank. • Short-term working capital loans to members. • Weekly repayments. • No traditional collateral.	• Minimal business assistance. • Savings programme and esteem-building.	• FINCA
Direct Lending	• Usually existing micro-businesses, rural or urban. • Objectives may be new business formation or microbusiness growth.	• Programme lends directly to borrower. • Small amounts of working capital or asset financing. • Underwriting based on business potential and borrower character and skills. • Often requires traditional collateral.	• Minimal training. • Demand-driven (determined by needs of borrowers once loan has been received). • US programmes introduced more structured business assistance component. • Often part of loan monitoring.	• BRI Unit Desa Pro-gramme
Transformational Lending	• Existing microbusinesses with the potential to transform into small businesses. • Usually direct lending.	• Direct loans for both working capital and larger amounts for fixed asset financing. • Loan maturities may be up to 36 months. • Underwriting criteria are business potential and borrower character and skills.	• More extensive business assistance component, usually delivered once loan is made. • Emphasises cash management, production, market development. • Generalist or sector-specific	• Enterprise Credit Corpo-ration (Poland) • ADEMI (an ACCION International affiliate) • Opportunity International
Loan Guarantees	• Existing, larger micro-businesses • Developed in North America to encourage bank lending.	• Usually requires collateral. • Programme provides full or partial guarantee to bank who makes loan.		

CHAPTER 5. FUNDAMENTALS OF PROGRAMME OPERATIONS

As noted in Chapter 1, microcredit finance has become more sophisticated, more cost-effective, and more professional over the past 10 years. The intent of this section is to introduce new microcredit managers to some of the generally accepted principles of microlending and to profile some of the more rigorous lending techniques, technical assistance methods, and operating systems that have been introduced by microcredit programmes. In addition, this section focuses on the adaptations that several organisations have made to operate in transition economies. For example, since one of the niches for microenterprise in these countries is serving larger businesses than traditional microenterprises, these programmes have adapted small business lending methods that focus on the viability of the business and the character of the borrower. This chapter highlights the experience of successful international microcredit programmes as well as these important adaptations.

A. The Art and Science of Effective Lending

Lending combines the science of obtaining and analysing the facts of a loan request and the art of making judgements about that information, the feasibility of the business, and the credibility of the borrower. Experienced lenders focus on the key business issues quickly, determine what information is needed, and then make prompt decisions based on that information. Developing sound credit judgement takes time and experience; development lending to small businesses "by the book" is difficult and rarely results in a quality loan portfolio.

This section sets out some basic principles for lending. However, it is the implementation of these principles by the right people that brings them alive and makes them work. Investment in people, management and leadership, and a systematic approach to risk are the key elements that allow micro and small business lenders to be effective.

The principles of effective lending presented below reflect the lessons that microlenders have learned through experience and the innovative approaches being used for small business lending in CEECs today. This does not include a marketing and outreach discussion because demand is assumed to exist if a programme offers the right products and services. The use of technical assistance in loan screening and borrower evaluation is discussed below under the Role of Technical Assistance.

- **Know your Borrower**:

  Understand your market niche and the types of people, and characteristics needed to succeed in the local environment. The best entrepreneurs may be stubborn, without formal education, and blithely unaware of any personal weaknesses, yet they may have the street smarts, resourcefulness, and ability to do one thing well to be successful entrepreneurs. Be aware of their strengths, limitations, and weaknesses, and why you like or dislike them (be careful of borrowers you like because they are similar to you). In other words, lend to the person, not to the idea. Personal commitment to repay is the strongest bond between a microlender and its customers. In the United States, microcredit programmes have used small first-time loans and pre-credit training or technical assistance to learn their borrowers potential strengths and weaknesses. Lending in transitional or uncertain environments requires lenders to develop a personal relationship with individual borrowers and the community within which the borrower is doing business.

- **Structure Loans to Minimise Risk:**

  Successful microlenders provide minimal credit amounts at first and then increase the subsequent loan size once a borrower has demonstrated his or her ability and commitment to repay. These "stepping loans" minimise risk to the borrower (particularly start-ups or early stage expansions) and to the lender. In addition to "stepping loans", other methods for reducing risk to the lender include:

- **It is Hard to Fix a Poor Underwriting Decision:**

  If staff misjudged either the business or the borrower, it is difficult to fix the problem once the loan is made. Loan restructuring and collections take significant staff time and reduce the time available for other borrowers. Careful evaluation of the business viability and borrower character are essential to microlending unless the organisation can rely on (a) collateral, (b) cross-guarantees within a group of borrowers, or (c) social pressure networks. While alternatives to traditional collateral have worked well in certain developing countries, they have worked less well in the individual-oriented culture of the United States. When it comes time to collect, "collateral melts like ice cream in the summer sun."[62] Therefore, prudent judgements of business viability and borrower character are essential.

- **Pay Attention to the Details:**

  Lending is a business of details. Careful information gathering and analysis, loan documentation (as streamlined a possible) and rapid follow-up on any discrepancies all require a focus on details. Although many microcredit programmes learned this the hard way, the most successful programmes now are meticulous in their loan procedures and prompt in their follow-up if any payments or reporting requirements are past due. Collect aggressively to establish market credibility and minimise loan losses.

- **Streamline loan administration systems, but stay in close touch with the borrower.**

  Most of the microlending programmes in operation in CEECs are using direct loans to individual businesses in a manner similar to traditional banking. The key is to stay in close touch with the borrower by (a) requiring frequent payments at the local office and (b) making periodic site visits. A missed payment or disarray at the place of business are immediate signs of trouble. Lending staff must monitor loans for changing economic or market conditions and spot early signs of potential trouble.

- **Charge "market" interest rates:**

  Access to credit is more important than its cost. Because access to credit can dramatically improve the income generation of a microbusiness, most entrepreneurs are less cost-sensitive and more access-driven. Most microcredit organisations charge fees and interest rates that are higher than the conventional finance system and lower than informal moneylenders. Additional margin on each loan has a relatively small impact on the borrower (given the small loan amounts and increased income generation) and a huge impact on the programme's prospects for self-sufficiency.

- **Be driven by the deal, not charity:**

  Despite their development mission, lenders must evaluate each deal on its business merits and the capacity and character of the borrower. Experience gives lenders the ability to recognise those deals that do not make sense and those that might if they were structured differently. If an existing loan suddenly looks precarious, take action swiftly with clear intentions rather than allowing non-payment or problems to continue.

- **Collect hard and fast:**

  Consistent and disciplined loan collection reinforces the business relationship between the lender and borrower, and sends a strong message that delinquency will not be tolerated. Never bluff: do not use the threat of collection actions unless you are prepared to take them.

  The key lending principles from international microcredit institutions serving the very poor have been to streamline the loan approval and delivery systems, rely on personal character rather than an analysis of the underlying business, and standardise products and delivery mechanisms to reduce administrative costs. In addition, they have demonstrated that subsidised credit benefits neither the borrower nor the institution in the long run. Within CEECs, however, existing programmes appear to combine the efficiencies of microcredit delivery with the more rigorous assessment of borrower and business that has been used in the United States. Programmes like the Enterprise Credit Corporation in Poland and Opportunity International in Bulgaria and Russia have adapted these development lending principles to serve microbusinesses in these emergent markets with great success. ECC, for example, has drawn on the strengths of both micro and small business lending approaches. Similar to large microcredit organisations, loan products are relatively standard, loans are disbursed near the borrowers (in rural and urban areas), and lenders focus greatly on the capacity and commitment of management. In addition, however, the ECC loan application pushes borrowers to identify their markets, their competition, and their projected cash flows and requires thorough loan write-ups by staff.

- **Loan Assessment and Credit Analysis**

  There is no formula for determining creditworthiness. The loan officer must assemble and evaluate information and then determine what the entire picture looks like. Traditional bank lenders refer to the "Four Cs" of lending: Credit, Capacity, Collateral, and Character. Development lending uses the same rigorous credit assessment principles, but applies them to situations in which the lender must rely on borrower character and cash flow from the business. The loan application and the first meeting with the borrower are the first screen of whether a business is a potential candidate for microcredit. Beginning with the first meeting, the lender must evaluate the quality of the business deal, the fit with the borrower's experience and capacity, and whether the financing amount and structure is appropriate.[63]

For Richard Turner, former manager of ECC and an experienced commercial lender, believes that lenders should focus on three conceptual questions:[64]

- **Deal:** Is this a good business opportunity? Does it make sense and is it financially viable?

- **Fit:** Is this the right borrower for this opportunity? Does he or she have the management experience, skills, or personality for this opportunity?

- **Financing**: What is the most appropriate financing for this transaction? Or, is the proposed financing right?

Evaluation of the deal is the analysis the facts and assumptions about the business itself. The second question balances the challenges of the deal with the abilities of the borrower. A quiet couple with minimal business experience but strong common sense, for example, may not be the right borrowers for a start-up business that will require strong sales and marketing skills. Finally, lenders must determine whether the venture is better suited to short-term debt financing or longer-term financing that places less drain on the company's cash flow. In addition, nearly all borrowers think they need more money than they actually do, so a careful evaluation of the business's financing needs is important. No one benefits from a credit review process that is not rigorous.

As part of his or her evaluation of the proposed loan, a lender should take the following four steps:

Step 1: Analysing the Deal:

Analysis of business feasibility and risks includes both a review of the client's operations or action plan and an assessment of the market conditions to support the proposed venture. The loan application should push the applicant to identify the key elements of the venture: what products and services will be offered; who will buy the product (or service) and why; how the product will be produced, priced, sold; how much cash will be required for production; and the amount of revenue and profit that sales will generate.

Based on our observations, a loan approval system that requires staff to prepare a written summary of the proposal ensures that the right business issues are considered and that the business assessment is rigorous. A sample outline of a loan write-up is shown on the following page. A good loan write-up should be brief but focus on the following elements:

- **Management:** who they are, their experience, whether they had help in preparing the business plan, and their credit history, if possible;

- **Reference checks** on the company with its customers and suppliers;

- **Organisational structure** of the company and of the project to be financed;

- **Products, services and place of business**, including a description of products and services and a site visit to determine the location, its assets, and claims already existing on those business assets;

- **Market analysis:** focus on customers, competition, the viability of the market niche, and the firm's competitive advantage;

- **Cash flow projections**: What are the projected monthly sales and are they realistic? How will they be achieved? What are the monthly cash expenses of the business, and how much does that leave for owner's draw on equity in the business? Is cash flow sufficient to finance the debt?

- **Key ratios**: The Debt to equity ratio reflects the personal investment by the borrower relative to debt financing. Most programmes want to see 20-30 per cent equity to ensure borrower commitment, but may be flexible on whether the equity is cash or labour by the owner.

  The historical debt service coverage ratio measures cash flow divided by the cash required to meet fixed commitments, such as debt service. A ratio of slightly more than one suggests that loan payments will take almost all of the business's disposable income; a higher coverage ratio (e.g. 1.5 to 1) means the business has more cushion to cover its fixed obligations.

Step 2: Assessing borrower character:

Microlending is a combination of character lending and rigorous assessment of business viability. In character lending, staff weigh several factors to evaluate the strengths and weaknesses of potential borrowers. These include their depth of personal commitment to the business; energy level and resourcefulness; breadth of management and entrepreneurial skills (including production experience, marketing and sales savvy, and financial discipline); shortcomings and weaknesses, willingness to listen to advice or guidance, their understanding of their business, and their demonstrated commitment to other responsibilities (such as family or marriage).

Step 3: Identifying key risk and success factors for the business:

For this particular business, what are the key risk factors for success? For a new retail business, it might be marketing and sales skills. For a production company, it might be methodical and budget-minded management of expenses. Does the market need to expand for this business to succeed, and is that a reasonable assumption? These factors are part of the consideration or fit between the deal and this particular borrower.

Step 4: Addressing challenges in emerging market economies:

Based on the experience of several lenders, there are unique challenges to lending in this context:

- **Evaluating Management:**

  How can management be evaluated when it previously operated under a state-controlled economy or has no direct management experience? Commitment to long-term obligations (employment, marriage, church) is one indicator of commitment. Management skills need to be assessed based on performance to date in production, pricing, selling, and overall management of the business. For start-up, intuitive understanding of the business and ability to relate with customers might be other indicators. A key concern is whether management will be able to handle higher levels of production, pricing, and sales in an expansion?

- **Assessing Market Depth:**

  How does a lender evaluate sales potential in a rapidly changing market? Is it likely that other competitors will emerge and erode the company's market? How will it maintain its competitive advantage? Because of the rapid changes and rate of new business formation, testing the entrepreneur's assumptions about the market and industry is as important as analysing cash flow from past operations.

- **Importance of Cash Flow:**

  Western accounting standards are relatively new in transition economies and the previous system focused more on the production of goods, rather than on conversion of inventory into sales and profits. As noted above, the impact of increased sales on cash flow is a key measure of the business's prospects and repayment ability.

Each microcredit programme finds the right balance of character assessment and business evaluation to allow the programme to serve its target market effectively. Programmes in the CEEC and NIS context will find that balance through experience. They must maintain rigorous lending principles and invest in quality staff to ensure the ongoing viability of the microcredit programme.

Table 5: Four Key Areas of Credit Analysis for Small Business and Microlenders

Cash Flow:	Do sales translate to cash or profit on the bottom line? What cash flow must be reinvested in the business's working capital or debt service and how much is "free cash flow" that is not relied on for a key business function?
Sales:	Sales are a key indicator for micro and small businesses because they are an early indicator of potential growth or decline of market demand. What is the market strength and depth? Who are the customers and why do they buy? (necessary item or a luxury good passed up when the budget gets tight? Who is the competition? Is pricing accurate and are margins narrowing, stable, or widening?
Inventory & Receivables:	For retail or manufacturing (and sometimes service companies), inventory levels are another key indicator of the health and risk factors of the business. If inventory levels are growing, the business is using up a lot of cash to finance its operations. Are receivables collected in a timely way? What is a reasonable cost of doing business? Are either managed well? Many entrepreneurs in CEECs focus on production rather than on sales to customers.
Management:	What is the personality and long-term commitment of management? Is he or she able to handle an expansion of the business? What is the breadth of his or her skills (production experience, sales and marketing savvy, financial discipline)? What are his or her shortcomings and are those recognised? How willing is he or she to accept advice and guidance?

To minimise transaction costs and prudently limit lending exposure early in a borrower relationship, most microcredit programmes have adopted highly structured loans and disbursement mechanisms to avoid unnecessary pitfalls in lending. These commonly used mechanisms to minimise lending risk include:

- **Relatively uniform short-term working capital loans and small asset financing loans:**

  Short-term loans (less than three years in term) can be repaid through the cash flow of the microenterprise. A standardised and routine loan product that can be assessed, closed, monitored, and collected in the same way every time is one strategy for making small loans more cost-effective.

- **Staged financial commitments or "stepping loans":**

  The use of stepping loans is a standard technique to both limit risk to the lender and ensure that the target customers are being reached with small loans. Stepping loans start with a small loan amount to a new borrower as a test of the relationship, the borrower's commitment, and the borrower's repayment ability. Once that small loan has been repaid, the borrower is eligible for larger loans, thus providing an incentive to the borrower to repay and reducing the credit exposure by the lender. Many US programmes provide a first loan of only US$500, with subsequent loans of up to $1 000, $3 000 and $5 000. This practice minimises risk to the lender, yet provides meaningful credit to borrowers relatively quickly.

  Stepping loans also impose a loan "ceiling" on early stage loans and thereby ensures that the smallest loan customers are being served. This avoids the problem of "creeping upward averages" discussed in Chapter 3.

- **Collateral:**

  A borrower’s willingness to provide collateral indicates his or her commitment to repay and underscores the seriousness of the business relationship. Although developing country programmes cite the use of group cross-guarantees and peer pressure as substitutes for collateral, almost all programmes require the pledge of any assets available as an indication of the borrower’s psychological commitment. The value of the collateral is usually far less than the value of the loan. This distinguishes development from conventional bank lenders. The Enterprise Credit Corporation in Poland always takes collateral for the same reason, despite the realistic obstacles that make foreclosure through the civil courts unlikely.

- **Personal Guarantees:**

  Like collateral, securing personal guarantees for the borrower is another means of screening out those entrepreneurs who are not committed fully to the success of their venture or to repayment of the loan.

- **Financial Incentives:**

  Bank Rikyat Indonesia and Project Micro in Arizona, for example, both discourages tardy loan payments by levying financial penalties or late payment fees that are quite substantial. These fees accounted for a significant percentage of programme income. These can be structured as late payment charges or as an “instant rebate” on loan payments received on time (with the total loan payments based on a certain delinquency assumption).

- **Disbursements and Use of Proceeds:**

  Most microlenders are careful to ensure that loan proceeds are used only for their intended purposes. Payments for purchasing equipment or assets are often made directly to suppliers, and lenders often require the borrower to draw funds according to their planned purchasing needs. As noted in Chapter 3, the Enterprise Credit Corporation disburses funds directly to suppliers, rather than to the borrower. The Agriculture Foundation requires that only 80 per cent of the funds can be drawn initially until the project has been completed according to plan, at which time the final 20 per cent can be drawn.

The loan approval process

The loan approval process has three components:

- The loan application;
- An interview and site visit with the applicant by the loan office; and
- Request to the Loan Committee.

This process is often less formal for poverty alleviation programmes providing standardised, small amounts of credit to peer groups and more formal for microcredit programmes lending to individuals and businesses (often larger loans). The Loan Committee can approve, ask for clarification, or deny the loan request. The function of the loan committee is to review loan applications objectively and seek to balance development mission with risk management.

For most microcredit programmes, the loan approval process should provide a relatively fast response to applicants. Microentrepreneurs do not want to wait for credit and the programme should be thorough yet prompt in meeting customer needs. Secondly, borrowers appreciate a quick turndown with clear, constructive criticism far more than a lengthy review process and a decline.

The loan application is the first screening of prospective clients. The objectives of the application are twofold: (1) dissuade those potential entrepreneurs who have not yet fully developed their business ideas or plans and to limit the time that staff must spend with not "entrepreneurially ready" customers; and (2) to encourage those potential entrepreneurs who are ready to commit to self-employment and need to more fully understand the costs, revenues, and cash flows associated with their business plans. The loan application includes different requirements, depending on the type of customer the programme is trying to reach. A requirement for cash flow projections and a description of customers and competition may be appropriate for a microcredit programme targeting existing businesses with experience. However, the same loan application would intimidate first-time entrepreneurs who need more assistance in preparing to receive credit, depressing loan demand from the very beginning. Applications that are easy to read and understand are of course less intimidating.

Loan applications are designed to meet programme objectives: to screen or encourage clients by pushing them for details on their business and credit needs. For self-employment ventures, the loan application may be a short three pages; for existing businesses seeking business expansion loans, the application may be 10 -- 15 pages.

Most loan applications require cash flow forecasts that show assumptions for revenues and costs (based on historical), projected sales and costs based on the expansion plan, and the break-even point of sales. To be sure that the entrepreneur has a good understanding of the fundamentals of the business and the sales volume required to break-even, many programmes assist applicants in completing the application fully (and thereby learn more about the borrower's strengths).

Many loan applications reflect the key elements of a business plan to identify the borrower's strengths and weaknesses. Part of the upfront technical assistance provided by programme staff is to assist prospective borrowers in completing the loan application. More sophisticated borrowers may submit a separate business plan, but the application can serve the same purpose.

In the transitional economy context, market information can be difficult to assess and past financials can be misleading. Staff need to ask specific questions to evaluate (a) whether the entrepreneur really knows the key elements of his or her business plan, and (b) whether the business assumptions are valid and the venture is viable. Examples of testing those assumptions include:

- To assess potential market demand or the attractiveness of a particular location, a retail business entrepreneur might (a) count the pedestrian traffic in that and alternative locations, and (b) count the number of competing establishments within a certain radius.

- To check the reasonableness of revenue forecasts, lenders often push entrepreneurs to translate their projections into a daily or hourly target to better assess its feasibility (for example, a revenue target might translate into selling 50 items per hour per day -- is this reasonable?)

- To assess the underlying business viability, lenders should determine the competitive advantage of this particular business. Advantages of physical location can be quickly lost if new competition arrives. Advantages based on elimination of a middle man to reduce costs, image marketing, or technology are more sustainable.

- To understand actual historical financial performance, the loan officer must push to understand the real financial performance of the business. Are profits kept artificially low to avoid taxes? How much does the owner draw as salary?

- To assess management's technical knowledge or business acumen, loan officers might discuss potential problems and evaluate the borrower's responses.

- To determine the monthly loan payments that cash flow can support (for determining the term of the loan), staff must untangle business expenses from personal owner's draws and tax liability management activities and determine whether additional debt obligations exist.

SAMPLE LOAN APPLICATION	
1. Applicant Information	• Who they are • Where they live • Basic information about the business • Legal structure (corporation, partnership, proprietorship)
2. Business Description	• Products or services • How they are produced (operations) • Management and ownership interests • Assets and liabilities
3. Purpose of Loan	• Purpose and amount of loan request • Specific purchases and costs
4. Market and Customers	• Who buys and why? • Competition • Market depth and risks • How will customers be reached? • How are products priced, and why? • Who performs what functions? • Projected sales or revenues per month
5. Cash Flow Forecast	• Assumptions for revenues • Assumptions for operating costs • Break-even sales volume • 12 month forecast by month
6. Financial Statements	• Personal financial statements of owners • Collateral sources

Site visits are an essential part of small business lending in western economies, and are equally important within the CEEC and NIS contexts. A site visit allows the loan officer to assess the physical ability of the borrower to produce or deliver a service, provides an impression of organisation and management skills, and allows verification of collateral and assets.

Once the loan application and assessment are completed, programme staff submit the request to loan committee (in either written or verbal form). The experience of several successful micro and small business lending organisations suggests the following observations:

- **Loan Committee members may be Board members, volunteers, or staff (or a mix), but they should make a long term commitment.**

  Outside members should be chosen carefully based on their belief in the programme's goals, their experience with small business lending or management, and their willingness to make a time commitment to the organisation. Loan Committees might also comprise only three people, as long as they are individuals with strong experience, credit judgement, and an understanding of the customers and context. Staff tend to be more consistently business-like than a Board of Directors or volunteers, and have more experience with customers.

- **Although a Loan Committee should have a range of opinions and experiences among its members, they should share a cohesive view of the programme's core business.**

  Building that cohesion takes time and investment. Loan committees should meet frequently to build a consensus view of their role and gain experience with their customer base businesses.

  In its early years, for example, the Enterprise Credit Corporation convened loan committees in each "windows" location that comprised the senior credit officer (who travelled from Warsaw), the ECC loan officer, and the local banker recommending the loan. The only consistent link was the senior credit officer, but the structure allowed them to cover a broad geographic area. Loan applications were reviewed each Monday and decisions relayed to borrowers that week.[65]

- **Among existing CEEC programmes, most loan committees appear to comprise of internal staff because outsiders bring little expertise in small business lending**.

  Among international development programmes and the early years of American microcredit programmes, few bankers understood this market or its distinctions from traditional bank lending customers. Similarly, microcredit lenders have the most knowledge and experience in CEECs. Some bankers cannot "unlearn" or recalibrate their own lending criteria; some do not take this type of lending seriously. In recent years, however, more US programmes report success with conventional bankers on their boards and loan committees. In part, this is due to (a) microcredit programme can better articulate their goals and objectives, and (b) microcredit finance is now perceived to be a more legitimate and complementary strategy to conventional lending.

  In CEECs, existing programmes typically rely on loan committees of internal staff and no outsiders because few have experience in small business lending.

- **A peer group lending programme's approval process must strike a balance between staff responsibility to husband resources and the need for collective responsibility within the borrowing groups.**

  Among peer group lending programmes in the United States, the credit decision hierarchy ranges from fully vesting the borrowing groups with approval authority to balancing that responsibility between the borrowing group and a staff Loan Committee. The goal is for the borrowing groups to assume responsibility for the group's obligations and appraise each loan vigorously. Without a vested interest and some control over lending decisions, members have less incentive to stay committed to the group, defeating the underlying premise of the group lending approach.

For example, the Rural Enterprise Assistance Programme (REAP) in the United States requires that the loan committee members of local Association (a group of up to 15 members) recommend the loan and personally fill out a loan evaluation form. These are then forwarded to a three-person, second loan committee that is comprised of the local Association chairperson, the REAP credit officer (who travels from town to town), and a local business person or banker.[66] This two-tiered loan committee structure ensures local scrutiny and endorsement of the loan while preserving programme staff's ability to exercise quality control.

As noted earlier, microcredit programmes have found their customers to be less sensitive to interest rates charged on loans because (1) the marginal increase in cost is minimal on such small loans, and (2) the benefits of access to credit outweigh the cost. At its simplest, interest is the cost of renting money to invest in another activity. It includes a base rate to compensate the lender for losing use of the funds and a risk premium that varies with the riskiness of the investment activity. Higher risk investments (or loans) should charge a higher risk premium and therefore higher interest rate. The experience of many experienced microlenders yields the following observations:

- **"Market pricing" is an effective screening device and does not inhibit demand:**

  Market pricing is based on the comparable interest rates in the economy and the relative risk of microlending. Most programmes price loans above the rates of formal financial institutions to reflect the higher risk of microbusinesses and no or partial collateral. Pricing that is higher than other alternatives is a very effective screening device. Any applicants who have the ability to access other sources (such as bank loans or credit programmes for the SME sector) will do so to avoid the microloan programme's higher cost. In both developing countries and North America, unsubsidised interest rates do not appear to inhibit demand as long as the products meet an existing demand.

- **Effective interest rates reflect the total financial costs of a loan to the borrower (interest and fees):**

  Lenders earn income from both interest on loans and fees paid by the borrower. Many programmes have instituted loan application fees, membership fees (in exchange for a newsletter, for example), or late payment penalties to boost their income. For an average loan, therefore, the total revenue to the programme is the sum of annual interest income plus annual fee income. To compare different cost structures, programmes can calculate an effective interest rate:

$$\textbf{Effective interest rate} = \frac{\textbf{Interest + fees}}{\textbf{Total principal of the loan}}$$

- From the programme's perspective, the combination of interest and fee income generates the total yield on the loan portfolio:

$$\textbf{Total Yield} = \frac{\textbf{Interest income + fee income}}{\textbf{Average loans outstanding in Portfolio}}$$

Clearly, a lending programme can increase the yield on the portfolio (or increase the effective interest rate) by charging fees as well as interest.

- Real vs. nominal interest rates:

- Nominal interest rates are the quoted interest rates on government bonds and bank loans. They include a base "risk-free" rate, a risk premium (this is zero for government bonds, for example), and an inflation premium to reflect expectations about inflation. Real interest rates are the underlying rates, with the inflation premium subtracted out. To avoid devaluation of the loan fund's capital, a lender needs to charge interest at a rate that includes both the real interest rate and the inflation rate. For example, if a programme charges an annual interest rate of 20 per cent but inflation is 18 per cent, the real interest rate on the loan is only 2 per cent.

- Methods of calculating interest payments -- flat rate vs. declining balance:

- Interest payments can be calculated in several ways. Each results in a different effective rate paid by the borrower and a different mechanism by the lender. Flat rate interest assumes a series of equal monthly payments based on the initial loan amount. Those payments are derived by multiplying the total principal of the loan by the interest rate. A monthly interest rate of 2 per cent on a 3-month loan for $100 would create a monthly interest payment of $2.00 (to be added to the amount or principal paid each month). This method is the easiest for the lender to calculate, sets equal payments for the borrower, and generates an higher effective rate because it assumes that the full $100 is outstanding for each period. The effective rate is 2.97 per cent compared to a stated rate of 2.00 per cent.

- Interest based on a declining, or amortising, loan balance calculates interest each month based on the outstanding loan amount. Interest in Month 1 is 2 per cent multiplied by $100, or $2.00. Interest for the second month is 2 per cent multiplied by the outstanding loan balance of $67.32 ($100 minus the first principal payment), or $1.35. Therefore, the effective interest rate is much closer to the 2 per cent nominal interest rate.[67]

Effective lenders monitor their loan portfolio closely to spot declining loan quality or to help a borrower address a potential problem before it threatens his or her ability to repay the loan. Since few microbusinesses produce regular financial statements, the best monitoring systems for microcredit lenders combine:

a) Frequent (biweekly or monthly) payments on the loan;

b) Monthly updates on sales and cash flow relative to budget (often reported at regular meetings with groups of borrowers to streamline staff time);

c) Periodic site visits to ensure that the business is operating satisfactorily.

Although microcredit programmes serving the poorest and smallest entrepreneurs in developing countries rely solely on frequent payment as an indicator of borrower liquidity, programmes in the US have increasingly required tracking of sales and cash flow as key monthly indicators for very small businesses. If one of these indicators dips or if there is a cash shortage in the business, lenders should probe more deeply to assess the extent of the problem and how to respond. The table on the next page shares some of the loan monitoring questions a loan officer might ask if a loan becomes delinquent and needs investigation. (See table on the following page)

Table 6: Sample Loan Monitoring (Questions for Lenders)[68]

1. Has the market changed since the loan was made?	• In what manner and why? (increased local competition, foreign imports reducing margins, changes in consumer preference, technology changes, government regulation).
2. Do the client's products still meet the needs of the market?	• Why or why not? • Has the product or service changed? • Is it more difficult or expensive to make? • Does the company have the expertise to do it?
3. Have the economics of the business changed?	• Have the prices changed or supplier costs increased? • What are the borrower's prices relative to the competition? • Have the suppliers changed?
4. Has the management or ownership changed?	• Has the division of management or owner responsibilities changed since the loan was closed? • Does the same person manage production? • Monitor and collect receivables? • Are there any obvious changes in the owner's manner of living (suggesting increased wealth or cash from the business?). • Has the owner/operator had personal difficulties that have affected the business?
5. What are the financial trends for the past 3-6 months?	• Monthly sales and cash flow figures, inventory levels, and cost of goods sold? • What is happening to gross and net margins?[69] • How does actual performance vary from projected? • What are the revised forecasts for sales, costs, and cash flow? • Are these reasonable based on the current environment? • Has the borrower borrowed any additional money and, if so, on what terms? • Has the owner put additional money into the business or sold interest to anyone else?

These questions help the lender determine whether the microentrepreneur is having temporary difficulties and will continue steady repayment or if there is a significant change in the viability of the business that requires close attention. Microbusinesses have a small cash cushion to absorb business shocks or changes, so lenders must judicially evaluate the seriousness of the problems and the risk to loan repayment. If the business has fundamentally changed, the terms of loan repayment may need to be extended to allow continued debt service. However, the borrower should continue to make regular payments on the loan in all circumstances.

Loan Collections

Loan collections directly determine a lender's survival. When customers perceive collection efforts to be weak or half-hearted, delinquency and default rates increase dramatically. To minimise losses, strong loan collection and workouts of bad loans are just as important as loan originations. For microlenders, this means collecting hard and collecting quickly to (a) reinforce the seriousness of the business relationship with the borrower and (b) staunch any spread of slow loan repayment to other borrowers. Several principles apply:

- **Missed payments should trigger an immediate response to alert the borrower that you are aware of the situation:**

  To stop delinquency immediately, staff must act quickly on missed payments. PRODEM, an ACCION International affiliate in Bolivia, appears on the debtor's doorstep the next day, often attired in a policeman's uniform to ensure his or her prompt attention.[70] BRAC goes to the borrower's home that day.[71] Most US programmes make telephone or letter contact within 10 days. Microlenders who make larger loans may wait a few days before declaring the loan delinquent.

- **Loan officers should maintain responsibility for loans from originations through collection:**

  This creates the incentive for loan officers and staff to spot potential problems early and avoid time-consuming "workouts" with problem borrowers. The executive director may step in to play the "enforcer" role at a later stage in the workout.

- **A clearly defined collections policy ensures consistency:**

  This limits the need for subjective judgement calls by the loan officer and sends a strong message to the borrowers about the consequences of delinquency. Strong collection has been a cornerstone of establishing borrower discipline at all successful microcredit institutions.

- **Know when to collect aggressively and when to be supportive:**

  When a business has problems, most borrowers go through two phases: denial, then panic. When they are in the denial stage, staff must collect aggressively (constant visits, written notices) to force them to recognise the problem and react. Once they realise the situation, they will panic. At this stage, lenders should be supportive to ensure continued borrower co-operation, but firm about what the programme can or cannot do. If a borrower becomes uncooperative and refuses to work with the lender to resolve the situation, the programme make take steps to foreclose on collateral.

- **In a workout, never make empty threats or bluff:**

  Although you can warn of the programme's need to "take action" if the situation is not resolved, do not be specific until you are ready to move quickly to foreclose on collateral.

Credit management systems to track delinquency are discussed later in Chapter 5.

B. The Role of Technical Assistance

As noted earlier, "technical assistance" is the umbrella term that describes both business management assistance and personal and other support services provided to microentrepreneurs. Nearly all microcredit programmes deliver credit with some amount of technical assistance. The nature and extent of technical assistance provided is determined by the operating context of the programme and the needs of the intended customer base. In developing countries, for example, the business assistance component is usually minimal. Other support services may include mandatory savings contributions, pre-credit orientation, or attendance at weekly meetings to instil repayment discipline. In North America, business assistance tends to be a more structured component of microlending because of the more complex business environment. Additional programme services may include savings programmes, assistance in receiving waivers from public assistance regulations, or child care assistance.

Technical assistance is widely believed to be integral to effective microlending because it (1) improves the likelihood of business success or (2) increases the probability of repayment by the borrower. There is limited evidence, however, that formal training and individual technical assistance that is not directly linked to the provision of credit achieves either of these objectives. As noted in Chapter 1, technical assistance is also an expensive component of microcredit and is one of the factors affecting financial viability. Therefore, microcredit programmes should evaluate and design the technical assistance component of their programmes carefully.

Based on observations of many successful lending programmes, the most effective technical assistance appears to be:

- Immediately relevant and valuable to the entrepreneur to address the issues faced by his or her microbusiness;

- Combined with the "carrot" of access to credit or with monitoring of an existing loan; and

- Co-ordinated with access to a peer support network to learn from those facing similar business issues and to find resources or mentors among those peers; and

How The Need for Technical Assistance Varies

Given these parameters, the specific nature of the technical assistance provided by a microcredit programme will vary based on three factors: the operating context and the presence of other technical assistance resources, the mission and goals of the programme, and the experience and skill level of the intended customers. Context affects the role of technical assistance in programme design by the availability of other resources and the nature of obstacles faced by entrepreneurs. Programmes near existing resources for general business planning assistance may direct prospective borrowers to those organisations to help them prepare a business plan or to receive specific assistance on the benefits of informal or legal incorporation, or on tax management. These programmes may focus on providing technical assistance only to existing borrowers through loan monitoring and problem-solving. Programmes in more isolated areas may need to provide more extensive general business assistance to potential borrowers. In addition, programmes operating in a context which has high barriers to entry for microenterprises and many obstacles will usually invest in more technical assistance for its customers.

Second, the development goals of the organisation also determine the importance and role of technical assistance within the programme. Transitional microlending programmes that support the transformation of microbusinesses into small businesses must provide more specialised and client-specific business assistance than a programme encouraging enterprise formation. Most microenterprises are simple organisations that produce one or two products based on traditional technology. Newly formed or early-stage microentrepreneurs usually need business planning assistance, including basic cash flow forecasting, marketing, and pricing. Transformation into a larger small enterprise involves:[72]

- Changes in the means of production and increases in productivity;
- Increases in sales and income sufficient to support the addition of new employees;
- Changes in the relationship between the business owner and employees;
- Increases in cash flow and assets; and
- Usually an increase in specialisation due to changes in supplier or customer patterns.

Microcredit programmes with this goal need to help entrepreneurs manage these changes in the operation of the business. Individual loan officers must be able to help entrepreneurs address the following types of issues:[73]

- **Personnel:** As the enterprise expands the number of employees, often extending beyond family members, labour management and training become concerns of the business owner.
- **Marketing:** Expanding businesses may need to expand from local community markets and encounter increased competition.
- **Technology:** New and larger markets often require higher production volume and improved quality standards to maintain a competitive advantage. To meet these requirements, microbusinesses often need to upgrade their technology or rethink their production processes.
- **Suppliers:** Increased production may create a need to expand the number of suppliers, to reduce dependence on a single supplier, or the opportunity to negotiate a longer-term relationship in exchange for lower costs.
- **Cash management:** The increased scale activity increases raw material and labour expenses and working capital investment, therefore increasing the need for careful cash flow management to avoid liquidity problems. Microbusinesses must be able to keep clear records and separate business versus household transactions.

Third, the experience and skill level of the target customers is a large factor in the design of technical assistance. Microcredit programmes targeting the unemployed and least entrepreneurial customers will need to incorporate confidence building and basic business training into the delivery of credit. Many programmes use group lending models to provide that peer support and encouragement for first-time entrepreneurs. Programmes targeting more experienced and "credit-ready" entrepreneurs may provide minimal business assistance. Microcredit programmes targeting populations with a strong entrepreneurial culture can rely more on local role models and provide less personal support and business assistance. One of the strengths of the transition economies is the general education level of the population. While many people have little experience with private business management or competitive markets, they can learn quickly and most will need minimal basic training before receiving credit. The greater need may be for ongoing technical assistance to borrowers through loan monitoring and help on specialised topics or sectors.

Delivering Technical Assistance Effectively

Drawing from the experience of micro and small business lenders, important lessons for the effective delivery of technical assistance include:[74]

- **Specialised and focused business advice provides greater value to borrowers than "generalist" business assistance.**

  Although "generalist" business planning is usually the most readily available form of technical assistance, microentrepreneurs who run going concerns or who have just received a loan are more focused on the particular operating challenges faced by their businesses. Regardless of the maturity of the business or the experience of the microentrepreneur, the most important areas of technical assistance are:

  Management Skills. Most entrepreneurs prefer to focus on production or sales rather than on overall financial management of the firm. Few small businesses have the internal financial reporting or monitoring systems to provide business information of sufficient frequency, quality, and understandability to inform the entrepreneur's decision-making. Microentrepreneurs need reliable financial information to maintain adequate profit margins, positive cash flow, and anticipate fluctuations or changes in markets or competition. Management assistance by programme staff might include frequent inquiries about key financial measures (such as monthly sales, cash flow, and operating expenses), watching trends in key ratios for that particular business, and comparing forecasts with actual levels. For more sophisticated microenterprises, this can develop into a management "coaching" relationship to help address complex and interactive business issues that arise during business expansion.

  Product Development and Marketing Assistance. To grow their businesses and generate cash flow, microenterprises must access markets and position their products and services to meet existing demand. Connecting microentrepreneurs to markets is important for both rural and urban microlenders, as the success of a microbusiness depends on its ability to generate sales. As microenterprises increase their sales or markets, they may need to face increased competition, improve quality or customer service, and develop a distribution system.

  Access to Information and Support Networks. Very small firms lack the staff and "sensing mechanisms" of larger firms and are therefore often limited in their knowledge of market, production, and management information. Microcredit organisations can link microentrepreneurs to each other, provide access to market information in certain sectors, and encourage peer support by developing or co-ordinating with local business associations. With this catalyst, entrepreneurs can share experiences and approaches to common management or operational problems, and create a collective market intelligence about trends affecting the business environment and changing competitive forces. As one business assistance provider in the United States stated, "the best technical assistance reduces the loneliness and isolation of the entrepreneur."[75]

Specialised business assistance, whether provided by experienced lenders or technical experts, is particularly important for programmes seeking to encourage the transformation of microenterprises into larger businesses. Several experienced lenders in selected formerly centrally-planned economies cited the lack of management skills among small-scale entrepreneurs as the biggest obstacle to the emergence of a broad-based SME sector.

- **Frequent, but meaningful, contact builds the strongest relationships.**

Entrepreneurial behaviour changes over time, rather than overnight, and regular contact reinforces ideas, encourages the adoption of promising new strategies, and provides an opportunity to discuss decisions and alternatives. Much like the old-fashioned community banker, a good microlender builds personal trust and confidence with an entrepreneur, tempers enthusiasm with sound business advice, and provides financial guidance from a lender's perspective.

The Enterprise Credit Corporation in Poland, for example, conducts regular site visits to borrowers, in addition to receiving monthly loan payments in person. This provides frequent opportunities to ask questions of the borrower and assess whether the business is meeting expectations or experiencing difficulties. The frequency of site visits declines as a borrower establishes his or her loan payment and performance record, reflecting the reduced risk to ECC.[76]

- **Charging fees for business assistance leads to better quality services that contribute to the customer's profits.**

The "market test" of the quality and value of products or services is whether customers are willing to pay for them. Although the majority of technical assistance resources in CEECs and NIS countries are provided without charge, several charge entrepreneurs for their services to help cover their operating costs. Charging fees, maintains a market discipline within the programme to provide services which actually contribute to the businesses' bottom line. It also increases the perceived value of the business assistance in the eyes of customers and strengthens the programme's image as a business partner and resource. Charging fees generates additional income for the microcredit programme and increases its ability to cover its operating costs. Finally, it is the only safeguard on the prudent allocation of scarce subsidy resources. All customers will indiscriminately use "free" services; too many non-profit technical assistance providers fall into a "giving" behaviour which does not ensure the most effective allocation of scarce subsidy to those customers with the highest potential to generate public benefit (such as increased employment or an additional tax base).

It is more difficult for microcredit programmes that incorporate technical assistance into loan approval and loan monitoring to charge separate fees for this service. In North America, some programmes charge an application fee to help cover the upfront time investment with applicants. Others charge an annual membership fee to offset some of the costs of loan monitoring and routine site visits. Alternatively, a programmes can build the cost of technical assistance into the interest rate charged on loans. The customer, however, should be aware that he or she is paying for technical assistance services.

- **Sector-specific knowledge and advice can be highly valued by entrepreneurs and cost-effective for the programme to deliver.**

  As repeat borrowers become increasingly sophisticated, microcredit programmes can provide increasing value by developing expertise in particular business sectors or topics. Developing expertise in one or two sectors or in a particular service (such as accounting assistance) can help routinise systems and generate additional deal flow as emerging microbusinesses in the sector learn that the programme is a source of information and financing. If a programme has a high number of retail borrowers, for example, identifying useful cash flow management or inventory management tools can provide significant value to borrowers. Although sector-specific expertise requires investment of staff time, programmes can then apply that knowledge to multiple clients and leverage that investment effectively.

  The Women's Rural Enterprise Development programme of the Foundation for Polish Agriculture is developing a sector focus on the operation of bed & breakfast establishments to complement the Foundation's rural tourism promotion programme. The loan fund may play an important role in financing home improvements and working capital needs for individuals who complete the Foundation's training programme.[77]

- **By connecting microentrepreneurs to markets in both rural and urban environments, microlenders improve business viability and gain credibility with entrepreneurs.**

  Entrepreneurs tend to be most interested in increasing sales. Microcredit programmes can assist the growth in sales, and thereby income and number of employees, by helping microentrepreneurs:

  a) identify potential target markets;

  b) assess competition and market niche potential;

  c) match growth to production capabilities;

  d) design marketing strategies (product design, packaging, pricing, promotion);

  e) find distribution channels to reach intended consumers;

  f) build selling skills/marketing approaches.

  The methods used by microcredit programmes have included organising or connecting with a local business association to increase market information, assuming some of the responsibilities of a trade association in distributing information, and tapping international or national information publications or experts. Associations among firms in similar business sectors may be highly effective ways to bring market information into the product design and production phases by local firms and increase their ability to export to non-local markets. This trade-association-as-marketing-vehicle approach has been very successful for small firms in

Northern Italy and in the United States, for example. Some programmes in isolated rural areas have assumed the function of marketing channel for sector-specific businesses.[78]

- **Not surprisingly, the impact of technical assistance depends on both the coaching abilities of the provider and the willingness of the entrepreneur to listen.**

  The best technical assistance providers have the credibility and experience to add value to microentrepreneurs and the personal style to engage the entrepreneur. They help communicate with suppliers, connect entrepreneurs to marketing opportunities and contacts, and generally "put the entrepreneur in play" by asking questions that expand horizons, raise issues, and provoke response.

  The characteristics of a good technical assistance provider, and often of a good lender, include:

  a) Small business management experience that lends credence and relevance to their support of entrepreneurs;

  b) The ability to see possibilities, connect entrepreneurs to resources and opportunities, and identify issues and tasks to be accomplished;

  c) Strong interpersonal skills that build a relationship of trust with the entrepreneur and the ability to relate to the challenges faced by the customer;

  d) Coaching and communication skills to help build plans that entrepreneurs feel are their own.

  Technical assistance providers identify key issues, set the order of battle, and motivate the entrepreneur to tackle challenges.

Although conventional bank-style lending mixes the two, conventional wisdom among microenterprise experts is that technical assistance and credit should be delivered separately. There is significant evidence, however, that technical assistance which combines business guidance with control over the purse-strings has the most success in changing entrepreneurial behaviour. In that approach, loan officers help applicants prepare applications and provide post-loan business guidance as part of loan monitoring.

Based upon the evidence that small trade associations can be highly effective in delivering market information and peer support, and on the rapid emergence of local business clubs, local trade and business associations are an important vehicle for promoting the growth of micro and small enterprises in transition economies.

C. Credit and Portfolio Management

Careful management of the credit portfolio, including delinquency, is essential for financial institutions to reach self-sufficiency. Non-repayment of loans directly reduces the organisation's capital (as operating losses); delayed repayment affects programme earnings and staff efficiency. In recent years, microcredit institutions and programmes have begun to adopt western banking tools for portfolio management to meet their particular monitoring needs and management information needs. International and American funders have pushed micro finance organisations to develop standard definitions that are consistent with prudent credit management and that provide consistent and reliable information. This section discusses those adaptations, with considerable discussion of conventional western banking standards to explain the underlying logic and importance of these measures.

The most important tools in managing financial institutions are ratio analysis and trend reporting. Ratios compare the relative magnitude of certain variables and reflect the relationship between certain numbers. The ratio changes if the relationship changes, not if the two numbers change while maintaining their relative magnitudes. Managing a bank requires balancing and maintaining certain relationships between variables: between funding sources and loan assets, for example, or between net interest revenue and total costs. Ratios are a useful tool because they allow management to make relative comparisons among time periods (e.g. monthly trends) or among branches and offices. Trend reporting presents certain key ratios and variables in comparison to previous periods to highlight changes over time. Rather than tracking individual numbers, management can review the ratios and trends and decide where to focus management attention where any suspicious changes appear.

Delinquency refers to the measurement of those loans that are non-current, or past due, in meeting a principal or interest payment obligation. The ability to measure and evaluate delinquency is an increasingly urgent issue for microcredit programmes as they reach scale, plan for financial viability, and respond to funder concerns about cost-effectiveness. Delinquency measures are both a useful reporting benchmark by which to measure financial performance and a valuable management tool. Microcredit programmes can improve their credibility with funders, and their own knowledge about their lending operations, by taking the following steps:

- Adopt standard definitions of measurement that are consistent with banking practices;
- Apply those measures consistently to report accurate and reliable data; and
- Analyse delinquency patterns to identify weaknesses in programme design and to identify areas for improvement.

Defining delinquency is a sensitive issue among microenterprises lenders. North American microcredit organisations are acutely aware of the scrutiny given such measures by funders and wish to report the best possible numbers. The limited financial resources of microcredits target customers can result in missed or late payments that are then fully or partially "caught-up" at a later payment date, a characteristic that muddies the clear measurement of delinquency.

The most common portfolio measures and tools used by financial institutions are:

- **Delinquency Trend Report**, showing the percentage of the portfolio that has missed at least one payment and how that ratio has changes;
- **Default ratio** showing loans that have been charged off;
- **Reserve ratio**, showing the loan loss reserve as a percentage of principal loan amount outstanding;
- **Loan ageings report, showing the ageing of the non-current portion of the** portfolio.

In addition, financial institutions that have smaller numbers of loans (microloan programmes rather than institutions with millions of borrowers) use a Watch List to highlight troubled loans and ensure management attention. The culture of most financial institutions is to avoid surprises: staff should identify and call attention to potential problems early so action can be taken. Finally, several large microcredit institutions report a "recovery rate." This measures the cumulative amount of loan principal collected as a percentage of the amount disbursed since the programme's inception. Although this summary measure may be a general description of the programme since its inception, it is not a useful ratio for two reasons: (1) the cumulative figures are very large and mask smaller changes in repayment rates on the current portfolio; and (2) the historical performance since inception is not very relevant as a management tool.

Over the last five years, measures of delinquency and default rates have become more standardised among microcredit lenders. In general, however, few microenterprise programmes calculate delinquency according to standardised ratios that would allow comparisons across NGOs or with other financial institutions. Both practitioners and donors have focused almost exclusively on the number itself rather than the formula by which such number is calculated and how that number might change if the calculation were done differently. Delinquency and default information should (1) be more clearly defined if it is to be used for broader comparison and analysis, and (2) be evaluated based on the relative risk appetite of the lender.

Acceptable levels of loan losses vary widely due to differing risk parameters. For example, regulated commercial banks take on very little risk and tolerate minimal delinquency. Loan losses and charge-offs typically range from 0.5 per cent -- 1.5 per cent. In contrast, the loan loss rates for banks that specialise in credit card loans, which typically charge higher interest rates and take on higher risk, was much higher at 3 per cent -- 4 per cent. The loan loss rates for several experienced microcredit programmes in the US range from 3 per cent to 8 per cent.[79] Delinquency and loan loss rates vary among microcredit lenders depending on their target markets and objectives. The key is to maintain loan losses at a reasonable level.

In her ACCION International publication, *The Hidden Beast: Delinquency in Microcredit Programmes*, Katherine Stearns observes that two definitions of delinquency had been commonly used by both US and developing country microenterprise lenders.

Formula 1: $\dfrac{\text{Amount of interest and principal payments past due}}{\text{Total outstanding loans in portfolio}}$[80]

This ratio reflects only the actual payment amounts that are past due rather than the entire outstanding loan amount at risk of default.

Formula 2: $\dfrac{\text{Outstanding balance of loans with any payments past due}}{\text{Total outstanding loans in portfolio}}$[81]

Formula 2 is a much more conservative and accurate reflection of portfolio quality. It represents the percentage -- and the scale -- of the portfolio at risk, rather than representing only the payments outstanding. Furthermore, this formula matches banking convention. The example in Table B-2 below, illustrates the vastly divergent results that are indicated by these two different calculations.

The Impact of Delinquency Ratio Definitions[82]		
	Year 1	Year 2
Portfolio:	$302 707	$422 862
Amount Past Due:	$77 672	$109 944
Balance of Loans with Payments Past Due:	$263 355	$131 087
% Delinquent Using Formula 1	26%	26%
% Delinquent Using Formula 2	87%	31%

Banking convention classifies a loan as "past due" once it has missed a payment for one interest period, and as "seriously delinquent" after three interest periods. Most microenterprise lenders report a loan as "past due" when a payment has been missed through a complete payment period, or when the second payment is missed (either 14 or 30 days). For example, payments are "past due" at ACCION if more than one consecutive payment is missed (usually 7 or 14 days).[83] Although these are formal classifications of past due, programme staff react to missed payments immediately. The most useful information to management is the trend report highlighting any changes in the delinquency rate from month to month. The Loan Ageings Report provides a more detailed glimpse into the delinquent component of the loan portfolio.

The Loan Ageing Report lists the number of loans and the amount of principal outstanding according to specific categories of non-current payment. These categories must be sensitive enough to detect shifts in repayment patterns and flag potential repayment problems as early as possible so management can take quick action. For most banks, the categories are 30, 60, and 90 days past due because bank loans typically require monthly payments. For microcredit programmes, the categories should be based on the number of payments missed.

The report might show the total amount of principal, the number of loans, and two ratios for each category:

- The amount of principal outstanding for the loans in that category as a percentage of the total loans outstanding;

- The amount of interest and principal collected in the last period (usually monthly) as a percentage of the amount due in that period.

The first ratio tells the user how much of the portfolio is at risk; the second tells how serious the problem may be, or how many loans are receiving steady payments despite the delinquency. In other words, the first ratio answers the question "how important is the game?" The second ratio answers the question "what's the score?". This report provides quantitative information that informs management's subjective decisions about the significance of trends or changes. Management can then classify the loan portfolio into relative degrees of loan quality, or the degree of confidence in being repaid in the future.

Advantages of the Loan Ageing Report are:

- Increased transparency of the loan portfolio
- Trend reporting to see changes by month
- Highlights strengths and weaknesses in programme design

While the delinquency and loan loss ratios ratios provide a single measure of the loan portfolio, the loan ageings report is perhaps the most useful management tool. It makes the non-current portion of the loan portfolio transparent and allows management to see changes from month to month (or quarter to quarter). It also highlights weaknesses and strengths in programme design. If delinquencies are high for one or two payment periods but subsequently drop, then perhaps repayment schedules should be lengthened or the amount of principal reduced. If the percentage of delinquent loans increases through successive periods, then earlier and more aggressive collection efforts are warranted.

Two examples highlight the importance of accurate portfolio information as a management tool:

- **Bangladesh Rural Advancement Committee:**

  Definitions of "past due" and "non-current" are particularly sensitive when borrowers are the very poor. They have limited financial liquidity and may miss a payment in a bad week but resume regular payments thereafter. The pay cycle of BRAC members is affected by seasonal variations and crop harvests, natural disasters, and death or childbirth. These borrowers have little cash on hand to "catch up" to the original amortisation schedule and can remain a payment or two behind indefinitely, a situation that technically places the client in default of the terms of the loan. BRAC therefore does not charge-off past due loans until considerable time has passed, but uses an Ageing of Principal Outstanding (APO) report to track delinquent loans by the number of payments missed. The categories are 0 weeks past due, 1-4 weeks past due, 5-12 weeks past due, and more than 26 weeks past due. Although the principal in the 1-4 weeks past due category shows seasonal patterns, any unexplained increases or loans more than 4 weeks past due are aggressively collected. As of December 1994, 92 per cent of BRAC's loans had missed 0 payments.[84]

- **Enterprise Credit Corporation:**

  ECC targets existing businesses that want to expand, and therefore makes larger loans that are tracked individually. ECC monitors classifies loans by 30, 60 and 90 days past due and maintains a Watch List of all past due loans, the responsible staff person, and the actions being taken. Through early 1994, ECC maintained a delinquency rate of less than 3 per cent, a target consistent with its goal of financial self-sufficiency.[85]

In both cases, the information presented is objective and informs management of the current status of the loan portfolio. However, each organisation interprets that information differently and responds accordingly. A sample loan ageings report is presented on the following two pages.

Managing delinquency is critical to the survival of a loan programme. Borrower delinquency and loan default risk are costs that pose the following threats to the soundness of a credit organisation:

First, the costs of delinquency are hidden, making it difficult for credit institutions to recognise them. Programmes managers generally try to minimise their levels of delinquency because it is used to judge their effectiveness. However, few understand the extent to which loan areas affect the programme's financial condition.

Second, programmes have a tendency to attribute delinquency disproportionately to external factors. Consequently, they do not confront and resolve the contributing factors within their control.

Third, delinquency is contagious. It has a tendency to spread and worsen, leading to high levels of default unless it is aggressively controlled.[86]

Borrower delinquency increases staff costs by requiring more frequent visits and closer monitoring. In addition, delinquency imposes an opportunity cost because the microlender must finance those loans longer and cannot extend credit to new borrowers. Loans outstanding that do not earn interest also create a financing cost if the organisation has a cost of capital. On the income side, delinquency postpones interest income (a loan fund's principal source of income) and reduces the "turnover" in the portfolio (e.g. the use of the same $500 for more than one loan per year). Further losses occur when programmes give up on recovering interest on a delinquent loan, choosing to focus on recovering principal.

Delinquency is often less a reflection of the "credit-worthiness" of the borrowers than an indictment of a loan fund's credit methodology.

Staff must act upon the information provided by these tools. Increased delinquency in the entire portfolio suggests poor collection enforcement or poor underwriting decisions. What changes can managers make to the programme design or policies? A review of subsequent ageing reports will reveal how effective those procedure or programme changes have been. For large organisations, portfolio information allows individual branch managers to review their performance and determine why portfolio quality has improved or declined.

> While many external factors influence the quality of a portfolio, the institution itself, through its philosophy, image, and methodology, plays the pivotal role in determining its own portfolio quality.[87]

Trend reports are perhaps the most valuable tool to accurately measure delinquency, since they reflect the sub-categories of delinquency. A trend report compares the monthly ratios in each category and therefore can highlight improvements or deterioration. For example, the delinquency ageing schedule of non-current loans can indicate how a loan fund needs to strengthen its collection efforts. If staff are undertaking prompt and convincing follow-up on missed payments, delinquencies that are more than 30 days past due should be significantly lower than delinquencies that are one day past due.

Many development lenders believe that more conservative and transparent portfolio reporting will hurt their eligibility with funders and donors in the short term. As donors become more sophisticated about credit and commit ever increasing amounts to microcredit, however, they will better understand these measures and the information to be gleaned from them. Over the long term, more conservative reporting will be more credible with both donors and other financial institutions.

Another key step in portfolio risk management is to adjust the amount of the loan portfolio downward to reflect the most recently estimated value of the loans, net of anticipated losses. Portfolio information is more meaningful to both management and outsiders if the numbers reflect a realistic expectation of how many of those loans will be repaid. Although those estimated values are based on management's subjective judgements about the likelihood of repayment, those estimates should be conservative enough to be credible to outsiders, such as donors and consultants.

A brief overview of the accounting used by financial institutions will help clarify this discussion.

- **Loan Loss Reserve:**

  The loan loss reserve is a line item on a lender’s balance sheet account that is created to reduce the value of the loan portfolio by the amount of anticipated losses (rather than reporting loans at full value until actual losses are incurred). The reserve usually includes an "allocated" portion in which specific amounts are earmarked for losses on specific loans, and an "unallocated" portion, which is a cushion for unanticipated losses. For example, the ratio of the loan loss reserve to total loans outstanding is a common bank measurement used to assess loan quality (a low ratio implies higher quality loans) and conservative management (a reserve account that parallels or exceeds actual loss experience).

- **Provision for Loan Losses:**

  The provision for loan losses is an income statement item that is expensed on a monthly or quarterly basis. The provision expense simultaneously reduces net income and increases the loan loss reserve on the balance sheet. Each period's provision adds amounts to the loan loss reserve sufficient to cover anticipated losses for which no reserves yet exist.

- **Loan Charge-Offs:**

  When an actual loss is realised if collection seems doubtful, the amount is charged against the loan loss reserve (reducing the estimate for future losses). In addition, the value of the loan is eliminated in the loan asset account on the balance sheet. Recovered amounts that were previously charged off are considered a gain "recoveries". Charge-offs do not affect the income statement, since the provisions were taken in earlier periods.

In a given financial period, therefore, the loan loss reserve is increased by the amount of the provision for loan losses and reduced by any amount of loans charged off (net of any recoveries). In the banking industry, each institution makes subjective decisions about when to reserve against particular loans and how much to reserve as a percentage of current loans, to provide a cushion for enforceable losses (the sum of which is the loan loss reserve). Banking regulators look very closely at the adequacy of the loan loss reserve during their annual examinations. Reserves should be conservative and realistic, with provisions that neither inflate or understate reported net income.

Although conventional banks make subjective judgements, the regulatory agencies enforce a minimum level of conservatism. Each US commercial bank, for example, reports detailed performance information to the regulatory authorities. Each bank's portfolio is reviewed by bank examiners for compliance with certain standards of loan classifications, including those that require a minimum allocation of reserves or charge-off action.

For unregulated, privately managed credit institutions, the responsibility for fairly representing loan values on the balance sheet rests on management's shoulders. Several microcredit lenders assign a rating to individual loans as a similar indication of loan quality.

Level 1: Excellent Quality

- Cash flow from operations is sufficient to repay loan.
- Sales and cash flow are above or at projected levels.
- The company's market position appears sound.
- Collateral value is partial.

Level 2: Adequate Quality

- Start-ups and companies with less than one year's operations experience.
- Cash flow coverage is not strong.
- Market position is uncertain (includes companies whose market position depends on undercutting state-owned competitors , fashion, or temporary geographic advantages.
- Includes traders and firms engaged in distribution only.

Level 3: Unsatisfactory Quality

- Cash flow may be (or is) inadequate to cover debt.
- Market position is weak.

Level 4: Problem Loan

- Payments are past due.
- Collection uncertain.

If the repayment of a loan seems doubtful, as under Level 4, management should reserve against a likely loss. Formal financial institutions often use some combination of a general, unallocated reserve and specific amounts allocated to problem loans. There are three basic approaches to determining the right amount for the loan loss reserve. The fundamentals of each are described below.

- **The Bank Method:**

  Banks determine the allocated portion of the reserve based on estimated loss percentages on individual problem and Watch List loans. Among US commercial banks, the loan loss reserve averages 1.25 per cent of total loans outstanding. About one-third of the reserve is unallocated, and two-thirds is allocated as a protection on anticipated losses on specific loans or groups of loans. Each month, bank management reviews the problem asset list to determine whether estimates for both possible and probable losses have changed. In contrast, ACCION International's affiliate organisations maintain average reserves equal to about 3 per cent of that "acceptable risk" portion of the loan portfolio.

- **Reserve Against Individual Loans:**

  This system requires regular assessments of the repayment risk and an estimate of loss on individual loans. Due to the level of detail, it works best for smaller lending programmes that can easily track individual loans. Some microenterprise lenders in the US assign a risk rating such as Level I through Level IV to individual loans, and ratings are reviewed at the end of each quarter. Risk ratings of Level I and Level II are acceptable levels of risk that require no allocation of reserves. Level III may require a provision to the allocated portion of the loan loss reserve. Level IV requires a definition allocation in the reserve and possibly a charge-off. The amounts actually reserved or charged off are determined by borrower history, their co-operation with fund staff, and the value of any collateral securing the loan.

- **Upfront Provisions On Loan Disbursements:**

  For smaller lending operations that have plenty of lending capital, management can set an automatic provision to the loan loss reserve upon disbursement of loans, thereby growing the reserve. This approach has several advantages: (1) a conservative reserve level is maintained with minimal management time; (2) it allows a new loan fund to build its loan loss reserve quickly in anticipation of the increased loan losses that will follow increased loan volumes. The reserve is only reduced by charge-offs and is increased when new loans are disbursed or if expected losses exceed the threshold percentage. The disadvantage of this approach, however, is that as the portfolio grows, management has less and less understanding about the repayment patterns within it. This risk becomes significant when the loan portfolio reaches a large size.

The most important elements of loan loss reserve management, however, are to use a method consistently and to review it regularly for accuracy by comparing it to actual loss experience. The reserve ratio (loan loss reserve to total outstandings) should be maintained at a relatively constant percentage unless the methodology changes.

A routine and standardised approach to portfolio analysis and reporting ensures that programme managers remain abreast of current trends in the portfolio and aware of any significant changes. Most microcredit organisations prepare monthly (or at least quarterly) reports that list individual loans in the portfolio, the total principal on each, the amount outstanding, and the loan rating. Either in a separate list or on the same report, any delinquent loans are also highlighted with the relevant information and a "Comments" column where the action steps being taken are described. For loan programmes with large numbers of loans in their portfolios, a loan by loan review is less feasible. These programmes usually review a "Watch List" or "Problem Asset List" of delinquent loans (or Level III and IV loans) to focus management attention on those loans that are of questionable or poor quality.

To use the tools described above, managers can employ a three-step portfolio analysis:

a) **Review of Portfolio Composition and Trends:**

In this step, managers review the entire portfolio for a "big picture" perspective and notes any changes from previous periods. Factors to consider include (1) composition or disbursement of loans by sector, (2) average loan sizes disbursed for the period, and (3) average term of loans disbursed. Trends in sector composition (such as the percentage of loans to retail, service, agricultural, or manufacturing businesses, might indicate growth or declines in demand in certain sectors. Concentrations in certain sectors (e.g. bakeries) might indicate potential risk to the portfolio. New sectors might grow into a possible focus area for the lender, such as child care centres, health care practitioners, or craft production. The Hungarian Foundation for Enterprise Promotion already tracks cumulative loan approvals by sector: as of October 1993, 22 per cent of loans were in agriculture, 15 per cent in industrial, 20 per cent in trade, and 39 per cent in services. However, HFEP cannot see trends clearly because it is not comparing information between periods.

Detecting changes in average loan sizes or maturities is important because these assumption affect how the programme forecasts future levels of the loan portfolio. As discussed under Financial Management, a programme's ability to forecast its financing needs depends on its ability to forecast loans outstanding (which generates interest income). Assumptions about average loan size and the length of time loans are outstanding are two of the three factors determining loans outstanding.

b) **Analysis of loan repayment performance:**

The second step is to review the delinquency ageing report for the loan portfolio to gain a transparent view of the non-current section of the loan portfolio. This report provides a snapshot in time (usually quarterly or monthly) to show how much loan principal is at risk and the degree of that risk. If most of the principal outstanding with missed payments has only missed one or two payments, the risk is not yet serious. However, management should ask whether there have been changes in loan underwriting or collection procedures that may have affected loan collections, or whether this is an early sign of reduced borrower repayment discipline. If a large amount of principal is in the older ageing categories (such 3 or 4 missed payments), the risk of loss to the portfolio is much higher. In most lenders experience, the risk of loss increases with the passage of time and with the number of missed payments.

c) **Assessment of concentration risk and overall portfolio quality:**

The final step is to observe the implications of the delinquency report and draw conclusions about risk to the portfolio. Concentrations of risk in particular sectors, or in particular types of loans, might indicate a need to change underwriting guidelines or collection policies. If a high proportion of loans to the retail sector are seriously past due, for example, management may increase scrutiny of those loan applications or propose more frequent loan monitoring site visits by programme staff. This step allows management to draw conclusions from the performance of the loan portfolio and make recommendations for how to avoid such problems in the future.

D. Financial Management

As discussed in Chapter 4, efficient operations are the companion to effective programme design. Although not all programmes will achieve financial self-sufficiency, institutional viability and the prospects for sustainable operation is in large part based on the financial management and operating efficiency of the organisation. This section discusses four aspects of prudent financial management for microcredit organisations: Ratio analysis and trend reporting, cash management, budgeting and forecasting, and internal management information systems.

As background for this section, a quick overview of the various levels of financial self-sufficiency may be helpful. As described by Maria Otero and Elizabeth Rhyne in their article "Financial Services for Microenterprises,"[88] there are four levels of financial self-sufficiency:

- **Level one** is associated with traditional, highly subsidised programmes that require grants to cover most of their operating expenses and provide loan capital. For these programmes, the value of the loan fund erodes over time through delinquency, default, and inflation.

- **Level two** programmes borrow loan capital or raise funds at near or below market rates and internally-generated interest income covers a significant portion of operating expenses. Some grant support is still required to finance some aspects of programme operations.

- **Level three** programmes have eliminated most of the need for outside subsidy, but remain dependent on receiving zero or low cost capital and perhaps on receiving below-market rate loan deposits to help fund operations. This is the level most commonly reached by most of the well-known microcredit institutions.

- **Level four** reflects full financial self-sufficiency in which the organisation is fully financed by internally-generated sources of income and market-rate sources of funding (capital and/or deposits), and can cover all operating costs (including loan losses), the cost of capital, and inflation. The only microcredit institutions to have achieved this level to date are some credit unions and perhaps the BRI Unit Desa System in Indonesia.

The key components of financial management in microcredit organisations are revenues, costs, and the relationships between certain variables. Revenues include loan interest income, investment interest income, and fee income. Operating costs include the cost of salaries and personnel expense, physical plant and occupancy expense, and loan losses. The cost of funds is the interest rate paid on borrowed funds (whether deposits or a loan) and determines the Net Interest Margin, or spread, earned by the programme. For grant funded programmes, this cost is often borne by donors. For a for-profit organisation, dividends are often paid to equity investors to provide them with a return on their equity capital. Non-profit organisations may pay a below-market interest rate on subordinated, long-term debt or enjoy no cost grant capital.

Whatever its equity and capital structure, the programme must manage those resources effectively to build long-term equity and position the organisation for future growth and/or institutional stability. As discussed under Pricing of Credit in Chapter 4, microcredit programmes must price their credit products to compensate for both lending and inflation risk. The cost of inflation can dwindle the value of the loan fund over time unless programmes can lend at interest rates that include the inflation rate and a risk premium for lending. Ratio analysis is one of the tools for identifying and managing the relationships between these revenue and cost variables.

As described in Chapter 3 under Strategic Planning, microcredit programmes need to identify performance measures and benchmarks to assess their progress towards their financial goals and give management the information it needs to make sound business decisions. The most effective management tools within financial institutions are ratio analysis and trend reporting. Like banks, microloan funds are intermediaries that survive on the margin earned between the cost of funds and the rate earned by investing in loans and investments. All expenses, including staff costs, operating expenses, and loan losses, can be expressed as percentages of total assets. Ratio analysis allows managers to track the relationships between different variables and set objectives and benchmarks for organisation performance. Trend reports show selected ratios over comparable periods (monthly or quarterly) and thereby allow management to detect changes in those relationships and understand their causes. These tools are particularly important in a field without "industry norms" and where the responsibility to monitor performance rests on management's shoulders rather than with regulatory agencies. Management needs financial tools to track performance, pinpoint the sources of problems, and evaluate the impact of changes in programme operations or design.

The recommended performance measures were captured by the acronyms of SCALE and OSI, as shown in Table 3 on page 106. This section details how these ratios on organisational financial condition can be useful management tools for microcredit programme managers.

- **Self-Sufficiency (a measure of profitability):**

  A self-sufficiency ratio is the percentage of expenses that is financed from revenues generated from internal programme operations rather than from fund-raising sources. Internally-generated revenues include interest income on loans, fee income for technical assistance services, late payment penalties collected from borrowers, fee income from the provision of loan guarantees, and interest income on idle funds. This ratio allows the organisation to track its dependence on subsidy to meet its operating budget. The ratio may be very small, particularly for new programmes that have high costs and a small loan portfolio. The goal is to steadily increase the ratio to a meaningful number as the programme reaches its full potential in loans outstanding and income and cost efficiencies. A “meaningful number” will vary among programmes with different contexts, missions, target customers, and resources for capital and funding.

  As noted in Chapter 1, several microcredit institutions in developing countries have achieved 100 per cent self-sufficiency because of very high loan volume and relatively low operating costs. In the United States, all programmes require continuing subsidy because of low loan volumes (filling a much narrower credit gap) and high operating costs. For the reasons cited in Chapter 1, microcredit programmes in transition economies have a strong potential to achieve a significant self-sufficiency ratio if they serve a broad range of microbusinesses. Those programmes that focus on the least entrepreneurially ready entrepreneurs will continue to require high levels of operating subsidy.

- **Capital Adequacy:**

  This ratio measures equity (or a non-profit organisation’s reserves) and long-term subordinated debt capital as a percentage of total assets. Financial institutions must have enough capital to withstand unexpected losses or risks and to support the growth of the organisation. Most microcredit organisations have been able to raise sufficient capital to meet loan demand. If loan demand is demonstrable and loan loss rates are reasonable, funders will often contribute equity for this purpose because it serves as a revolving loan fund or reusable capital. (As discussed under Capitalisation Strategy in Chapter 4, annual operating grant support is usually more difficult to raise.). Programmes that are entirely funded by grants or soft capital will have a very high Capital Adequacy ratio because all of their funding sources are in the form of capital. Programmes that borrow from a commercial bank, receive loans from philanthropic sources, or accept deposits are leveraging their equity with borrowed funds and will therefore have a lower ratio.

While this ratio does not vary much from period to period, it has several implications for managers. First, programmes should strike a balance between having sufficient capital as a financial cushion and leveraging their equity capital to increase their cost-effectiveness. Second, programmes with large endowments, or large amounts of capital that can be invested in safe securities, can generate interest income on investments and increase their internally-generated sources of income. The Grameen Bank, for example, can attract capital from donors because of its strong track record and has built a large capital base which earns significant investment income. While the net interest margin earned on investments is lower than that earned on loans, this can provide an additional inflation hedge to microcredit programmes operating in inflationary environments.

- **Asset or Portfolio Quality:**

  The Asset Quality measures (including delinquency, the loan ageings report, and loan loss rate) are discussed under Section C, Credit and Portfolio Management.

- **Liquidity:**

  Liquidity is measured by the percentage of programme assets that are held in liquid form (such as cash or marketable securities, such as short-term government bonds) as a percentage of total assets. This ratio tracks the ability of the organisation to avoid any interruption in lending due to a shortage of funds, or the inability of a deposit-taking organisation to meet the demand for withdrawal of deposits. For non-deposit taking microcredit programmes, this ratio indicates the availability of funds to respond to additional loan demand. Management can also forecast whether sufficient cash will be available to repay a funding source at a loan's maturity and the resulting impact on the organisation. Some advocate an additional liquidity measure that measures cash and expected recoveries during a period as a percentage of anticipated cash disbursements during the same period. This measure may be more appropriate as a cash management tool, as it depends upon the accuracy of the projections of cash receipts and disbursements.[89]

- **Earnings Quality:**

  Earnings quality refers to the validity of the income figures for the financial institution and how well they reflect the cash coming in the door. It focuses on how well reported net interest income matches actual cash received, and whether earnings are solid without reliance on one-time or extraordinary items. Most financial intermediaries use accrual accounting to recognise revenue. Interest income on all loans in the portfolio is counted as revenue when it is due (monthly or quarterly), rather than when the cash is actually received. As discussed under Credit and Portfolio Management, loan loss provisions and loan charge-offs adjust the balance sheet value of the loan portfolio to better reflect those loans that are earning income and are likely to be repaid. However, if delinquency rates are high, there is a significant delay before interest income is received and net income may be overstating revenue. To better reflect reality, many institutions place some loans on "non-accrual status" and recognise interest income only when it is received in hand.

The second aspect of earnings quality is whether it is generated by the principal business activities of the organisation or by one-time events, such as a gain on the sale of an asset, the recovery of interest on a previously charged-off loan, or other event. Such one-time events skew the organisation's self-sufficiency or profitability ratios.

- **Unit Cost:**

  The unit cost is the level of expenditure necessary to provide one unit of a particular service. That service might be preparation of the loan application as pre-credit technical assistance, approving and servicing a new loan, or spending one hour with an existing loan customer as loan monitoring. Unit cost is often expressed as a US dollar cost (for ease of comparison) per unit of service and is calculated by dividing the total cost of providing a service by the number of transactions. Like a business, most programmes have an optimum unit cost that will allow them to serve a high number of customers at a low cost per transaction. A key question among microcredit programmes is what level of cost is reasonable. Compared to traditional banks, microcredit programmes have higher unit costs per loan due to more time spent with each borrower for the loan application and loan monitoring. Loan loss rates are also slightly higher than in conventional western financial institutions and take a larger percentage of staff time. Alternative measures that are also used include the ratio of loans per staff member or customers to staff member.

  One way to evaluate the reasonableness of a programme's unit costs is to compare it to other programmes, such as unemployment compensation. If a microcredit programme can provide a source of income to someone previously unemployed, the one time investment of the microcredit programme is usually less than the value of unemployment benefits over a year's period. For programmes that are providing credit with minimal technical assistance to those able to use credit quickly, the standard of operating efficiency should be slightly higher because the costs of alternatives (if they exist) are also lower.

In addition to the above measures which capture the overall financial condition of the organisation, managers can use additional ratios to track particular aspects of programme operation or to compare performance between various locations or branches. For example, an organisation might compare the loan ageings reports between branches to detect which staff are aggressively collecting on delinquent loans. Other ratios might include:

- Staff expense as a percentage of total loans outstanding: Personnel expense is usually the largest cost for a lending intermediary. This ratio allows management to monitor staff costs relative to loans outstanding, track the impact of any programme design changes, or the progress of a new branch or location. This ratio will be high in the early years because it takes time to build the size of the loan portfolio.

- Investment income as a percentage of total income: This ratio highlights the programme's dependence on the investment returns earned on unlent capital.

- Operating expenses as a percentage of total loans outstanding or total assets: There is an optimal relationship between operating costs and loans outstanding. Tracking this ratio monthly or quarterly allows managers to see increases in costs or track improvements in operating efficiency.

- Total loans or customers divided by number of staff: This ratio measures loans per staff person. It allows managers to identify the average number of loans generated or monitored per staff and whether it can be increased efficiently.

A sample ratio report is presented in Table 7. Each organisation identifies the ratios most relevant to its operations and the trend reports that management finds the most useful. For larger or decentralised organisations these management reports are essential tools to track operations and monitor the financial condition of the entire organisation. A sample trend report for loan delinquency is included in Section C above.

Cash management refers to the investment methods and policies that an organisation uses to maximise its investment income from idle cash while ensuring that the organisation has sufficient cash on hand to conduct its lending business and pay operating expenses. Most financial institutions maintain a balance of cash on hand (or in a demand deposit account at a bank) and invest their remaining idle funds in short-term, highly liquid investments. The primary objective of those investments is to earn a return that reflects low risk and the inflation rate, with minimal risk of losing the principal. They are typically short-term government bonds (of 30, 60 or 90 day maturities) that mature often and can be easily re-evaluated as either needed for expected cash disbursements or "rolled over" for another investment period.

In the event of a miscalculation and a temporary shortage of cash, many organisations have a small line of credit with a bank from which they can draw additional funds if needed. Because borrowing funds costs money, most organisations manage their money conservatively to avoid unexpected cash shortages. The alternative liquidity ratio cited above is a tool that financial managers can use to forecast the amount of cash they need on hand.

$$\textbf{Available Cash} = \frac{\textbf{Cash balances plus expected inflows (loan repayments, maturing investments)}}{\textbf{Expected Cash Outlays (expenses, loan disbursements)}}$$

After tracking these figures for several months, managers can set a target level of cash on hand based on a standard ratio. For example, maintaining a ratio of 1.5 provides a cushion for unexpected cash outlays or lower than expected cash inflows.

Decentralised organisations that rely on grant or loan funding sources must distribute cash among local branches or offices. Most require branch locations to maintain a minimum amount of cash at each branch (or in a nearby bank account) based on expected disbursements less expected cash payments to be received. All excess cash is transferred to the head office where cash management is centralised. Branches can request additional funds from the head office if necessary. In organisations that also accept deposits, each branch has its own funding source (the deposits it collects) and may need only limited funds from the head office. To earn a net interest margin, however, those deposits must be invested in either loans or investment instruments.

To develop an efficient cash management system, microcredit programmes should consider the following steps:

- **Identify a formal investment policy** that clearly identifies the types of and maturities of investments permitted and carefully track the maturity dates and amounts of those investments. A clear policy can avoid financial mishap or disaster through accidental or uninformed investing.

- **Set targets for funds availability and review it periodically based on changing disbursement levels or expenses.** Targets should be based on actual experience with some margin for error. If the cushion is consistently very large and very rarely needed, the programme may be minimising the potential cost of borrowing funds from a bank at the expense or maximising investment interest income.

- **Develop controls and policies for cash disbursement and collection to maximise earnings and avoid fraud.** Clear policies about the amount of petty cash kept on hand in head office or branch locations, the centralisation of cash for investing, and centralised authority for disbursements are wise investments. "The benefits of less idle cash are analogous to the benefits of a manufacturing company having less inventory on hand: fewer funds are tied up in non-productive uses (not earning interest), reporting systems are more accurate and timely, and the opportunity for misuse of funds (whether innocent or intentional) is minimised."[90]

- **Develop separate reporting of cash and loan portfolio earnings as a check and balance system.** Particularly within larger organisations, separate reporting of loan interest income and principal payments from one side and cash balances and accounting from another allows managers to compare numbers and ensure that the cash on hand matches the amounts collected. This check and balance system is used within all financial institutions to minimise human error and identify any fraud.

- **Maintain clear accounting and reporting and avoid co-mingling of funds between programmes or organisations**. Clear reporting and accounting systems are the most important tools for cash and financial management. Organisations that run more than one programme, or microcredit programmes within larger organisations may be tempted to co-mingle funds to smooth out funding shortfalls or make investing more efficient. Co-mingling has several disadvantages, however. It increases risk if funds for several activities are at risk for the activities of any single segment. It also limits the transparency of cash management and clouds the true cost of funds for any individual programme. Therefore, the best practice is usually to maintain separate financial reporting and cash management for each individual programme. If funds are shared between programmes, it should be carefully documented and on an arm's length basis (as if between two unrelated parties) to reflect the cost and benefit to each party. Clear accounting is also necessary to track and monitor funding from separate sources.

Microcredit programmes need clear financial reporting to give them accurate information for management decisions and to give funders and investors information about programme operations. At a minimum, organisations should produce a quarterly income statement, balance sheet, and cash flow statement. Any organisation that receives grant funding and prepares detailed budgets should carefully track cash spending relative to budget through quarterly cash flow statements. Budgeting has several purposes within financial management. First, organisations dependent on outside sources of funding need to forecast their cash expenditures and funding needs to determine the amount of outside funding required for that year. Programmes should forecast all cash needs: operating expenses, investments in fixed assets, and any growth in the loan portfolio outstanding during the year. Second, they should forecast all sources of income, including internally-generated sources and outside funding anticipated. If there is a shortfall, management knows how much in operating funds needs to be raised. During the period (perhaps quarterly), management should compare actual performance to budget and identify the variances between the two. High variances may result if certain purchases are delayed, if new staff members are hired earlier or later than forecast, or for other reasons. The budget, actual, and variance comparison is not used to judge performance -- it is a management tool to better identify how reality varied from the forecast and the implications. Management should review the variances to understand why actual performance was different than expectations and adjust the next year's budget accordingly. Some issues are insignificant and easily explained by management decisions to shift priorities. Yet some may be highly significant and less easily explainable. These variances raise "red flags" to management to investigate the reasons behind the variance and determine if any other action is needed. For example, if loans outstanding are much higher or lower than forecast, management needs to determine why. Projecting loans outstanding is important for two reasons: it is a potentially large use of cash during a year, and it is the principal source of earnings for the organisation. While operating expenses and fixed asset investments are relatively easy to forecast, forecasting loans outstanding can be more difficult. Loans outstanding (or the size of the loan portfolio) is determined by three factors:

- **Loan Disbursements:**

  New loans are created through disbursements. Disbursements are the product of the number of loans multiplied by average loan size. The rate of disbursements may grow during the year as new staff are added, as demand and the number of borrowers increase, or as new locations are added.

- **Loan Term or Maturity:**

  A loan remains outstanding based on its term or maturity, and the principal outstanding steadily declines with each payment (each payment includes some principal and interest). Therefore, an organisation making one-year loans will "turn-over" the portfolio each year and total outstandings will remain relatively constant (unless the number of new borrowers is growing each year). An organisation making three-year loans will have much higher outstandings because each loan remains in the portfolio for a longer period.

- **Repayment Rates:**

  If no loans are delinquent, then the portfolio balance could by forecasted only by the above two factors. If there is some delinquency on a percentage of the loans, however, loans will be repaid at a slower rate and outstandings will be higher than projected.

Therefore, if loans outstanding are far higher than projected, management should check the level of disbursements, the average maturity of loans or the mix of loan terms, and the rate of repayment. Note that while a higher level of loans outstanding may appear to generate more interest income, longer-term loans are often correlated with higher delinquency and loan losses. Many microcredit lenders have increased their profitability and reduced delinquency by shortening the average term of loans and focusing on increasing the number of borrowers. In addition to portfolio management and financial management, organisations need to manage operating risk. Operating risk is the exposure to errors and oversights by staff members and to inaccurate or incomplete information that can lead to poor management decisions, unwanted liabilities, or loss due to fraud or stealing. Internal controls are the clear policies and procedures that protect the organisation without creating unnecessary bureaucracy. As noted above under cash management, obvious targets for internal controls are cash receipts and disbursements, purchasing authority, and loan approval authority. Clear procedures requiring certain signatures to authorise checks, purchase orders, contracts, and loan documents should be developed. The staff who service loans (collect payments) should not have access to accounting systems that track cash.

Sample internal controls are:

- Loan documents will be reviewed by the person directly in charge of the loan fund and by one other person who is a member of the loan committee;

- All checks in excess of $5 000 are required to have two signatures, one from the programme director; and

- Every purchase order will bear the initials of an officer within the organisation.[91]

Accurate and timely information systems are also essential for managing operating risk. Microcredit organisations need an accounting system to track cash and help prepare financial statements, and a loan tracking or servicing system to monitor the loan portfolio and the disbursements and receipts of loan principal and interest. While such systems do not need to be computerised, the spreadsheet software available today may make this a cost-effective investment. In addition, programmes should maintain client files with copies of loan applications, all loan documentation, and correspondence with each borrower.

While accurate information systems are the first step, managers need to also design the summary and trend reports that managers and directors can review on a regular basis to evaluate and monitor the overall performance of the organisation. Simple monthly reports can be designed within the loan and accounting systems to provide timely information and analysis. These reports are both more meaningful and easier to produce if part of a routine system rather than on an ad hoc basis.

E. Staffing & Staff Development

As discussed in the above sections, capacity and resources are two critical components of a microcredit organisation's institutional development. Building capacity requires investments in staff, systems and methodologies, and organisational structure. This section complements the previous chapters of this handbook by focusing on staff, perhaps the most important component of all.

Microcredit is a specialised niche within small business lending. Borrowers and customers are entrepreneurial, yet also need strong encouragement and support. Microbusinesses operate without management depth and minimal financial cushion, and are therefore highly vulnerable to external factors. The cash flow from the business, and the source of loan repayment, is directly related to the skill, commitment, and motivation of the entrepreneur. The lending and business assistance staff of a microcredit programme need to be able to relate to these clients, establish trust and rapport, and develop the judgement and experience of good lenders. This is all part of the unique credit culture of a development lending institution.

In establishing a new programme, management and leadership are essential elements: management articulates the vision for the organisation, motivates staff to achieve their goals, and mobilises the resources to support the organisational structure needed to make the programme work. The goals are to bring in clients, orient staff, and demonstrate that the methodology works. Once an organisation is established, however, management must also focus on developing operating efficiency and building organisational capacity. This also requires leadership -- effective programmes are much more than a set of principles, policies, and procedures. It is the way that effective small business lenders operate and their relationships with their customers that sets them apart. A key aspect of developing that capacity is management's ability to recruit and nurture a competent and committed staff. To do so, management must focus on three important tasks:

- Recruitment;
- Training; and
- Compensation and Evaluation.

Recruitment

Programmes must identify the types of skills, characteristics, and aptitudes they seek and develop the recruitment processes to find candidates that meet those criteria. Given the overall education level of the population in CEECs and the NIS and the current level of interest in small business development, programmes may have a range of candidates to consider. Practitioners in the United States have sought staff with the following general characteristics:

- Familiarity with small businesses and the challenges of operating a small enterprise;
- The ability to identify with the social, personal, and economic challenges confronting their customers and respond with sensitivity;
- Sound business judgement combined with the ability to identify business issues clearly and help entrepreneurs identify action steps;
- The ability to see possibilities and make connections among entrepreneurs and new opportunities (an entrepreneurial creativity and sense of the possible that is often rare among experienced and conservative lenders);
- The ability to establish trust and rapport with clients so that the borrower feels that the lender wants them to succeed and trusts the lender's judgement (allowing a "coaching" role, rather than a disciplinarian or rule-maker).

Staff who are familiar with the social and political nuances within a community and with the specific issues facing small businesses can often quickly gain credibility among potential clients. In the United States experience, many programmes have found it difficult to bring outsiders into a rural or ethnic area, even if those individuals quickly demonstrated business expertise and knowledge that was immediately valuable to customers.

In addition to the above characteristics, has been that successful development lenders also:

- Like the customer base;
- Are deal makers who get out of the office to know the community and find potential deals;

- Listen carefully to applicant responses to questions and create an interview atmosphere where all relevant professional and personal information is shared;

- Help borrowers structure good relationships with their business partners, suppliers, and customers;

- Identify the worst case scenario for an applicant's business to ensure the entrepreneur's awareness of risk, but do not make a lending judgement based solely on the worst case;

- Are decisive and confident;

- Are sensitive to borrower concerns about price and the cost of loans, but never compromise on the credit or collateral quality;

- Document loans carefully and with attention to the details;

- Stay responsive to customers both before and after a loan is made;

- Aggressively collect and call customers immediately if loan payments, monthly sales, or financial reports are not received on time (and show borrower's that they are watching the loan and the business);

- Identify potential problem loans early and discuss them with management;

- Know when to pressure or support a borrower that is in trouble.[92]

Overall, micro and small business development lenders appear to have found the greatest success in hiring people with a generalist background, a strong commitment to the importance of the work, and the ability to learn the technical skills of lending. These "generalists" are able to think broadly rather than along narrow parameters, and are able to adapt to microcredit organisations as a hybrid between the "giving" mentality of many assistance programmes and the strictly-business orientation of a traditional bank.

Training

Training is an important vehicle in two ways: for integrating new staff into the culture and spirit of the organisation, and for rekindling motivation and improving technical skills through continuing professional development. Training of new staff imparts basic technical skills, establishes the procedures that protect the organisation from poor loan decisions and documentation, and builds teamwork and camaraderie that will help staff counter the inevitable periods of disillusionment and frustration.

Training may be one person at a time, depending on the size of the organisation. This should include an orientation to the organisation and its goals, as well as partnering the new staff person with an experienced lender and allowing them to observe and participate. Building judgement and experience takes time, but new staff can best learn by working with experienced lenders, presenting loans to the Loan Committee, and learning through their mistakes. Preparing loan write-ups to the Loan Committee and discussing loans in Loan Committee is perhaps the best forum for establishing the credit culture of the organisation and developing strong lenders.

For an organisation hiring a group of lenders or seeking to expand, more formal training may be required to bring those staff up to a minimum performance level and prepare them for their responsibilities. A training programme might include several elements:

- Basic western accounting principles and cash flow analysis to establish clear understanding and a common language among staff;

- Loan assessment and credit evaluation through use of case studies and actual loan applications to highlight analysis techniques, concerns, and how to evaluate certain risks;

- Role plays between customers and lenders to help staff become comfortable in their role as advocate of the borrower and judge of creditworthiness.

The most effective training methods for lending appear to combine technical credit analysis skills with case studies to highlight how these principles are applied and how borrower situations differ. An in-depth training session on technical skills should then be followed up with on-the-job training in Loan Committee, reviews of loan applications with individual lenders, and feedback from the senior credit staff in the organisation.

Compensation and Performance Evaluation

To attract the best and brightest staff to their organisations, microcredit programme managers must be able to manage people as well as microcredit programme operations. Good managers communicate performance expectations clearly, offer feedback, and help staff meet their personal goals for skills development and experience. Idealism in the mission can carry a staff person only so far -- to motivate and get results from staff, a programme must treat staff fairly and give them strong job satisfaction in their work. Over the long-term, a programme cannot cost-effectively deliver services at the expense of its staff.

Staff need to feel personal commitment to the mission of the organisation, yet also feel the appreciation and support of their peers. Many programmes use team-building and support methods to help staff avoid burnout, such as weekly meetings to discuss loan applications, problem loans, or other concerns. Equal weight should be given to the financial or credit achievements of the programme as to discussion of customers and social achievements.

Some organisations have experimented with incentive compensation systems based on performance. ADEMI in the Dominican Republic and Working Capital in the United States both pay their lenders with incentive bonuses that reward staff for both originating new loans and maintaining a low delinquency rate. The bonus increases if the delinquency rate declines to ensure that staff have an incentive to make high quality loans. These methods have met with mixed success in programmes where staff have dual responsibilities for both credit and social objectives. The softer development objectives are more difficult to measure and therefore harder to evaluate. As a result, staff tend to focus on the more quantifiable goals of increasing the number of loans or reducing delinquency. Each programme must determine the appropriateness of these incentives given its own operating context and mission.

In conclusion, staff development is an essential component of building effective microcredit organisations. As many development lenders have said, "it is not what we do, but how we do it" that makes the difference between successful programmes and others.

CHAPTER 6. SUGGESTIONS FOR FUNDERS AND POLICYMAKERS

If microcredit organisations are going to reach their potential as a valuable, additional resource to accelerate the emergence of the private sector in CEECs and other transition economies, funders and intermediaries need to adopt strategies and standards to achieve that goal. Whether their goals are small business development or granting access to economic opportunity, microcredit organisations need a combination of capacity-building, funding, policy development, and performance-based objectives to develop into professionally managed, permanent financial institutions.

1.	**Encourage experimentation in the field to develop local models, yet require thorough strategic and business planning.**
2.	**Establish long-term capacity-building programmes that can ensure the effectiveness and success of microcredit organisations.**
3.	**The multi-year operating grant and capital commitments to programme performance.**
4.	**Promote policy changes to provide public sector funding for microcredit organisations.**

- **Encourage experimentation in the field to develop local models, yet require thorough strategic and business planning.**

  Given the wide range of market conditions within and among CEECs, no one model of microcredit is the most appropriate. Some programmes may serve those needing only access to credit; others may serve the unemployed or more distressed markets (such as agricultural areas or towns that have lost their primary employer). Funders should be open to a range of programme missions and designs to determine which models are most effective in differing environments. However, funders can influence the prospective success of individual programme's by requiring a strategic plan, careful market assessment, and an operating plan that demonstrates some planning. Funders might develop an outline of the key issues in microenterprise that they would like included in the strategic plan.

- **Establish long-term capacity-building programmes that can ensure the effectiveness and success of microcredit organisations:**

  A 6-12 month training programme or seminar series could result in production of a strategic plan and provide training for managers and staff in key operations areas. Such a programme might cover the principles of sound management presented in this Report and include the following elements:

a) In-depth seminars on small business and cash flow lending to strengthen staff technical skills in lending and microbusiness assessment;

b) Seminars and assignments in strategic planning, market assessment, and operational systems and portfolio reporting systems;

c) Site visits and in-depth follow-up to workshops and seminars for programme-specific issues and trouble-shooting;

d) Annual peer reviews and evaluations to assess programme strengths and weaknesses and provide feedback on additional opportunities or solutions;

e) A resource pool for technical assistance which participants could call upon for strategic or operational issues;

- Such programmes would also be a cost-effective means of introducing common standards for microcredit programme operation and a common set of performance measures that would allow funders and practitioners to track their progress. In addition, periodic seminars would enhance information exchange and provide a way for programme managers and staff to share experiences and address shared operational issues or solutions. Information sharing among groups with similar experience levels has been very valuable in the United States, even among the more sophisticated programmes who are facing management challenges different from the start-up issues faced by younger programmes.

  The most effective capacity-building programmes in the United States, for example, have been those that tie access to funding with some incentives to professionalise and improve programme operations. These types of programmes have been very successful in the United States. Examples include the peer reviews and annual training conferences conducted by the National Association of Community Development Loan Funds, and the Ms. Foundation's grant programme that links access to annual funding commitments with programme operating improvements. The duration of the programme, its linking of capital to operating improvements, and its rigorous standards for staff training are all critical elements to being able to induce organisational change and growth among individual organisations.

- **Tie multi-year operating grant and capital commitments to programme performance.**

  Funders and intermediaries that are able to articulate clear performance expectations, and tie multi-year funding support to improvements in operations, are more likely to create improvements in microcredit programme operations and development performance. Each funder should consider its objectives and negotiate milestones and expectations with each grantee/investee as part of the funding approval process. Examples of such milestones could include target levels of loan volume, growth in new members, delinquency and default rates, or self-sufficiency ratios. These could be in part based on the strategic plans developed in the capacity-building programme and would be tailored to each individual programme depending on its particular market niche and its own level of programme operations. Depending on their markets and their internal resources, different microcredit organisations may face different challenges.

  The development of multi-year funding commitments has two objectives: The first is to foster more business discipline in microcredit programme operations and improve both development outputs and cost-efficiency. The second is to provide these programmes with more predictable funding sources and require less management time on fund-raising. This will encourage microcredit programmes with the greatest potential to emerge quickly and become leaders in the field, able to share their experiences with their less experienced peers.

Promote policy changes to provide public sector funding for microcredit organisations.

Because the majority of economic development funding flows into CEECs from other governments to the national government, policy changes may be needed to allow portions of such funding to flow into microcredit initiatives. This is particularly important for those microcredit programmes that serve as a policy alternative to unemployment benefits and job training programmes. This appears to be possible with the EC sources of funding, for example, however, microenterprise must be recognised as a valid policy tool by local governments. To focus exclusively on microcredit as business development strategy greatly underestimates its contributions to self-employment and the economic self-reliance of low-income families or dislocated workers.

The priorities for development of microcredit in transition economies such as the CEECs are capacity-building and information sharing. Training of staff in lending and loan fund management is paramount to ensuring the cost-effective use of resources to promote microenterprise. As one of several development strategies for an emerging private sector economy, microenterprise provides economic opportunity for disadvantaged individuals and provides natural entrepreneurs with a way to enter the private market and gain the experience needed to undertake larger entrepreneurial ventures. Microenterprise is an effective tool for both poverty alleviation and for "priming the pump" for future SMEs.

Microenterprise lending intermediaries can be an effective way to distribute credit resources. With a strong local presence, they can evaluate and monitor loans and local markets accurately. In character lending, local relationships are more cost-effective than highly centralised lending programmes, which rely less on the personal commitment of the entrepreneur for repayment.

NOTES

[1] Estimated by Matt Gamser, Executive Director, Development Alternatives, Inc.

[2] Although USAID and other international organisations define microenterprises as having less than 10 employees, most microenterprises in the US are typically less than 5 employees. In addition to number of employees, many in the United States define microenterprises as businesses requiring less than $25 000 in credit or financing.

[3] Although often used interchangeably, self-employment more accurately refers to the status of the owner, while microenterprise refers to the business itself.

[4] Otero and Rhyne, Editors, *The New World of Microenterprise Finance*, pg. 18.

[5] Rhyne, Elizabeth and Otero, Maria, *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor.*

[6] *Innovation & Employment,* No. 13, October 1993. (Newsletter published by OECD.)

[7] Interview with Bruce Heatly, one of the authors of *Investing In The Future: Report of the Taskforce for Small and Medium-Sized Enterprise in Poland*, GEMINI Technical Report No. 60, May, 1993.

[8] Interviews with Dariusz Stola, PhD., Warsaw, Poland, and with Professor Peter Szirmai, Small Business Research Institute, Budapest Economic University, Hungary.

[9] Small Enterprise Development: An International Journal, from the Editors, Sept. 94, Vol. 5, No. 3.

[10] Wilson, Sandra and Adams, Arvil. *Self-Employment for the Unemployed: Experience in OECD and Transition economies.*

[11] “From the Editors”, *Small Enterprise Development: An International Journal*, Editors Malcolm Harper and Jacob Levitsky, Vol. 5, No. 3, Sept. 94.

[12] *Short-Term Economic Indicators*, OECD, February, 1995.

[13] Ibid.

[14] "Tired of Capitalism? So Soon?" *The Economist*, January 21, 1995.

[15] *Short-Term Economic Indicators: Transition Economics,* February 1995. OECD

[16] All four countries are seeking to become members of the Organisation for Economic Co-operation and Development (OECD). *Short-term Economic Indicators: Transition Economies*, February 1995.

[17] Ibid.

[18] Ibid.

[19] Interview with Dariusz Stola, Consultant, Warsaw, based on original PhD research on Poland’s small business sector.

[20] The following observations are based upon interviews in the respective countries and from published sources where noted. Observations on the Polish economy are from David Fischer of Caresbac-Polska and from other sources where noted.

[21] Interviews with Bruce Heatly, GEMINI Poland Small Business Project, and Dariusz Stola, Consultant, Warsaw.

[22] Interviews with Eva Bakonyi of the BB Foundation and Maria Flynn, Peace Corps Volunteer, Budapest. According to the OECD publication Short-term Economic Indicators: Transition Economics, the contributions made by employees to the social security system ranged from 33% in the Czech Republic to 49% in Hungary as of October 1993.

[23] David Fisher, Director, CARESBAC-Polska.

[24] OECD, Short-term Economic Indications: Transition Economics, February 1995.

[25] Interview with Richard Turner, Executive Vice President of South Shore Bank and former Chairman of the Enterprise Credit Corporation, Chicago.

[26] Eva Bakonyi, formerly of the BB Foundation in Budapest; now Director of the Soros Foundation in Hungary.

[27] Interview with Dariusz Stola, PhD, Independent Expert.

[28] Interviews with Eva Bakonyi and Professor Szirmai.

[29] Interview with Dariusz Stola

[30] "Hungarians Have Cash to Buy Homes If There Were Any", *Wall Street Journal*, July 31, 1995.

[31] "Relieving Central Europe's Banks of their Burdens." *The Economist*, August 27th, 1994.

[32] Eva Bakonyi, B'Nai B'Rith Foundation.

[33] Ibid.

[34] Ibid.

[35] American-Enterprise Funds for individual countries have been established and capitalised by the US Government. They are privately managed and governed permanent institutions. They currently exist in Poland (the Polish-American Enterprise Fund, or PAEF, established in 1990), the Czech Republic, Hungary, Bulgaria, Russia, Romania, Central Asia, Baltic States, and Western NIS.

[36] Source: CARESBAC-Polska marketing materials made available by David Fischer, President.

[37] Source: BISE Annual Report for 1993. Interviews with selected staff at BISE and FISE in Warsaw.

[38] Source: Interviews with Agnes Tibor, former Director, Aniko Solkesz, Director, and Zsusanna Laczko, staff.

[39] Interview with Zuzana Holubcova, EC PHARE program, Prague.

[40] Interview with Aidan Garrity and Sally Kelly, advisors to the Co-operation Fund, Warsaw.

[41] *Small Enterprise Development: An International Journal.* From the Editors, Vol. 5, No. 3, Sept. 1994.

[42] Interview with Jerzy Drzkiewicz and Sally Kelly, EC PHARE Local Initiatives Program. Warsaw.

[43] Interviews with Leszek Niemecki of Enterprise Credit Corporation and Mark King of Opportunity International.

[44] Nineteen of the twenty LEA offices are in rural towns and small cities throughout Hungary. The twentieth LEA office was opened in Budapest in 1995.

[45] Judith Tendler, *Whatever Happened to Poverty Alleviation?* Report to The Ford Foundation, 1989.

[46] Reports of the entrepreneurial history and small business starts in Poland based on an interview with Darius Stola, Independent Consultant, Warsaw. Also, draft manuscript, "Investing in the Future: Report of the Task Force for Small and Medium Enterprise in Poland." GEMINI, May 1993. In Hungary, interview with Professor Peter Szirmai, Small Business Research Institute, Budapest Economic University.

[47] Reports from Calmeadow Foundation consultants.

[48] Interview with Richard Turner.

[49] Training and technical assistance, although distinct, are used quite interchangeably here since the effect of both is that is critical to the success of business owners, but will increase costs and challenge programmes in achieving their goals. For microcredit programs, technical assistance refers to one-on-one consultations business-specific and advice provided once a

loan has been disbursed. Technical assistance can include helping a customer develop markets or suppliers, providing engineering or management consulting, or solving systems problems specific to a firm. Training programmes are usually focused on business planning to help prepare borrowers for business start-up and/or getting financing.

[50] Katherine Stearns, Assistant Director of US Programs, ACCION International, Washington, D.C.

[51] Rhyne, Elisabeth, "A New View of Finance Programme Evaluation." *The New World of Microenterprise Finance*. Kumarian Press.

[52] Minimalist credit refers to credit provided with a minimum of technical assistance.

[53] Rhyne, Elisabeth and Otero, Maria, "Financial Services for Microenterprise: Principles and Institutions." *The New World of Microenterprise Finance.*

[54] Three of these four structures were first described in "Financial Services for Microenterprises: Principles and Institutions". *The New World of Microenterprise Finance.*

[55] Ibid.

[56] James J. Boomgard, Development Alternatives, Inc. *AID Microenterprise Stocktaking: Synthesis Report.* A.I.D. Evaluation Special Study No. 60. December 1989.

[57] Break-even requires: Net Interest Margin x Total Earnings Assets = Total Operating Expenses.

[58] Interview with Richard Turner.

[59] Holt, Sharon, "The Village Bank Methodology: Performance and Prospects." *The New World of Microenterprise Finance*. Kumerian Press.

[60] Reed, Larry and Befus, David. "Transformational Lending: Helping Microenterprises Become Small Businesses." *The New World of Microenterprise Finance*. Kumerian Press.

[61] Interview with Eugene Severens, former Executive Director, REAP, April, 1995.

[62] Richard Turner, Executive Vice President, South Shore Bank, Former Chairman of the Enterprise Credit Corporation.

[63] Interviews with Richard Turner, and Leszek Niemycki, Vice President, Enterprise Credit Corporation.

[64] Richard Turner and Lisa Richter, "Concepts of Credit Underwriting."

[65] Interview with Richard Turner.

[66] Interview with Gene Severens, former Executive Director of REAP. February, 1995.

[67] Example taken from Waterfield, Charles, "Designing for Viability: Facilitator Notes.", SEEP and GEMINI Tools and Techniques for Enterprise Development.

[68] Training materials prepared for the South Shore Bank.

[69] Gross margin is calculated as (revenues less all expenses) minus cost of goods sold, expressed as a percentage of revenues. Net Margin is net profit expressed as a percentage of revenues. The percentages should stay relatively constant and express the relationship between two figures, rather than absolute levels.

[70] Pancho Otero, Executive Director, PRODEM, November 1993 visit to Shorebank Corporation in Chicago.

[71] Interview with BRAC staff, November 1995.

[72] Reed, Larry and Befus, David, "Transformation Lending: Helping Microenterprises Become Small Businesses." *The New World of Microenterprise Finance.*

[73] Ibid.

[74] This discussion draws upon a Shorebank Advisory Services publication, *Widening the Window of Opportunity: Strategies for the Evolution of Microenterprise Loan Funds.*

[75] Robert Meeder, President of the Southwestern Pennsylvania Enterprise Development Incubator Network.

[76] Interview with Leszek Niemycki, Vice President, Enterprise Credit Corporation.

[77] Interview with Ela Dec.

[78] For example, the Watermark Association of Artisans acts as a marketing and distribution channel for rural microbusinesses engaged in craft production. Watermark staff travel among different parts of the state of North Carolina to give market specifications for craft production based on current market trends. The same organisation then buys the produced crafts from local women and sells them in the marketplace to identified buyers.

[79] Telephone interviews with selected microcredit programs, including Coastal Enterprises, The Cascadia Revolving Loan Fund, the Rural Enterprise Assistance Project, and the Good Faith Fund.

[80] Stearns, Katherine. *The Hidden Beast: Delinquency in Microcredit Programs*. ACCION International. 1991.

[81] Ibid.

[82] Ibid.

[83] Ibid.

[84] "BRAC Financial and Credit Report: RDP IV Proposal", May 1995, Carpenter and Kellog, Shorebank Corporation.

[85] Interview with Leszek Niemycki, Vice President, Enterprise Credit Corporation.

[86] Stearns, Katherine. The Hidden Beast: Delinquency in Microenterprise Credit Programs, pg. 30, ACCION International. 1991.

[87] Stearns, Katherine. The Hidden Beast: Delinquency in Microcredit Programs. ACCION International. 1991.

[88] Rhyne, Elizabeth and Otero, Maria. "Financial Services for Microenterprises: Principles and Institutions." *The New World of Microenterprise Finance*. Rhyne and Otero, Editors. Kumarian Press. 1994.

[89] Calmeadow Foundation, "Financial Ratio Analysis: Microcredit Programmes and Institutions." Draft. Toronto.

[90] Kellogg, Clifton, "BRAC RDP II & RDP Mid-Term Evaluation - Financial Annex." March 1992.

[91] Example taken from The Community Reinvestment Fund's *Building A Microloan Program: Considerations for the Development Lender*. Minneapolis.

[92] See, South Shore Bank Commercial Lending. "Characteristics of Good Lenders."

APPENDIX A: INTERVIEW LIST BY-COUNTRY

UNITED STATES and WESTERN SOURCES

Antonia Bowring	Women's World Banking New York, NY
Judith Brandsma Private Sector Development	World Bank Washington, D.C.
Brian Dabson Executive Director	Corporation for Enterprise Development Washington, D.C
Susan Davis	(Formerly of Women's World Banking) Currently at: Women's Environment & Development Organization, (WEDO), New York, NY
Martin Forst	Organization for Economic Cooperation & Development LEED Programme
Mathew Gamser Executive Director	Development Alternatives, Inc. (DAI) GEMINI Project Bethesda, MD
Mark King Former Executive Director	Opportunity International, Inc. Oak Brook, IL
Peter McFadden President	Central Europe Institute Washington, D.C.
Maria Nowak	World Bank Washington, D.C.
Elisabeth Rhyne Director	USAID- Microenterprise Programs Washington, D.C.
Richard Turner Executive Vice President	Shorebank Corporation, Former Chairman, Enterprise Credit Corporation

David Wright Senior Advisor	Overseas Development Agency (ODA) United Kingdom

HUNGARY

Eva Bakonyi Former Managing Director	B'Nai B'Rith Foundation, Budapest Currently Executive Director, The Soros Foundation
Tim Drakall Financial Consultant	B'Nai B'Rith Foundation Budapest
Maria Flynn Peace Corps Volunteer	The Center for Private Enterprise Development Budapest
Totisz Gyorgy Programme and Training Assistant	US Peace Corps Small Business Assistance - Hungary
Tibor Hari Manager	Hungarian Foundation for Enterprise Promotion Budapest
Zsusanna Laczko, PhD	Foundation for Small Enterprise Development (SEED) Budapest
Ms. Aniko Solkesz Director	Foundation for Small Enterprise Development (SEED) Budapest
Dr. Laszlo Szekely Deputy Director	Hungarian Foundation for Enterprise Promotion Budapest
Professor Peter Szirmai	Small Business Research Institute Budapest Economic University Chairman, Hungarian Association of Entrepreneurs
Agnes Tibor	Budapest Economic University (former Director of SEED)
Dr. Ersebet Timar Senior Associate	Hungarian-American Enterprise Fund Budapest

POLAND

Eva Banachowicz	Polish American Small Business Advisory Service

Tomasz Bochenski Specialist	Lodz Business Support Centre
Natalie Bolgert Advisor to President	Bank of Socio-Economic Investment (BISE)
Elzbieta Dec Programme Manager	Women’s Rural Enterprise Programme (WRED) Foundation for Polish Agriculture Warsaw
Jerzy Drazkiewicz	Local Initiatives Program
Adrej Dziurdzik Programme Manager	SME Programme-Corporation Fund Warszawa
David Fisher Director Genera	CARESBAC - Polska, S.A. Warsaw
Maciej Gajewski Chief Executive Officer	Uniconsult Partnership Warsaw
Aidan Geraghty EC Advisor	SME Programme-Corporation Fund Warszawa
Grazyna Gesicka	Local Initiatives Program
Wojciech Glowacki Specialist	Lodz Regional Development Agency
Bruce Heatly Senior Advisor	GEMINI Poland Small Business Project Warsaw
Jacek Janczewski Director of Programmes	SME Programme-Fundusz Warszawa
Prof. Zdzislawa Janowska	International Women’s Foundation Lodz
Simon Johnston EC Advisor	STRUDER Program Warsaw
Krzysztof Kaluza	Foundation of Socio-Economic Investment (FISE) Warsaw
Sarah Kelly EC Advisor/Consultant	Local Initiatives Program Corporation Fund Warsaw
Tod Kerstin	Polish-American Enterprise Fund

Maria Anna Knothe Executive Director	Center for Advancement of Women (formerly part of WRED)
Ted Kontek Small Business Development Director	US Peace Corps, US Embassy Warsaw
Grazyna Kopinska Programme Director	Polish American Enterprise Clubs Foundation in Support of Local Democracy Warsaw
Mr. Andrzij Kuliszewski President	Agriculture Foundation Warsaw
Anthony Levitas	Resource Development Foundation
Martin Myhre Peace Corps	Polish Foundation of Opportunities
Leszek Niemycki Vice President	Enterprise Credit Corporation/Polish- American Fund
Wojciech Piotrowski Vice President	Enterprise Credit Corporation/ Polish- American Enterprise Fund
Mario Reyes-Vidal Senior Operations Officer	The World Bank Poland
Mary Roberts Scott Senior Policy Advisor	GEMINI Poland Small Business Project Warsaw
Dariusz Stola, PhD	Independent Consultant to GEMINI
Iwona Swiecieka Manager	FISE, Lodz Office

CZECH REPUBLIC

Paul Gibian President	Czech American Enterprise Fund Prague
Jeanne Hilsiger Former Senior Investment Officer	Czech-American Enterprise Fund Prague
Zuzana Holubcova	EC PHARE Programme for SMEs Czech Ministry of the Economy- Small Business Development Agency
Tara McMahon Small Business Programme Director	SBD APCD US Peace Corps

Rob Mulligan Director	Central Europe Institute/Entrepreneurship Centers Prague
Bob Posner	USAID United States Embassy
Kirsten Rodine	Entrepreneurship Foundation
Mr. Lubos VAVRA	EC PHARE Programme for SMEs Czech Ministry of the Economy- Small Business Development Agency
Karl Wimer Investment Associate	Czech-American Enterprise Fund Prague

APPENDIX B: BIBLIOGRAPHY, SUGGESTED SOURCES & REFERENCES

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Suggested Newsletters:

The SEEP Network Newsletter	The Small Enterprise Education and Promotion, c/o PACT, 777 United Nations Plaza, New York, NY, 10017. Tel. 212-808-0084
GEMINI Newsletter	The GEMINI Newsletter, Development Alternatives, Inc. 7250 Woodmont Avenue, Suite 200 Bethesda, MD 20814 USA Tel. 301-718-8699 Fax. 301-718-7968