In Good Times and Bad

Monica Landrum works at the business she and Todd Warfield started with a loan from ACCION USA. Photograph: Rohanna Mertens

Yankee Ingenuity Keeps Microfinance Strong

Credit has been called the grease for the gears of the economy, the oxygen of free enterprise, or as Federal Reserve Chairman Bernanke puts it, the lifeblood of our financial system. But for businesses with five or fewer employees, accessing credit can be difficult. Whether it's because lenders don't handle small loan requests or because borrowers have less-than-perfect credit scores, many of the 22 million microentrepreneurs in America cannot access capital from banks or get appropriate forms of financial training.[1]

by Gina Harman and Matthew Royles
ACCION USA

Fortunately, microenterprise development programs, now entering their third decade, have been able to be both lender and mentor to these smallest of businesses. Their support is especially important today because microenterprises create jobs in bad times as well as good. Consider that in 2002, when the unemployment rate reached an eight-year high, microenterprises created nearly 1 million new jobs.[2] And in 2005, microenterprises represented more than 60 percent of the total number of businesses.

Tweaking the Model

Massachusetts microenterprise development got off the ground in 1990 with Cambridge-based Working Capital Inc. Low- and moderate-income microentrepreneurs were offered Working Capital's technical assistance and microloans of up to $5,000 under the peer-group group model (small groups of individuals assume shared responsibility for one another's loan repayments).[3]

In 1991, ACCION International launched a microenterprise pilot program in Brooklyn, New York, that would become the U.S. ACCION Network. Now operating in 18 cities, it has disbursed nearly a quarter of a billion dollars in microloans, primarily to low- and moderate-income microentrepreneurs. Like Working Capital, ACCION New York began by making microloans to groups. But it ultimately determined that an individual-lending model was better suited to U.S. borrowers, who often resisted peer collateralization, the sharing of sensitive information, and the perceived inequities in loan amounts. The individual model was also seen as doing a better job of preparing borrowers to enter the traditional credit system.

Working Capital arrived at a similar conclusion. It found that peer group networking and mutual support were beneficial, but that participants often resisted the responsibility of managing the loan repayments of others, frequently strangers.[4] By the time Working Capital merged with ACCION USA in 2001, it had already switched to the individual-lending model. The New England program has since disbursed $10 million, which (according to an internal study by The Social Compact and ACCION USA) has supported the employment of 1,467 people and has had a historical repayment rate of better than 91 percent.

Microenterprise loans range in size from $500 to $25,000 and are priced between prime and subprime sources of credit. Interest rates start at 12.5 percent and are capped at 17.5 percent. The higher rates offset the significant costs—including write-offs—associated with even very small loans. For a microlender, a $2,000 loan costs roughly the same to disburse and service as a $50,000 loan. Microlending is also time-intensive because of the diligence required to ensure that loans help and not burden clients. Loan officers spend extra time with each client to ensure payments are manageable and that principal amounts are appropriate. In many cases, loan officers also provide free technical assistance, such as credit-repair advice, to clients and nonclients alike. Even at the above interest rates, no U.S. microenterprise development lender has yet achieved 100 percent self-sufficiency.

That is why innovation and economies of scale are so valued. To control costs, portfolio risk needs to be carefully managed, and it is important to have a flexible but comprehensive underwriting process that includes collecting documentation on clients' cash flow and ability to repay the loan. And to help clients build strong credit and eventually move into prime-rate loans from mainstream institutions, microlenders should report loan repayment to the three major credit-reporting agencies.

Innovations: Striving for Self-Sufficiency

Because the costs associated with operating a microfinance program are so high, a recurring theme among practitioners is the need to find savings through technological innovation. To that end, in 2006 ACCION USA piloted a character- and credit-scoring model. The model facilitated a rapid response by segmenting potential borrowers into three categories, each one associated with a range of interest rates, a maximum loan amount, and the associated documentation needed.

Another innovation to build scale and sustainability was an Internet microlending platform. After ACCION USA launched the first one in 2005, microentrepreneurs anywhere in the United States could apply online, execute promissory notes through an electronic signing system, and receive loan disbursements via an Automated Clearing House (ACH) deposit. The system dramatically reduced the time spent on loan renewals. Since ACCION USA made the first Internet microloan to an East Boston bodega owner in 2005, it has lent money in 45 states and Puerto Rico. Although Internet lending means working remotely, delinquency and write-offs remain in line with the overall portfolio.

Partnerships are a good way to reduce marketing costs and expand a lending footprint. Microlenders may partner with banks to get customer referrals, financial support, or loan capital. Some choose to collaborate with municipalities. Contracting with microenterprise development programs has helped community and economic development departments in cities such as Boston, Somerville, and Lawrence, Massachusetts, to tap federal grant funding for microenterprise development. Community-based groups that work with business owners, women, and immigrants also connect clients with microlenders.

Consider that in 2002, when the unemployment rate reached an eight-year high, microenterprises created nearly 1 million new jobs.

Additionally, large corporations understand the challenge of running a business and may be willing to add economic and community development to their portfolios of socially responsibility investments. In one example, ACCION USA launched a loan fund in partnership with the Boston Beer Company to support New England microentrepreneurs in the food and hospitality industries. Microentrepreneurs who receive loans from the "Samuel Adams Brewing the American Dream Micro-Loan Fund" also receive counseling and mentoring through a financial education program.

Current Challenges

Although, like much of the country, low- and moderate-income microentrepreneurs have struggled in the recession, nonprofits lending to these borrowers generally escape the widespread charge-offs (the value of loans removed from the books and charged against loss reserves) that many subprime lenders have seen. Careful management of risk helps with weathering financial downturns. ACCION USA, for example, maintains a prudent debt-to-net assets ratio of roughly 4:1, and although it saw delinquency grow in 2008, the rate did not exceed manageable levels.

In fact, for ACCION USA, the most visible impact of today's economy has been a decline in loan disbursements from 2007 levels. Prospective borrowers may hold mortgages that are adjustable and subprime or may carry too much credit card debt. A lack of available collateral and reduced cash flow may also make lending to microentrepreneurs problematic.

As a result, technical assistance, coupled with microloans when appropriate, has become increasingly important. In one case, ACCION USA assisted a Boston-area entrepreneur whose business had recently grown from four to 12 employees. With her money tied up in receivables, she was having trouble getting paid, which hurt her cash flow. ACCION USA provided a loan to make payroll and also linked her to pro bono legal help provided by Greater Boston Legal Services.

Countering the Credit Crunch

Federal intervention into the U.S. banking system is helping to relieve the pressure on banks resulting from bad debt. However, in light of the continued challenges facing both banks and borrowers, a resurgence of widely available credit is not a given. Alternative sources of credit, including microlenders, community development financial institutions (CDFIs), and peer-to-peer lenders are likely to play an increasingly important role in financing small businesses both today and in the long term.

Gina Harman *is president and CEO of ACCION USA in Boston, Massachusetts, where* **Matthew Royles** *is associate director of resource development.*

Endnotes

[1] Elaine L. Edgcomb and Joyce A. Klein, "Opening Opportunities, Building Ownership: Fulfilling the Promise of Microenterprise in the United States" (Washington, DC: The Aspen Institute, February 2005).

[2] See http://www.microenterpriseworks.org.

[3] Nancy C. Jurik, *Bootstrap Dreams: U.S. Microenterprise Development in an Era of Welfare Reform* (Ithaca, New York: Cornell University Press, 2005).

[4] Nazli Kibria, Susan Lee, Ramona Olvera, "Peer Lending Groups and Success: A Case Study of Working Capital," *Journal of Developmental Entrepreneurship* (April 2003).

Store owners Leonardo Clavijo and Leticia Mantilla were able to begin their business with a loan from ACCION USA when no traditional bank would give them a loan. Photograph: Rohanna Mertens