REPLICATING MICROFINANCE IN THE UNITED STATES

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The Future of Microfinance in the United States: Research, Practice, and Policy Perspectives

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In many countries around the world—from Bangladesh to Bolivia, from India to Indonesia—microfinance initiatives and institutions have become important tools to promote self-employment and entrepreneurship, create jobs and wealth for low-income people and welfare recipients, increase affordable housing and homeownership, and strengthen families and communities. In particular, the success of the Grameen Bank in Bangladesh has been widely discussed and emulated during the past two decades, not only in developing countries, but also in the United States.

Hundreds of public- and private-sector microfinance programs are now operating in the United States, with substantial diversity in how they are funded and operated, and in what target populations they serve. There is also a growing body of research and program evaluation information regarding the accomplishments of these programs. Many programs now belong to one or more trade groups, including the national group, the Association

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for Enterprise Opportunity, and a sector-based group, the National Association of Small Business Administration Microloan Intermediaries. Most of the programs are supported by a wide range of private foundations, government agencies, financial institutions, corporations, research centers, and nonprofit organizations.

To explore the extent to which the many benefits of the international microfinance experience can be replicated in the United States, the Fannie Mae Foundation and the Woodrow Wilson International Center for Scholars sponsored a conference, "The Future of Microfinance: Research, Practice, and Policy Perspectives," on October 11, 2001. The conference was designed to explore cutting-edge issues, recent experiences, and lessons learned both domestically and globally through a daylong conversation among leaders in the field of microfinance. A special focus was on challenges and opportunities for increasing scale, outreach, effectiveness, and sustainability of microfinance institutions and activities in the United States. Conference participants included leaders of nationally recognized microfinance institutions, senior government officials, senior foundation executives, leaders of trade associations and intermediaries, senior executives of financial institutions and corporations, affordable housing and community development leaders, and distinguished scholars from universities and research centers. The conference participants are listed in appendix A.

The conference was organized into three sessions: "Microfinance and Development: The International Experience"; "Microfinance in the United States: Challenges and Opportunities"; and "The Future of Microfinance: Innovations and Interventions." The presentations and discussions contrasted the relatively recent U.S. experience with the international experience and highlighted the important distinctions between the two contexts, especially with regard to financial infrastructure, markets, populations served, program objectives, and regulatory environment. The participants agreed that though there are many best practices in developing countries, their applicability to the United States is limited given these contextual differences, and therefore the United States needs to develop its own model. Underlying the conversations was the belief that microfinance—though currently limited in scale, scope, and outreach—can fill a niche within broader poverty alleviation and community development efforts in the United States. In this direction, a promising trend observed by participants is the integration of microfinance programs within larger entities such as community development corporations, community development credit unions, and other community-based organizations. The participants also expressed curiosity and enthusiasm about efforts to incorporate microenterprise into affordable housing production and delivery in the United States.

In this chapter, we summarize the conference and report on the major points, themes, and recommendations that emerged throughout the presentations and discussions; the day's agenda is included as appendix B. Although not directly addressed in the agenda, a constant concern throughout the day was how to define the terms microfinance, microcredit, and microenterprise. We felt it would therefore be useful to make these initial distinctions for the reader of this chapter.

Definitional Distinctions: What Is Microfinance?

"What constitutes microfinance?" was an important question discussed at the conference. A number of important distinctions were drawn among the terms "microfinance," "microcredit," and "microenterprise." The following is a brief summary of the main features of those distinctions.

Microfinance refers to the institutional infrastructure that supports the provision of very small loans ("microcredit") and increasingly other financial services, such as savings, insurance, and payment services to low-income people. In addition to credit and financial services, many microfinance institutions (MFIs) provide social and technical assistance, including group organizing skills, development of self-confidence, and training in financial literacy and management capabilities for members of a microfinance group.

Credit-based microfinance tools rely on alternative sources of collateral, such as communal or solidarity-group lending where everyone in the group is responsible for everyone else's debt. Savings-based microfinance tools also make use of the solidarity-group concept to pool savings. There are programs that combine both credit and savings strategies to shore up the financial capacity of the borrowing household on the one hand, and reduce the risk to the lender on the other, such as housing finance programs that have a mandatory savings component to cover the down payment and to demonstrate repayment capacity.

Microcredit is a consumer loan that is usually less than \$200 in developing countries or \$2,000 to \$3,500 in the United States. Microcredit typically supports the capital needs of very small businesses ("microenterprises") engaged in a variety of productive activities. Other uses of the small loans received by the clients include "consumption smoothing" (which is credit used to supplement income), housing, and education. Because microenterprise support through microcredit can be the major or only activity of an

MFI, at times the term microfinance is used interchangeably with microenterprise or microcredit.

There is considerable variety in the types of organizations engaged in microfinance. One category includes the specialized providers, including nongovernmental organizations and other nonprofits (e.g., ACCION International and FINCA USA) that have become commercially sustainable. Some credit unions, cooperatives, and commercial banks also are engaged in microfinance and have a tremendous presence in many countries. Examples of large banks engaged in microfinance include the Bank Rakyat Indonesia and the Grameen Bank in Bangladesh. In the United States, a hybrid has developed that includes nonprofit community-based organizations that loan funds under various government and private-sector lending programs. These include community development corporations, small business development corporations, economic development offices, and other government agencies. Large banks are indirectly involved in the movement via loan guarantees, backroom services, and donations of capital and time.

A *microenterprise* (or *microbusiness*) is a business with capital needs of less than a given amount and no more than a set number of employees. The definition is stated in this manner to allow for the different thresholds for capital and staff requirements of small businesses that vary both from one national context to another, as well as over time. According to the Association for Enterprise Opportunity, in the United States the maximum capital need is $35,000 and the maximum number of employees is five.[1] According to the Aspen Institute's Self-Employment Learning Project,[2] a microbusiness has a staff of fewer than five people, has had no previous access to commercial sources of credit, and may require a loan of up to $15,000 to get started.[3] In developing countries, microenterprises are usually engaged in production-based economic activities such as food processing and petty trade, whereas in the United States microenterprises can be found in industries across the board, from manufacturing to services to

1. The U.S. government, the largest supporter of domestic microenterprise activity, does not offer a single definition of "microenterprise" but describes it in terms of particular programs.

2. It was a multiyear research and evaluation effort designed to produce new information about the field of self-employment and about microenterprise as a poverty-alleviation and job-creation strategy in the United States. The project tracked the progress of 405 individuals who were running microbusiness for a 5-year period from 1991 to 1997.

3. For more on this issue, see Peggy Clark and Amy J. Kays, *Enabling Entrepreneurship: Baseline Year Report of the Self-Employment Learning Project* (Washington, DC: Aspen Institute, 1995).

sales. Although many are service based, offering a wide variety of services such as child care, house cleaning, delivery services, window washing, and catering, a significant portion are in light manufacturing, food processing, retail trade, and communications.

Microfinance for housing is a separate category of interest. The microfinance industry is involved in housing in two very different ways. In the United States, microlenders provide funds to microenterprises involved in the *production* of low-cost housing. Internationally, although microloans are made to finance businesses, in up to 25 percent of the cases, borrower households use the loan proceeds to pay for household *expenses*. Because of the ways these loans are collateralized, the household is underwritten rather than any specific property or asset, and this fungibility of the proceeds is achieved with the full knowledge and consent of the lender.

The applicability of microlending to housing in developing countries is enhanced by a phenomenon prevalent in these countries called progressive or incremental housing. Incremental housing is the practice of families building their own homes gradually during a period of 5 to 15 years as savings or other funds become available. Although it is more prevalent in the informal sector of the economy, it also accounts for the high rate of homeownership among low-income households in developing countries. Its effectiveness in this regard has not gone unnoticed, and commercial builders recently have begun offering expandable core housing for sale. One potential growth area for microfinance is in the affordable housing field, and creative energy is being spent on developing the financial tools that match the equity dynamics and risk profiles of this potential market.

Microfinance and Development: The International Experience

Microfinance has transformed the lives of millions of people in developing countries since its introduction by Mohammad Yunus, founder of the Grameen Bank in Bangladesh. It has helped low-income people build businesses, create jobs, and lift themselves and their families out of poverty. International microfinance programs—based on the concepts of free enterprise and self-help—have proven that given access to small amounts of credit (usually less than $200), low-income people can through their own efforts pull themselves out of poverty and sustain the wealth they build.

Today, the international microfinance industry with its 25 years of experience is quite mature and includes formalized institutions, markets, and business practices. In this section, we summarize presentations and discussions from the first panel of the conference, in which the panelists and participants described the key features of the international experience in microfinance and shared the lessons learned.

Today, there are about 10,000 microfinance institutions in developing countries serving about 16 million low-income people. The target population, as was pointed out by J.D. Von Pischke of Frontier Finance International, includes the "working poor" (people right above and below the poverty line), mostly women who already own their businesses but do not have sufficient access to affordable capital. Microenterprise development is the primary use of microfinance, followed by housing, education, and consumption smoothing. Microfinance has only begun to scratch the surface of what is possible. It is estimated that as much as two-thirds of the adult population in developing countries, only 3 to 6 percent of whom are currently being served, can benefit from microfinance programs.

The relative success of the microfinance industry in developing countries, in terms of its scale, performance, and outcomes, is to a large extent attributable to the following factors:

- limited availability of commercial capital,
- sizable market demand for microenterprises, and
- sophisticated microfinance infrastructure.

With regard to the limited availability of commercial capital, commercial credit in developing countries is typically available to 1 or 2 percent of the population. A large segment of the working poor, especially in vast rural areas in developing countries, is left out of the mainstream banking system and lacks access to commercial credit. This huge capital gap constitutes unmet demand for credit in these countries and has fueled the market for microlending. It is the major driving force behind the microfinance industry.

As for the sizable market demand for microenterprises, in developing countries local economies typically are based on the principle of import substitution, thereby creating a strong market for local producers. As Bruce Ferguson of the Inter-American Development Bank explained, "There is a big market for very basic quality affordable products that are locally made." Further, because regional economies are not well integrated, local economies can flourish through local production. This creates significant pent-up demand for capital and market for microentrepreneurs, and therefore the infusion of a very small amount of capital into these markets triggers substantial business growth and development.

With respect to a sophisticated microfinance infrastructure, Maria Otero, the president and chief executive officer (CEO) of ACCION International, pointed out three major infrastructure-related "breakthroughs" (which actually have happened gradually over time) in the microlending industry. These three breakthroughs have brought it to the scale and sustainability that it enjoys today in the developing world: the development of a rigorous and effective lending technology, the shift from donor-based to commercial-based funding, and the formalization of microfinance.

The first breakthrough, a rigorous and effective lending technology, has evolved during the 25-year history of microfinance in developing countries. This lending technology combines the basic financial principle of risk protection with business practices driven by the social and cultural values of the various countries. Leading microfinance programs charge interest at rates that sufficiently cover the cost of credit delivery, which enable them to grow quickly in markets where there is a very large unmet demand. Although the basic requirement is that the borrower has operated a business that has been in existence for 6 months to a year before applying for a loan, the underwriting criteria applies to the income of the entire household or family, rather than only focusing on potential revenue from specific entrepreneurial activities.

As a result, although there is always a business behind the borrower, the microloan might be used for housing, education, consumption smoothing, or creating a new business depending on household needs at the time. Another feature of these microfinance programs is solidarity-group lending, a practice whereby business owners who have received direct loans from the program are then encouraged or required to provide credit to other program participants. These programs substitute peer pressure for collateral and foster-group support for the entrepreneurial effort. The flexible uses of the loan proceeds coupled with solidarity-group lending have led to very high repayment rates—about 95 to 97 percent.

The second breakthrough, the shift from donor-based to commercial-based funding, also has happened incrementally. Although international microfinance is still primarily donor driven and hence is highly subsidized, there has been a gradual movement from donor-based to commercially driven programs. This has been achieved by using subsidies for institution building, while using interest income to cover the costs of loan transactions. Over time, as institutions have matured, the need for subsidies has correspondingly diminished. Linking MFIs to commercial sources of capital rather than donor funds and grants has revolutionized the field. For example, ACCION created a bridge fund based on a guarantee fee that allows smaller MFIs to borrow from commercial lenders against this guarantee, thus overcoming the biggest barrier in developing-country microfinance, which is access to capital and growth of programs.

The third breakthrough, the formalization of microfinance, which is still going on, reflects the increasing sustainability and institutionalization of the sector in the international context. Nonprofit microfinance institutions are transforming themselves into commercial, regulated banks or finance companies, and are becoming part of the mainstream financial systems of their countries. The largest, most successful microfinance programs abroad are freestanding, self-sufficient organizations.

These three key breakthroughs, though revolutionizing microlending technology, currently apply to only a small number of institutions—about 65 out of approximately 10,000 MFIs worldwide. These 65 institutions, which control the bulk of global microlending, each year serve half a million people and lend $650 million, with an average loan size of about $500 to $600.

A major discussion topic at the conference was the extent to which the ability of microfinance programs in developing countries to generate substantial accomplishments both efficiently and cost-effectively can be successfully replicated in the United States. The panelists and participants agreed that, though there are many excellent practices in developing countries, their applicability in the United States is very limited given that there are substantial contextual differences governing the activities of the U.S. microfinance industry. As Maria Otero told the conference, the major lesson from the international experience that applies to the United States is that "low income people, when given the access and opportunity, will take advantage and improve their lives."

The participants concluded that the United States needs to develop its own microfinance model, achieve its own breakthroughs, and create its own best practices in response to its own context. In fact, William Burrus, the president and CEO of ACCION USA, cautioned the conference against making casual comparisons, reminding them that whereas internationally microfinance has a track record of more than a quarter-century, in the United States it is a relatively nascent industry with about 10 to 12 years of serious experience. We now turn to a discussion of U.S. microfinance experience.

Microfinance in the United States: Challenges and Opportunities

In comparison with 25 years of international experience, microfinance in the United States with its 15 years of history can be considered a relatively recent development. Regardless of its short history, however, the field has grown tenfold in the past decade and now enjoys an established national microfinance infrastructure. Microfinance programs have also revealed the powerful impact that microenterprises have on people in terms of asset building opportunities and have shown that self-employment can be a good vehicle to move people off welfare.[4]

In this second panel discussion, the participants took a critical look at the state of microfinance in the United States and made observations about the dominant trends in the field. A major focus of this session was contextual distinctions between the United States and developing countries that explain the differences in scale and program structures. This session also identified opportunities in the United States that will be critical for advancing the field. Underlying the presentations and the discussions was the belief that microfinance, though currently limited in its scale, scope, and outreach, has an important role to play in contributing to broader efforts to reduce poverty and improve the lives of low-income families and communities in the United States.

The State of Microfinance: Small Scale, Large Subsidies, and Weak Financial Performance

In comparison with the international experience, the scale of microfinance in the United States is much more modest. Currently, about 283 U.S. microfinance programs each reach 100 to 200 clients annually. Most of these programs are heavily subsidized. Since the inception of its microfinance program nearly 10 years ago, the U.S. Small Business Administration (SBA) has loaned about $145 million to microlenders. SBA appropriations for grants to support the nationwide training and technical assistance provided by funded microlending organizations annually have fluctuated between

4. For more detailed information on this issue, see Peggy Clark and Amy J. Kays, *Microenterprise and the Poor: Findings from the Self-Employment Learning Project* (Washington, DC: Aspen Institute, 1999).

$15 and $24 million. The financial performance of the industry in general is weak. The best operations consume $1.50 in administrative costs for each $1.00 loaned, and this measure ranges up to $3.60, with an industry average of $2.00. Of 16 microfinance programs surveyed in California during 1996, 5 were no longer in existence 2 years later.

The SBA's performance expectations are low as well. A lender's performance is not deemed inadequate under the regulations unless they produce fewer than four loans a year. The chief of the SBA's Microenterprise Development Branch, Jody Raskind, pointed out that the total production of SBA-supported microlenders has yet to exceed 2,500 loans a year.[5] Compare this with the international experience, where half a million people are served annually, and where average administrative costs and bad debt losses combined amount to 20 percent of the value of the total loan portfolio. Internationally, in the village bank model, a loan officer is not thought to be productive until he or she has at least 150 borrower clients. One conference participant reported having met two loan officers who each routinely served 600 borrower clients. This begins to shed some light on the differences between microfinance in the United States and in some developing countries.

Trends and Challenges for Microfinance

The conference participants identified four broad trends and challenges for microfinance practice in the United States. In this discussion, major emphasis was on the contextual differences between the United States and developing countries with respect to the financial services industry, consumer markets, and regulatory environments as an explanation for the relatively modest scale of microfinance in the United States, as well as the important differences in program design.

The first—and major—challenge facing the microfinance field in the United States is the *limited market demand for goods and services produced by microenterprises.* Instead of the vast pools of demand that exist in developing countries, the United States faces what conference participants referred to as "puddles of demand." In comparison with 75 percent in developing countries, only about 5 percent of the U.S. population is self-employed.

5. However, approximately 15,000 jobs have been created or retained as a result of the lending. The microloan portfolios of SBA microlenders must perform at an 85 percent or better repayment rate, and most enjoy repayment rates of 92 to 98 percent.

According to a recent survey conducted by the National Commission on Entrepreneurship, roughly 8 to 12 percent of American adults are serious about starting their own businesses, and only about 1 to 2 percent actually end up starting one. Of those started, only about half become viable and remain in business.

Another characteristic of the self-employed in the United States is their less entrepreneurial nature, when compared with clients of microfinance programs abroad. Lisa Servon of the New School University in New York observed that only 35 percent of people who start small businesses in the United States are genuine entrepreneurs. The others are doing it because it is their best available option—there are fewer jobs in the mainstream market, they need to care for an ailing parent, they need to be at home when their children return from school, or they need to accommodate some other difficult or special circumstance in their lives that requires a more flexible work schedule.

Another observation regarding the nature of market demand for microenterprises is its countercyclical nature. Katherine McKee, director of the Office of Microenterprise Development at the U.S. Agency for International Development (USAID), observed that in recessionary economic times many more people pursue self-employment opportunities because there are fewer jobs available, but that a downturn in the economy is clearly not the most advantageous moment to start a business. All of these variables lead to fluctuating, limited market demand for small entrepreneurial activities that can be supported by microfinance in the United States.

The second challenge is that *market entry into local economic activity is highly complex and regulated.* In the United States, there are major barriers to market entry and expansion by small businesses. Starting a business in a developing country often involves nothing more than setting up a roadside stand, whereas in the United States even establishing a tiny kiosk requires permits, licenses, and inspections. The need to clear these bureaucratic hurdles acts as a disincentive to starting small businesses, and also necessitates training and technical assistance for the inexperienced entrepreneur. An additional barrier to market entry is the tight competition in highly integrated U.S. consumer markets. For example, the retail trade sector is very competitive, with several major national chains such as Wal-Mart and Target, along with many large regional supermarket chains controlling local markets. It is extremely difficult for small businesses to successfully compete against these retail giants.

The third challenge is the *need for training and other supportive services.* Participants observed a shift from focusing on lending to placing more emphasis on training. The skill sets and therefore the training required to start small businesses and generate income from self-employment in our complex, highly integrated, service-based economy go far beyond those needed to initiate microenterprises in developing countries. As Jonathan Morduch of New York University pointed out, a lack of training is one of the core challenges that microfinance programs in the United States have been struggling with. In the early years of the U.S. microfinance movement, many thought that it would be possible to recover costs with the assumption that the biggest barrier to becoming self-employed was credit. But many program administrators and field experts have learned that many potential entrepreneurs come to microfinance programs needing much more than credit. Consequently, a broader range of services are being incorporated into microfinance programs. One program requires 108 hours of training in marketing, finance, and sales, along with preparing a business plan, as prerequisites to establish eligibility to obtain a loan.

The fourth challenge is the *need for subsidies*. Successful microfinance programs abroad are freestanding and self-sufficient. The interest rates charged are quite high in order to cover the cost of operations and transactions. In the United States, the interest rates charged on credit cards serve as an effective microloan interest rate ceiling. At these rates, most U.S. microfinance programs cannot achieve sustainability unless they scale up to international standards and increase efficiency dramatically. As a result, in the United States microfinance programs are primarily supported by grants and low-interest loans from government agencies, private foundations, and other philanthropic entities. Heavy reliance on subsidies and a lack of commercial capital limit both the number of programs that can be funded and the scope of existing ones.

Opportunities for Microfinance

In spite of these serious challenges, the conference participants agreed that there are many opportunities to advance microfinance practice and improve its scale. They identified six opportunities for microfinance practitioners to pursue in driving its future growth and development.

The first opportunity is to *serve the consumer finance needs of the "unbanked."* The limited scale of the microfinance industry contrasts with the tremendous size of the consumer finance market it can potentially serve. Some estimates suggest that more than 15 million people in the United States do not have any relationship with a banking institution. These consumers rely on high-cost, alternative providers—including pawnshops, check-cashing outlets, and payday lenders—that are rapidly growing in many low-income and distressed communities. Microfinance, both microcredit and savings products, can be used to address the unmet financial services needs of low-income households. Monique Cohen of USAID emphasized the need to analyze carefully how low-income Americans are meeting a variety of financial service needs (e.g., savings, life insurance, health insurance), both through formal and informal channels, and carefully assess the niche for microfinance in servicing this population. James Carr of the Fannie Mae Foundation pointed out that certain types of households with very good risk characteristics can very easily be connected to mainstream financial institutions.

The second opportunity is the *untapped consumer market for microenterprise.* Some participants argued that there is a vibrant informal economy in the United States, although not enough is known about its presence, size, or characteristics. Jack Litzenberg of the Mott Foundation pointed out that many low-income households, including those on public assistance, supplement their formal income with jobs in the informal sector. These are mostly young adults, 18 to 30 years old, operating small businesses primarily in low-income and immigrant communities, to supplement their wage incomes during periods of need.

Connecting these low-income households to the formal U.S. economy through microfinance will require a better understanding of barriers to their current participation in microfinance programs. An optimistic view is that every one of them is a potential beneficiary of microfinance services. A more cautious view is that only 8 percent of low-income people and only 1 percent of displaced workers would be willing and viable microfinance customers. Resolving the difference between these two perspectives is at the heart of defining the future of microfinance in the United States.

The third opportunity is *consumer tolerance for high interest rates.* Several participants indicated that it is not precisely true that credit card rates mark the upper limit of tolerance for interest rates by low-income U.S. borrowers. Interest rates for certain alternative "fringe" consumer financial services range from 400 percent to more than 1,000 percent on an annualized basis, and in some cases up to more than 2,000 percent, according to the Consumer Federation of America. Payday lenders, for example, routinely charge 15 to 17 percent for relatively small consumer loans for a period of just 2 weeks, which represents a 400 percent annual interest rate.[6]

6. For more detailed information on alternative or fringe financial sectors, see James Carr and Jenny Schuetz, "Financial Services in Distressed Communities: Framing the Issue, Finding Solutions," in *Financial Services in Distressed Communities: Issues and Answers* (Washington, DC: Fannie Mae Foundation, 2001).

James Carr stated that claims of high risk to justify this type of usurious lending are highly exaggerated, for three reasons. First, in the 6 years between 1993 and 1999, the number of financial institutions offering payday loans grew from 300 to 8,000, with projected growth of another 1,000 lenders during the next 2 years. Second, the most recent data available on the payday lending industry indicate that the loan loss rate for these institutions is an extremely low 1.1 to 1.3 percent, which makes it prime credit. Third, the average return on investment for payday lending is currently 25 to 35 percent, which clearly makes it a very profitable enterprise.[7]

The fourth opportunity is *socially responsible investment as a new source of capital.* One of the speakers at the conference was Barbara Krumsiek, the president and CEO of the Calvert Group, a $7.5 billion financial intermediary in the mutual funds business. She stated that mutual funds are a sector of the financial services industry that is now larger in terms of assets than both the insurance and the banking sectors. The Calvert Group is looking for ways to tap into the financial potential of the lower end of the income spectrum, because through surveys of their clients, they have discovered that 43 percent of affluent investors, approximately 33 million Americans, are willing to place some of their money into socially responsible investments.

In response to this growing interest, the Calvert Group has created the Calvert Socially Responsible Mutual Fund. The Calvert Foundation will channel 1 percent of the assets of this new mutual fund into the kind of economically underserved activities that the microlending industry generally supports. The Calvert Group is not alone among mutual funds in its efforts to invest in low-income families and communities—it is currently managing a similar "private-label" community investment initiative for another mutual fund company. Also, American Express is investing 1 percent of the value of all credit card charges from its Small Business Services in microenterprise programs. These are all good examples of leveraging the power of major financial institutions to increase the availability of resources and economic opportunity for low-income families and communities, creating the potential for even larger pools of capital to meet such vital needs.

The fifth opportunity is *microfinance and housing.* One of the dominant uses of microfinance in developing countries is for the construction of

7. For a more detailed treatment of payday lending in the United States, see Jean Ann Fox and Edmund Mierzwinski, *Rent-a-Bank Payday Lending: How Banks Help Payday Lenders Evade State Consumer Protections,* 2001 Payday Lender Survey and Report (Washington, DC: Consumer Federation of America and United States Public Interest Research Group, 2001).

incremental or progressive housing. This practice—building a house in stages during a period of 5 to 15 years, and occupying the house as it is being built—dramatically lowers the costs of homeownership. It is the single most important reason why homeownership rates are so high among low-income households in many developing countries. Residential builders in some developing countries are beginning to operate incrementally by selling expandable homes. The difference it makes is that, for example, a two-bedroom expandable home in Mexico sells for the equivalent of $12,000 to $15,000, whereas a newly constructed basic house across the border in Texas costs more than $100,000.

The formal marriage between housing microfinance and progressive housing is not yet well developed, but many people are looking for more creative, affordable ways to finance housing production and homeownership, because traditional mortgage finance typically reaches less than 10 percent of households in developing countries. As Bruce Ferguson explained, "Microcredit can finance the steps in the progressive housing process—a small loan to purchase the lot, a small loan for titling, a small loan for improvement or expansion, and a somewhat larger loan for a core unit." Practices accompanying microfinance and progressive housing include mandatory savings to accrue a down payment and demonstrate repayment capacity, and joining microcredit together with homebuyer savings and government grants to finance a home purchase.

One of the opportunities for microfinance of special interest to the Fannie Mae Foundation is the potential use of microcredit to provide affordable housing and homeownership opportunities in the United States. William Edwards, executive director of the Association for Enterprise Opportunity, observed that housing and microenterprise is a growing segment within their membership and that the Association for Enterprise Opportunity is working on a relationship with the national Neighborhood Reinvestment Corporation to increase participation in microenterprises within their many homeownership and home renovation campaigns and programs in low- and moderate-income communities.

The conference participants questioned the potential for successfully implementing incremental home construction and financing programs in the United States—where, to buy a house, a person must deal with a sophisticated network of lenders, secondary mortgage market institutions, title companies, real estate brokers, land developers, and home builders, all tied together by an intricate network of local, state, and federal regulations governing everything from building codes to wage rates. What American approach to incremental housing would enable large numbers of low-income people genuinely to benefit from substantial cost reductions in home prices? The Fannie Mae Foundation and USAID have recently initiated a joint research project to investigate this topic.

The sixth opportunity is the *movement away from freestanding credit-driven MFIs to more integrated institutions.* A promising trend noted by participants is the integration of U.S. microfinance initiatives and institutions with broader community development strategies and programs. Unlike the international model of freestanding, credit-driven models, there is a growing U.S. trend toward microfinance programs that are nested within larger entities, such as community development corporations, community development credit unions, and other community-based organizations.

Millard Owens of the Ford Foundation told the conference that this trend is central to the future success of microfinance in the United States. He emphasized the great potential of microfinance for both consumer finance and the microenterprise needs of low-income people, and he pointed out that the field is at a crossroads: "Nearly 15 years of experience in the United States is ending, and the next growth spurt will require surviving the scrutiny of funders, policymakers, practitioners, researchers, and advocates. The challenge is in transitioning from marginalization to mainstream. The next great leap forward will require microenterprise to strengthen its identity and position itself as a partner in the broader world of economic security programs." In the next section, we present policy and research recommendations that were offered by participants to help make possible this great leap forward.

The Future of Microfinance: Innovations and Interventions

In the United States, economic security is viewed as the overarching goal of microfinance efforts. As such, microfinance leaders are increasingly promoting microfinance as a tool for meeting a variety of consumer needs aside from its traditional role of microenterprise. As was expressed by participants during the conference, there is growing interest in exploring how microfinance may be used to address the consumer finance needs of underserved populations in addition to providing microcredit to support self-employment and microenterprises. A growing number of U.S. microfinance programs are becoming integrated with broader community development strategies and programs.

Microfinance leaders are also placing more emphasis on the human capital development aspects of the practice. They believe that the human development investments made in the clients of microfinance programs will yield long-term benefits for them in the labor market, whether or not they actually form or operate their own microenterprise. Growing recognition of microfinance as a tool for developing human capital emphasizes the need to better understand the needs of clients and to develop alternative business models to address different clientele needs. Business models need to be customized to take into account unique goals and unique populations. One potential development strategy in this direction, according to Karen Mocker of the CDFI Fund at the U.S. Department of the Treasury, is market segmentation—developing niche products to meet the unique needs of different types of clients. This strategy may actually lead to a business model for increasing the scale of microfinance and for mainstreaming it.

Policy and Program Recommendations

In keeping with the broad themes outline above, the conference participants offered eight recommendations for practitioners, policymakers, and researchers to advance the field of microfinance in the United States so that it can become more effective in meeting the financial and economic needs of economically disadvantaged people. First, the participants recommended that *increases in scale should be pursued through the formation of partnerships.* They emphasized the importance of creating "fungibility" at the institutional level through partnerships and alliances with other financial institutions (e.g., community development financial institutions and community development credit unions) that are engaged in microenterprise lending. They stressed that microfinance institutions also must partner with community development corporations, community action program agencies, workforce and entrepreneurial training organizations, and other community-based groups. With each partnership, the overall client base for microfinance will expand.

Jeffrey Ashe of Brandeis University proposed an innovative approach to partnerships. He suggested that through short-term partnerships, large, established MFIs can share their resources and technical experience with smaller microfinance organizations, and then step back once the capacity has been fully developed. He argued that such an approach would contribute to building scale within the microfinance industry by eliminating the interorganizational tensions associated with affiliate-based models. MFIs should also partner with major human services organizations and encourage microfinance clients to use these diverse services, rather than trying to provide for everything in house.

Second, the participants recommended that *the financial performance of microcredit programs should be measured* because it is critical to build credibility and gain acceptance from funders, policymakers, and practitioners. Information on the profitability and overall performance of microloan portfolios is essential to gain greater support for microfinance from mainstream financial institutions and socially responsible investors. Currently, there are very limited data on the financial performance of microfinance institutions and programs.

Third, the participants recommended that *new organizational arrangements in the field of microfinance should be considered* to increase efficiency and improve cost-effective financial performance. One suggestion is to consolidate microloan programs and standardize loan underwriting. Currently, many disparate loan funds are offered by different microfinance programs, and these could be more efficiently managed if the funds were pooled together. Only 30 percent of the funds available for loans on average have been dispersed, and this proportion should be much closer to 70 percent. Linking microlending capacity more closely with mainstream financial institutions is another strategy to explore. This would enhance the sustainability of microfinance intermediaries, expand capital accessibility for microenterprise borrowers, and also help strengthen mainstreaming opportunities for microfinance clients.

Fourth, the participants recommended *the development of an adequate institutional infrastructure on a statewide basis,* which many believe is crucial for the industry's future growth in the United States. Recently, there have been some promising developments, including state microenterprise associations—there are now practitioner-oriented advocacy groups in nearly two dozen states. These entities are playing a major role in policy development and capacity building within their respective states. Another new state infrastructure trend is in the establishment by state governments of microenterprise intermediaries, which have the ability to leverage national sources of capital with state and local public and private funds in significant ways. Examples include the Nebraska Microenterprise Partnership, which has successfully tripled state microfinance funding during the past 3 years.

Fifth, the participants recommended that *microfinance leaders should participate in the federal welfare reform discussions in 2002* and explore ways to incorporate opportunities for social service agencies to connect with the microfinance industry. Under the current federal welfare law (Temporary

Assistance for Needy Families, or TANF), microenterprise development is not considered as an eligible activity under the mandatory job search requirements. Consequently, only after people fail in their formal job search and cannot find any full-time employment does starting their own business become an approved option. Jack Litzenberg persuasively argued that federal and state policymakers should directly address this issue by including microenterprise development under the job search category as an acceptable form of self-employment. Microenterprise is one good way for certain people to escape from poverty—not only to leave public assistance, but also to earn a decent family income and gain economic security.

Sixth, the participants similarly recommended that *state and local government policymakers should be educated about the nexus between microfinance and welfare-to-work initiatives.* Usually, a lack of understanding of this connection leaves microfinance off the policy agendas of state and local policymakers. Some states are moving in this direction, including New Jersey and Texas, both of which have legislation enabling welfare recipients to legitimately own and operate microenterprises without losing their benefits.

Seventh, the participants recommended that, in the U.S. context, *those concerned with microfinance should consider separating the concept of "financial viability" from that of "sustainability";* that is, a microfinance institution can be efficient and a high performer yet still not be commercially sustainable. If subsidies are regarded as investments in human capital development, then financial assistance to microfinance institutions should be viewed as fees for service, and sustainability should be measured in terms of return on investment in human capital.

Detaching the measurement of sustainability from commercial or financial viability, however, does not eliminate the need to hold MFIs accountable for performance criteria such as loan loss rates, loan delinquencies, risk management, number of clients served, costs per client, and effective service delivery. These and other relevant measures should be incorporated into microfinance performance evaluations. The participants raised concerns that the expectation of ongoing subsidies for microfinance institutions and programs may not be realistic given that philanthropic foundations and government agencies often are reluctant to subsidize organizational activities on a long-term and continuing basis. Many private and public providers of grant funds operate within a maximum 5-year cycle of ongoing funding, essentially requiring microfinance programs to diversify their sources of income and become self-sustaining within that time frame or face possible closure.

Eighth, the participants recommended that, to maximize the goal of economic security for low-income families and communities, *closer linkages must be forged between savings strategies such as individual development accounts and microenterprise investment opportunities.* Robert Friedman, chair of the Corporation for Enterprise Development, told the conference that, for low-income people, personal savings and the savings of family and friends are the financial foundations for starting a small business. Currently, the second highest use of individual development accounts is for starting microbusinesses.

A related, very important phenomenon based on the federally funded American Dream Demonstration project is that low-income people can save an average of $25 per week without losing any benefits. The proposed Savings for Working Families Act, if approved by Congress and signed by the president, could provide important incentives to help expand the scale of the savings movement in the United States by creating at least 1 million new accounts worth $1.7 billion for low-income households. Along these lines, Caroline Glackin, executive director of the First State Community Loan Fund in Delaware, announced at the conference that her organization is going to implement a pilot project funded by the Corporation for Enterprise Development to put savings and microcredit together in a comprehensive microenterprise program during 2002.

Research Directions

A strong consensus emerged during the conference that the microfinance field can greatly benefit from research to improve its efficiency and effectiveness, expand the scale of its activities and the scope of its market impact, and more clearly define and publicize best practices in the U.S. context. Roy Priest, the president and CEO of the National Congress for Community Economic Development, told the conference that solid research is a vital tool for advocating on behalf of microfinance and microenterprise with business, government, and civic leaders. The participants identified two areas of research as the keys to strengthening the identity and position of microfinance in the United States. The first area is improving the evaluation of microfinance programs. Several speakers underscored the current lack of good performance data and emphasized the need to undertake solid evaluation studies, particularly to demonstrate the financial viability of microfinance and to correlate financial performance measures with other indicators of social outcomes.

The second area is market research. Most participants agreed that there is a substantial need to obtain better understanding of the size, structure, and characteristics of market demand for effective microfinance product and service development. Solid market research will also permit the careful delineation of "niche" consumer segments to provide much better products and services that satisfy a wide range of potential borrower-client needs. Karen Mocker urged the participants to prod the microfinance industry to engage in continual self-assessment and to generate internal critical evaluations. In her view, microfinance practitioners must constantly reexamine their product development and service delivery, and use this knowledge to generate new and more effective innovations.

Conclusion

The conference participants left the daylong event with energy and enthusiasm for the challenges ahead. Bringing together many of the industry's key players and engaging in many hours of lively discussion and forthright interchange turned out to be an elixir. New ideas and relationships were forged, and new directions—such as examining the informal sector and linking to broader community development and human capital activities—were articulated and refined. The U.S. microfinance industry will certainly not be an exact replica of its international counterpart, but it will surely grow and be an important part of our national search for economic opportunity and community empowerment for generations to come.

Appendix A:
Microfinance Conference Participants

Jeffrey Ashe
Visiting Scholar
Institute for Sustainable Development
Brandeis University

Sabrina Atwater
Program Manager
PACT Publications

This list is based on the RSVPs received prior to the conference. The names of those who participated, but missed the RSVP deadline, are not reflected on this list.

Anna Awimbo
Research Director
Microcredit Summit

Jerry Black
Program Manager
Economic Opportunties Program
Aspen Institute

Amy Bogdon
Director
Fannie Mae Foundation

Sandra Braunstein
Assistant Director
Division of Consumer and Community Affairs
Federal Reserve Board

James Dickson Brown
Executive Director
James Dickson Brown & Co. Inc.

Robert Buckley
Lead Economist
Infrastructure Sector Unit Europe and Central Asia
World Bank

William Burrus
President and CEO
Accion USA

Ayşe Can Talen
Senior Director
Fannie Mae Foundation

Richard Chi-kan Hung
Human Services, CPCS
University of Massachusetts–Boston

Gail Christopher
Executive Director, Innovations in American Government Awards Program
John F. Kennedy School of Government, Harvard University

Peggy Clark
Executive Vice President
Aspen Institute

William Cobbett
Senior Urban Upgrading Adviser
The Cities Alliance

Monique Cohen
Office of Microenterprise Development
U.S Agency for International Development

Nigel Collie
Consultant

Brenda Costello
Senior Policy Manager
FINCA International

Amanda Crook Zinn
Executive Director
Women Entrepreneurs of Baltimore

Stacey Davis
President and CEO
Fannie Mae Foundation

Bill Edwards
Executive Director
Association for Enterprise Opportunity

Mark Engman
Staff Director
Bureau for Legislative and Public Affairs
U.S. Agency for International Development

Bruce Ferguson
Housing/Urban Development Specialist
Inter-American Development Bank

Robert Friedman
Chair and Director of West Coast Office
Corporation for Enterprise Development

Zach Gast
Policy and Research Manager
Association for Enterprise Opportunity

Mike Getubig
Manager, Grameen Bank Replication Program
Grameen Foundation USA

The Honorable Benjamin A. Gilman
Representative
U.S House of Representatives

Ellen Golden
Senior Program Officer
Coastal Enterprises, Inc. (Maine)

Caroline Glackin
Executive Director
First State Community Loan Fund

David Hirschmann
Director, International Development Program
American University

Kent H. Hughes
Director
America and the Global Economy Project
Woodrow Wilson International Center for Scholars

Lopa Kolluri
Senior Community Finance Consultant
Fannie Mae Foundation

Daniel Krotz
Senior Consultant
Institute for Social and Economic Development

Barbara Krumsiek
CEO
Calvert Group

Marlene Leon
Assistant Director
Foundation for International Community Assistance, USA

Jack A. Litzenberg
Senior Program Officer
Charles Stewart Mott Foundation

Eliza Mahoney
Program Manager
Enterprise Development
Corporation for Enterprise Development

Katherine McKee
Director
Office of Microenterprise Development
U.S. Agency for International Development

Elsie Meeks
Executive Director
First Nations Oweesta Corporation

Karen Mocker
Director of External Affairs
CDFI Fund, U.S. Treasury Department

Jonathan Morduch
Associate Professor of Public Policy
Robert F. Wagner Graduate School
New York University

Karen Murrell
Senior Director
Fannie Mae Foundation

The Honorable Andrew S. Natsios
Administrator
U.S. Agency for International Development

Robert Oriko
Loan Fund Manager
Women's Opportunties Resource Center

Maria Otero
President and CEO
Accion International

Millard "Mitty" Owens
Program Officer for Economic Development
Ford Foundation

Eric R. Pages
Policy Director
National Commission on Entrepreneurship

Gary Painter
Assistant Professor
School of Policy, Planning and Development
University of Southern California

Claudia Pharis Weiss
Senior Policy Advisor
U.S. Congressman Chaka Fattah's Office

Lynn Pikholz
Senior Development Consultant
Shorebank Advisory Services

J.D. Von Pischke
President
Frontier Finance International

Roy Priest
President and CEO
National Congress for Community Economic Development

Philip Psilos
Director
Technology and Economics Policy Studies
National Governors Association

Yulonda Queen
Business Service Manager
H Street Community Development Corporation

Jody Raskind
Chief
Microenterprise Development Branch
U.S. Small Business Administration

Kristopher Rengert
Senior Research Fellow
Fannie Mae Foundation

Ana Rodriguez
Chief Operating Officer
Women's Opportunties Resource Center

Sherry Salway Black
Acting President
First Nations Development Institute

Sohini Sarkar
Research Fellow
Fannie Mae Foundation

Timothy H. Schwantes
Policy Associate
National Congress for Community Economic Development

Lisa J. Servon
Associate Professor
Milano Graduate School of Management and Urban Policy
New School University

Shannon H. Sorzano
Deputy Assistant Secretary for International Affairs
U.S. Department of Housing and Urban Development

Guy Stuart
Lecturer, Public Policy
John F. Kennedy School of Government
Harvard University

Laurence Taff
Consultant
Fannie Mae

Richard Taub
Paul Klapper Professor of Social Sciences
University of Chicago

John Taylor
President and CEO
National Community Reinvestment Coalition

Zhong Yi Tong
Senior Research Fellow
Fannie Mae Foundation

Tina Trent
Senior Director
Fannie Mae Foundation

Diana Varat
Project Associate
Woodrow Wilson International Center for Scholars

Andrés Vinelli
Assistant to the Chairman
National Association of Securities Dealers

Marc A. Weiss
Public Policy Scholar
Woodrow Wilson International Center for Scholars

Barry Wides
Director, Community Development
Office of the U.S. Comptroller of the Currency

Jaime Yordan
Managing Director
Goldman Sachs

Appendix B: Microfinance Conference Agenda

Thursday, October 11, 2001

Welcome and Introduction of the Keynote Speaker
Stacey H. Davis, president and chief executive officer, Fannie Mae Foundation

Keynote Address
Congressman Benjamin A. Gilman, U.S. House of Representatives

Conference Overview
James H. Carr, senior vice president, Fannie Mae Foundation

Session I: Microfinance and Development: The International Experience
Moderator: Jody Raskind, U.S. Small Business Administration
Panelists: J. D. Von Pischke, Frontier Finance International; Maria Otero, ACCION International; Katharine W. McKee, U.S. Agency for International Development; Jonathan J. Morduch, New York University
Discussant: Robert M. Buckley, World Bank

Luncheon Speaker
Kent H. Hughes, director, Project on America and the Global Economy, Woodrow Wilson International Center for Scholars

Keynote Address
Jonathan Conly, deputy assistant administrator, U.S. Agency for International Development

Session II: Microfinance in the U.S.: Challenges and Opportunities
Moderator: William D. Edwards, Association for Enterprise Opportunity
Panelists: Lisa J. Servon, New School University; Jeffrey Ashe, Brandeis University; Barbara J. Krumsiek, Calvert Group; Bruce W. Ferguson, Inter-American Development Bank
Discussant: Millard A. Owens, Ford Foundation

Session III: The Future of Microfinance: Innovations and Interventions
Moderator: Marc A. Weiss, Woodrow Wilson International Center for Scholars
Panelists: Robert E. Friedman, Corporation for Enterprise Development; Jack A. Litzenberg, Charles Stewart Mott Foundation; Karen A. Mocker, Community Development Financial Institutions Fund, U.S. Department of the Treasury; Roy O. Priest, National Congress for Community Economic Development
Discussant: William W. Burrus, ACCION USA

Closing Remarks
Ayşe Can Talen, senior director, Fannie Mae Foundation