

**U.S. MICROFINANCE AT THE CROSSROADS
SCALE AND SUSTAINABILITY: CAN LESSONS
FROM INTERNATIONAL EXPERIENCE HELP
GUIDE THE U.S. SECTOR?**

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Preface

The idea for this report came from Martin Connell an early pioneer in microfinance in Canada and a founder of Calmeadow Foundation and the Omega Foundation, two of the paper's sponsors. Calmeadow played an important early role in microfinance internationally, including the founding of one of Africa's first microfinance equity funds, AfriCap, which is still operating and investing in microfinance institutions (MFIs) in East and West Africa

The report's primary aim was to analyze the existing microfinance industry in the United States from the point of view of its ability to scale up services to the underserved (the working poor) and its sustainability, i.e., its ability to operate such that MFIs cover all of their operating costs, including financial costs and loan losses, and are able to generate a reasonable profit to attract private lenders and investors and thus decrease the sector's dependence on subsidies. The report seeks to draw lessons from international microfinance, recognizing that the operating environment for microfinance in the United States is distinctly different than that in the developing and transition economies.

To analyze the U.S. microfinance sector we interviewed many individuals, representing a diversity of institutions in the sector. The list of people and institutions interviewed is in Appendix 6.1. The authors thank each of the individuals who so graciously made their time available to us and conveyed valuable information, not only about their institutions, but also about the sector more broadly. We also analyzed various sources of data on the industry, much of which

is presented in boxes, tables, and charts. Finally, we asked a number of readers to review an initial draft. These readers represent an array of expertise in the sector internationally and in the United States. We thank them all for their valuable comments, which led to redrafting of the report. The readers are listed in Appendix 6.2. Any mistakes in this report are those of the authors alone.

We recognize that some of our views with respect to the sustainability of the sector and our concern that the sector in the United States remains fragile and unable to scale, may be controversial. We, of course, take full responsibility for the views presented.

We would like to thank Alex Silva and Georgina Vazquez of Calmeadow for their support throughout this effort. Also, May Wong of the Omega Foundation for her detailed comments on the paper and her support throughout. We would like to acknowledge the support of the Center for Financial Inclusion at Accion. We would also like to thank Jill Moxley for her expertise and commitment in editing this paper. Amy Gough did an excellent job in editing all of the charts, tables, and graphics in the paper, and we thank her for her effort. Above all, we would like to thank Martin Connell for his efforts throughout the years in moving microfinance to new frontiers and his on-going support for the sector.

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and Phil Goodeve**

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List of Abbreviations

ACH	Automated Clearing House
AEO	Association for Enterprise Opportunity
APR	annual percentage rate
ASIFCU	ASI Federal Credit Union
ATI	Accion Texas Inc.
ATMs	automated teller machine
BRI	Bank Rakyat Indonesia
CAGR	compound annual growth rate
CBA	Credit Builders Alliance
CCSH	Center for Community Self-Help
CDCI	Community Capital Development Initiative
CDB	Community development bank
CDBA	Community Development Bankers Association
CDBG	Community Development Block Grant
CCD	Citi Community Development
CDCU	community development credit unions
CDFIs	Community Development Financial Institutions
CDP	CDFI Data Project
CDVC	Community development venture capital
Cenfri	Centre for Financial Regulation and Inclusion
CFPB	Consumer Financial Protection Bureau
CFSI	Center for Financial Services Innovation
CGAP	Consultative Group to Assist the Poor
CRA	Community Reinvestment Act
CRL	Center for Responsible Lending
CRM	customer relationship management
DFIs	Development Finance Institutions
EBRD	European Bank for Reconstruction and Development
ELF	Emergency Liquidity Facility for Latin America
FA	financial assistance
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FICO	Fair Isaac Corporation
FIELD	Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination
FSS	financial self-sufficiency
FY	fiscal year
GA	Grameen America
GAAP	Generally Accepted Accounting Principles

IDA	individual deposit account
IF	Intersect Fund
IFC	International Finance Corporation
ILO	International Labour Organization
IPO	initial public offering
IRA	individual retirement account
LEDAs	Local Economic Development Agencies
LICUs	low-income credit unions
LMI	low and moderate income
MDOs	microenterprise development organizations
MF	Microfinance
MFI	microfinance institution
MIF	Multilateral Investment Fund
MIS	management information system
MIVs	microfinance investment vehicles
NBFI	non-bank financial intermediaries
NCUA	National Credit Union Administration
NFCDU	National Federation of Community Development Credit Unions
NFIB	National Federation of Independent Business
NGO	non-governmental organization
OFN	Opportunity Finance Network
OMB	Office for Management and Budget
OUR	OUR Microlending
PAR	portfolio at risk
P2P	peer-to-peer lending
PRIME	Program for Investment in Microentrepreneurs
ROA	return on assets
ROE	return on equity
ROSCAs	rotating savings and credit associations
SBA	U.S. Small Business Administration
SDI	Subsidy Dependence Index
SEC	U.S. Securities and Exchange Commission
SHFCU	Self-Help Federal Credit Union
SMEs	small and medium-sized enterprises
SMS	short message service
TA	technical assistance
USAID	U.S. Agency for International Development

Executive Summary

This report seeks to answer several questions with respect to access to finance in the United States, drawing on lessons from international microfinance while recognizing that the U.S. sector operates in a very different context:

- Is demand sufficient to allow the sector in the United States to be scaled up successfully?
- If yes, what combinations of human and financial capital, institutional support, and technology could make this happen?
- A series of questions on financial sustainability: (1) Are leading microfinance providers *operationally self-sufficient* or likely to be so in the foreseeable future? That is, do they cover all of their operating costs?; (2) Are these institutions *financially self-sufficient*? Do they cover both their operating costs and financial costs, ideally adjusting financial costs for the subsidy element? ; and, finally, (3) are these institutions financially sustainable (or likely to be so in the medium term) and providing a reasonable return on assets and equity?
- If so, what institutional models appear to be working well, if any, to achieve sustainability?
- Will federal and regional authorities allow institutions that offer microfinance—e.g., microenterprise development organizations (MDOs), community development financial institutions (CDFIs), and credit unions—to price their services and products such that access to finance can become a fully sustainable business able to draw on capital markets and other private sector markets? If so, is there a willingness from microfinance providers, creditors, and donors to support pricing at such levels?
- Is there potential to selectively commercialize some of the existing non-profit institutions as has occurred internationally, with the transformation into for-profit financial institutions or commercial banks?
- Is there potential to scale up credit unions serving low-income communities such that they increase their outreach? Will regulators support a substantial increase in micro and small business lending?
- Are the new for-profit entrants in the sector (i.e., those that are primarily using internet technology platforms to lower the cost of delivering financial services to underserved microentrepreneurs) likely to make an important difference in bridging the financing gap that exists in service to the underserved?
- Are there lessons to be learned from international experience, particularly in the area of new product development and mobile technology that could motivate CDFIs, the banks, and credit unions to increase access for underserved microbusinesses?

We recognize that direct comparisons are difficult, partly because the density of poverty in low-income developing countries allows MFIs there to scale up rapidly. Also, in many of these countries, the formal banking sector simply does not reach the underserved. Their recourse is to moneylenders, family, and friends. In developing countries, the vast majority of microbusinesses operate in the informal sector, so technical assistance for licensing and registration is less of a consideration than in the United States.

These conditions have allowed the microfinance sector in the developing world to scale up rapidly since the mid-1990s. In addition, while most MFIs have remained as NGOs or cooperatives, a strong consensus by many players in the industry to become sustainable has led to a significant reduction in sub-

sidy. International MFIs charge rates of interest that have allowed them to become fully self-sufficient. Starting almost universally as non-governmental organizations (NGOs), the sector has seen many MFIs become shareholder institutions, microfinance banks, and non-bank financial institutions (NBFIs), many of which are regulated. These institutions now operate commercially and sustainably, that is at a profit with reasonable returns on equity and assets, raising their funds through various channels. In contrast to the situation in the United States, the international microfinance market has ample liquidity.

The recent financial/economic crisis has had a sharp impact on U.S. poverty and unemployment. In addition, the crisis has exacerbated income inequality, which has been rising in the United States for some time. The crisis in banking and financial markets seems to have offered real opportunities for non-profit institutions serving underserved micro-businesses to bridge the gap that emerged in serving this population. But, in fact, much of the gap in small scale consumer loans has been filled by private sector institutions, charging high rates of interest, such as payday lenders, cheque cashers, pawn shops, and tax anticipators. Since money is fungible, it seems highly likely that some percentage of these funds have filled part of the gap for microbusiness loans. Despite the decline in the ability of the underserved to use or obtain credit cards, credit and debit cards remain the primary instruments with which the underserved balance their cash-flow needs and obtain working capital for self-employment opportunities, micro, and even small businesses.

In terms of specialized U.S. institutions serving microentrepreneurs, the mission-driven, non-profit sector (largely CDFI loan funds that offer microloans) simply cannot fill the gap in providing financial services to underserved entrepreneurs. The vast economic, social and regulatory differences between the U.S. and developing countries accounts for much of this disparity (see Section 3.1.2). However, non-profits have also found it difficult to scale up their model since their financing is highly subsidized and therefore limited, their operating costs are very high, and

the interest rates that they are able, and perhaps willing, to charge simply do not leave the margin required for them to be self-sufficient or sustainable. Hence, the model is not scalable. Perhaps of greatest importance, those institutions that have sought to scale have found it difficult to access sufficient capital from funders which would allow them to build capacity in such areas as market research, MIS and accounting systems, recruitment of senior/ experienced staff and staff training and development.

While the low-income credit union (LICU) and the community development credit union (CDCU) business models in the United States are based on self-sufficiency and sustainability, the small net margins generated by this group of institutions do not allow for rapid growth through earnings. Therefore, their prospects for such growth rely on support in the form of non-member deposits, secondary capital, and/or the opportunity to merge with other CDCUs—a type of support that the industry as a whole is not yet tapping in earnest. Although, at least one industry leader sees the LICU/CDCU model as “hugely scalable,” the lack of industry-wide data on microloans makes it difficult at this juncture to understand the potential outreach to microbusinesses. It is also not clear whether regulators would support any moves toward what some consider the “riskier” business of lending to microentrepreneurs.

Largely as a result of both the financial crisis and emerging technology, a group of for-profit financial institutions have emerged in the U.S. market with different models and methodologies, but which seem to offer approaches to scale. For the most part, their interest rates are more in line with international experience. Emerging technology, such as internet-based credit scoring, coupled with an intense focus on specific target markets (e.g., Hispanic consumers or small “main street” businesses in need of working capital) seem to offer the greatest opportunities for for-profits. (It should be noted, however, that these for-profits as a group are reaching out to a diverse range of both micro and small business clients at varying loan amounts and as such may not be directly comparable to some non-profit institutions.)

Based on these findings, the authors suggest that microfinance leaders, investors, and regulators in the United States consider the following:

- **Non-profit CDFI loan funds:** Given the industry-accepted need to continue offering technical assistance and training at little to no cost, can these institutions re-orient themselves to focus on achieving financially self-sufficient or fully sustainable *lending* operations? Doing so would likely require an increase in interest rates and fees to levels of between 18% and 36% per annum, a change which would require a significant paradigm shift on the part of government agencies, donors, creditors, industry support organizations, those state regulators that set interest rate caps, and, in some cases, the management of the CDFI loan funds themselves. Capacity-building funds to help institutions lower operating costs could also play a very important role in the drive toward sustainable lending operations, particularly for those well-run entities whose missions allow them to expand beyond their current geographic reach as a way of attaining scale. If, for instance, high costs are due to client acquisition, then capacity-building funds could be used for credit scoring and MIS systems designed to reduce operating inefficiencies.
- **Low-income credit unions:** These institutions are well-structured to support micro-lending operations in that they are (1) already operating on a financially sustainable basis, (2) are community-based, (3) raise the majority of their funding from member depositors, but also have the wherewithal to raise deposits from outside their membership base, and (4) according to at least one industry leader, are “hugely scalable”. However, the financing of microentrepreneurs does not appear to have been a particular focus of the sector to date, with regulatory constraints likely to be a barrier. Does the current economic environment open up opportunities to make headway on this front? If so, are industry leaders willing and able to champion (and regulators willing to support) the case for increased levels of microfinance via these types of credit unions?
- **Emerging for-profits:** Are those for-profit institutions which are exclusively focused on the provision of small working-capital loans to main street businesses, well-positioned to reach profitability? If so, what can the government, donor, creditor, and regulatory communities do to support their efforts to reach underserved microentrepreneurs? In terms of those consumer-oriented for-profit entities which are seeing a portion of their loan proceeds used for business purposes, is there an opportunity for them to proactively target microentrepreneurs?
- **CDFI Bond Guarantee Fund:** To the extent that funders such as the CDFI Fund provide advantageous long-term, low cost capital in the form of bonds, there exists an opportunity to focus exclusively on those institutions (both non-profit and for-profit) that show the potential to scale and reach profitability or at least achieve financially self-sufficient lending operations. If, instead, this capital is spread over a large number of smaller regional institutions as politically directed credits, an opportunity for the sector to restructure will be wasted.
- **Comprehensive database:** It would appear that there is a need to support efforts by FIELD to develop a more comprehensive data base for the sector similar to that available in international microfinance through the MIX Market, an affiliate of CGAP. That would require substantial funding in the medium-term (three to five years). Ideally, some of the funders who have supported the MIX would also come to the table to support FIELD’s efforts.

1

Introduction

This report is intended to be a comparative analysis of the access of underserved microentrepreneurs in the United States and internationally to financial services, particularly as regards the ability of those services to scale up and reach sustainability in each case. The report seeks to answer several questions regarding access to finance as presented below. Access to financial services is sometimes used interchangeably with microfinance, to the extent that microfinance means not only microcredit but also savings products and, increasingly, other financial products. The underserved are that segment of the population that generally do not have access to formal financial services. This population is generally the working poor.

By “access to finance” we mean primarily credit (working capital loans for businesses) and savings, although we recognize that other international products, such as microinsurance, loans for education and housing rehabilitation, transfers and remittances for the underserved are also an important part of the picture. Many microfinance institutions (MFIs) internationally, as well as Community Development Financial Institutions (CDFIs) in the United States also provide loans to small businesses. In the United States, access to finance or the broader term frequently used, “financial inclusion,” includes mentoring, training, matched-savings products, asset-building, and credit-enhancement programs.¹

In terms of financial products available to microentrepreneurs in the United States, this paper focuses mainly (though not exclusively) on microloans offered by both non-profit and for-profit institutions. As Table 1 illustrates, the definition of a microloan varies across different economies. In poorer developing nations, the widely accepted international definition is a loan of US\$2,000 or less. In transition economies, such as the former Soviet Union and Eastern Europe, the maximum loan size is US\$10,000. MIX² data indicate an average loan

size of US\$500 for all MFIs across the developing world, with country averages generally between US\$300 and US\$1,200. The average for the nine transition economies most heavily engaged in microfinance is US\$2,400.³ In the United States, the Small Business Administration defines a microloan as one at or below US\$50,000, while FIELD⁴ data show an average of US\$14,000 for those entities reporting to its microTracker™ database.⁵

Of course, definitions of poverty differ between the United States and developing countries. A major difference between poverty and access to financial services in the United States versus internationally, is the pervasiveness of poverty in many of the world’s developing countries. For instance, in the developing world, where microfinance seeks to reach the poor (many of whom are living on US\$2 or less per day), a relatively high percentage of the population lives in poverty. Thus, there is significant demand from the

¹ Since money is fungible, international loans to micro enterprises are at times utilized to smooth family income. In the U.S., micro loans from the NGO sector are predominantly business loans, though again money is fungible. Borrowers seeking consumer loans, who cannot utilize credit cards, have turned, especially during the crisis, to alternative lenders-pay day lenders, check cashers, and tax anticipators.

² The MIX Market collects, analyzes, and reports financial and social performance data from over 2,000 MFIs worldwide <www.mixmarket.org>. The MIX Market collects, analyzes, and reports financial and social performance data from over 2,000 MFIs worldwide <www.mixmarket.org>.

³ The nine countries analyzed include Albania, Azerbaijan, Bosnia and Herzegovina, Kazakhstan, Kyrgyz Republic, Poland, Russia, Serbia, and Tajikistan. Sourced from <www.mixmarket.org> (accessed June 17, 2012: 2011 data).

⁴ The Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD) tracks the U.S. microfinance industry, documents its outcomes, explores and evaluates new ideas, and disseminates best practices.

⁵ Sourced from <www.microtracker.org> (accessed June 1, 2012).

poor for financial services, which has allowed MFIs to scale up and become financially sustainable. In contrast, poverty as a percentage of the population is

much lower in the United States, and demand from the underserved for financial services is much less dense or less concentrated than internationally.

Table 1. Size of Microloans Compared with GDP

Country or Region	Max. Size of Microloan (US\$)	Avg. Size of Microloan	GDP per Capita (2011 est, 2011 US\$)	Max./Avg. Loan Size as % GDP
Poorer Developing Nations	\$ 2,000	lower end of \$300 to \$1,200	\$ 2,525 (average across Bolivia, India, Nicaragua, Cambodia, Bangladesh, Kenya, Tanzania, Uganda; GDP ranges from \$1,300 to \$4,800)	79% / 20% (using average loan size of \$500)
Transition Economies	\$ 10,000	\$2,400	\$ 10,266 (average across Albania, Azerbaijan, Bosnia, Kazakhstan, Kyrgyz Republic, Poland, Russia, Serbia, Tajikistan; GDP ranges from \$2,100 to \$20,600)	97% / 23%
United States	\$ 50,000	\$ 14,000	\$ 48,011	104% / 29%

In this report, the term “internationally” refers to developing countries and former transition economies (in transition from socialism), such as those in Central and Eastern Europe, the former Soviet Union and select countries in Asia, such as China, Vietnam, and Laos. We exclude discussions of other advanced industrial countries, such as those in the European Union.

We use the term “scale” to describe the goal of

servicing large numbers of individuals. When using the terms “sustainability” or “financial viability”⁶ we are referring to an organization’s ability to adequately cover its operating and financial expenses with earned revenues (versus income from grants or donations), such that it generates a return on assets and equity significant enough to attract funding from equity investors, commercial lenders, and the interbank or capital markets.⁷

⁶ In the mid-1990s, institutions such as CGAP and leading microfinance networks such as Accion International, discussed self-sufficiency in terms of operational and financial self-sufficiency. At that time, a number of MFIs covered all of their operating costs and were able to breakeven, but were unable to cover their financial costs, especially if grants or subsidized loans from donors were adjusted to market rates of interest. Industry leaders felt this adjustment better reflected the financial performance of these institutions from a risk perspective. When MFIs began to transform into shareholder institutions and sought funding in the inter-bank markets or from equity investors, expectations shifted to sustainability - the ability to cover all costs and also generate a reasonable return on assets and equity.

⁷ It is the view of some thought leaders in the sector that CDFIs and other NGOs providing microfinance loans are not seeking and should not seek to commercialize and generate a profit. Their view is that these institutions fill key gaps in the provision of financial service and as such their goal need not and should not necessarily commercialization. We agree that there are many MFIs that remain NGOs internationally and provide valuable services to their clients and the sector as a whole. However, even these institutions have largely sought to reduce or eliminate their subsidy dependence. The se thought leaders do acknowledge that many institutions seek to become fully self-sufficient in order to become more stable. Further, their principle argument is that if microlending proved profitable, the for-profit sector would move in and effectively “crowd out” (our term) NGOs. In fact, international experience has gone both ways. In many markets MFIs operating as NGOs have transformed to commercial, shareholding institutions, have attracted both equity and debt from both private and public funders, and have been able to scale substantially. As a result of achieving scale, interest rates in the sector have declined substantially. Many of these former NGOs serve over a 100,000 clients and several over a million clients. In some markets banks have down-streamed into microfinance, but mostly after transformed MFIs demonstrated profitability. We are not suggesting scale of this type is broadly feasible in the U.S., but it would seem to us that commercialization and attracting private capital for a handful of leading players should not be ruled out. Rather we believe it should be encouraged.

Box 1. Sustainability and Subsidies

The microfinance sector both internationally and in the United States has been supported by subsidies.

These have been provided in the form of grants for diverse purposes: (i) to provide a capital base for non-profit institutions, which populate the sector; (ii) to support the building of both human capital and institutional capacity, such as management information and accounting systems; (iii) to support scaling up of the portfolio-loans to clients; (iii) to assist in new product development; and, (iv) primarily in the United States, to cover operating costs. Below-market interest rates on financing from public and private investors have also served to subsidize the sector.

Despite the opportunity to remain reliant on donor support, given the still large number of donor institutions supporting microfinance, the international microfinance sector has had a strong push towards sustainability. In the mid-1990s, leaders in the industry recognized that in order to meet the demand that existed in both developing and transition countries, MFIs would need to become fully self-sufficient, in fact, sustainable; i.e., covering all operating costs and financial costs, as well as generating a profit to show an adequate return on assets and equity to attract private capital. Many MFIs internationally have since become commercial entities, and the subsidy level in international microfinance has diminished substantially relative to the scale of the sector. To achieve this, MFIs had to charge their clients interest rates that not only covered costs, including financial costs and adequate provisions for loan losses, but that also provided margins sufficient to generate a profit.

For many reasons, the U.S. sector's ability to reduce its reliance on subsidies has been difficult. On the programming side, the provision of technical assistance (TA) and training programs at little to no charge requires ongoing grant funding. In terms of lending operations, however, one primary factor may be constraint of the sector by state laws, investor requirements, and its own conviction that interest rates which would move their institutions, primarily CDFI loan funds, towards sustainability are not feasible or viable for the borrower. This assumption does not appear to have been fully market tested, since emerging for-profit institutions are now charging rates equivalent to international rates and seem to have unlimited demand.⁸

CDFI loan funds have become dependent on subsidized financing from the Small Business Administration (SBA), from the CDFI Fund at the U.S. Treasury, and from support from large commercial banks and their foundations, owing to regulation under the Community Reinvestment Act (CRA). These entities are the primary source of funding for many CDFIs. In addition, a number of foundations, state and local governments and private donations also provide support to the sector. This is a difficult existence, since funding is irregular and insufficient. CDFI loan funds spend a good deal of their time hunting for financing. Financing from the SBA and the CDFI Fund also has a variety of constraints and reporting requirements that make loan administration costly and burdensome. The subsidies have become distorting and have introduced inefficiencies into the sector, not the least of which is the time spent by senior management hunting for funds.

Many of the CDFI loan funds provide a complex mix of products to survive; they usually lack a primary product focus that would allow them to scale up. Because they are financially unsustainable, they cannot access capital from the market in order to scale up. Conversely, emerging private providers are accessing markets for their capital and are rapidly scaling up. Similar to international MFIs, some are adding products as they grow. However, all of these for-profit institutions are relatively new and have had difficulty raising funding at reasonable costs in the market. It remains to be seen whether or not they will become profitable and sustainable.

If the CDFI Fund is to disburse funds under its Bond Guarantee Program, it should focus on CDFI loan funds that are able to restructure to meet some acceptable level of scale and sustainability to reduce the level of subsidies required by the industry. The bonds should also be made available to for-profit institutions (including credit unions) who qualify as CDFIs.

⁸ A direct comparison may not be feasible: NGOs are largely providing term loans for two to five years from \$500-\$50,000, while Progresso (for example) is providing shorter maturity loans and smaller loans of \$2,500 on average. On-Deck Capital, on the other hand, charges market rates but for larger loan sizes and shorter maturities. Still we believe the proposition is worth testing.

This report seeks to answer several questions regarding access to finance in the United States, drawing on lessons from international microfinance while recognizing that the North American sector operates in a very different context:

- Is demand in the United States sufficient to allow the sectors there to be scaled successfully?
- If yes, what combinations of human and financial capital, institutional support, and technology could make this happen?
- Which, if any, institutional models appear to be working well and achieving sustainability?
- For sustainable models, is there potential to commercialize a select number of institutions in the sector as has occurred internationally, with the transformation of some of these existing non-profit organizations into for-profit financial institutions or commercial banks?
- Will federal and regional authorities allow institutions that offer microfinance (e.g., microenterprise development organizations (MDOs), community development financial institutions (CDFIs), banks, and credit unions) to price their services and products such that access to finance can become a fully sustainable business proposition able to draw on capital markets and other private

sector markets? If so, is there a willingness from microfinance providers, creditors, and donors to support pricing at such levels?⁹

- Are the new for-profit entrants in the sector (i.e., those that are, using internet platforms to lower the cost of delivering financial services to the underserved) likely to make an important difference in filling the financing gap that exists in serving the underserved?
- Are there lessons to be learned from international experience, particularly in the area of new product development, such as microinsurance and mobile technology, that would encourage CDFIs, the banks, and credit unions to increase access for the underserved?

To address these questions, this report first provides an overview of the development of international microfinance. A discussion of the sector in the United States follows, with a particular focus on issues affecting scale and sustainability. Conclusions are summarized at the end of each section, followed by specific recommendations borne out of international experience, which could possibly be adopted in the United States.

To the extent that we are able to compare and contrast access to finance for underserved entrepreneurs internationally and in the United States, we have done so in the table below.

⁹ This is a key policy issue as states now allow widely differing interest rates to be charged from state to state and even within states such that micro and small business loans may be capped at 18% but pay day lenders providing short term consumer loans are able to charge up to 400% effective interest rates. Advocacy for uncapping or lifting the cap on interest rates would most likely have to be addressed on a state to state basis and also seek to prevent predatory business lending practices. Note that international best practice to prevent interest rate capping was addressed in a large number of countries, on a country-by-country basis.

Table 2. Comparison of Access to Finance by Underserved Microentrepreneurs in the United States and the Developing World

Access to Finance by Underserver Entrepreneurs: omparative Analysis		
Dimensions	Developing Countries	United States
Types of Entities	NGOs, NBFIs, MF Banks, Credit Unions	non-profit CDFIs, low-income credits unions
Operating Environment		
% of Unbanked in Poorest Quintile (adults with no account at a formal financial institution)*	67% - 93% (depending on region, with E. Asia & Pacific beig most inclusive and Middle East & N. Africa being the least)	26%
Micro Business Environment	Informal	Formal
Regulatory Environment	for commercial MFIs, increasingly under bank regulation & supervision	non-profit CDFI loan funds not federally regulated, though subject to federal / state interest rate caps
		low-income & community development credit unions (LICUs & CDCUs) under federal and state regulation
Sustainability / Subsidy Element	drive towards financial self-sufficiency; small and diminishing levels of subsidy; investors/lenders charge market rates; MFIs interest rates at a level to allow self-sufficiency and to also allow a reasonable investors/lender	no non-profit CDFI loan funds changing prices that allow them to fully cover the cost of their microlending; sinificant subsidies from government entities whose budgets are subject to high degree of volatility; subsidized interest rates from investors
		LICUs/CDUs chargins market rates which allow them to operate on financially sustainable basis; some subsidized support from U.S. Treasury programs
Labor Costs	Relatively low	High
Banking Technology	largely unsophisticated, larger MFIs diversifying their produts need to investment in software/ MIS systems in order to manage risks; emerging techonologies are leap-frogging developed world	Advanced

Table 2. Comparison of Access to Finance by Underserved Microentrepreneurs in the United States and the Developing World (Continued)

Access to Finance by Underserver Entrepreneurs: omparative Analisis		
Dimensions	Developing Countries	United States
Types of Entities	NGOs, NBFIs, MF Banks, Credit Unions	non-profit CDFIs, low-income credits unions
Operating Environment		
Use of Credit Bureaus	Minimal	Pervasive
Non-MFI Competition	less intense/informal: money lenders; local practices (i.e., roscas)	intense/ formal: payday lenders; new players/ technology platforms; credit card companies/ equity lines (especially pre-crisis)
Traits of Microfinance Industry	globalizing; asset consolidating; commercializing; regulated; select pockets of over-saturation	fragmented and regionally atomized; some microlending with low-in come and community development credit unions; but most appears concentrated in non-profit CDFI loan funds
Economic Model	Vibrant - largely driven by market forces	CDFI loan funds: Fragile - dependent on government budgets/regulations (CRA) and donor support; complex structure due to wide range of products & services not necessarily related to microfinance
		LICUs/CDUs: model based on financial sustainability, but difficult to scale institutions quickly
MFI Methodology	diversity of lending models little borrower TA-training	CDFI loan funds: largely individual lending couple with borrower TA and training, including credit builder products
		LICUs/CDUs: individual lending
Product Development	credit product brought to scale, then introduction of other microfinance services including savings, insurance, education, housing rehabilitation, money transfers and remittances	CDFI loan funds: wide array of products from the beginning, including micro loans, TA, training, mached savings, small business loans, affordable housing loans, financing for community facilities
		LICUs/CDUs: consumer and business loans, depository accounts
Interest Rates Charged	High, market races	CDFI loan funds: low, subsidized rates
		LICUs/CDUs: market races needed to cover operating expenses and generate a small profit
Funding	MIVs, interbank market, deposits, increasingly capital markets, donors supporting NGO capacity building	CDFI loan funds: U.S. Tesaury CDFI Fund, SBA, banks-bank foundations looking to meet CRA requirements, local and state government agencies, charitable
		LICUs/CDUs: members deposits, nonmember deposits, loans and subordinance debt from private banks, foundations, investors, andgovernment entities (primarily U.S. Tesaury programs)

ç-Kun & Leora Clapper, "Measuring Financial Inclusion: The Global Findex Database", Pocity Research 6025, The World Bank, April 2012

2

Access to Finance Internationally

2.1. A Primer on International Microfinance

Microfinance seeks to provide financial services for that segment of the population in the developing world and in transition economies that does not generally have access to formal financial services. This population is often called the **underserved**. These are primarily the working poor, many of whom live on US\$2 dollars a day in poorer developing countries, such as Africa, Bangladesh, Cambodia, and India.

In this respect, microfinance in the developing world is distinctly different than in the United States. Poverty definitions differ. The percentage of the population that is poor is much lower—about 15% in the United States (elevated because of the financial crisis). Also, a much smaller percentage of the population remains unbanked in the United States.

Internationally, clients of MFIs are either self-employed or are microentrepreneurs that operate a microbusiness.¹⁰ Most of these people work in the informal sector, which in poorer countries may constitute up to 80% or more of employment. Poor people have various informal ways to secure financing: from family and friends, from money lenders, and from traditional financing schemes such as ROSCAs (rotating savings and credit associations). They generally do not have access to formal finance institutions either for borrowing or saving, and these informal sources may not be able provide financing in the amounts or with the timing needed.¹¹ Alternatively, they may obtain financing from moneylenders, who often charge 10% to 12% a month or more on a compounded basis. Moneylenders can be compared to payday lenders in the United States, who supply the urgent, short-term capital needs of

those without access, generally at interest rates of 400% per annum.

Microfinance refers to the provision of formal financial services to poor and low-income people. Microfinance refers not only to a range of credit products for business purposes, for consumption/income smoothing, and to fund social obligations, etc. but also to savings, money transfers, remittances, and insurance.¹² Microfinance is provided by MFIs, most of whom were non-profit institutions or non-governmental institutions (NGOs) in the eighties through the mid-nineties when microfinance spread throughout the developing world and, at a later date, through the transition economies of Eastern and Central Europe, the former Soviet Union and southeast Europe (the Balkans).

Now, however, microfinance is increasingly provided by commercial banks that have down-streamed into microfinance and by NGOs that have transformed to become non-bank financial institutions or microfinance banks. There are still thousands of NGOs locat-

¹⁰ Microbusinesses in the developing world are defined as having 10 or fewer employees, in contrast to the United States, where they are defined as businesses with 5 or fewer employees (see “A Newly Crowded Marketplace” p. 3, available at www.fieldus.org).

¹¹ Daryl Collins, Jonathan Murdoch, Stuart Rutherford and Orlanda Ruthven, *Portfolios of the Poor: How the World's Poor Live on \$2 a Day* (New Jersey: Princeton University Press, 2009) spells out in some detail the diverse sources of financing for the poor and how they manage their cash flow on US\$2 a day or less. An average of US\$2 dollars a day may mean no cash flow some days and more on other days, so cash-flow management, including safe savings through MFIs may, in fact, be more important to these individuals than loans.

¹² This definition borrows from Robert P. Christen, Kate Lauer, Timothy Lyman, and Richard Rosenberg, “A Guide to Regulation and Supervision of Microfinance, Microfinance Consensus Guidelines” (CGAP, Public Comment Version, April 1 2011), 10.

ed throughout the developing and transition economies. In some countries, such as in West Africa or in rural/agricultural regions of East Africa, co-operative structures are very important. Regulated MFIs, operating as commercial banks, are able to mobilize savings. This has two important advantages: first it provides a steady source of capital for MFIs, and second it provides a safe place for the poor to save. It turns out that the poor may need a safe place to save more than they need loans.¹³

It is expensive to deliver microfinance sustainably, a fact not necessarily intuitive to those outside the industry. To be sound, MFIs must operate directly in the poor communities they serve. They provide small loans with relatively short maturities and without any or with limited collateral. This means that MFI clients pay more for their money. That is, they pay higher interest rates on their loans. Although there are examples of MFIs charging very high interest rates, from 1998 to 2006, average rates were 34.7% for regulated institutions and 38.1% for non-regulated institutions. In fact, NGOs charged higher rates than commercial institutions. From 2007 to 2009, lending rates dropped, and regulated institutions charged 30.7% on average, while non-regulated institutions charged 36.1% (data provided in Table 5).

Microcredit is often called character or cash-flow lending. While U.S. providers of microfinance have historically based their loan decisions on both the character of the business owner and its cash flow, some have recently started using proprietary credit-scoring tools (data from credit bureau reports) to help determine creditworthiness. There are relatively few credit bureaus internationally, however, and to the extent they do exist, they are generally inadequate (see Table 5.)

Increasingly, larger MFIs that have scaled up to at least 30,000 to 50,000 clients also provide other financial services, such as insurance, remittances or money transfers, and loans for education and home improvement, some of which may require different terms with respect to maturity, interest rates and fees when compared with the short-term working capital loans that are the “bread and butter” of microfinance. Although these new product offerings are still a relatively small

part of the product base of most MFIs, the demand for them is growing.

Rural microfinance differs from urban microfinance. Rural clients might require loans to grow cash crops or raise animals to be sold for cash, rather than the standard small enterprise end use of traditional microfinance products. Rural areas are also less populated than urban areas, so the market for microfinance clients is less dense and, hence, more expensive to recruit and service.

Increasingly the industry talks not just about microfinance but about access to finance or financial inclusion. The latter might also mean small business loans, since MFIs increasingly reach up to service the owners of small versus microbusinesses.

Technology is potentially a powerful driver of access to finance, especially for rural populations. In a select number of developing countries, the providers of mobile phones are working with commercial banks or large MFIs to bring cell phone banking to the poor. For example, in Kenya, M-PESA (*pesa* means cash in Swahili), a product of Safaricom, Kenya’s largest mobile operator, has some 14 million clients primarily doing people-to-people money transfers. In 2010, Equity Bank, the largest microfinance and small business bank in Kenya, with branches throughout the country, signed a joint venture deal with Safaricom to extend M-PESA’s penetration. Equity Bank will also use M-PESA to mobilize deposits and originate loans.¹⁴

While virtually all MFIs seek to be fully self-sufficient, covering their operating and financial costs, commercial MFIs seek to be sustainable, generating a profit and a return on assets and equity adequate enough

¹³ See Stuart Rutherford, *The Poor and Their Money* (U.K.: Practical Action Publishing, 2009), which discusses the importance of safe savings for the poor. Marguerite Robinson has also written a seminal work in two volumes to date. Volume I discusses the importance of savings for the poor, and Volume II, focused on Indonesia, extensively discusses Bank Rakyat’s Uni Desa system, which mobilizes savings from the working poor in over 3,000 villages throughout the country. Marguerite S. Robinson, *The Microfinance Revolution: Sustainable Finance for the Poor* (Washington, DC: World Bank and the Open Society Institute, 2001).

¹⁴ See Elisabeth Rhyne, *Microfinance for Bankers and Investors* (New York: McGraw-Hill, 2009), 204–8.

to attract commercial funders. For the most part, they do not rely on explicit subsidies. In addition to their efforts to operate on a sound financial basis, MFIs seek to maximize their outreach to the working poor, thus also creating a positive social impact. This dual role –operating self-sufficiently and also serving the poor– is called “managing the double bottom line.”

In 2001, Marguerite Robinson produced her seminal work on microfinance, *The Microfinance Revolution: Sustainable Finance for the Poor*, in which she defined the microfinance revolution in terms of commercial microfinance:

The microfinance revolution is a commercial revolution based on new financial technology and greatly accelerated by the information revolution that developed concurrently. It began in the 1970s, developed in the

*1980s, and took off in the 1990s... These combinations enabled institutional profitability and long-term viability, making possible large-scale formal-sector financial outreach to low income segments of the population.*¹⁵

In the most recent study of commercialization of microfinance, Preetesh Kantak examines the sector from 2005 to 2008. He identifies some 619 commercial MFIs of which the largest 310 MFIs represent 98% of assets.¹⁶ In his analysis of the 619 commercial MFIs, Kantak demonstrates the rapid maturing of these institutions through improvements in return on equity, profit margins, and use of leverage.

Table 3 analyzes the performance of MFIs by size, demonstrating the advantages of scale in serving a larger number of poor clients (impact) and in increased sustainability and profitability.

Table 3. Characteristics of MFIs by Size, 2009¹⁷

MFI Size (# of Borrowers) ¹⁸	Number of Institutions	Share of Total Institutions	Number of Borrowers (Millions)	Share of Total	Assets/MFI (Millions US\$)	Profit (% of Revenues)
<100,000	982	89%	17.1	21%	57.2	+1.0
1,000-10,000	401	36%	1.8	2%	7.0	-14.0
10,000-100,000	439	40%	15.2	18%	48	+3.0
>100,000	122	11%	67.5	79%	1,271	+20.0
100,000-1 million	109	10%	26.8	32%	193	+15
>1 million	13	1%	40.7	48%	1,078	+23

2.2. Definition of Commercial Microfinance

By commercial microfinance we mean MFIs that meet the following criteria:

- They are structured as shareholder-owned institutions, joint stock, or limited-liability companies.
- They seek to operate sustainably, covering all of their costs with earned revenues and, in time, providing an adequate return on assets and equity.

- They raise their funds in commercial markets in a variety of ways.

¹⁵ Robinson, *The Microfinance Revolution*, 28-29.

¹⁶ Preetesh Kantak, “Growth in Commercial Microfinance 2005-2008” (Council of Microfinance Equity Funds, Winter 2011).

¹⁷ David Roodman, *Due Diligence: An Impertinent Inquiry into Microfinance* (Washington, DC: Center for Global Development, 2012), 112.

¹⁸ **Note:** The 10 large Indian MFIs have been dropped from this original table of 20 largest MFIs, owing to the crisis in the state of Andhra Pradesh in India, which has left most of these institutions in great difficulty since the end 2010.

- They operate as regulated non-bank financial institutions or commercial banks, the latter able to mobilize deposits.
- They are increasingly expanding their offerings to products such as savings, insurance, money transfers, housing-improvement loans, education loans, and small business loans. They also offer a variety of savings products.
- They serve the double bottom line: serving the working poor, while also operating in a sustainable manner. Increasingly, the microfinance industry is focusing on increasing transparency in disclosing the costs of borrowing to clients; e.g., effective interest rates and fees, as well as client protection and social impact—the extent to which

loans, savings, and other products benefit the poor.

2.3. Transformation of MFIs

Many MFIs have moved through the process of transformation from NGO, to NBFIs to become commercial microfinance banks. There are currently several microfinance banks in the sector with millions of clients and depositors and many more with hundreds of thousands of clients and/or depositors. The advantage of shareholder institutions is their ability to attract shareholders to build their capital (equity) base. (ACLEDA Bank, in Cambodia, is an example of an MFI that operated initially as an NGO under very difficult circumstances and subsequently converted to become a microfinance bank.)

Box 2. ALCEDA Bank Plc., Cambodia.¹⁹

Mission. “ACLEDA Bank’s vision is to be Cambodia’s leading commercial bank, providing superior financial services to all segments of the community”

Origins. ACLEDA originated from the tragedy that befell Cambodia with the assumption of power by the Khmer Rouge in 1975. The International Labour Organization (ILO) and Care International recruited the company’s management from refugee camps on the Thai-Cambodian border. Although initially targeting demobilized soldiers, the program quickly grew to assist refugees, widows, and other displaced persons of the war. The program’s initial aim was to develop LEDAs (Local Business Development Agencies). ACLEDA was the association of these independent regional agencies. In 1996, a liquidity crisis forced ACLEDA to decide between offering business-development services and providing financial services –microfinance– to its constituency. The General Assembly of the Association decided to unify ACLEDA’s agencies into a single unified institution and focus on microfinance. With funding from the Swedish International Development Cooperation Agency and USAID growth was substantial, such that the portfolio increased five times between 1996 and 1999.

Transformation. ACLEDA began the process of transformation to a bank in the mid-1990s and finalized the legal transformation into a bank in 2000. Since 2000, both the loan portfolio and savings have grown at an incredible pace: savings at a cumulative growth rate of 137% and loans at a cumulative growth rate of over 50% a year. The bank has expanded its base to almost all provinces of Cambodia. Based on the institution’s growth and progress, it is widely considered a very successful case. The transformation was driven largely by growth and the need to secure funding to continue to grow. As an NGO the MFI would have quickly outpaced its ability to secure donations and even subordinated debt; savings deposits offered an attractive source of leverage that also provided an important service to clients.

¹⁹ Elisabeth Rhyne, Ira W. Lieberman, Brian Busch, and Stephanie Dolan, “Aligning Interests: Addressing Management and Stakeholder Incentives During Microfinance Institution Transformations” (Calmeadow and the Center for Financial Inclusion at Accion International, 2009).

2.4 Operating Performance of MFIs

As Tables 4 and 5 illustrate, international MFIs have been able to reach scale and sustainability regardless of legal structure. The tables summarize the operating performance of MFIs from 1998 to 2009 in a vari-

ety of ways: by legal type (NGOs, credit unions, NBFIs, and banks) and according to whether or not they are regulated institutions. The data in the table, such as percent increase in various categories, represent average annual increases over the period, while portfolio at risk (PAR) and return on equity (ROE) represent the average for those years.²⁰

Table 4. MFI Performance Indicators by Legal Structure (1998–2009)²¹

1998–2006	BANKS	CREDIT UNIONS	NBFIs	NGOs	REGULATED	NON-REGULATED
Assets % increase	43.7	39.4	39.3	30.7	39.0	30.8
Lending % Increase	48.4	40.4	45.8	34.9	44.5	33.7
Borrowing % Increase	43.0	25.6	62.3	49.1	55.5	46.4
PAR > 30	2.5	5.0	2.7	3.3	3.0	3.6
Write-off % Portfolio	0.9	1.1	1.0	1.0	1.0	1.0
ROE	15.2	6.8	9.1	8.7	10.5	8.5
2007–2009						
Assets % Increase	26.4	20.8	25.2	20.3	24.1	18.3
Lending % Increase	28.0	22.5	28.2	21.2	26.5	19.4
Borrowing % Increase	12.2	15.5	27.5	22.7	26.3	19.4
PAR > 30	2.9	5.6	3.2	4.4	3.4	4.9
Write-off Ratio % Portfolio	0.9	1.4	1.2	1.5	1.1	1.6
ROE	12.8	7.6	10.6	8.3	11.4	7.3

Source: Gabriell di Bella, IMF, from MIX data

²⁰ Data presented here are derived from the MIX Market database. The MIX is an affiliate of CGAP and has a database that represents most of the sustainable MFIs internationally by region, network, and at the level of the MFI. The MIX is the primary source for investors to analyze MFIs and for other analytical and research work in the sector.

²¹ Gabriel di Bella, "The Impact of the Global Crisis on Microfinance and Policy Implications" (International Monetary Fund, July 2011), 13.

Table 5. MFI Lending Rates and Loan Sizes By Legal Structure²²

1998–2006	BANKS	CREDIT UNIONS	NBFIs	NGOs	REGULATED	NON-REGULATED
Lending rate %	36.3	25.4	35.5	38.5	34.7	38.1
Spread %	29.2	22.0	31.2	33.6	29.8	33.0
Loan size US\$	895	688	500	179	515	205
2007-2009						
Lending Rate %	27.7	26.1	31.4	36.1	30.7	36.1
Spread %	22.9	22.7	25.1	31.1	24.5	30.9
Loan size US\$	2,167	1,167	963	283	978	338

Source: Gabriel di Bella, IMF, from MIX data

Table 6 demonstrates that microfinance and MFIs have spread to all regions of the world over the past decade and have grown substantially in virtually all regions.

Table 6. MFI Performance by Region from 1998 to 2009²³

1998-2006	All	Sub-Saharan Africa	Asian Pacific	Central America and Caribbean	Eastern Europe	Middle East and Central Asia	South America
Assets % Inc.	36.0	34.8	36.1	31.7	43.9	36.8	33.5
Lending % Inc.	39.9	40.8	38.4	33.1	49.0	52.1	34.5
Borrowing % Inc.	51.7	40.9	49.2	51.0	52.0	76.8	43.6
PAR 30	3.3	4.3	3.6	4.2	1.2	1.7	4.1
Write-off %	1.0	1.4	0.9	1.4	0.6	0.6	1.2
ROE	9.8	4.5	11.8	13.6	9.1	6.0	12.0
2007-2009							
Assets % Inc.	21.9	22.2	28.0	10.2	17.3	19.7	29.2
Lending % Inc.	23.7	24.1	28.6	9.7	16.2	25.4	27.8
Borrowing % Inc.	23.3	21.7	34.9	10.8	18.4	25.9	22.6
Par 30	3.9	5.7	3.7	6.7	3.4	2.2	3.5
Write-off %	1.2	1.8	0.5	2.3	1.3	0.7	1.2
ROE	9.7	6.4	14.0	7.3	4.8	12.5	11.7

Source: Gabriel di Bella, IMF, from MIX data

²² Ibid., 14.

²³ Ibid., 13.

2.5. Sustainability/Subsidies

The international microfinance sector has been subsidized from the beginning by the donor community. Donors have included a large number of multilateral and regional financial institutions, various U.N. agencies, and the development ministries and aid agencies of the United States, Canada, Japan, and virtually all western European governments. They have supported microfinance and have provided an array of different subsidies. Foundations, such as the Ford Foundation, the Open Society Institute (Soros Foundation), Omidyar Foundation, the Bill & Melinda Gates Foundation, and the MasterCard Foundation have also supported the sector. Founded in May 1995, the Consultative Group to Assist the Poorest (CGAP) served *de facto*, if not *de jure*, as the international secretariat and coordinating agency for the industry. CGAP was initially supported by nine donor agencies. Three years later it had 26 donor institutions plus the Ford Foundation as members. Each of these institutions supported the microfinance sector in various ways in total in amounts ranging from US\$300million to US\$500 million a year from 1995 to 1999. In addition, CGAP, funded by these agencies, provided approximately US\$10million to US\$12 million a year in capacity-building grants to MFIs seeking to become sustainable.²⁴

Subsidies were provided for a variety of purposes:

- As capital grants to expand the capital base of a sector that was predominantly populated by NGOs at that time
- Loans, mostly on soft or concessional terms, to expand the portfolios of MFIs to assist increasing outreach and in scaling up the sector
- Support for capacity building; for example, to support technology absorption by MFIs in the form of MIS, financial reporting systems, and branchless banking, as well as training in the sector, such as the training program at the Boulder Microfinance Institute
- Support to improve knowledge in the sector through, for example, the development of re-

gional microfinance networks, publication of a series of short notes and technical papers by CGAP and others in the sector, the creation of various support institutions, such as an industry database available as a public good (the *MicroBanking Bulletin*, subsequently expanded to the MIX Market), and support for microfinance rating agencies to evaluate the performance of MFIs as they began to transform into commercial institutions

It seems clear that subsidies for building institutions and capacity in the sector, as well as for knowledge transfer and training, has been highly effective.

With the push by institutions such as CGAP, Action International, the Microfinance Network, and a number of other players in the sector towards sustainability the extent and total amount of subsidy in the sector began to diminish significantly. MFIs began to transform (as discussed in Section 2.3) into commercial MFIs and sought investors to expand their capital so that they could continue scaling up. The sector's annual average growth in lending from 1998 to 2006 ranged between 35 % for NGOs to 48% for microfinance banks (Table 4). This required substantial increases of capital, which only access to a heterogeneous mix of private capital could provide.

By 2000 and thereafter, the private development arms of the multilateral, regional donors and bilateral donors, such as the International Finance Corporation (World Bank), European Development Bank, European Investment Bank, the Multilateral Investment Fund (MIF) at the Inter-American Development Bank, and a large number of bilateral agencies in Europe, were providing loans and equity investments to MFIs

²⁴ One of the authors of this report, Ira Lieberman, started the CGAP Secretariat for the World Bank and other donor agencies. Donor statistics on microfinance funding for 1995–99 were weak to non-existent, owing to the relatively small amount of funds for microfinance relative to overall aid funds. These estimates were developed by CGAP based on project-by-project reports from the donors and as compiled by CGAP, hence, the broad estimate of donor funding.

at interest rates much closer to market rates than initial funding from donor agencies. In addition, microfinance investment funds, most of which were public-private investment vehicles, were providing increasing amounts of capital to the sector via both equity and loans.

The *MicroBanking Bulletin* concluded that the level of subsidy in the sector has diminished. If analyzed by the number of MFIs that are financially self-sufficient, the data range from 59% in 2003 to 61% in 2007 for all MFIs, with the database in 2006 constituting almost 900 MFIs versus 250 MFIs in 2003., "This corresponds with the changes in the microfinance world where donations are (at a global level) declining in importance as more institutions commercialize, especially many of the largest providers."²⁵

Today, while donors continue to fund the sector, their role, relative to the size and needs of the sector, has diminished substantially. While still needed, funds for technical assistance to support capacity building on a concessional (grant) basis from donor agencies have become highly targeted to the poorer countries, such as those in Sub-Saharan Africa and Haiti, and are currently available in relatively small amounts. There is a continued need for targeted subsidies in the sector. However, continued reliance on donor support would have risked overdependence and the possibility that the sector would have seen diminished donor support through donor fatigue or as it lost its position as "the flavor of the month." Also, over-subsidization leads to distortions, and that would have prevented MFIs from becoming efficient and fully self-sufficient. Researchers continue to debate the degree of subsidization in the sector and its merits.²⁶

2.6 Financing the Sector

The key to the rapid growth and increasing scaling up of microfinance throughout the developing world has been the ability of successful MFIs to largely wean themselves from donor support, in particular donor subsidies. Many MFIs that depended mainly on donors for their capital in the 1980s and

1990s, can now access a heterogeneous mix of capital that ranges from mobilized deposits, interbank loans, debt and equity from investment funds, direct loans and equity investments from Development Finance Institutions (DFIs) such as the World Bank's International Finance Corporation (IFC) and IFC's bilateral equivalents. Increasingly, purely private investors –through investment funds or directly– are funding the sector.

Since the mid-1990s, another layer of financial-service providers has entered the microfinance industry. It consists of international microfinance investment vehicles (MIVs) that provide intermediate term loans to, or make equity investments in, MFIs. MicroRate, a microfinance rating agency, estimated the total assets of MIVs (both debt and equity funds) at US\$7.0 billion as of December 31, 2010. Of microfinance assets held, debt represents 82% and equity 18%. However, that funding is concentrated in the top tier of MFIs. MicroRate's analysis found that 50% of total MIV funding, some US\$5 billion dollars, is concentrated in 33 MFIs. The top 100 MFIs receive 75% of funding, while 90% of funding goes to the top 200 MFIs and the remaining 10% is allocated to an additional 400 MFIs around the world.²⁷

²⁵ Scott Gaul, "Breaking it Down: SDI vs. FSS," *MicroBanking Bulletin* Issue 18 (Spring 2009): 18.

²⁶ Beatriz Armendariz de Aghion and Jonathan Morduch, have a balanced discussion on subsidies and sustainability in Chapter 9 of *The Economics of Microfinance* (Cambridge, MA: MIT Press, 2005), 231–55. Morduch argues in favor of targeted subsidies in Financial Access initiative, Blog February 4, 2010, Smart Subsidies for Microfinance, <<http://financialaccess.org/node/2609>>; See also Marek Hudon and Danilel Traca, "On the Efficiency of Subsidies in Microfinance: An Empirical Inquiry" (Université Libre de Belgique, Bruxelles and Universidad Nova de Lisboa, 2010) and Ahmad Nawaz, "Performance of Microfinance: The Role of Subsidies" (CEB Working Paper no. 10/008, 2010).

²⁷ It is important to note that, with the exception of CDCUs/LICUs (credit unions that serve the poor), it may not be appropriate for nonprofit microlenders in the U.S. to think about moving into savings. There is currently a good amount of work going on in the U.S. on the savings front that focuses on innovation in the for-profit sector, along with creating policy incentives and other supports to provide access to savings for those that don't currently have it.

2.7 Product Diversification

As international MFIs have commercialized and reached sufficient scale, they are increasingly seeking to diversify their product offerings. Today, in addition to their core microloan products, MFIs are offering housing-rehabilitation loans, agricultural loans, educational loans, insurance, money transfers, and remittances. In addition, many MFIs have moved upstream to small-business lending in order to increase average loan size and thus enhance profitability. Money transfers, remittances, and insurance are most often fee-based product lines and generally do not represent the same risk considerations as do other new product lines.

Diversification has usually come after the MFI has scaled up and is fully sustainable, and frequently af-

ter it has transformed into a commercial, shareholding institution with investors. The addition of savings products as a regulated microfinance bank is a very important contribution to serving the underserved.

Those MFIs that have transformed into commercial banks have come to understand the importance of savings (Table 7).²⁸ Commercial banks will invariably seek to mobilize deposits that require important considerations as to product design, capacity of the branches to absorb long lines of savers, and the economics of handling the accounts of small savers. From a client perspective, safe savings products may be as important as lending products. In Africa, MFIs usually mobilize substantially more savings accounts than loans. It turns out that the poor may need a safe place to save more than they need loans.²⁹

Table 7. Ten Largest Savers: Voluntary Savings Accounts as of 2009

Name	Country	Ownership	Regulated	Accounts ('000s)
BRI	Indonesia	Investors/Government/banks	Yes	21,229
Grameen bank	Bangladesh	Members/Government/Bank	No	7,970
ASA	Bangladesh	NGO	No	6,613
BRAC	Bangladesh	NGO	No	5,447
Equity Bank	Kenya	Investors/Bank	Yes	4,038
Caja Popular	Mexico	Members	Yes	3,514
Khan Bank	Mongolia	Investors/Bank	Yes	2,500
Capitec Bank	South Africa	Investors/Bank	Yes	1,297
UNACOOPEC	Cote d'Ivoire	Members/Co-operative	yes	925
Creditscotia	Peru	Investors/Bank	Yes	808

Source: Roodman, *Due Diligence*, 2012

Microinsurance is increasingly recognized as an important product for the underserved. It is meant to protect a family in case of illness, death, or property loss, including crop or livestock losses in rural areas. Access to insurance may be an important strategy for reducing poverty. Despite the growing recognition of its importance and the rapid growth of the market, the penetration of microinsurance remains limited,

²⁸ See Stuart Rutherford, *The Poor and Their Money*, which discusses the importance of safe savings for the poor. Marguerite Robinson's, *The Microfinance Revolution*, Volume I also discusses the importance of savings for the poor, and Volume II, focused on Indonesia, extensively discusses Bank Rakyat's Unit Desa System, which mobilizes savings from the working poor in over 3,000 villages throughout the country.

²⁹ Doubell Chamberlain, Hennie Bester, and Christine Hougaard, "Making a Market for Microinsurance" (Micro Insurance Network, Focus Note 12, October 2008).

leaving the vast majority of poor people without adequate protection.³⁰

The microinsurance sector is complex and requires an understanding of many issues. These include client demand, perceptions of value added from insurance, client literacy, formal versus informal distribution channels, as well as newly emerging unconventional channels, policy and regulation governing insurance institutions and products, and the ability of institutions to manage the entire product life cycle from sales to administration of policies to delivery of benefits when an insured event has occurred.

Key considerations for the penetration of microinsurance with clients would appear to be:³¹

- Affordability
- Increased client literacy about insurance and available products
- Value added
- Trust
- Distributional capacity and proximity to the clients.
- Client literacy

As with microfinance, regulatory issues are an important consideration in moving beyond informal pools of self-insured poor individuals. That means allowing microinsurance to operate through distribution channels that work, including MFIs, and not requiring that the formal agent-insurance carrier model be the means of delivery.³²

To the extent that an MFI has reached scale, it will presumably have the means to align itself with an insurance company to offer a suite of products to its clients. In fact, most microinsurance is currently tied as a compulsory product to credit products such that the loan is repaid in the event of death or disability, and payment is also made to the family to cover the disability or to protect the family in case of death. Credit-tied insurance accounts for the vast majority of microinsurance in India and Uganda and approximately half in the Philippines. Of all the voluntary products sold, funeral insurance appears to be most in demand. For

example, it accounts for 72% of the market in South Africa and 52% in Colombia.³³

Microinsurance would appear to be an important product for MFIs to provide in addressing the needs of the underserved and also a product with enormous growth potential. Going beyond a compulsory credit-life product requires building significant capacity in terms of training or recruiting staff, engaging in client literacy, developing administrative and MIS systems, and providing service to the client.

2.8 Technology and the Future of Microfinance

As MFIs gain sophistication, they are seeking to adopt advanced technologies, such as branchless banking capability, and are increasingly working with mobile carriers to develop mobile banking capability. The provision of microcredit to very poor people without collateral and while working in the informal sector was a technological revolution in the delivery of credit to the poor. But it was a low-tech revolution. Microfinance has advanced, and it now faces the challenge of adopting and adapting new technology that is high tech, such as banking software to support management information systems, that will allow MFIs to extend their branch structures and adopt new products.³⁴

³⁰ Doubell Chamberlain, Hennie Bester, and Christine Hougaard, "Making a Market for Microinsurance" (Micro Insurance Network, Focus Note 12, October 2008).

³¹ Doubell Chamberlain, Hennie Bester, and Christine Hougaard, "Risk it or Insure it?" (Micro Insurance Network, Focus Note 8, March 2009).

³² Hennie Bester, Doubell Chamberlain, and Christine Hougaard, "Making Insurance Markets Work for the Poor" (Micro Insurance Network, 2009), 4–13 on policy and regulation of microinsurance.

³³ Chamberlain et al., "Making a Market," 2–3.

³⁴ MIS software has become vital to the ability of MFIs to scale, with good data on branch performance or new product performance. This requires significant funding for the initial software purchase, ongoing licensing fees, training of staff, recruitment of an IT manager, and adaptation of existing systems to the software package.

Mobile banking relies on smart phones, which have increasingly saturated both developed and developing markets. At the core of mobile banking is a mobile telecom operator, agents to receive and disburse cash, and the consumer as an owner of the mobile phone willing to perform banking functions through his/her phone as an alternative to doing so at a bank or MFI branch, or as an alternative to a credit or debit card, depending on the banking or financial operation involved.

Mobile banking is viewed as extremely cost efficient, particularly in comparison to branch banking operations. Mobile banking is increasingly being used for money transfers and remittances, people-to-people transfers (P2P), payment of utility bills, bank deposits, and more recently, loans.³⁵ Industry analysts believe that as consumers become accustomed to using smart phones for various applications, bank and financial operations will simply join the ranks of those applications. From a generational perspective, young mobile phone users are likely to adopt mobile banking very rapidly.³⁶

In the developing world, it has allowed those who are unbanked or under-banked (i.e., the underserved) to carry out vital financial operations without necessarily having a bank account. In Kenya, M-Pesa, with some 14 million users and thousands of agents throughout Kenya, allows a family member working in Nairobi to transfer funds to his/her family in a remote village without making the trip personally or using unreliable postal banking or bus service. It lowers the cost of transfer dramatically and also reduces the danger of an individual personally carrying the cash to his or her village. M-Pesa was developed by Safaricom, an affiliate of Vodaphone and the largest mobile carrier in Kenya.³⁷

Recently, M-Pesa and Equity Bank (the largest micro/SME bank in Kenya, with an extensive branch structure) have reached an agreement to utilize Equity Bank's branch structure for payment transfers and deposits (savings). Equity has also initiated a unique lending product through M-Pesa. Through the combination of product offerings using M-Pesa, Equity an-

ticipates rapidly extending its customer base. In this case, Equity as a large MFI with an extensive borrower and deposit base, serves as an agent to M-Pesa, extending the outreach of the mobile system for banking applications.³⁸

2.9 The Financial Crisis and International Microfinance

Although the global financial crisis has brought attention to several problems in microfinance, the industry as a whole has performed exceptionally well, with one microfinance rating agency commenting:

*The microfinance market in 2011 looks much different from 2007. Despite the worldwide financial crisis, the sector has doubled in size, transformed from mostly a NGO driven market to one increasingly dominated by regulated institutions, experienced a strong expansion of savings services, and held its first public listings and mergers. Microfinance is displaying the signs of a maturing industry. It has also weathered its first global downturn, lived through several major market crises, and is currently living through a crisis of perceptions and confidence on whether microfinance actually helps alleviate poverty in the first place. None of these issues existed in 2007.*³⁹

Complementary papers on the crisis and problems in the sector, one focused on Latin

³⁵ For a good overview of mobile banking operations see Ignacio Mas and Kabir Kumar, "Banking on Mobiles: Why, How for Whom?" (CGAP, No. 48, June 2008) and Kabir Kumar, Claudia McKay, and Sarah Rotman, "Microfinance and Mobile Banking: The Story So Far" (CGAP, No.62, July 2010).

³⁶ *The Economist*, Special Report, "International Banking," May 19, 2012, 4.

³⁷ Elizabeth Rhyne, *Microfinance for Bankers and Investors*, 204–08.

³⁸ *Ibid.* Also see Kumar et al., "Microfinance and Mobile Banking," and CGAP, "Trends and Innovation in Mobile Banking" (presented at Africap Conference, Nairobi, May 2012).

³⁹ MicroRate "Role Reversal II, Learning to Wield the Double Edged Sword," October 2011, 4.

America,⁴⁰ and one looking at crises internationally, excluding Latin America,⁴¹ examine individual problem cases in Latin America and such diverse countries as Ghana, Nigeria, Morocco, Central Asia, and southeast Europe. These papers have developed a typology of problems or risks, many of which were highlighted or came to the surface during the crisis, such as poor governance practices, fraud, methodological flaws, uncontrolled growth of the MFI, mission drift, uncontrolled growth in select markets leading to over-lending

and over-borrowing, macroeconomic shocks, and state intervention.

Despite this list of problems, most serious issues were limited to a handful of countries such as Bosnia, Nicaragua, Morocco, Pakistan, Nigeria, and India. This experience is far from the type of systemic failure seen in the banking sectors of individual crisis countries, such as Mexico and Argentina (1995 and 2001, respectively), Turkey (2001), East Asia (1997–99), the United States (2008), or the euro zone (ongoing).

Box 3. Reputation Risk and the Crisis in India

In 2010, a crisis hit the Indian microfinance sector. Focused on the state of Andhra Pradesh, it is only slowly being resolved. Five of the ten largest MFIs in the state were accused of very aggressive lending practices, which led to charges by the state administration of overlending/overborrowing. State authorities and local politicians stepped in and declared a payment moratorium on microfinance loans in the state, thereby effectively bringing lending to a halt. The crisis in India demonstrates a number of credit risks associated with international microfinance, including overlending, as well as political and reputational risks, which in this case were quite serious.⁴²

2.10 Conclusions: Key Successes of International Microfinance as Lessons for Microfinance in the United States⁴³

The international microfinance industry has had a number of successes, as outlined below. The ability of the U.S. sector to adopt some of the lessons learned by its international counterparts is discussed in the conclusions of the section of this report on the United States.

- **Large outreach to clients** has allowed the international sector to increase its impact on the working poor.
- **High growth rates** have enabled the industry to expand rapidly from its roots in Bangladesh, Indonesia, and Bolivia and operate throughout the developing and transition

⁴⁰ Beatriz Marulanda, Lisbeth Fajury, Mariana Paredes, and Franz Gomez, "Lo Bueno de Lo Malo en Microfinanzas: Lecciones Aprendido de Experiencias Falladas en America Latina" (The Good from the Bad in Microfinance: Lessons Learned by Failures in Latin America) (Calmeadow and FOMIN, June 2010).

⁴¹ Daniel Rozas, "Weathering the Storm: Hazards, Beacons, and Life Rafts" (Center For Financial Inclusion, 2011).

⁴² There is a substantial literature on microfinance in India and the crisis. A select list includes M-Cril "Microfinance Review" (M-Cril, 2010) (M-Cril is a rating agency in India.); M. S. Sriram, "Commercialization of Microfinance In India: A Discussion of the Emperor's Apparel" *Economic & Political Weekly* XLV No. 24 (2010): 65–73; Intellecrap, "Indian Microfinance in Crisis: Turf War or a Battle of Intentions?" (October 2010); Intellecrap, "Indian Microfinance Crisis of 2010: Finding the Silver Lining" (October 25, 2010); "Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector" (Reserve Bank of India, January 2011); Response to the Malegam Committee Report 24th March 2011; CGAP, "Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance" (CGAP, 2010).

⁴³ We are indebted to Professor Shannon Mudd of Haverford College for his suggestion to consider the successes of international microfinance as the key to potential lessons for microfinance in the United States.

world, as well as operating effectively in challenging geopolitical environments.

- **Access to diverse funding sources** has allowed the industry to move away from initial dependence on donors and subsidies and to obtain funding from a variety of funding sources both domestically and internationally. This removes the risk of donor fatigue, i.e., that microfinance and MFIs may be the “flavor of the month” at one point in time and not find donor funding available soon thereafter.
- **An emphasis on financial sustainability** has ensured that major MFIs are not dependent on capricious donor funding. They avoid the distortions of subsidies and politically directed credits. They have obtained sustainability by containing costs and charging interest rates and fees sufficient to cover all costs, including financing costs, and thus generate a reasonable return on assets and equity. This, in turn, has attracted capital market or private sources of funding.
- **Product diversity built on a sustainable base** has allowed MFIs to better serve client needs. The diversification of products to include money transfer and remittance services, loans for education and housing rehabilitation, and above all, savings products as regulated MFIs, has allowed MFIs to improve services to their clients. These services have generally been added to the base of a sustainable institution, often following transformation to a commercialized MFI.
- **Targeted, productive use of donor (donor in this case refers primarily to multilateral, regional, and bilateral aid agencies and government ministries focused on economic aid and development) and philanthropic funds to build capacity** has enabled “best-in-class” MFIs to achieve sustainability over time. Institutions in the sector, such as CGAP, and leading microfinance networks, such as Accion International and the Microfinance Network,⁴⁴ convinced the donor community that sustain-

ability was important, who in turn provided the necessary technical-assistance funds to gradually build capacity in the sector.

- **The adoption of emerging technologies** has spurred the development of various product-delivery methods. The microfinance industry emerged as a low-technology approach to providing credit to the working poor in developing countries. As the sector has scaled and MFIs have built capacity—both human resources and systems—many MFIs have been able to adopt new technologies, such as branchless banking, debit/hard cards, and most recently, mobile banking to serve clients such as the rural poor.
- **Regulation of transformed MFIs to NBFIs and MF banks** has meant that MFIs are subject to increased oversight and supervision. As an MF bank, the MFI can mobilize deposits and offer various savings products tailored to their clients’ needs. The change should also improve governance standards, since supervisors require MF banks to establish “fit and proper” boards of directors and seek to ensure that the MFI improves its risk-management practices.
- **Improved governance practices** have normally emerged as NGOs transform to shareholder-owned MFIs. Investors seek to have board representation and will focus on strengthening governance practices with respect to such areas as oversight of product diversification and expansion; improved MIS and reporting standards; enhanced risk-management practices through the appointment of internal and independent external auditors, recruitment of a risk manager, and the establishment of board committees, such as audit, compensation, risk management, and conflict, as appropriate.

⁴⁴ The Microfinance Network is a group of leading MFIs throughout the world focused initially on achieving sustainability.

Microfinance in the United States

3.1 Operating Environment: Background and Context

3.1.1 The Microfinance Movement Takes Shape in the United States

Microfinance institutions and initiatives began to appear and take root in the United States during the 1980s and early 1990s with the establishment of such institutions as WEDCO in Minnesota, Working Capital in Massachusetts, and Accion International's U.S. operations in Brooklyn, New York. The first half of the 1990s witnessed several important milestones in support of the country's nascent microfinance industry:

- The Association for Enterprise Opportunity (AEO), the first member-based microfinance trade association in the United States, was established in 1991.
- The Aspen Institute began its work in the U.S. microenterprise field with the creation of the Self-Employment Learning Project in 1991, which evolved seven years later into the Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination (FIELD). FIELD tracks the industry, documents its outcomes, explores and evaluates new ideas, and disseminates best practices.
- Also during 1991, the first major legislation solely for microenterprise development was enacted when Congress authorized the U.S. Small Business Administration (SBA) to implement their Microloan Program, which

makes subsidized investments to microfinance providers for on-lending to micro-businesses.⁴⁷

- Congress established the Community Development Financial Institution Fund (CDFI Fund) in 1994, which provides subsidized government investment directly to CDFIs (banks, credit unions, loan funds, or venture funds) working in underserved communities.
- The Community Reinvestment Act (CRA), a U.S. federal law designed to encourage commercial banks and savings associations to help meet the needs of borrowers in their entire community (including low- and moderate-income (LMI) neighborhoods)⁴⁸ was reformed in 1995 to shift the focus of enforcement from banks' *plans* for lending to *actual* lending performance. As a result, paperwork burdens declined, CRA loan commitments by banks substantially increased, and CRA grading by the regulatory agencies became tougher.⁴⁹

⁴⁷ James H. Carr and Zhong Yi Tong, *Replicating Microfinance in the United States* (Washington, DC: Woodrow Wilson Press, 2002), 1.

⁴⁸ Housing and Community Development Act of 1977 - Title VIII, Sections 801 – 804, sourced from <<http://www.fdic.gov/regulations/laws/rules/6500-2515.html#6500hcda1977>> (accessed June 1, 2012).

⁴⁹ Eugene Al Ludwig, James Kamihachi, and Laura Toh, "The Community Reinvestment Act: Past Successes and Future Opportunities" Federal Reserve Bank of San Francisco, 88-89. Available at <http://www.frbsf.org/publications/community/cra/cra_past_successes_future_opportunities.pdf>.

3.1.2 Microfinance in the United States Versus the Developing World

Primary Differences

By the early 2000s, with several years of history on which to draw from approximately 280 microfinance programs,⁴⁸ microfinance practitioners and researchers were reflecting on the achievements made by the industry and looking ahead at the opportunities and challenges. Because the scale of microfinance was much more modest in the United States when juxtaposed against international experience, industry leaders also began openly acknowledging and discussing the differences between the two operating environments in an attempt to better understand the comparatively low level of outreach in the United States and the inability to operate at financially sustainable levels.

The primary distinctions drawn between the two contexts were characterized generally by economic, social, and regulatory differences. In 2002, Mark Schreiner and Jonathan Morduch identified seven major challenges for the U.S. industry that were driven by these forces—all of which, in large part, still exist today:⁴⁹

- *Size of the microenterprise sector:* The potential market for microfinance is large in the developing world but small in the United States. In many developing countries, large numbers of workers are part of the microenterprise sector, with informal jobs estimated in 2002 to represent between 50% and 75% of all non-agricultural employment.⁵⁰ In the United States, however, the rate of self-employed workers relative to the total labour force hovered around 11% between 2003 and 2009.⁵¹
- *Functional safety net:* The United States, unlike most of the developing world, has a public safety net via its welfare programs that serves as a functional alternative to self-employment and discourages the buildup of savings that could be used to start businesses and keep them going.

- *Competition from large firms:* Shopkeepers and street vendors in developing economies compete mainly locally and against each other, while U.S. microentrepreneurs must compete against large retailers, service providers, and restaurant chains, such as Wal-Mart and McDonald's.
- *Competition from commercial lenders:* Microfinance in the developing world competes with moneylenders and other forms of informal finance. Microfinance in the United States competes mainly with credit cards (particularly before the financial crisis), but also with large payday lending companies, cheque-cashing outlets, and pawn shops.⁵²
- *Limits to joint-liability groups:* The success of group-lending microfinance models in developing countries rests partially on the ability of self-selected peer groups to judge risk and enforce repayment. In the United States, groups are often made up of strangers, thereby losing the potential for gains from self-selection,

⁴⁸ Ayse Can Talen, Marc A. Weiss, and Sohini Sarkar, in *Replicating Microfinance in the United States: The Future of Microfinance in the United States: Research, Practice, and Policy Perspectives* James Carr and Zhong Yi Tong eds. (Washington, DC: Woodrow Wilson Center Press, 2002), 339.

⁴⁹ Mark Schreiner and Jonathan Morduch, in *Replicating Microfinance in the United States*, 23–31.

⁵⁰ Benjamin Temkin, "Informal Self-Employment in Developing Countries: Entrepreneurship or Survivalist Strategy? Some Implications for Public Policy." *Analyses of Social Issues and Public Policy* 9, No. 1 (2009): 135–56. Available at <http://flacso-mx.academia.edu/BenjaminTemkin/Papers/240731/Informal_Self-Employment_In_Developing_Countries_Entrepreneurship_or_Survivalist_Strategy_Some_Implications_for_Public_Policy>.

⁵¹ Steven F. Hipple, "Self-Employment in the United States," *Monthly Labor Review Online* 133, No. 9 (2010). Available at Bureau of Labor Statistics <<http://www.bls.gov/opub/mlr/2010/09-art2exc.htm>>.

⁵² Before the financial crisis – and prior to that, before much consolidation took place in the U.S. banking/financial services industry – many banks were doing more small business lending. Consequently, at that time, the role of nonprofits was to reach those who were unable to tap the banks due to issues of race, gender, business status (start-ups), and income status. (source: Joyce Klein, FIELD, November 10, 2012).

allegiance to group members, and the desire to maintain an unblemished reputation within one's community.⁵³

- *Microfinance for housing:* In developing economies, the fungibility of cash loans allows microenterprise loans to finance home repairs or improvements indirectly. Microfinance for housing is less common in the United States, not because loans are less fungible, but because state and local laws impede progressive home improvements (carried out in stages, often over several years) to low-cost homes.
- *Regulation:* Developing countries tend to have large, dynamic informal sectors where regulation and taxes are largely absent. In the United States, regulatory constraints affect both microfinance lenders and microentrepreneurs. For lenders, the chief regulatory restrictions are state-by-state laws that cap interest rates (ranging from 7% in Michigan to 45% in Colorado⁵⁴), which constrain their ability to generate profits and thereby limit the potential of U.S. microfinance. For entrepreneurs, the primary regulatory constraints concern taxes, licenses, and welfare. For example, a food vendor in a developing country could, in practice, go out on the street with a cart and start to sell. Localities in the United States, however, first require a license, an inspection, and a permit, if street-vending is allowed at all.

To a large degree, regulatory requirements also drive the much greater need for training in the United States versus the developing world. Entrepreneurs in the United States need economic literacy to navigate the complex regulatory environment surrounding business ownership. Consequently, U.S. programs allocate much more of their budgets and human resources towards training and TA (most of which is provided free of charge), whereas MFIs in developing countries can focus on lending (at rates that fully cover all operating costs).

In addition to training and TA, U.S. institutions also tend to offer a fairly large array of other products

and services, including credit-builder loans,⁵⁵ IDAs (individual deposit accounts),⁵⁶ small business loans, affordable-housing loans, and financing for community facilities. Thus, microfinance in the United States is often provided by institutions that have complex business models not necessarily focused solely on microlending. Unlike international MFIs, which perfected a single credit product for microentrepreneurs and brought it to scale before adding other services, U.S. institutions have, in general, offered a range of products and services from the start, with microloans being only one of them.⁵⁷

Other differences between the two environments include higher operating costs in the United States, driven primarily by higher staff salaries for loan officers, as well as a larger number of non-lending personnel who focus on the provision of TA and training in addition to more stringent compliance issues, the continuous generation of grant proposals, and often substantial levels of funder reporting. A larger percentage of delinquencies and loan losses also contribute to the elevated operating costs characteristic

⁵³ FIELD reports that it has also been difficult in the United States for peer-lending groups to become self-managing because the sophistication and variety of business types make it difficult for members (which could, for example, include a childcare provider, specialty cake maker, and graphic designer) to assess risk without some type of support in the underwriting process. Businesses in the United States also tend to be much more geographically dispersed (versus businesses in small villages), making it hard for members to monitor each other in terms of products sold, sales volume, competition, etc. (Joyce Klein, FIELD Senior Consultant, correspondence with the author, July 16, 2012).

⁵⁴ Knowledge @ Wharton, "American Offshoots: Will Microfinance Ever Really Take Root in the U.S.?" June 17, 2011. Available at <<http://www.knowledge.wharton.upenn.edu/article.cfm?articleid=2797>>.

⁵⁵ Credit-builder loans help consumers establish or rebuild their credit histories.

⁵⁶ An IDA is a matched savings account that helps people of modest means save for an asset-building purpose—typically for post-secondary education or job training, home purchase, or to capitalize a small business. <www.cfed.org>.

⁵⁷ Many CDFIs are structured this way due to their missions to serve a specific community in a particular geographic area. In such cases, the CDFI offers multiple products to address the diverse financing needs of its community.

of the U.S. sector. (For instance, Accion Texas, Inc., one of the nation's largest microfinance providers, reports a historic loss rate of 10.7%, which is higher in general than what international MFIs have experienced).⁵⁸ Additionally, the 17 CARS™-rated CDFI loan funds⁵⁹ that engage in microlending ended their 2010 fiscal years with average net write-offs of 3.8% (see Table 12), a figure that is not fully comparable to international microfinance standards, given that the portfolios of these CDFIs comprise loans not only to microenterprises, but can also include loans for small business, affordable housing, community facilities, etc.

On the positive side, the U.S. industry has been working to cut costs by using credit scoring and online services to automate the loan-approval and customer-service processes. Technology is also starting to play a role in connecting individual investors with microfinance practitioners and their borrowers via entities such as KIVA. Other internet-based technology platforms, such as those developed by Accion East (formerly Accion USA) and On Deck Capital (see Box 13), are bringing entrepreneurs from a wide geographic range directly into contact with microfinance entities that have a small physical footprint.

Despite these advances, however, U.S. programs remain reliant on a limited supply of heavily subsidized funding from government, private for-profit, and non-profit sources, owing to the high cost of acquiring clients, the necessary emphasis on training provided at little or no charge, higher operating costs, and the inability to price loans at interest rates that cover expenses. Thus, microfinance programs in the United States are far more expensive to maintain, slower to expand, and much less likely to reach 100% financial self-sufficiency than their developing-country MFI counterparts.

The capital requirements for U.S. microentrepreneurs are much higher than they are for their international equivalents, with the SBA defining a microloan as one at or below US\$50,000 versus the widely accepted international definition of US\$2,000 or less for poorer developing nations and US\$10,000 or under for transition economies (i.e., former Soviet Union, Eastern Europe). The SBA reports an average loan size under its

Microloan Program of approximately US\$12,000,⁶⁰ and FIELD data show an average of US\$14,000 for those entities reporting to its microTracker™ database.⁶¹ This compares to MIX data, which indicate an average of US\$500 for all MFIs across the developing world, with country averages generally vacillating between US\$300 to US\$1,200, depending on each one's level of economic development. Thus, the same amount of investment dollars touches far fewer entrepreneurs in the United States than in the developing world, putting a damper on client outreach.

Growth has also been stagnated by the low levels of capacity-building grants available to U.S. institutions, compared with the capacity-building grants CGAP and bilateral donors, for example, made available to the international industry in its early days. Institutions interviewed during the research for this report frequently noted how difficult it is to come by grant funds for capacity-building in such areas as strategic planning, marketing and branding, MIS upgrades, and geographic expansion. Although the U.S. Treasury CDFI Fund does have some funding for these purposes, the majority of donors provide grants to be used only for loan capital or programmatic expenditures.

Impact on Scale and Financial Sustainability

As a consequence of these differences, today's U.S. microfinance organizations continue to be small scale in comparison to the large or even medium-sized MFIs operating internationally. For example, Accion U.S. Network, the largest and only nationwide microlending network in the United States, has disbursed

⁵⁸ This loss figure is representative of ATI's entire portfolio, which includes small business loans up to US\$250,000; the figure was derived from ATI's 2010 Annual Report, available at <www.acciontexas.org>.

⁵⁹ CARS™, the CDFI Assessment and Ratings System, is a third-party rating service for CDFIs. Ratings address financial strength and performance, as well as social impact. (See <www.carsratingsystem.net>)

⁶⁰ Jody Raskind conversation and power point.

⁶¹ <www.microtracker.org>, sourced on June 1, 2012.

approximately 44,000 loans totaling US\$320 million since its inception in 1991, equating to an average of 2,200 loans per year.⁶² One of its five affiliates, Accion East (also founded in 1991) provided 20,326 loans totaling US\$128 million, equating to an average of approximately 1,015 loans per year. Accion East had its most productive lending year in 2008, when it closed 1,708 loans for US\$11.4 million, culminating in a base of 3,299 active clients by year-end.⁶³

Across the country in 2008, FIELD estimates that 362 microfinance programs disbursed approximately 9,191 loans for a total of US\$100 million.⁶⁴ During 2010, output increased to an estimated 17,623 microloans totaling US\$164 million, disbursed via 403 microlenders.⁶⁵ The average number of loans disbursed per program increased between 2008 and 2010, from 25 to 44.

To provide perspective on the relatively small scale of microfinance in the United States, consider that, according to FIELD, a large-scale microfinance program operating in the country is one that disburses more than 100 microloans a year. In 2008, only ten microfinance providers in the United States reported making more than 100 microloans, and the median number of loans disbursed across the 139 organizations that provided data to FIELD that year was only 13.⁶⁶ (Note: as discussed above, many U.S. microfinance providers offer their clients other products and services, and, thus, the provision of microloans may not be their primary focus.)

In terms of financial sustainability, FIELD reports that, as of June 2011, there were no large-scale non-profit, community-based lenders charging prices that allowed them to fully cover the costs of their micro-lending operations. For instance, in fiscal year (FY) 2010, the median rate of operational self-sufficiency among 15 reporting credit-led microfinance programs was 26%.⁶⁷ And, while community development credit unions are in large part operating on a financially viable basis, it is difficult to assess their level of commitment to microentrepreneurs, given that they are not required by their regulators to report on loans under US\$50,000 and that no data on the extent of these loans are available.

3.1.3 Today's Operating Environment

The financial/economic crisis of 2008 has resulted in low economic growth from 2008 to the present time. The unemployment rate rose dramatically from 4.4% in March 2007 to a high of 10.2% by October 2009, and remained high at 8.2% as of May 2012.⁶⁸ In fall 2009, at the peak of the crisis there were some 15 million unemployed workers and, when underemployed workers were factored in, the ratio jumped to an estimated 18%.

Given this situation, poverty levels in the United States are rising. According to the Census Bureau, by the end of 2010, there were approximately 49 million people in the United States living below the poverty line: 16% of the population, or one out of every six Americans. African Americans and Hispanics were even more affected, with 27.5% and 28.2% living in poverty, respectively.⁶⁹

The crisis has led to high unemployment and poverty rates that have hit minority communities especially hard.⁷⁰ This has presented new opportunities and also challenges for mission-driven CDFIs and credit unions to scale up their support to the underserved. It has also provided an opportunity to for-profit financial institutions, using internet technology and proprietary scoring models, to step into the breach and begin serving these communities, in particular the Latino community.

⁶² <<http://accionusnetwork.wordpress.com/about/>>.

⁶³ <www.accionusa.org>.

⁶⁴ William Girardo and Elaine Edgcomb, "Key Data on the Scale of Microlending in the U.S." (FIELD at the Aspen Institute, February 2011), 17.

⁶⁵ "2011 U.S. Microenterprise Census Highlights: FY2010 Data" (FIELD at the Aspen Institute, March 2012).

⁶⁶ Girardo and Edgcomb, "Key Data on the Scale of Microlending in the U.S." 17.

⁶⁷ The maximum operational self-sufficiency rate out of the 15 programs was 75%; Self-sufficiency ratio = (earned income)/(operating expenses, including interest expense, but exclusive of pass-through grants).

⁶⁸ *Jobs Report* (Washington DC: U.S. Bureau of Labor Statistics, May 2012).

⁶⁹ *Ibid.*

⁷⁰ *Revised Report on Poverty* (Washington DC: U.S. Census Bureau, 2010).

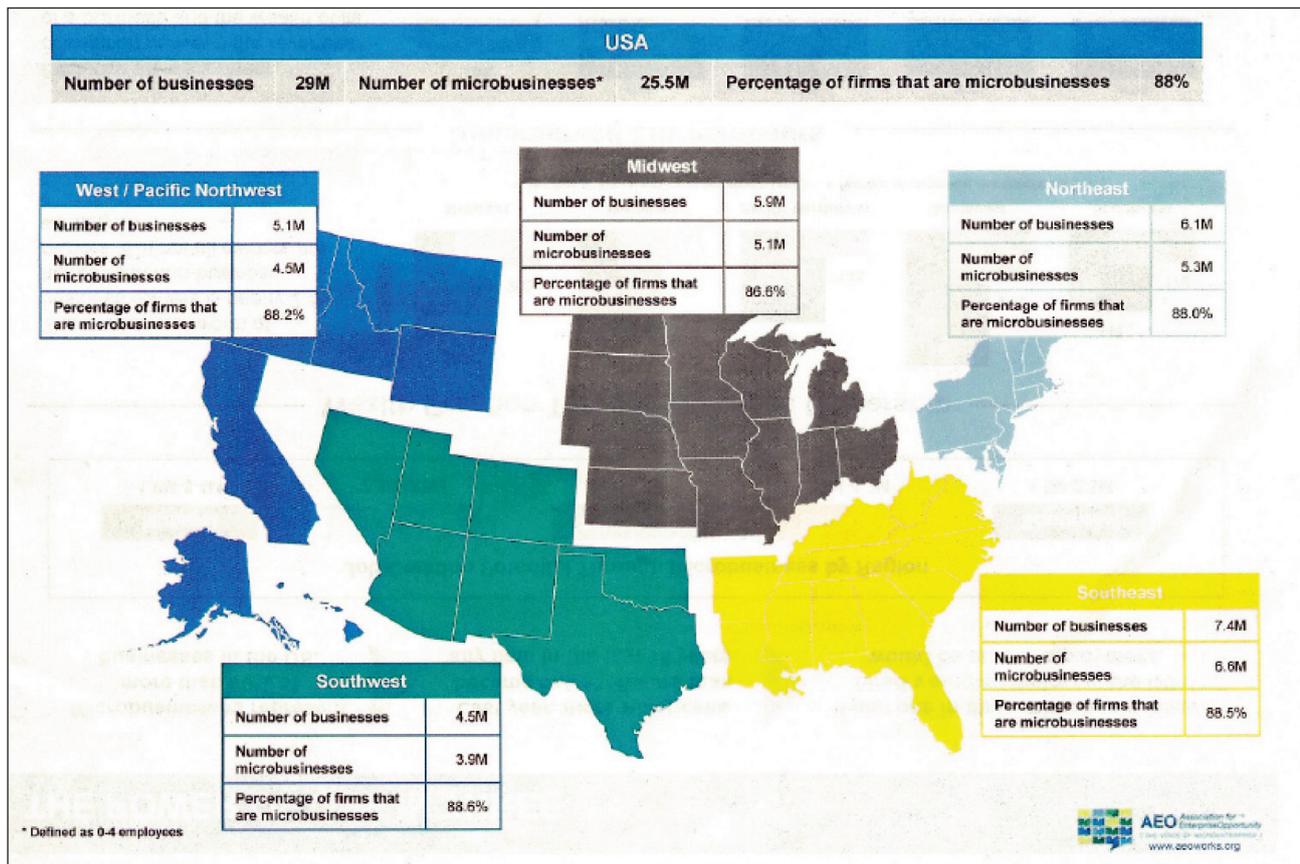
The Microfinance Opportunity

With such a high percentage of people in the country unemployed, living below the poverty line, and unable to access credit, a question is now being asked of the U.S. microfinance sector: Is the industry, as it is structured today, able to step into the void to take part in helping revive the American economy?

Certainly there is an opportunity. According to AEO, a national membership association that promotes entrepreneurship, U.S. Census Bureau data released in 2011 identified 25.5 million microbusinesses (those with zero to four employees, exclusive of the owner) operating across the country in 2007. At the time, these com-

panies represented 88% of all of the nation's business establishments (Figure 1.) Based on this data, AEO estimates that, if just one in three microbusinesses hired a single employee, the United States would be at full employment today.⁷¹ However, there is evidence that microbusinesses are unable to access the financing they need to grow. For example, according to the National Federation of Independent Business (NFIB) Research Foundation, 25.6% of the smallest businesses they surveyed in 2010 (those with one to nine employees) indicated that they were unable to obtain any of the credit they wanted in the past year.⁷² Thus, it is likely *microbusinesses* (with a maximum of four employees) had even more difficulty tapping the financing needed.

Figure 1. Number of Microbusinesses Operating in the United States (2007)



⁷¹ "The Power of One in Three: Creating Opportunities for All Americans to Bounce Back" (AEO, 2011). Available at <www.aeoworks.org>.

⁷² "Microenterprise Development: A Primer," *FDIC Quarterly* 5, No. 1 (2011): 36. Available at <http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_1/FDIC_Vol5No1_Article_1.pdf>.

3.2 Key Actors in the U.S. Microfinance Field

This section offers a brief introduction to the key players in the U.S. microfinance industry, including microfinance providers, investors, and donors. Section 3.3 provides a detailed review of some of the primary microfinance practitioners in the nation.

3.2.1 Overview of Microfinance Practitioners

3.2.1.1. CDFIs and other non-profit organizations

Today, as in the international microfinance sector, a variety of institutions in the United States offer microfinance products and services. During 2011, 762 microenterprise-development organizations (MDOs)

were identified by FIELD, all of which were providing some combination of loans, training, technical assistance, and other services directly to microentrepreneurs. Of these, FIELD estimates that 403 offered microloans, although for some this was a very small percentage of the overall services provided.⁷³ While most organizations reporting to FIELD were non-profit loan funds,⁷⁴ the pool included credit unions, community banks, local chambers of commerce, and small business development centers. Many also described themselves as CDFIs.⁷⁵

CDFIs fill a market gap by supplying financial products and services tailored to the needs of underserved communities whose constituents often cannot easily access financing from mainstream commercial banks. CDFIs may take the form of non-profit loan funds, credit unions, banks, bank holding companies, and venture funds. As Table 8 indicates, CDFI loan funds comprise the lion's share of the 988 certified CDFIs⁷⁶ operating in the United States today.

Table 8. Breakdown of CDFIs by Institution Type

Institution Type	Total # of Institutions ⁷⁷	# Certified CDFIs (as of 4-30-12) ⁷⁸	# Total CDFIs identified by OFN ⁷⁹
Loan funds	Unknown	608	> 500
Credit unions	7,503	219	> 290
Banks	6,838	82	> 350
Bank holding companies	3,984	54	n/a
Venture funds	462	25	> 80

⁷³ FIELD, "2011 US Microenterprise Census Fast Facts" (FIELD at the Aspen Institute, February 2012).

⁷⁴ Non-profit loan funds are typically set up as tax-exempt 501(c) (3) organizations.

⁷⁵ FIELD "Key Data on the Scale of Microlending in the U.S." (FIELD at the Aspen Institute, February 2011), 2.

⁷⁶ CDFI certification is a designation conferred by the CDFI Fund and is a requirement for accessing financial and technical award assistance from the CDFI Fund through the CDFI Program. To become certified, an applicant must meet each of the following requirements: (1) be a legal entity at the time of certification application; (2) have a primary mission of promoting community development; (3) be a financing entity; (4) primarily serve one or more target markets; (5) provide development services in conjunction with its financing activities; (6) maintain accountability to its defined target market; and (7) be a non-government entity and not be under control of any government entity (Tribal governments excluded).

⁷⁷ Michael Swack, Jack Northrup, and Eric Hagen, "CDFI Industry Analysis: Summary Report" (University of New Hampshire, Carsey Institute, Spring 2012).

⁷⁸ CDFI Fund website: <http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=9# certified> (accessed June 7, 2012).

⁷⁹ Opportunity Finance Network's website; includes certified and non-certified CDFIs, <<http://www.opportunityfinance.net/industry/default.aspx?id=234>> (accessed June 6, 2012).

As the above data from FIELD suggest, not all CDFIs engage in microlending. Those that do offer financing to microentrepreneurs, more often than not, also provide loans to other types of borrowers, including small businesses, individuals requiring affordable housing, developers of affordable housing, and community centers.

In addition to CDFIs, there are other non-profit microfinance providers. Those that reported to FIELD in FY 2010 included community development corporations (which offer a myriad of economic well-being

programs and represent 20% of institutions reporting), stand-alone programs (which offer only microfinance; 17%) community-action agencies (which are often federally designated programs with a strong social-service focus; 9%), and “other” groups (which include university-based programs; 13%). As Table 9 illustrates, CDFIs as a group, in addition to having the highest representation (41%), disbursed a much larger average number and volume of loans and, therefore, also had an average portfolio size at least double that of all other institutional types.

Table 9. Types of Institutions Reporting FY 2010 Data to MicroTracker

Institution Type	# Microloans Disbursed			\$ Microloans Disbursed			\$ Microloans Outstanding			
	n=	Mean	Median	n=	Mean	Median	n=	Mean	Median	n=
Community Development Corporations	53	33	13	35	\$418,111	\$150,000	35	\$742,316	\$401,000	33
CDFIs	107	120	26	88	\$1,013,574	\$442,240	85	\$1,442,842	\$1,029,324	72
Standalone Programs (doing microfinance only)	44	46	12	35	\$372,606	\$120,000	33	\$633,468	\$252,000	27
Community Action Agencies	24	18	10	9	\$247,790	\$30,000	9	\$462,745	\$116,133	8
Other (including university-based programs)	35	12	9	19	\$155,184	\$56,950	18	\$560,003	\$226,510	16
TOTAL	263			186			180			156

3.2.1.2 Emerging for-profit lenders

In addition to the entities mentioned above, several commercially oriented, non-bank institutions have entered the sector in the past five to six years. Some of these for-profit entities work in the retail financial services arena and are offering microloans to micro-businesses and consumers alike, as well as additional development benefits, such as credit building (e.g., *Progreso Financiero*). Other for-profit lenders focus explicitly on the microbusiness segment, targeting the low-to-moderate microenterprise market exclusively (e.g., *Financiera Confianza* and *Our Microlending*). One commercial lender, On Deck Capital, has developed a proprietary model targeting Main Street businesses that uses data aggregation and electronic-payment technology to evaluate the financial health of small businesses and to efficiently deliver capital to a market underserved by traditional bank loans. Large retailers,

such as Sam’s Club, are also entering the playing field with loan programs targeted towards its small business customers. Several of these new entrants have designed technology-based platforms to more easily reach a large base of clients.

3.2.1.3 Alternative lenders

Lastly, there exists a group of “alternative” lenders in the United States that primarily target consumers with tarnished credit histories, some of whom use borrowed funds to support their microbusinesses. This group of institutions, which often engages in predatory lending practices, includes payday lenders, cheque cashers, and pawn shops. Some new entrants, like Zest-Cash, are working to compete as fair and transparent substitutes to these alternative lenders. For instance, they are designing loan products to ensure that pay-

ments are relatively cheaper than payday loans⁸⁰ and are also structured to avoid the prolonged debt cycles that often result from borrowers being unable to fully repay their loans at maturity.

3.2.2 Microenterprise Support Organizations

The U.S. microfinance sector is supported by a number of industry associations and organizations, some of which focus specifically on microentrepreneurs and microfinance, and others that support all or some subset of CDFIs. The two primary organizations supporting the microfinance industry are AEO and FIELD:

Association for Enterprise Opportunity (AEO)

Established in 1991, AEO is a national membership organization and “the voice of microbusiness development in the United States.”⁸¹ The organization “supports the development of strong and effective U.S. microbusiness initiatives to assist underserved entrepreneurs in starting, stabilizing, and expanding businesses.” The association represents the public policy interests of its more than 450 member organizations.

FIELD (Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination)

FIELD’s mission is to “identify, develop and disseminate best practices in the microenterprise field, and to educate funders, policy makers and others about microenterprise as an anti-poverty strategy.”⁸² FIELD’s Scale Academy for Microenterprise Development,⁸³ launched in 2007, provides grant funding, peer learning events, and technical assistance to twelve “high-performing microenterprise organizations⁸⁴ that have

demonstrated a commitment to scaling up operations to serve more clients.”

3.2.3 Investors/Donors

3.2.3.1 Government agencies

As previously mentioned, there are two primary federal government programs that help finance microfinance operations in the United States: the SBA and the U.S. Treasury CDFI Fund. Both agencies offer programs that target microlenders either directly or indirectly. There are also a myriad of state, county, and local government institutions that provide loan capital that can be used to fund microloans.⁸⁵

⁸⁰ In one example, a US\$300 ZestCash loan with an annual percentage rate (APR) of 365% requires \$221 in interest and fee payments versus a US\$300 payday loan with an APR of 480% requiring US\$480 in payments. <<http://www.zestcash.com/not-payday-loans/cheaper-than-payday-loans>>.

⁸¹ Information in this section derived from <www.aeoworks.com> (accessed on June 2, 2012).

⁸² Information in this section sourced from <www.fieldus.org> (accessed on June 2, 2012).

⁸³ The Scale Academy, managed by FIELD in partnership with AEO, is designed to address the challenges of scaling microlending programs by offering organizational development grants, technical assistance, and peer learning to leaders in the field. The initiative, funded by the Citi Foundation and the Charles Stewart Mott Foundation, also incorporates documentation of the experiences and lessons learned so others can benefit.

⁸⁴ The initial cohort of seven comprised Accion USA, Accion New Mexico-Arizona-Colorado, ACEnet, Justine Petersen, Mountain Bizworks, Opportunity Fund, and WESST Corp. In 2011, five new members were selected: ACCION Chicago, Four Bands Community Fund, The Intersect Fund, Mercy Corps Northwest, and MicroMentor.

⁸⁵ The U.S. Department of Housing and Urban Development’s CDBG (Community Development Block Grant) program also likely provides substantial levels of funding to microenterprise programs. However, it is difficult to track the extent to which this is the case because funding decisions are made at the local level, and, at the federal level, the reporting system does not break out funds used to support microenterprise development. (Joyce Klein, FIELD Senior Consultant, correspondence with the author, July 26, 2012).

SBA Microloan Program⁸⁶

The SBA's Microloan Program, which has been in existence for 20 years, makes funds available to specially designated intermediary lenders that are non-profit, community-based organizations with experience in lending, as well as providing technical assistance. Participating intermediaries on-lend to eligible microbusinesses. The maximum loan amount has recently been raised from US\$35,000 to US\$50,000. As stated earlier, the average loan size is just over US\$12,000. The maximum loan term is six years, and interest rates are capped at not more than 7.75% to 8.5% over the cost of funds.⁸⁷

Institutions participating in the program receive subsidized funding and are required to provide business training and technical assistance to their microborrowers. They must also maintain a dedicated loan-loss reserve of 15% of their SBA loan portfolio and adhere to purportedly tedious reporting requirements.

Table 10 illustrates the Microloan Program's lending activity over the past two decades. Close to US\$520 million in loan capital has been made available to microentrepreneurs via program participants—an average disbursement rate of US\$26 million per year. Based on a mean loan size of US\$12,055 over the 20-year period, an average of 2,166 microloans have been disbursed per year. Approximately US\$47 million in nearly 4,000 microloans are now being disbursed annually.

Table 10. SBA Microloan Program: Historic Lending Activity.

Period	SBA Loans Disbursed	Microloans Made	Multiplier
1992-1996	\$57,928.00	\$51,819.00	0.89
1997-2001	\$81,810.00	\$91,218.00	1.11
2002-2006	\$91,200.00	\$168,097.00	1.84
2007-2012	\$115,717.00	\$208,483.00	1.80
1992-2012	\$346,655.00	\$519,617.00	1.50

Twelve program participants out of 150 accounted for 33.5% of the overall *dollar volume* disbursed via the program in FY 2011. At the same time, the top twelve producers accounted for 54.3% of the aggregate *num-*

ber of loans closed under the microloan program, with Grameen America disbursing 860 loans, well above the next most prolific lender, Justine Petersen (284 loans).

Between FY 2003 and FY2011, the average microloan delinquency rate for the aggregate SBA Microloan portfolio registered 10.4%, while the average microloan default rate stood at 9.1%. The microlender default rate on SBA loans measured 3.03% over the same period.

While the Microloan Program provides important capital (and grant support for technical assistance) to microlenders, at least one grantee member of FIELD's Scale Academy voiced concern that it is impossible to scale an organization by relying on Microloan Program capital because the margin between the costs of running the program and the revenues generated is simply too large. Consequently, until late 2009, only two of five Scale Academy lenders had elected to participate in the program. As of May 2012, two more had chosen to participate, owing partly to the fact that the recession led to constraints in other sources of loan-fund capital and because the rates to borrow from the program had dropped to almost zero. Nonetheless, as was echoed by several lenders interviewed for this report, the Scale Academy grantees remained concerned about the extent to which participation in SBA's Microloan Program would support their goals of scale.⁸⁸

Aware of these constraints, the SBA has recently moved to eliminate certain barriers to broaden the geographic reach of the program, reduce costs, and ease reporting processes. Regardless, the most significant limitations remain in the form of interest rate caps and cash-funded loan-loss reserves.

⁸⁶ Unless otherwise noted, data, tables, and charts in this section are taken either from SBA's website <<http://www.sba.gov/content/microloan-program>> (accessed June 1, 2012), or from SBA's presentation "The First 20 Years!: Microloan Update, April 16, 2012" provided by Jody Raskind in a meeting with the author May 7, 2012.

⁸⁷ "Federal Program Update: SBA," April 26, 2012 at <<http://www.nado.org/wp-content/uploads/2012/05/Closing-Federal-Plenary-SBA-Darcy-Carter.pdf>>.

⁸⁸ Elaine Edgcomb, Joyce Klein, and Luz Gomez, "Dollars for Dreams: Scaling Microlending in the United States," Findings from the Scale Academy (FIELD at the Aspen Institute, May 2010), 21.

SBA Program for Investment in Microentrepreneurs (PRIME)

PRIME is a grant program available to MDOs and other non-profit organizations that help underserved entrepreneurs. Grants up to US\$250,000 can be awarded to fund direct assistance to customers of MDOs or to build the MDO's own resources or research capabilities. The SBA awarded approximately US\$8 million in PRIME grants to 92 recipients in 2010.⁸⁹

CDFI Program⁹⁰

Through monetary awards and the allocation of tax credits, the U.S. Treasury CDFI Fund helps promote access to capital and local economic growth in urban and rural low-income communities across the nation. The entity accomplishes this goal through a number of programs, the most relevant to the microfinance sector being the CDFI Program.

The CDFI Program uses federal resources to invest in CDFIs via two types of monetary awards: Financial Assistance (FA) and Technical Assistance (TA) awards, applications for both must be submitted annually.

FA awards range up to US\$2 million, are available only to certified CDFIs, and may be used for financing capital, loan-loss reserves, capital reserves, or operations. FA awards are made in the form of equity investments, loans, deposits, or grants, and CDFIs are required to match their awards dollar-for-dollar with non-federal funds.

TA awards are capacity-building grants for certified CDFIs and established entities seeking to become certified within two years. Award monies may be used for a wide range of purposes, including the purchase of equipment, materials, or supplies; consulting or contracting services; salaries and benefits of certain personnel; and/or training of staff or board members. These awards are provided in amounts up to US\$100,000.

Since its inception, the CDFI Program has awarded more than US\$1 billion in FA and TA awards combined, a portion of which has been provided to a

number of CDFI loan funds engaged in microfinance. These institutions state that microloans represent more than 10% of their new originations. From 2005 to 2010, these CDFIs reported the origination of US\$150 million for almost 15,000 microloans. Their cumulative outstanding microloan portfolio was US\$117 million in 2009 and US\$137 million in 2010.⁹¹ In FY 2011 14% of FA awards went to organizations that provide microenterprise loans.⁹²

CDFI Fund's CDFI Bond Guarantee Program

In addition to these activities, the CDFI Fund is also in the process of launching its Bond Guarantee Program, which was created by the Small Business Jobs Act of 2010. Although not geared specifically towards microfinance providers, it will offer CDFIs a new source of long-term, patient capital for loans and investments in low-income communities, thereby laying some of the groundwork needed to help bring some of the more robust institutions engaged in microfinance to scale.

Although this program has been authorized by Congress since 2010, it is not yet operational, partly because of a long delay in receiving a credit-subsidy score of zero (indicating that the program is structured to generate no net losses to the taxpayer). The Office for Management and Budget has now approved the CDFI Fund's zero-credit-subsidy model, and the CDFI Fund thus continues to work proactively to get the legislative authority to move the program forward. The President's FY 2013 Budget includes support to implement the program, and industry leaders are now

⁸⁹ Information on the PRIME program was derived from the SBA Web site, <<http://www.sba.gov/content/prime-program-0>>.

⁹⁰ Unless otherwise noted, information in this section derived from the CDFI Fund website: <<http://www.cdfifund.gov>> (accessed June 4, 2012).

⁹¹ Note: these numbers reflect all microloans made by these organizations, not just that portion funded with CDFI Fund FA awards.

⁹² Donna Gambrell, CDFI Fund Director, Keynote Address, 2012 AEO National Conference, April 30, 2012.

Box 4. Select features of the CDFI Bond Guarantee Program

- Guarantee by U.S. Treasury of up to 10 bonds per year, each at a minimum of US\$100 million, with aggregate bonds not to exceed US\$1 billion per year
- Federal guarantee to cover 100% of the principal, interest, and call premium, if any
- Ability for CDFIs to issue bonds with terms up to 30 years
- Low cost of funds, with pricing tied to rates for current U.S. Treasury bonds of comparable maturities
- Use of bond proceeds restricted to community and economic development activity as defined by the Riegle Act (the enabling legislation for the CDFI Fund)
- Administration of the program by the CDFI Fund

expecting the first bond guarantee to be issued in FY 2013. While the program is authorized only through 2014, industry representatives expect the deadline to be rolled to 2016.⁹³

Limitations on Client Outreach and Financial Viability

While the federal government programs discussed above provide a critical source of financing for organizations engaged in microlending, they also incorporate a number of features that make it difficult for institutions to reach scale and achieve financial self-sufficiency:

- Annual funding is limited and can be highly volatile, owing to budgetary constraints and changes in the political environment.
- Subsidized funding introduces a distortion that tends to “crowd out” market-rate financing that could substantially expand resources available for lending or, of greater importance, equity capital to build the capacity of these institutions.
- Interest rate caps prohibit organizations from charging rates that cover the costs of delivering microfinance products.
- Administrative requirements (reporting, annual applications, etc.) elevate compliance and human resource costs.

3.2.3.2 Commercial banks as funders

The commercial banking sector has a history of providing short- to medium-term debt financing, as well as grant support, to MDOs. The driving force behind this activity has been, and continues to be, the Community Reinvestment Act, which was enacted in 1977 to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods.

To fulfill their CRA obligations, banks often make investments in CDFIs and other financial entities serving LMI neighborhoods, with the intention that loan proceeds will be on-lent to community-based businesses and residents. Many of the nation’s largest banks have community-development arms that actively finance this group of organizations, including Bank of America, Citigroup (Box 9), HSBC, JPMorgan Chase, TD Bank, and Wells Fargo. Regional and local banks also make CRA-related investments in CDFIs operating in their service areas.

The CDFI industry has, for a number of years, been pushing for CRA reform, including:

⁹³ Mark Pinsky (Executive Director, Opportunity Finance Network) interview with the author, May 7, 2012. Jesse Chancellor (Managing Director, Community Investment Partners, Calvert Foundation) interview with author, August 21, 2012.

- Expansion of CRA compliance rules to include all portions of the financial services industry that compete with banks and thrifts; e.g., credit unions, mortgage bankers, securities firms, insurance companies, payday lenders, and pawn shops.
- “ Imposition of penalties for lending and other services that are performed in a manner inconsistent with statutory and regulatory guidance.
- “ Establishment of effective public-disclosure regimes.
- “ Inclusion of all broad geographies in which an institution does a significant amount of business rather than only the location where it has a physical branch presence.
- “ Limitation of the number of “outstanding” ratings given by federal regulatory agencies to stimulate better performance and to limit grade inflation.⁹⁴

While the CDFI sector pushes for positive reform, industry leaders have expressed some concern that CRA may be open to reforms that will weaken its impact in the years ahead. For instance, in June 2010, after the federal bank and thrift regulatory agencies announced a series of proposed changes to CRA regulations, Jeannine Jacokes testified before the Federal Financial Institutions Examination Council hearing on the proposed revisions.⁹⁵ Presumably feeling that CRA was somehow endangered, she stated that, “over the past two-plus years, CRA has been under unfair assault by those who wish to shift the blame for the financial meltdown from Wall Street to low-income neighborhoods and people.” The goal of her testimony was to underline (i) how “CRA is essential to the health of our country’s LMI communities,” and (ii) the “need to look forward and identify how CRA can become a more effective tool” to promote direct investment in LMI communities and forge partnerships with CDFIs to reach deeper into underserved communities.⁹⁶

Although no changes to CRA came out of these most recent hearings, CDFI industry leaders remain at-

tuned to any upcoming proposed changes that could weaken the legislation, especially given how vital it is in channeling funds to the sector.⁹⁷

From observations made during the research for this report, most national, regional, and local banks seeking to meet their CRA requirements are providing three- to five-year unsecured loans to CDFI loan funds priced between 2% and 4%. While a 2011 FIELD report relates that most private funders do not have a predetermined perspective regarding the interest rates CDFIs should charge end borrowers, they do speak in terms of “fair” and “equitable” pricing, which can cause confusion among practitioners. For instance, does an MDO think it is fair and equitable to charge interest rates that cover actual costs? Or, is a fair rate no higher than borrowers eligible for financing from more mainstream sources would receive?⁹⁸

Neither FIELD nor AEO collect data on the total dollars made available by commercial banks to intermediary institutions specifically for the provision of microloans.

⁹⁴ Ellen Seidman, “Modernization & Expansion of the Community Reinvestment Act,” at “The Next American Opportunity: Good Policies for a Great America” (Opportunity Finance Network, 2008), 22.

⁹⁵ Jeannine Jacokes was, at the time, Chair of the CDFI Coalition, CEO of the Community Development Bankers Association, and Chief Executive of Partners for the Common Good, a non-profit CDFI loan fund.

⁹⁶ Jeannine Jacokes, Testimony of on behalf of the Community Development Bankers Association and CDFI Coalition, before the Federal Financial Institutions Examination Council (FFIEC) Hearing on Proposed Revisions to the Community Reinvestment Act Regulations, Arlington, Virginia, July 19, 2010. Available at <<http://www.fdic.gov/regulations/laws/federal/2010/10c06AD60.PDF>>.

⁹⁷ According to several industry leaders interviewed for this report, the time is ripe for CRA reform. For instance, because there remain few opportunities for continued bank mergers, the incentive to ensure strong compliance with CRA regulations as one precondition to receiving authorization for a merger has diminished.

⁹⁸ “Is the Price Right? The Role of Pricing in Microenterprise Lending,” *FIELD Funder Guide*, Issue 17 (June 2011): 3.

Box 5. Issues of Pricing

In June 2011, FIELD published a funder's guide to pricing, which highlighted a number of key findings:

- Most, if not all, non-profit microlenders in the United States are charging prices that are subsidized and, therefore, do not cover the costs of their microlending programs.
- There is no industry-wide data on the prices charged by non-profit lenders, although participants in the Scale Academy reported charging rates between 5% and 18%.
- In comparison, as of April 2011, for individuals with subprime credit, the average credit card interest rate was 23.95%, the national average credit card interest rate was 14.67%, and the average rate for business credit cards was 12.91%.
- Rates offered by several for-profit microfinance organizations to microentrepreneurs in California and Florida vary broadly, ranging from 18% to 60%.
- Funding sources play a critical role in pricing, with public sector funders appearing to be the most likely to specify the interest rates and fees that can be charged on loans made with the capital they provide.
- MDO staff members often believe borrowers will be resistant to higher pricing, although microlenders have done very little market research to test borrower perceptions.
- Some market surveys point to the willingness of potential customers to pay significantly higher prices if they can access financing in days rather than weeks.
- There is growing recognition that charging below-market interest rates may be one factor hindering the growth and sustainability of non-profit microlenders.

Based on this information, FIELD recommends the following actions pertaining to pricing:

- Microlenders need to develop a clear pricing strategy, including a rationale for their rates.
- Funders should consider whether their expectations with respect to a program's scale and sustainability are reasonable and consistent with rates being charged.
- The industry should support market research that could illuminate pricing sensitivity.
- The industry should promote pricing transparency rather than placing restrictions on pricing.

3.2.3.3 Foundations and other donors

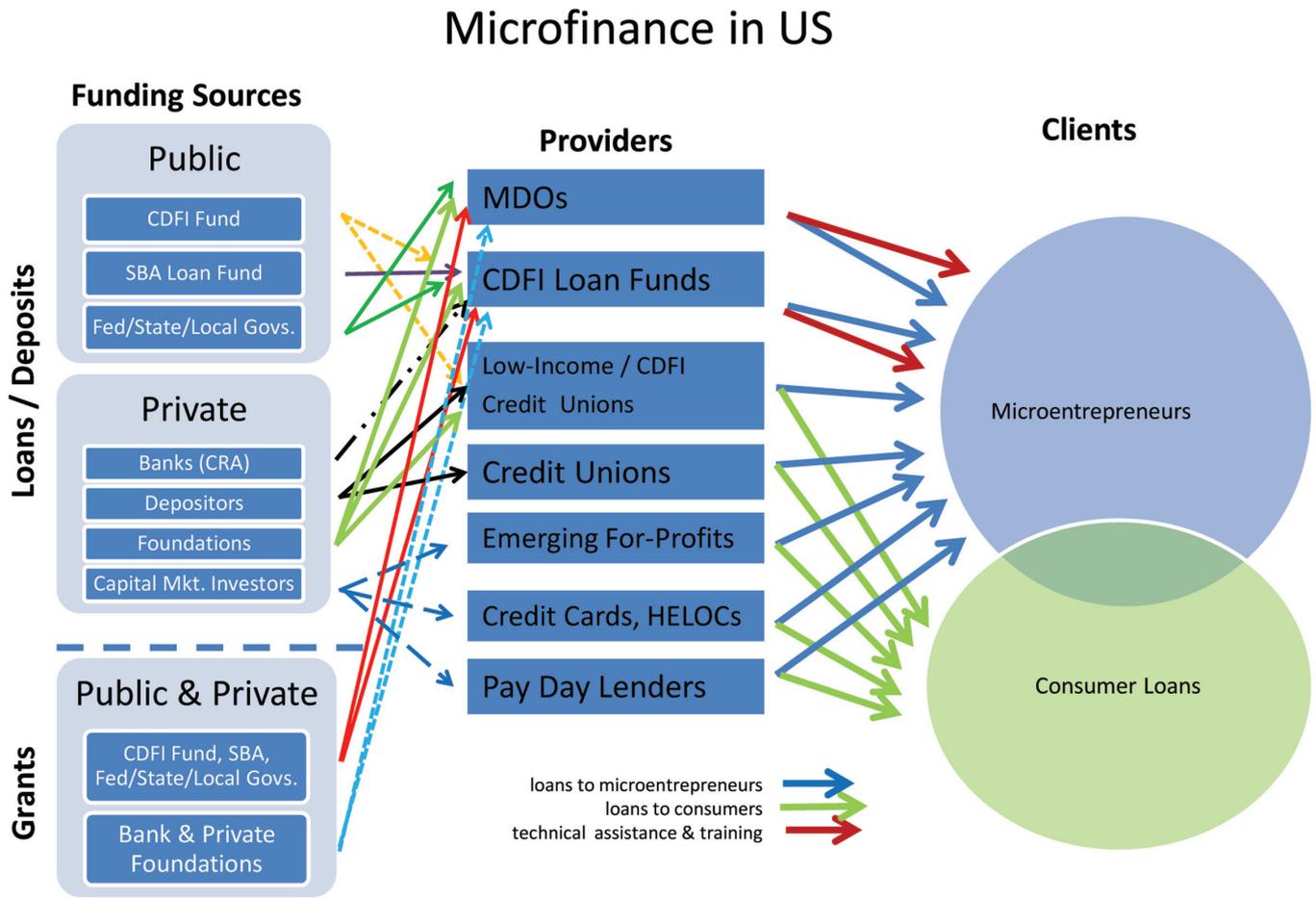
Foundations serve as another source of loans and grants for MDOs. Several of the country's most prominent foundations provide such financing for CDFI loan funds engaged in microfinance, including the Annie E. Casey Foundation, Calvert Foundation, and the Ford Foundation to name a few. As with debt sourced from commercial banks, foundations tend to provide unsecured loans for three to five years, most at below-market interest rates of less than 4.0%. In addition to

foundation support, MDOs have attracted subsidized loans and grants from other sources such as religious institutions, social investment funds, and individual donors. No aggregate data on the level of support to the industry from these entities are readily available.

3.2.3.4 Venture capitalists

Historically, venture capitalists have had no involvement in financing the U.S. microfinance sector. However, sev-

Figure 2. Participants in the U.S. Microfinance Sector



eral are now supporting a handful of newly emergent, technology-based for-profit entities engaged largely in financing consumers (some of whom use their loan proceeds for business purposes) or microbusinesses. For instance, On Deck Capital⁹⁹ (Section 3.3.2.2) was launched with backing from venture capital firms that specialize in technology and/or financial services, such as SAP Ventures, Village Ventures, Contour Venture Partners, and First Round Capital.¹⁰⁰ Given that venture capital is expensive, entities like On Deck, which have successfully made it through their initial years, are now in the process of raising private equity to replace this initial funding source. Other organizations, such as *Financiera Confianza* (also Section 3.3.2.2), are instead merging with CDFIs, in part, to access less-costly capital.

3.2.3.5 Relationship between various players in the sector

Figure 2 summarizes the relationship between the various types of microfinance providers, investors, and donors described above.

⁹⁹ Although On Deck does make microloans of less than \$50,000 (and has an average loan size of \$35,000), the company primarily targets small and medium size companies with revenues in the \$1 million range, a market segment which FIELD states is outside that of the typical non-profit microfinance provider (source: Joyce Klein, FIELD, November 10, 2012). See Box 8 for a description of the program in which On Deck is participating to facilitate expansion of the microfinance sector.

¹⁰⁰ On Deck Capital, <<http://www.ondeckcapital.com/our-company/investors>> (accessed June 14, 2012).

3.3 A Detailed Look at Microfinance Practitioners

This section further describes the various types of institutions involved in the provision of finance for microbusinesses, focusing on those institutions which were most frequently identified as leaders in the U.S. microfinance sector by industry representatives during our research. The institutions highlighted have developed certain products, services, and/or business models that have (or could) allow them to achieve higher levels of scale and financial sustainability than their counterparts.

3.3.1 CDFI Loan Funds

As previously outlined, the CDFI industry comprises four types of institutions: (i) community development loan funds, (ii) community development credit unions, (iii) community development banks, and (iv) community development venture capital (CDVC) funds. The four types have distinct histories and growth trajectories. Community development banks and credit unions are the most mature, with institutions dating back to the turn of the twentieth century. They have had slow and steady growth for the past several decades. Loan funds are much newer: 73% of this sector commenced lending operations in the 1980s and 1990s, and 14% began financing after 2000.¹⁰¹

As there is little evidence that community development banks are actively engaged in microfinance, they will not be discussed in this section. CDVC funds are also not included, since they provide equity and debt-with-equity features to small and medium-sized businesses (versus microenterprises).

Overview of CDFI Loan Funds:

The growth of the CDFI movement has been focused largely on CDFI loan funds, which have, for example, received 80% of the CDFI Fund's monetary awards over the past five years.¹⁰² CDFI loan funds

are typically structured as non-profit organizations that are governed by boards of directors with community representation. There is no regulatory body to oversee or assess their financial status. With no external shareholders expecting a return on investment, these organizations are primarily mission driven rather than profit-maximizing, with a focus on serving disadvantaged communities and people via the provision of finance for micro and small businesses, affordable housing, and/or community service organizations.

Level of Outreach to Micro-entrepreneurs:

Although FIELD's microTracker database currently provides information on 817 MDOs operating throughout the United States, it does not track data by type of institution. It is therefore difficult to ascertain exactly what portion of overall microfinance activity can be attributed to CDFI loan funds. With that said, most of the larger MDOs highlighted in this report are certified as CDFI loan funds.

To provide some sense of scale, Table 11 shows data provided to FIELD by several of those CDFI loan funds identified during our research as leading providers of microfinance. These entities, along with the 158 other MDOs reporting to FIELD, financed a very small percentage of the nearly 25.5 million microbusinesses operating in the United States during FY 2010. We recognize that a much smaller sub-set of microbusinesses are in need of, and would be eligible for, microloans from CDFI loan funds. In 2005, FIELD estimated only 10 million individuals fit the characteristics of the target groups the microenterprise industry seeks to serve:

¹⁰¹ "Providing Capital, Building Communities, Creating Impact" (CDFI Data Project report, FIELD, 2008). Available at <<http://fieldus.org/Publications/CDPfy2008.pdf>>.

¹⁰² Clifford Rosenthal, "Credit Unions, Community Development Finance, and The Great Recession" (Working Paper No. 2012-01, Community Development Investment Center, Federal Reserve Bank of San Francisco, February 2012).

such as women, minorities, low-income individuals, individuals with disabilities, and those with difficulty accessing commercial credit markets.¹⁰³ Even taking

these parameters into account, however, the sector has to date reached a relatively small percentage of the micro firms which the industry is targeting.

Table 11. Five Leading CDFI Loan Funds (FY 2010 data reported to microTracker)¹⁰⁴

Institution	Geographic Area Served	Year Founded	# FTEs	Lending Methodology	Other Products / Services Offered	# Microloans Disbursed	\$ Microloans Disbursed	Avg. Size Loan Disbursed	\$ Microloans Outstanding	Mean Interest Rate
ACCION Texas	TX; Mississippi Delta (LA, AR, MO)	1994	65	individual	TA, training, small business loans, credit-builder loans, com'l	2,018	\$ 22,481,156	\$ 11,140	\$ 24,624,767 *	12%
ACCION USA	NYC; Boston, MA; Atlanta, GA; Miami, FL; and, via internet service, other states not served by ACCION affiliates	1991	not reported	individual	TA, training, credit-builder loans	618	\$ 4,356,071	\$ 7,049	\$ 7,441,799	not reported
Grameen America	NYC; Omaha, NE; Indianapolis, IN	2008	not reported	group/peer	TA, Training, credit-builder loans, savings program via local partner banks	4,153	\$ 8,856,584	\$ 2,133	\$ 3,300,000	15%
Justine PETERSEN	MO, southern IL	2001	9	individual	TA, Training, IDAs	354	\$ 2,198,038	\$ 6,209	\$ 2,921,771	8%
Opportunity Fund	CA: San Francisco Bay Area & Los Angeles	1995	6	individual	TA, Training, IDAs, small business loans, credit-builder loans, affordable housing loans, community facility loans, NMTC	195	\$ 1,798,502	\$ 9,223	\$ 1,986,058	8%
Sub-total						7,338	\$ 39,690,351	\$ 5,409	n/a	
microlenders reporting to microTracker (MT)	national coverage	mean program age = 15 yrs	mean = 5	various	various	12,561	\$ 104,200,000	\$ 8,296	\$ 135,600,000	mean = 8%
# MDOs reporting to MT	238	212	186	238	238	164	164	n/a	137	157

* Number reported by Accion Texas

As Table 11 illustrates, these five CDFI loan funds accounted for 58% of all microloans disbursed by the 164 organizations reporting FY 2010 data to microTracker. This is in keeping with a 2008 FIELD finding that only 10 out of 263 microenterprise programs participating in that year's census reported disbursing more than 100 microloans during the year.¹⁰⁵ Grameen America, in operation for only two years at the time, disbursed twice as

many loans as the next most productive institution, Accion Texas, which had been in existence for 16 years. However, because of Accion Texas' significantly larger average loan size, its annual disbursements of US\$22.5 million outpaced those of Grameen America by 2.5 to 1.

Grameen America's early success in reaching a large number of borrowers appears to be related to a number of factors, as outlined in Box 11.

¹⁰³ <http://fieldus.org/Stories/FastFacts.html#micro>

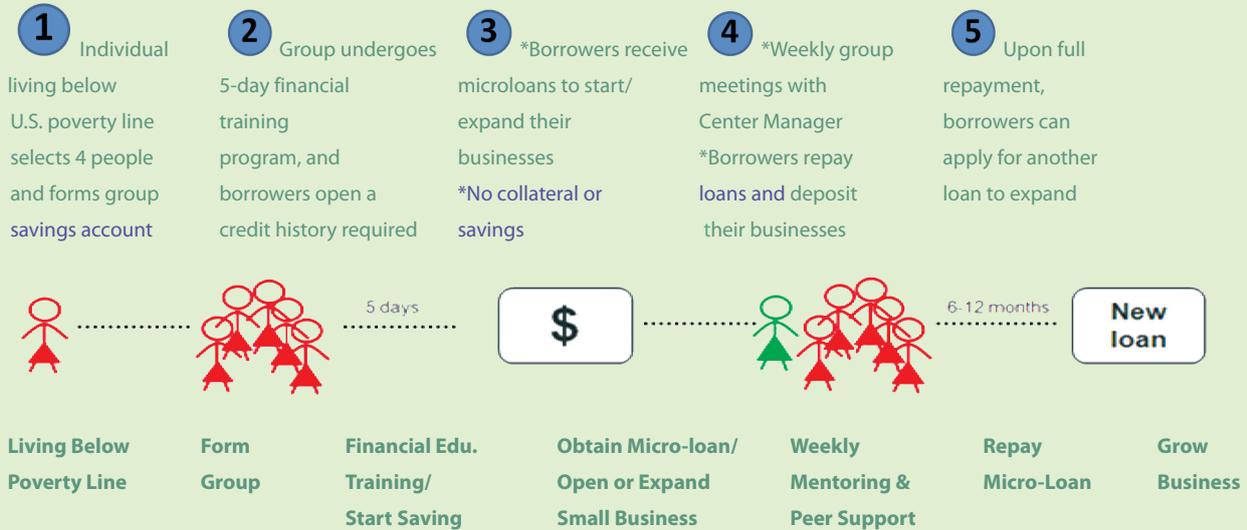
¹⁰⁴ <www.microtracker.org> (accessed June 5, 2012).

¹⁰⁵ Girardo and Edgcomb, "Key Data on the Scale of Micro-lending in the U.S." 9.

Box 6. Grameen America: Focus on One Core Product ¹⁰⁶

Grameen America (GA) opened its first U.S. office in New York City in 2008 and has grown to seven branches (with 4 in New York City; and one each in Omaha, Nebraska; Indianapolis, Indiana; and Oakland, California), with plans to open four more by the end of 2012. Since its inception, GA has more than doubled in size each year, growing from 500 borrowers at the end of 2008 to 9,295 by the end of first quarter 2012. During FY 2010, GA disbursed 4,153 loans, making it the most prolific non-profit microlender in the United States. From FY 2010 to FY 2011, the outstanding portfolio nearly doubled from US\$3.3 million to US\$6.4 million.

Unlike most microfinance providers in the United States that use an individual-lending methodology, GA utilizes the peer-lending model developed by Grameen Bank in Bangladesh:



In comparison to most other U.S. microfinance providers, Grameen America's business model more closely resembles that of international MFIs in a number of ways:

- Focus on one core microloan product.
- No staff dedicated to business-development training and TA, as Center Managers (GA's loan officers) provide savings, credit, and financial education to borrowers during weekly group meetings.
- Smaller average loan size, with maximum first-time loan of US\$1,500 versus average U.S. loan size of US\$14,000.
- Branches are managed by deeply experienced team from Bangladesh.
- Center Managers have strong ties to and understanding of GA's client base.
- Focus on sustainability; interest rates of 15%, declining balance, no fees.

Financial Self-Sufficiency:

As discussed earlier, CDFI loan funds' joint focus on lending at subsidized interest rates and providing training at minimal to no cost, has created a group of organizations heavily reliant on government subsidy

and donor support and, thus, very unlikely to achieve financial self-sufficiency.

¹⁰⁶ Information in this Box derived from meeting of author with Grameen America's senior staff, April 2, 2012, as well as from their website: <www.grameenamerica.com>.

As of June 2011, FIELD reported that there were no non-profit, community-based lenders that were charging prices which allowed them to fully cover the costs of their microlending operations. For example, in 2010, the total cost recovery for microlending oper-

ations of five Scale Academy lenders studied by FIELD ranged between 12.2% and 36%. For 27 microlenders that reported data to FIELD's MicroTest program for 2009, the range was 0% to 46%. The mean was 23%, and the median was 15%.¹⁰⁷

Box 7. Accion Texas, Inc. and the Self-Sufficiency Question¹⁰⁸

Accion Texas, Inc. (ATI) is a multi-state, non-profit micro and small business lender that offers loans from US\$500 to US\$250,000. Over the years, management has worked to increase self-sufficiency levels either by augmenting earned revenues (for example, by moving into small business lending and therefore disbursing larger loans that generate higher levels of interest income) or reducing operating costs. Many of the efforts to lower expenses have been technology based:

In 2004, the institution developed a proprietary scoring engine, using data from thousands of loans generated by the organization since 1994.

In late 2006, ATI deployed its first web-based platform for loan applications, eliminating much of the paperwork involved in the loan-approval process and allowing for a quicker loan decision-making process.

For a fee, ATI now provides its web-based platform (MMS™) to 12 microlenders across the country.

Largely because of these innovations, ATI has become the largest non-profit microlender in the country, with an outstanding loan portfolio of US\$24 million comprising nearly 2,000 loans at FYE 2010.¹⁰⁹

In 2007, management was nearing its internal self-sufficiency goal of 80%. However, with an opportunity to expand into Louisiana and other states in the Mississippi Delta region, management and the board decided that the chance to finance a larger number of underserved entrepreneurs was more important than achieving higher levels of self-sufficiency. As a result, operating expenses have increased as a percentage of earned revenue, owing to the start-up costs associated with geographic expansion, and self-sufficiency has fallen back to around 50%.

In line with ATI's decision, other non-profit microfinance institutions interviewed for this report indicated high levels of self-sufficiency were not a primary driver in their business decisions.

Table 12 shows FY 2010 indicators of financial strength and sustainability for the seventeen CARS™-rated CDFI loan funds that are engaged in microlending. Although these organizations do offer financing for microentrepreneurs, they also provide a number of other products and services,

including small business loans, business training and TA, financial literacy training for individuals, credit-builder loans, IDAs, affordable-housing loans, and financing for community facilities. Therefore, a direct comparison to most international MFIs is not possible.

¹⁰⁷ "Is the Price Right?" 3.

¹⁰⁸ Janie Barrera (ATI President and CEO), meeting with author April 26, 2012 and ATI's website at <www.acciontexas.org>.

¹⁰⁹ Outstanding loans include both microloans and small business loans.

Table 12. CARS-Rated CDFI Loan Funds Engaged in MicroLending (n = 17)
FY 2010 Indicators of Financial Strength and Sustainability

FY 2010 Ratios	Average	Median	Max	Min
Total Assets ('000s)	\$ 22,395	\$ 14,129	\$ 73,662	\$ 1,739
Capital Adequacy (Net Assets / Total Assets)	46%	46%	82%	16%
Earned Income / Total Revenues	33%	33%	83%	4%
Self-Sufficiency (Earned Income / Total Operating Expenses)	49%	47%	100%	11%
PAR > 30 Days ((delinquencies > 30 days + restructured loans) / outstanding portfolio)	17.6%	13.0%	64.0%	1.6%
Net Write-offs (% outstanding portfolio)	3.8%	3.6%	9.2%	0.3%

As Table 12 illustrates, self-sufficiency levels are very low, which is typical of CDFI loan funds, given their reliance on grants and donations. Conversely, capital-adequacy ratios tend to be strong (particularly in comparison to those of community development credit unions and banks), indicative of the level of capital grants available to most of these organizations. The median portfolio at risk (PAR) ratio is quite high relative to international microfinance standards. But, again, a direct comparison is impractical, given the mix of loans for micro, small business, affordable housing, and community facilities in the U.S. portfolios.

Future Prospects:

While the recession has put strains on the financial performance of many CDFI loan funds, the sector as a whole has survived. Nonetheless, the future remains hazy. Both the political and economic environments will likely present more challenges for CDFIs.

While President Obama's FY 2013 budget provides US\$221 million for the CDFI Fund (matching the FY 2012 appropriation), the outcome of budget negotiations remains to be seen, and the entire process is expected to be drawn-out and difficult, as in previous years.¹¹⁰

As regards the SBA Microloan Program, the President is requesting US\$18 million to fund loans to microenterprises, a 28% reduction from the FY 2012 funding level of US\$25 million. The FY 2013 budget

request for the technical assistance component of the Microloan Program stands at US\$19.8 million, nearly equivalent to the FY 2012 level of US\$20 million.¹¹¹

The sector is also waiting for the CDFI Bond Guarantee Program to become operational, as it could provide a long-awaited source of predictable capital. Although the exact terms of the bond issue are still unknown, access to such long-term financing could be the impetus that allows participating institutions to grow their portfolios to a scale which could create greater levels of earned income in conjunction with lower operating costs per customer. Individuals interviewed for this report have expressed concern that the terms of the bond issue may well exclude many of the institutions in the sector.

Opportunities are also developing for CDFI loan funds to benefit from the technology platforms that newly emerging for-profit entities have introduced to the market. The One in Three pilot project recently launched by AEO in partnership with On Deck Capital and Justine PETERSEN has the potential to increase client outreach, generate a higher proportion of earned revenues for the sector, and reduce operating expenses.

¹¹⁰ Donna Gambrell (CDFI Fund Director), Keynote Address at the CDFI Coalition's 2012 Institute, March 7, 2012. Available at <<http://www.cdfifund.gov/speeches/Gambrell-2012-1-Keynote-Address-by-CDFI-Fund-Director-Donna-Gambrell-at-the-CDFI-Coalition-s-2012-Institute.asp>>.

¹¹¹ Cfed Advocacy Center < <http://www.capwiz.com/idanetwork/issues/alert/?alertid=61030281> > (accessed June 5, 2012).

BOX 8. AEO's One in Three National Campaign

Based on research showing that if one in three microbusinesses hired just one employee, the nation would be at full employment, AEO recently rolled out its "One in Three National Campaign." Through partnerships with On Deck Capital and several MDOs, AEO hopes to (i) reach one million underserved entrepreneurs with capital and services, (ii) create 500,000 jobs, and (iii) mobilize US\$40million to US\$50 million in new capital for lending to microenterprises in the next three years.

AEO has selected On Deck Capital (a venture-backed technology company that has created an innovative platform to originate, decision, and service working-capital loans to "Main Street" businesses) as the service provider for its new One in Three marketing and matching platform. The platform has been designed to serve two functions: (i) as a portal for community-based MDOs, and (ii) as a service matcher to connect entrepreneurs to finance and business development services provided by participating MDOs.

AEO has chosen Justine PETERSEN, a CDFI located in St. Louis, Missouri, to participate in the platform's pilot phase. AEO expects the first loan to be made in September 2012. A broader roll out of the loan program is anticipated in January 2013, and, by May 2013, AEO hopes to have capitalized a loan fund and credit-enhancement facility.

By means of these activities, AEO is working to unlock the flow of capital to its members and extend the reach of capital and services to underserved entrepreneurs in communities where CDFIs do not exist or where it is cost prohibitive for an existing CDFI to expand its infrastructure. In the long run, AEO hopes to see a material increase in services provided to microentrepreneurs without a commensurate rise in operating expenses or loan losses, leading to measurably improved health and sustainability of participating organizations.

In the meantime, the continuing uncertainty over future federal support highlights the CDFI loan fund industry's key risk: operating via a business model that is not predicated on charging market rates to cover expenses and, therefore, is highly dependent on continued grant support and subsidized loans from government agencies, CRA-incentivized banks, and the donor community. The years ahead could well highlight the fragility of this model, particularly if economic and political circumstances lead to reduced appropriations for the CDFI Fund and other government programs, weakened CRA requirements, and/or diminished philanthropic support, owing to continued low returns on endowments. This could lead to smaller institutions that are not fully sufficient failing and a consolidation in the sector.

3.3.2 Credit Unions: LICUs, CDCUs, and CDFI Credit Unions

Overview:

All credit unions in the United States are tax-exempt, non-profit co-operatives regulated by the National Credit Union Administration (NCUA, an independent federal agency), by state agencies, or both. In most instances, deposits are insured by the NCUA.

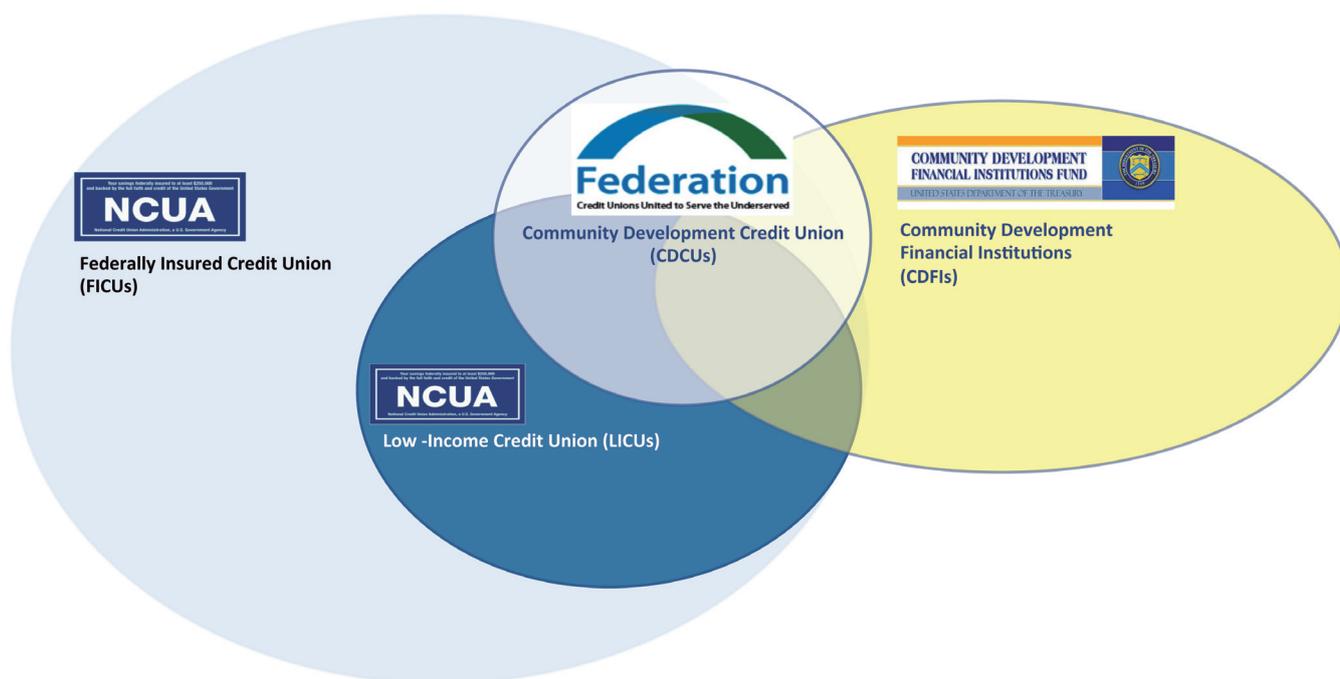
The credit union movement has been steadily consolidating for several decades, from a peak of 23,866 institutions in 1969 to 7,380 by June 2011. While the number of credit unions has fallen substantially, the number of people served and the average size of credit unions has increased. Today, more than 90 million people are credit union members, and aggregate industry assets exceed US\$900 billion. Thus, the credit union business model has demonstrated scalability, despite its inability to grow net worth rapidly (see below).

While the majority of credit unions in the United States serve moderate- to middle-income members, there is a substantial segment of the industry that serves a majority of low-income people. As of October 2011, there were 1,128 institutions designated as “low-income credit unions” or LICUs, 202 of which were also certified CDFIs. The LICU designation conveys several powers unavailable to “mainstream” credit unions: (i) the ability to accept non-member deposits from bank CRA programs, religious investors, social investment funds, corporations, etc.; (ii) the right to raise deeply subordinated debt that counts towards net worth for regulatory purposes; and (iii) permission to make busi-

ness loans in excess of US\$50,000 above the statutory limit of portfolio concentration for other credit unions (12.25%).

Three distinct but overlapping designations encompass those credit unions which are serving the low-income market and are, therefore, more likely to be offering microfinance products: (i) low-income credit unions, designated as such by the NCUA (ii) community development credit unions, designated as such by the National Federation of Community Development Credit Unions (CDCUs), and (iii) CDFI credit unions, certified by the CDFI Fund. Figure 3 illustrates the overlay of each respective set of credit unions.

Figure 3. FICUs, LICUs, CDCUs and CDFIs



Level of Outreach to Microentrepreneurs:

Credit unions are not obligated to report on lending to small businesses and microenterprises in amounts

less than US\$50,000. Consequently, the exact degree of LICU / CDCU financing targeted to microentrepreneurs is not available. Table 13 does, however, illustrate the size of the CDCU sector in terms of membership and loans outstanding.

Table 13. The CDCU Movement at a Glance, 2008–10

The CDCU Movement at a Glance, 2008 - 2010

CDCU Data	2010	2009	2008	Change 2008 - 2010	% change
Membership	1,667,394	1,600,872	1,544,818	122,576	7.90%
Assets (\$ billions)	\$11.00	\$10.38	\$9.20	\$1.80	19.70%
Loans Outstanding (\$billions)	\$7.77	\$7.43	\$7.25	\$0.52	7.20%
Loans Originated (\$ billions)	\$2.88	\$2.93	\$3.07	(\$0.19)	(6.3%)
Net Worth (\$ billions)	\$1.10	\$0.98	\$0.94	\$0.16	16.70%
Net-worth Ratio (NWR), aggregate	9.98%	9.41%	10.23%	(0.26)	
Return on Avg. Assets (ROA), aggregate	0.59%	0.28%	0.43%	0.17	
ROA (median)	0.17%	-0.05%	0.38%	(0.22)	

While the lack of data on microfinance activities may indicate a general lack of industry focus on microentrepreneurs (perhaps due to regulatory restrictions as some microfinance industry leaders suggest), there are a number of credit unions that do provide financing and other services to the sector. For instance, 45 credit unions out of 817 institutions (18% of the total) reported their FY 2010 data to mi-

croTracker.¹¹² Included in that group is Hope Credit Union, headquartered in Jackson, Mississippi, which is committed to helping small, local businesses succeed in impoverished areas of the South, as well as Alternatives Federal Credit Union in Ithaca, New York and ASI Federal Credit Union in Harahan, Louisiana, both of which offer loans through the SBA's Microloan Program.

Box 9. ASI Federal Credit Union

ASI Federal Credit Union (ASIFCU) helps people borrow money for transportation, home ownership, business, and education with loans of all sizes. As of FYE 2008, the entity had US\$1.19 million in outstanding microloans.¹¹³ In August 2011, it began offering microloans in partnership with Kiva, a non-profit that connects individual investors with microfinance institutions in the United States and across the world. Partnership with this global organization gives them added financial security and the ability to make small loans that do not affect their lending cap. As of July 2012, ASIFCU had raised US\$342,500 via Kiva for loans to 39 entrepreneurs (average loan size US\$8,782) during its 11-month partnership with the entity.¹¹⁴ In October 2011, ASIFCU also received a US\$3 million grant from the U.S. Treasury's Healthy Food Finance Initiative to help entrepreneurs borrow money for grocery and restaurant businesses in New Orleans "food deserts" (places where people don't have easy access to fresh, healthy food).¹¹⁵

¹¹² The microTracker database cannot be sorted to determine the exact number of credit unions engaged in microlending (versus those serving microentrepreneurs in some other capacity). Thus, it is possible that not all 45 institutions are active microlenders.

¹¹³ Data from <www.microtraker.org> (accessed July 30, 2012).

¹¹⁴ Data from <www.kiva.org> (accessed July 30, 2012).

¹¹⁵ "NerdWallet's Top 10 Community-Focused Credit Unions of 2011," Available at <<http://www.nerdwallet.com/blog/nerdwallets-top-community-credit-unions/>>.

Financial Self-Sufficiency:

Credit unions are structured to be financially self-sufficient, sustainable institutions. The income generated from lending and other services is used to cover operating costs and build net worth. Unlike banks, credit unions do not have external shareholders who are entitled to a return on their equity investments. While the co-operative structure ensures that credit unions work for the benefit of their members, it can inhibit growth: in times of rapidly expanding assets, credit unions cannot raise equity by selling stock and, thus, must rely on the generation of earnings which, in good years, usually equates to a return on assets (ROA) of 1%.

The defining characteristic of credit unions is their ability to fund themselves through deposits, which depend on neither federal nor philanthropic support. As highlighted above, low-income credit unions have the right to accept deposits not only from members, but also from non-members. This ability, coupled with the authorization to raise subordinated debt, allows CDCUs to grow their capital base more rapidly.

Credit unions must maintain a minimum ratio of 7% of net worth-to-total assets to avoid “Prompt Corrective Action” by its regulators. Credit unions be-

low the “adequately capitalized” threshold of 6% face increasingly stringent measures, including removal of officials, suspension of dividends, and in extreme cases, conservatorship or liquidation.

The 2008 financial crisis affected the vast majority of credit unions in the United States, with many experiencing higher delinquencies and mounting loan losses. This situation was compounded by the imposition of additional premiums for deposit insurance, following the insolvency of several “corporate” credit unions, which depleted the National Credit Union Share Insurance Fund.¹¹⁶

The pain wrought by the crisis was heightened for CDCUs in particular, since they typically had a thinner cushion of equity to absorb losses and assessments than their non-low-income peers. Furthermore, compared with other credit unions that were generally larger and served more prosperous members, CDCUs served communities with unemployment and poverty rates far above the national averages, making them more susceptible to loan losses. Consequently, as Table 13 shows, the median ROA for CDCUs declined from 2008 to 2010 (from 0.38% to 0.17%, respectively), and the CDCU sector has experienced increased numbers of liquidations or forced mergers (Box 10).

¹¹⁶ For details on how the corporate credit union network is structured, how the crisis affected the network, and how the insolvency of corporate credit unions, in turn, impacted the financial status of CDCUs, please see Rosenthal, “Credit Unions, Community Development Finance, and The Great Recession.”

Box 10. Self Help Federal Credit Union¹¹⁷

The 2008 recession hit the Central Valley of California hard, resulting in skyrocketing foreclosures, plummeting real estate values, and huge increases in unemployment of up to 20% or more. A number of long-established CDCUs that served predominantly Latino members were badly damaged by the economic distress that their members experienced. Instead of being dissolved or merged into other less-mission-driven institutions, the Center for Community Self-Help (CCSH), based in Durham, NC was able offer a solution.

In 2008, CCSH chartered a companion institution to its credit union in North Carolina. The new entity, Self-Help Federal Credit Union (SHFCU), was founded to serve California as part of a strategic initiative to combat predatory lending. Shortly after its establishment, SHFCU merged with one small CDCU, People's Community Partnership FCU in Oakland, CA. As shown in the table below, several other mergers followed, allowing SHFCU to end 2010 with more than 30,000 members and over US\$200 million in assets. Much of this growth was enabled by major investments of equity-like secondary capital supplied by the Ford Foundation.

	Assets (millions)	Members
Before: Self-Help Federal Credit Union, December 2008	\$8.1*	2,981
Merger Partners		
People's Community Partnership FCU (2008)	\$3.7	2,767
Community Trust Credit Union (2009)	\$40.7	11,826
Kern Central Credit Union (2010)	\$34.3	8,288
El Futuro Credit Union (2010)	\$6.9	2,946
United Savings Federal Credit Union (2010)	\$23.6	4,047
After: Self-Help Federal Credit Union, December 2010	\$209.8	30,664
* People's Community Partnership FCU is included in the December 2008 figures.		

¹¹⁷ Rosenthal, "Credit Unions, Community Development Finance, and The Great Recession."

On the positive side, many CDCUs not only survived, but grew between 2008 and 2010, aided in part by widespread public revulsion at the bailout of the largest banks, which prompted calls by social media and even mainstream financial publications to “move your money” into local credit unions and banks. More importantly, many CDCUs were able to rebuild or expand their net worth via CDFI Fund awards and/or secondary capital loans from the Community Capital Development Initiative (CDCI) launched by U.S. Treasury in 2010 to aid CDFI-certified credit unions and banks.¹¹⁸

Future Prospects:

As discussed above, the CDCU business model is based on self-sufficiency and sustainability, and, therefore, is not dependent on the CDFI Fund or other external sources to support core operations. (Indeed, of those CDCUs that have received awards from the CDFI Fund, the overwhelming portion of that support was not for operating expenses.) With that said, their small net margins do not allow for rapid growth through earnings. Therefore, CDCU’s prospects for accelerated growth are limited without support in the form of non-member deposits, secondary capital, and/or the opportunity to merge with other CDCUs.

During the recession, deposits did grow, providing credit unions with ample liquidity. However, this situation caused numerous CDCUs to experience an “equity squeeze,” as their ratio of net-worth-to-assets shrank alongside the increase in deposits.

This situation has led Cliff Rosenthal, Assistant Director for the newly created Consumer Financial Protection Bureau (CFPB) and head of its Office of Financial Empowerment,¹¹⁹ to posit a question about combining the complementary strengths of CDFI loan funds (which typically have strong equity positions of 20% or more) with credit unions (which operate according to a financially viable business model and have ready access to liquidity): Can the advantages of these two types of institutions be harnessed in a single entity – “a complex or hybrid CDFI”?

If the recession produced one possible answer, Rosenthal believes it came from Self-Help, an integrated, multi-unit CDFI that includes two credit unions (Self-Help Federal CU in California (Box 10) and Self-Help CU in North Carolina), Self-Help Venture Fund, a non-profit CDFI loan fund, and associated non-profit entities. During the recession, when liquidity became a huge problem for its loan fund because of the pulling of credit lines by banks reeling from the demise of Lehman Brothers, Self-Help was able to shift some of the lending functions previously performed by its non-profit loan fund to its credit unions, which had plenty of liquidity.

Rosenthal also sees the credit union movement as a possible solution to the lack of scalability often cited as a key problem by critics of the CDFI movement. In fact, he sees the credit union model as “hugely scalable,” pointing out that the largest credit union in the country (Navy Federal Credit Union with US\$45 billion in assets) has the same legal structure as the smallest credit union. The industry has also developed corporate forms (credit union service organizations) to share functions such as mortgage origination and servicing, business loan underwriting and servicing, or core processing, allowing institutions to reduce operating costs.

Although, on the surface, CDCUs appear to be a scalable and financially viable vehicle for the provision of microfinance, it is not easy at this juncture to understand the potential outreach to microentrepreneurs via this model, owing to a lack of industry-wide data on business loans of less than US\$50,000. Also, CDCU’s are regulated institutions and there may be a limit on the number of loans that regulators will allow these institutions to make to microbusinesses.

¹¹⁸ In the three years from 2008 to 2010, US\$34.9 million (11.5%) of the CDFI Fund’s FA and TA awards were made to 42 CDCUs, most of which used the funds to rebuild or expand net worth. The CDCI disbursed US\$69.9 million in secondary capital loans to 48 CDCUs, providing them with eight years of low-cost (2%) funds, with the option to extend the loans for another five years at an increased rate (9%).

¹¹⁹ Cliff Rosenthal was President and CEO of the National Federation of Community Development Credit Unions from 1980 to May 2012.

3.3.3 Emerging For-Profit Microfinance Providers

3.3.2.1 Introductory remarks

Aside from the payday lenders discussed in the next section, there are few examples of financially viable for-profit lenders to the underserved in the United States. However, that may be about to change.

First, to recap some basic characteristics of lending to the underserved in the United States, as discussed previously:

- Customer density is typically low; customers are diffuse and expensive to reach.
- Customers value convenience and proximity; hence, big premium to point-of-sale proximity. They also value speed, which opens up the potential for new technology.
- Small transaction size; hence, high cost to serve (particularly for larger micro loans that require an understanding of the client's ability to generate adequate cash flow to cover loan payments). Higher credit risk.

The new technologies of internet, mobile phones, cards, and "big data" may be able to overcome some of these long-standing challenges in serving the underserved. A large number of very interesting new technology-oriented ventures have started in recent years, backed by large and sophisticated pools of venture capital, that aim to be a disruptive force and change the paradigm in the industry. Venture capitalists are also attracted by the profit potential, particularly if the industry can expand by providing new services to those that are underserved and unbanked.

Financial services is a huge industry, a very large part of the national GDP, and an even larger part of the total stock market capitalization. The potential for profit is therefore huge, particularly if the industry can be expanded by the provision of new services to those hitherto underserved. The venture capital industry sees the potential of technology to transform

financial services to the underserved. Venture capitalists are not motivated by altruism alone. They see significant profit potential.

There is so much innovation occurring globally that it is impossible to be comprehensive or exhaustive in reviewing the developments of the emerging for-profit providers. Therefore, we shall discuss only a few of the emerging models that we consider particularly noteworthy, and some others in a very cursory fashion.

3.3.3.2 "New" for-profit players

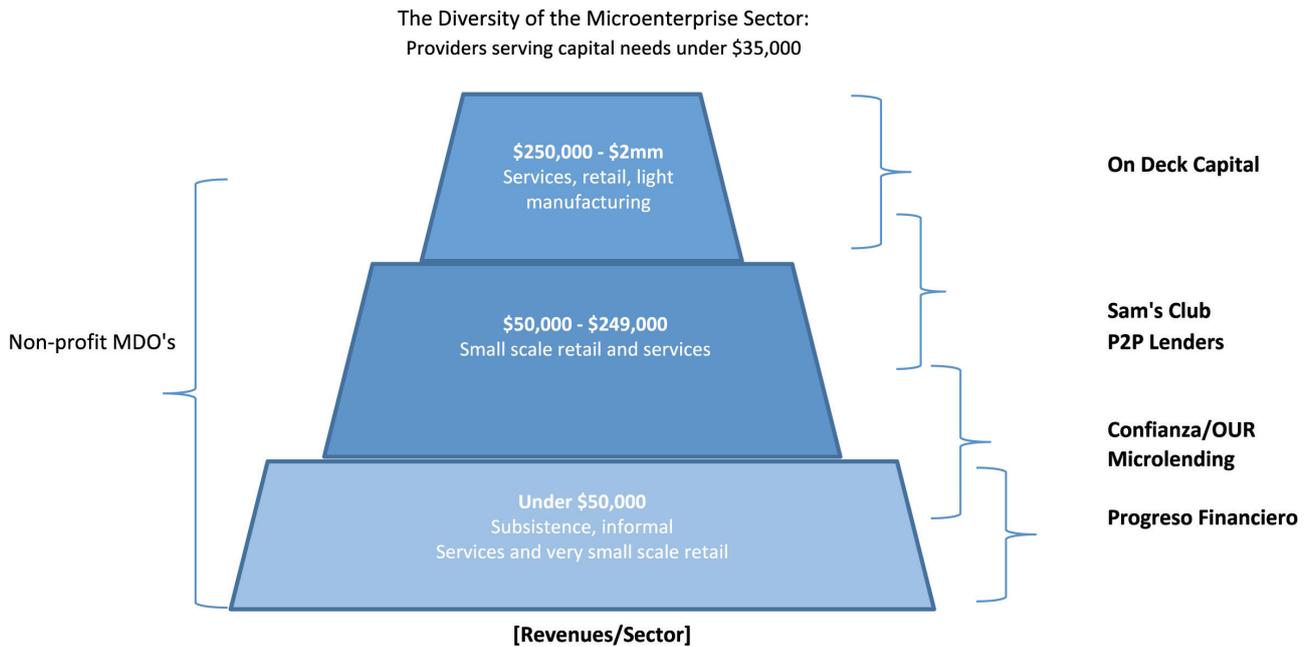
In March 2011, FIELD published a report identifying a group of newly emerging for-profit lenders that are serving microentrepreneurs.¹²⁰ FIELD's research focused on institutions that target two groups: (i) those working directly with clients that non-profit microlenders have typically served—clients that are low-to-moderate income, have had difficulty accessing business credit, and have capital needs of less than US\$35,000; and (ii) emerging or fast-growing companies that have broader client bases, which include more moderate-income small businesses whose capital needs are typically under US\$35,000.

The former group includes small-dollar consumer lenders, such as *Progreso Financiero*, and for-profit commercial microlenders, such as *Financiera Confianza* and OUR Microlending. The latter group comprises commercial, internet-based small business lenders, such as On Deck Capital, peer-to-peer (P2P) lenders, including Prosper and Lending Club, and larger retailers (e.g., Wal-Mart / Sam's Club).

Figure 4 highlights some of these players' key operating metrics and shows that, in general, the organizations are stratifying based on loan size and, partly, on whether they are consumer or business oriented.

¹²⁰ Luz Gomez and Elaine Edgcomb, "A Newly Crowded Market Place: How For-profit Lenders Are Serving Microentrepreneurs" (FIELD at the Aspen Institute, March 2011).

Figure 4. The Diversity of the Microenterprise Sector



Source: Field, Aspen Institute, 2011

Figure 5 displays the wide range of effective interest rates charged by these institutions. While their rates in general are much higher than those of the non-profit providers considered in this report, some of them have been experiencing extraordinary rates

of growth, are approaching the break-even point, and have already made more loans and achieved further outreach than some longer-established non-profits. Thus, rates sufficient to permit financial viability do not seem to be barriers to growth.

Figure 5. Effective Interest Rates: Providers Serving Capital Needs Under US\$35,000



Source: Field, Aspen Institute, 2011

In addition to the entities identified by FIELD, there are other for-profit companies that are poised to make a mark in the financial sector, but largely focused on providing small, short-term, consumer loans to the underserved. These include the alternative payday lenders ZestCash (headquartered in California) and Wonga (based in the United Kingdom).

Small-Dollar Consumer Lender: Progreso Financiero¹²¹

Progreso Financiero, founded in California in 2005 and now also serving Texas via 83 stores, focuses on meeting the financial needs of underserved Hispanic customers. Clients have an average annual gross income of US\$27,360, and 92% have either “thin” credit or no credit file at all.

The company offers unsecured, non-revolving loans with small, fixed payments. Amounts range from US\$500 to US\$2,500, with a typical loan size of around US\$1,000. Loans to consumers make up the lion’s share of their portfolio (90%), with loans to microbusinesses accounting for roughly 10% of the total outstanding. Loans are disbursed either via check or on *Progreso’s* prepaid Visa debit card. Cash-based payment options are available at all *Progreso* stores and partner locations (such as 7-Eleven, Wal-Mart, CVS Pharmacy, and Nexxo, which have, in aggregate, over 35,000 locations), although customers with bank accounts can choose to pay via electronic funds transfer.

Progreso’s model combines “high touch” with “high tech.” Management states that there is much to learn from the “high touch” world of international microfinance, where institutions lend to the poor at very low losses, primarily because of the personal bonds created between lenders and borrowers. The company therefore works to combine the best practices of the “high touch world of microfinance” with the “high-tech” world of automation, statistical scoring, and customer relationship management (CRM) modeling employed by credit card companies in the United States.

From a credit perspective, *Progreso* has developed a proprietary credit-scoring model to assess credit risk among Hispanic consumers with no formal credit history and, in turn, to lend money at fair rates and lower losses. As for marketing, they serve their customers in the locations that they typically frequent by offering credit inside ethnic supermarkets and nationally recognized department stores, using familiar faces from the local community. The firm also sets up small, predictable, and frequent weekly or biweekly payments to help their customers more easily manage their cash flow and loan obligations.

Progreso is now disbursing approximately 15,000 loans per month. With roughly 10% being used for business purposes, the number of loans disbursed to microentrepreneurs each month is estimated to be well in excess of the 346 loans that Grameen America (the nation’s most productive CDFI loan fund in terms of number of loans disbursed) averaged per month in FY 2010.

Despite having evolved into a multi-channel delivery firm (via the internet, direct mail, store locations, a large agent network, access to third-party ATMs, and prepaid debit cards) the company estimates that it has penetrated only 1% of its target market for credit products.

Progreso’s loan portfolio has grown rapidly. By year-end 2011, the entity had disbursed US\$258 million in cumulative loans since inception, and outstanding gross loans receivable totaled US\$103 million. Thus, as per management’s assumption that at least 10% of outstanding loans are financing micro-business activities, *Progreso’s* microfinance portfolio totaled roughly US\$10 million, surpassing the reach of all CDFI loan funds except Accion Texas, whose outstanding portfolio stood at US\$24.6 million at FYE 2010.

Progreso charges rates higher than most MDOs or CDFI loan funds. With an average interest rate in the

¹²¹ Unless otherwise stated, information in this section derived from a meeting of the author with *Progreso* management, April 25, 2012, as well as from their website <<http://www.progessfin.com/en/>> (accessed in June 2012).

25% to 28% range and an upfront fee, the company's average APR is 36%. Despite these rates, which are far above what CDFI loan funds are charging, *Progreso* has had strong growth. Because the company is not yet profitable, it also pays high rates for the money it receives from investors. *Progreso* CEO Raul Vazquez states that as the company's costs decrease, he plans to pass along those savings to customers in the form of lower interest rates.¹²²

As is typical of many international MFIs, *Progreso* began with a small-balance loan product and has been steadily broadening its product range. It has partnered with Transamerica to offer life and health insurance and has plans to eventually offer auto loans, small business loans, and asset-building products, such as saving and IRAs (individual retirement accounts).

Progreso is licensed by the State of California as a lending institution and is not a bank. Since it does not have access to deposit funding, the company must borrow to fund its balance-sheet growth. Funding has thus far come from venture capital partners,¹²³ commercial banks, and, most recently, mezzanine financing. The company received CDFI certification in 2009 and hopes to access long-term financing from the CDFI Fund Guarantee Program when it becomes operational.

For-Profit Commercial Microlenders: Financiera Confianza and OUR Microlending¹²⁴

Both *Financiera Confianza* (established in 2006 and headquartered in Los Angeles, CA) and OUR Microlending (founded in 2007, headquartered in Miami, FL) focus explicitly on lending to microbusinesses. Both also have operational models based on their founders' experience in Latin American microfinance.¹²⁵

The core products offered by both companies are term loans up to US\$20,000 and US\$50,000, respectively. Rates charged by OUR Microlending (OUR) are between 15.375% and 18% (in line with Florida's rate cap).¹²⁶ *Financiera Confianza* (*Confianza*) has dropped its rates over time, from highs of 50% to 80% down to 12%, owing to its partnership with Opportunity Fund, a CDFI loan fund operating in northern California (Box 11).

Both organizations faced limited liquidity during 2010, which stifled their growth. OUR addressed its capital constraints by submitting a Regulation A filing with the SEC to raise debt or equity from individual investors in five states, while *Confianza* accessed the capital it needed for portfolio growth via its partnership with Opportunity Fund.

¹²² "Lender Fills Gap for Hispanic Community," MarketPlace: Wealth & Poverty, American Public Media, radio broadcast on July 6, 2012 <<http://www.marketplace.org/topics/wealth-poverty/lender-fills-gap-hispanic-community>>.

¹²³ Venture capital firms include Greylock Partners, Charles River Ventures, and several angel investors who include partners and founders of leading private equity firms and hedge funds, U.S. Hispanic community leaders, and Silicon Valley entrepreneurs and business leaders. TPG (the former Texas Pacific Group) has board observer status and may have a stake.

¹²⁴ Unless otherwise noted, information for this section derived from Gomez and Edgcomb, "A Newly Crowded Marketplace".

¹²⁵ The founder and CEO of OUR Microlending helped establish a Venezuelan for-profit banking institution focused on microfinance, while the founder and CEO of *Financiera Confianza* gained experience through a family-owned consumer finance operation in Peru.

¹²⁶ OUR Microlending, "LLC Offering Circular," December 23, 2011. Available at <<http://www.ourmicrolending.com/>>.

Box 11. Partnership between *Confianza* and Opportunity Fund

In May 2010, *Confianza* launched its partnership with Opportunity Fund by introducing its “Opportunity Loan,” allowing *Confianza* to offer larger loans at significantly reduced rates.

According to FIELD, “*Confianza* sources and processes the applicant, and then uses Opportunity Fund capital to fund the loan. The loan is serviced by *Confianza* but stays on Opportunity Fund’s books. *Confianza* is paid a fee for its services, yet the risk is shared between the organizations in that fees are paid out towards the latter part of the loan being successfully repaid. While *Confianza* has found a way to diversify its client base and earn revenue, Opportunity Fund has found a means to scale its operation in other parts of California, and to benefit from an organization that could more quickly process and disburse quality loans. At the same time, Opportunity Fund has been able to deploy low-cost capital to which it has access.” As of July 1, 2011, Opportunity Fund sets the terms and conditions and provides the capital for all loans originated by *Confianza*.¹²⁷

In a June 11, 2012 speech at the Clinton Global Initiative, Opportunity Fund CEO, Eric Weaver, stated, “Opportunity Fund is successfully expanding microlending in California. Over the past year, we provided \$7.5 million in loans to 850 small business owners... These loans have helped California’s entrepreneurs to keep and create 2,125 jobs. Our microlending increased by 90% statewide in the last 12 months, well ahead of our goal to achieve 60% growth.”¹²⁸

The partnership with *Confianza* has allowed Opportunity Fund to quickly scale its microfinance operations, as evidenced by the increase in disbursements this past year, compared with FY2010 disbursements of US\$1.7 million via 195 loans. Although CEO Weaver states that he expects the *Confianza* partnership to create efficiencies, he does not anticipate that his organization will ever reach the point where earned revenues cover 100% of expenses, partly because of the lower interest rates Opportunity Fund has set on loans sourced by *Confianza*.

Table 14 highlights the FY 2010 performance of *Confianza* and OUR relative to two cohorts of non-profit lenders reporting to MicroTest: (i) a group of programs that mirror the two for-profits in terms of their age and target market, and (ii) a set of the largest-scale microlenders (those disbursing more than 100 loans per year).

These data reveal that, at the time, *Confianza* and OUR were both outpacing their direct peers –pro-

grams less than five years old that are urban-based—in most indicators of portfolio performance. Furthermore, when compared with the group of larger-scale microlenders who have been in existence for close to 15 years, the two for-profit companies approached or exceeded the median for all indicators related to client outreach.

¹²⁷ <http://www.confianza-usa.com/en/about_us.html> (accessed June 24, 2012).

¹²⁸ <<http://www.opportunityfund.org/news/press-release>> (accessed June 24, 2012).

Table 14. Confiianza and OUR Microlending: Peer Comparison¹²⁹

<i>Confiianza and OUR statistics as of December 31, 2010. Data for nonprofit comparisons from 2008 and 2009.</i>				
	Financiera Confiianza (as of 12-31-10)	OUR Microlending (as of 12-31-10)	MT Young Urban Programs (median values) (FY2009 data)	10 Large-scale Microlenders (>100 loans disbursed) (median values) (FY2008 data)
Age	2006	2007	urban, 2005 (n=9)	urban; started before 1998
Loan Ranges (update = June 2012)	\$2.5k - \$35k (now \$1k - \$50k)	\$1.5k - \$20k (now \$1.5k - \$25k)	\$500 - \$25k	\$214 - \$35k
# Loans Disbursed	495	299	23 (n=6)	178
Dollars Disbursed	\$2.7m	\$1.66m	\$ 204,750 (n=6)	\$1,517,979
Average Loan Size	Confiianza: \$4,250 OF: \$12,500	\$6,262	\$12,722 (n=6)	\$6,819
Outstanding Portfolio	\$1.73m	\$2.11m	\$259,945 (n=6)	\$1.75m
Operational Cost Rate	\$0.52	\$0.40	\$0.47 (n=5)	\$0.45 (n=7)
Portfolio at Risk > 30 Days	5%	not available	0% (n=6)	11.50%
Loan Loss Rate	~ 10%	0%	2.6% (n=6)	9.8% (n=5)
Source: FIELD at the Aspen Institute				

Although the pace of growth achieved by the for-profit lenders demonstrates potential for continued scale and performance, balancing portfolio quality with such growth can be a challenge, especially for younger institutions. While 2011 data on portfolio quality have not been made public, OUR's December 2011 offering circular indicates that the organization was already facing serious delinquency issues at the end of 2010, with loans past due more than 30 days representing 56% of gross outstanding loans.¹³⁰

Commercial Internet-Based Small Business Lenders: On Deck Capital¹³¹

On Deck, established in New York in 2006 and backed by several venture capital firms,¹³² is an internet-based lender of small business working capital, offering loans from US\$5,000 to US\$150,000, with an average loan size of US\$35,000.

On Deck has a very specific business model and target clientele and states that its competitive advan-

tage is a proprietary small business credit model and daily collection servicing platform. Instead of relying on industry standard credit scores, the company lends to small businesses with good cash flow, lots of small transactions, and generally, US\$1 million plus in revenue (e.g., a restaurant). Traditional physical collateral is not required, although personal guarantees are taken. Its scoring model is based on a historic analysis of the business's cash transactions, by examining 3 months

¹²⁹ As of FY2010, OUR Microlending had not written off any delinquent loans in its portfolio since inception, making comparison with other programs that regularly write off loans difficult. The company had also just recently started tracking all loans according to the PAR>30 industry benchmark, making accurate data for comparisons unavailable for 2010.

¹³⁰ OUR Microlending, "LLC Offering Circular."

¹³¹ Unless otherwise noted, data for this section derived from a meeting of the author with On Deck management, April 30, 2012 or from the company's website <www.ondeckcapital.com>.

¹³² Investors include SAP Ventures, RRE Ventures (with former Chairman and CEO of American Express as a general partner), and Khosla Ventures (founded by Vinod Khosla, co-founder of Sun Microsystems).

of bank and accounting records. The company makes credit decisions in 1 to 2 days and funds in 5 days; thus, it is very useful for businesses facing emergency cash-flow crunches.

Loans are fully amortizing term loans, with tenors ranging from 3 to 18 months and averaging 9 months. Interest rates range from 20% to 35%.¹³³ Payments are automatically taken from daily cash flow accounts of the business via the Automated Clearing House (ACH).

The company has disbursed over US\$250 million in cumulative loans to date and reports that the portfolio grew at a compound annual rate (CAGR) of 100% of 2011 over 2010. On Deck management says that they manage to a NET loss rate of 5%, with delinquencies around 10%. Management believes that their business model will allow them to eventually fund three to four million businesses each year.

On Deck has 500 distribution partners, including independent sales organizations, small business funding advisors, leasing brokers, marketing firms, trade groups, and other organizations that offer products and services to small businesses. It also offers its software as a stand-alone service to national, regional and community banks, non-profit lenders and CDFIs, credit card processors, loan-matching services, and other advanced small business service providers. Examples include US Bank, the National Small Business Administration, Heartland Payments, and, as described in Box 8, the Association for Enterprise Opportunity.

Large Retailer: Walmart Money Centers

Walmart offers unsecured SBA loans ranging from US\$5,000 to US\$25,000 to start-ups and existing small businesses that are members of Sam's Club. A one-page application pre-qualifies borrowers in seconds and, once approved, funding is received in a matter of days. (See www.samsclub.com for further details.)

Walmart has over 1,500 Money Centers in its stores. It began by offering services targeted towards the unbanked, such as cheque cashing, remittances, bill paying, and money orders. It now also offers credit

cards, prepaid debit cards, payday loans, tax preparation, and SBA small business loans (US\$5,000 to US\$25,000) and a business credit card. It acts as the retailer of these products manufactured by leading wholesale product experts, such as MoneyGram, Discover, Green Dot, Checkfree, GE Money, and Superior Financial. Some people talk of mortgage and auto loans coming from Walmart, and wealth-accumulation products would be logical thereafter. Walmart has explicitly said that its plan is to "climb the credit ladder" as it expands its product offering to broader segments of its customer base. It also offers savings and deposit services through in-store branches of local smaller banks and credit unions. It delivers these products through multiple channels, including in-store Money Centers, an online offering, as well as third-party ATMs, card and telephone, with rumors of a mobile phone app coming.

Walmart has the potential to quickly become the largest provider of financial services to the underserved in the United States. It is already a major provider of financial services in Mexico. It says that 20% of its U.S. customers do not have checking accounts, which equates to 27 million people. It already processes almost 250 million transactions a year, is growing its number of Money Centers by 30% to 40% per year, and claims to be earning "healthy margins" on its financial services business.

3.3.3.3 Payday lenders¹³⁴

Payday lenders, cheque cashers, and pawn shops are referred to in the United States as "alternative" or "predatory" lenders. Although these products are most often targeted towards consumers, some institutions,

¹³³ John Tozzi, "On Deck Targets Business Banks Won't Touch," *Business Week*, September 7, 2010.

¹³⁴ Unless otherwise noted, information in this section was derived from the website for the Center for Responsible Lending, at <http://www.responsiblelending.org> (accessed June 15, 2012).

¹³⁵ Available at <http://www.mypaydayloan.com/online-payday-loans/free-small-business-loan-2.asp>.

such as MyPayDayLoan.com, also cater to small business owners.¹³⁵ This section gives a brief overview of the payday lending industry in the United States.

Payday loans are small loans, usually in the US\$300 range, marketed as a quick, easy way to tide borrowers over until the next payday. However, the typical borrower is indebted for more than half the year, with an average of nine payday-loan transactions at annual interest rates over 400%. In addition to lenders that offer payday loans as their core product, large national banks, such as Wells Fargo, US Bank, Fifth Third, and Guaranty Bank, are making deposit “advance” loans, which are structured much like payday loans.

Non-profit organizations, such as the Center for Responsible Lending, are engaged in research and policy efforts to fight the predatory lending practices employed by these institutions. Efforts to outlaw triple-digit interest rates have so far succeeded in 16 states and the District of Columbia.

Despite the exorbitant rates, the industry, since its inception in the 1990s, has established over 22,000 locations, which originate an estimated US\$27 billion in annual loan volume—demonstrating its ability to fill a void.

Given the volume of loans paid out by the sector each year, the product is obviously attractive to a large array of people and demonstrates the willingness of borrowers to pay substantially higher than market rates to access financing via a fast, simple (albeit, in this case, often detrimental) loan product.

3.4 Lessons from International Microfinance: Adaptability in the U.S.

As outlined in Section 2.10, the international microfinance industry, which has evolved in developing and transition economies over the past several decades, has had a number of successes that offer lessons for microfinance practitioners in developed economies. The extent to which each lesson has an opportunity to be developed in the United States is discussed below.

- **High growth rates, allowing for large outreach to clients, increased impact on the working poor, and rapid expansion across different operating environments**

The density of people living in poverty is much lower in the United States than in the developing world, making it more difficult for U.S. providers to reach the working poor and grow rapidly. As outlined in Section 3.1.2, there are numerous other reasons why microfinance providers in the United States have been unable to reach the scale of their international counterparts, including, among others, the relatively small size of the microenterprise sector, the safety net made available via welfare programs, which serves as a functional alternative to self-employment, competition from large nationwide firms, such as Walmart, and competition from commercial lenders such as credit card companies and payday lenders. Given these differences, U.S. microfinance providers are not positioned to achieve the level of scale experienced by international MFIs.

The question then becomes, what level of scale is reasonable for the U.S. sector, and which models currently offer the most potential for reaching the largest number of clients?

Non-profit MDOs and CDFI loan funds have the longest track record of targeting microenterprises, but their dependence on operating grants and subsidized financing makes it extremely difficult (and perhaps impossible) to achieve full financial sustainability, which, in turn, holds back their growth. At the same time, grants specifically for geographic expansion (e.g., as used by Accion Texas and Grameen America) do allow for increased outreach to previously underserved regions of the country. Perhaps of equal or greater importance would be funding to allow these institutions to build capacity. We believe these grants should be benchmarked to projected performance and focused largely on

the institutions that have shown the inclination to become more self-sufficient.

One goal in terms of scale might be for non-profits to grow to the point where they (i) can adequately serve those who fall outside the private markets, (ii) can operate their lending programs (versus their grant-supported TA and training programs) on a fully self-sufficient and eventually (for a selective number of institutions) on a sustainable basis, (iii) have the sophistication to perform in a nimble and efficient manner; and (iv) serve as a demonstration case to attract more substantial financial sector institutions to meet the demand in the sector. For-profits, on the other hand, are naturally looking to scale to levels that ensure profitability. It is unclear at present, however, which of the newer for-profits will become fully sustainable.

The ability of the non-profits to scale will in large part be dependent on how quickly for-profits fill the market void. If the experience in the U.S. at all resembles international experience, we should expect to see both—a select number of non-profits transforming and attracting capital so that they can scale substantially, and emerging for-profits also scaling and accessing the market for capital.

In terms of business models that support outreach to a large population of microentrepreneurs, for-profit lender Progreso is a leader in terms of number of loans disbursed, partly because of its innovative credit-scoring system and a physical presence in locations regularly frequented by its Hispanic clientele. The company is still young, however, and, therefore, not yet profitable.

While credit unions (both LICUs and CDCUs) are operating on a financially viable basis, using a model that at least one industry leader believes is “highly scalable,” the current level of outreach to microentrepreneurs is difficult to assess, owing to a lack of industry-wide data.

- **An early emphasis on financial sustainability by international agencies, donors, and industry leaders, ensuring that MFIs decreased their dependence on capricious donor funding and eventually positioned themselves to access diverse funding sources, including capital markets and private sources**

A number of factors have prevented the non-profit U.S. microfinance sector from achieving financial viability. These include the need to offer training and TA at little or no cost to help businesses comply with regulations and navigate a more complex operating environment. At the same time, the cost of acquiring clients is high given the lack of client density found in most developing countries. Additionally, most credit operations are not run on a financially sustainable basis because of below-market interest rates. Such rates are currently imposed by state regulators, mandated by government funding sources, required by donors, and/or supported by the microfinance providers themselves as a result of their mission-driven nature. The sector would greatly benefit from a shift on the part of regulators, investors, and donors from an insistence on, or expectation of, below-market rates, to an environment that encourages interest rates set at levels which at least cover the costs of lending operations, including the cost of capital at market rates and provision for loan losses. Although some industry leaders believe that charging high rates could be damaging to borrowers, we believe there is truth somewhere in the middle of this argument. The interest rate that can be absorbed by the borrower depends on a number of factors, including how large the loan service is relative to cash flow (debt coverage ratio), how leveraged the business is, what types of margins it has, and how quickly it is able to grow.

In the meantime, however, the non-profit sector remains dependent on subsidized financing from the government and foundations, much of which needs to be sourced

every year and is not always available on a year-to-year basis. They are also funded by commercial banks, many of which are active in the sector only because of existing CRA requirements. The non-profit MFIs interviewed for this report emphasized very clearly how much of their time was absorbed by the search for financing.

LICUs and CDCUs, in turn, are required by their regulators to operate on a financially self-sufficient basis. Their ability to fund themselves through deposits means that they are not dependent on either federal or philanthropic support. Nevertheless, their legal structure as co-operatives precludes them from attracting capital-market financing, making their growth reliant on the generation of earnings, which, even in good years, usually equates to an ROA of only 1%.

Most emerging for-profit entities are charging higher interest rates than the non-profit sector and have based their business models on achieving financially sustainable operations once they reach a certain level of scale. Some of these institutions initially attracted venture-capital support and are looking to additional sources of private financing to lower their cost of capital and continue their growth. It remains to be seen whether or not they will achieve scale and profitability.

- **Product diversity built on a financially sustainable base, allowing MFIs to better serve client needs**

International MFIs began by offering a simple, core product: working-capital loans. Once the institutions reached scale with this product and became financially sustainable, they began to diversify the products and services offered. The U.S. non-profit sector has done the reverse, resulting in the creation of complex institutions serving a wide array of constituents (from microentrepreneurs, to small businesses,

to affordable-housing developers), thereby necessitating relationships with a plethora of government agencies, donors, and investors to obtain ongoing support for operations. The non-profit sector spends a good deal of time and effort, at great cost, seeking to raise funds.

Credit unions are member based and mobilize savings primarily from, and lend to, members. Growth is therefore organic—based on attracting new members and on the economic success of existing members. Those credit unions designated as serving low-income communities can also mobilize deposits and generate loans outside their member base. CDFI-accredited credit unions can potentially borrow from the CDFI Fund at the U.S. Treasury. An important feature of credit unions is that they mobilize savings, which most non-profit CDFIs do not, with the exception of limited matched-savings programs (which are limited since they require donor grants for matching). International MFIs have found that assisting clients in mobilizing safe savings may be as important as credit. Low-income credit unions or CDFI credit unions that mobilize member savings play an important role in meeting the needs of the underserved.

The emerging for-profit sector appears to be following the international model, with companies such as Progreso and On Deck Capital starting off with one or two standard “bread and butter” products, with plans to diversify once they near or reach profitability.

- **Targeted, productive use of government, donor, and philanthropic funds to build capacity, enabling “best-in-class” MFIs to achieve scale and financial sustainability over time**

Access to increased levels of donor funds to build institutional capacity and expand reach, could help non-profit microfinance providers scale to a point where higher levels of financial

self-sufficiency could be achieved. For example, should the non-profit sector push for financially sustainable lending operations, grants could be used to purchase the MIS and accounting software needed to track income and expenses by cost center. Grants could allow be used to attract qualified and experienced human capital, develop risk management systems, conduct market research and market products and services. Institutions might even decide to transform, as international MFIs have, to for-profit entities for their microfinance business, enabling them to tap private sources of capital facilitating their ability to scale-up.

At the same time, low-cost, long-term capital for lending (i.e., from the CDFI Bond Guarantee Program) could decrease the annual need for non-profits to source grants for lending. Should the bond program become operational, there would exist an opportunity to award bonds to a select group of “best-in-class” institutions (including CDFI credit unions and for-profit CDFIs) who could serve as industry leaders to push the sector forward. In other words, funds should be concentrated with the most viable players in the sector.

- **Adoption of emerging technologies, spurring the development of various methods of product delivery, such as branchless banking, debit/hard cards, and most recently, mobile banking, to serve clients such as the rural poor**

Both non-profits and for-profits in the United States have adopted emerging technologies to improve product delivery. For instance, several CDFI loan funds now process loan applications via the internet, decreasing the need for physical branches. For-profit Progreso has developed a multi-channel delivery system, which includes the internet, direct mail, store locations, a large agent network, access to third-party ATMs, and prepaid debit cards.

- **Regulation of transformed MFIs to NBFIs and MF banks that are subject to increased supervision, are able to mobilize deposits, and improve governance standards and risk-management practices**

In the United States, credit unions are the only group of microfinance providers that are regulated. They, therefore, have the governance standards, risk-management practices, regulatory structure, and depository system in place to grow microfinance operations if management so desired and regulators supported an increased concentration of microbusiness loans. To date, however, this does not appear to be a focus and more research would be needed to determine what regulatory and other constraints might be preventing these institutions from scaling-up their micro and small business loan operations.

Unless non-profits can change their business model to one based on financial sustainability, they will not be in a position to transform into regulated entities.

Emerging for-profits are unlikely to become regulated entities from a banking perspective. But as shareholding businesses, seeking to attract private capital and eventually go public through an IPO, these institutions will need to build strong management teams, attract “fit and proper” board members, and demonstrate good governance practices. Once public, they will be regulated by the U.S. Securities and Exchange Commission.

- **Improved governance practices-strengthening areas such as oversight of product diversification and expansion- improved MIS and reporting standards, and enhanced risk management**

Non-profit CDFI loan funds, for-profit entities, and credit unions are all focused on

improving their governance, oversight, and risk-management practices. Although non-profits are often behind the curve in terms of the most up-to-date MIS and reporting systems necessary to enhance

these practices, the top-tier institutions understand the need for improved systems and are therefore continuously seeking donor financing to help build capacity in this area.

4

Report Summary, Conclusions, and Recommendations

This report provides an analysis of the access to finance/microfinance for the underserved in the United States, drawing lessons from international experience. We recognize that direct comparisons are difficult partly because of the density of poverty in low-income developing countries and the ability of MFIs to scale up rapidly in these countries. Also, in many of these countries, the formal banking sector simply does not reach the underserved. Their only recourse is to moneylenders, family, and friends. The vast majority of microbusinesses operate in the informal sector in developing countries, and so licensing and registration is less of a consideration than in the United States.

The conditions internationally have allowed the microfinance sector to scale rapidly, starting in the mid-1990s up to the present time. Also, a strong consensus by many players in the industry to become sustainable has led to a significant reduction in subsidy. International MFIs charge rates of interest that have allowed them to become fully self-sufficient. While almost all operations began as NGOs, the sector has seen a transformation of many MFIs into shareholder institutions, MF banks, and NBFIs, many of which are regulated. These institutions now operate commercially and sustainably, that is at a profit with reasonable returns on equity and assets, raising their funds through various channels. In contrast to the situation in the United States, the international microfinance market has ample liquidity.

From their inception, most MFIs offered a straightforward, “plain vanilla,” financial product: short-term loans of working capital, largely without collateral and without the benefit of credit scoring,

as in the United States. Many MFIs provided loans to small groups, with members of each group cross-collateralizing one another. Repayment of initial loans offered the promise of new loans of larger amounts. The low-tech, but effective, approach to serving the underserved was developed by Grameen Bank and was soon replicated around the world. Other models, including individual loans and village banking, were soon introduced into the market, but all offered working-capital loans. Co-operatives and credit unions have existed for some time. In the developing countries, many operate as MFIs.

As MFIs have scaled and become sustainable, they have been able to add diverse products, the most important of which is the mobilization of savings. It seems clear that safe savings may be as important to the underserved as credit.¹³⁶ International MFIs have also added insurance, loans for housing rehabilitation and education, and increasingly, money transfers and remittances. But all of this has been done from a strong base, with many MFIs having over a 100,000 clients and operating sustainably. More recently, MFIs are increasingly adopting advanced banking technologies, such as branchless banking and mobile banking, which we see as an emerging opportunity to lower the cost of intermediation and increase outreach to the underserved both internationally and in the United States.

¹³⁶ Some analysts in the U.S. do not see a comparable role for the not-for-profit microfinance institutions in the U.S. given the extensive branch structure of the large retail banks in the U.S., and other initiatives that are supporting savings mobilization in the U.S. We have not studied this issue and hence cannot offer an opinion.

The recent financial/economic crisis has had a sharp impact on both poverty and unemployment in the United States. In addition, income inequality, which has been rising for some time in the United States, has been exacerbated by the crisis. The banking and financial markets crisis seems to have provided real opportunities for those non-profit institutions currently serving the underserved to bridge the gap that emerged in services for this population. But, in fact, much of the gap has been filled by private sector institutions, charging effective high rates of interest, such as payday lenders, cheque cashers, pawn shops, and tax anticipators. These loans are primarily consumer loans for individuals or families. However, give that micro and many small business loans go to “family style” businesses and money is fungible, there is bound to be overlap between the two, with underserved individuals and families seeking funding wherever and however they are able.

Despite the decline in credit card availability and usage to the underserved as they deleveraged, credit and debit cards remain the primary instruments with which the underserved balance their cash-flow needs and obtain working capital for self-employment opportunities, micro, and even small businesses. The mission-driven, largely not-for-profit sector, CDFIs as microlenders, and low-income-designated credit unions, simply cannot fill the financial gap in providing financial service to underserved entrepreneurs. They have found it difficult to scale up their model since their financing is highly subsidized and therefore limited, their operating costs are very high, and the interest rates they are able, and perhaps willing, to charge simply do not leave a sufficient margin to allow self-sufficiency or sustainability. Hence, the model is not scalable.

Largely as a result of the crisis and emerging technology, a group of for-profit financial institutions have emerged in the United States market with different models and methodologies that seem to offer approaches to scale. For the most part, their interest rates are more in line with international experience. Emerging technology, such as internet-based credit-scoring and platforms and, above all, the emergence

of mobile banking, would seem to offer the greatest opportunities for for-profits, including banks, and possibly non-profits to lower their costs of servicing underserved entrepreneurs and reaching scale. This will depend on policy changes allowing these institutions to charge a rate of interest sufficient to cover their costs and generate a reasonable return on assets and equity and thus attract capital from the capital markets. Also, to the extent that funders such as the CDFI Fund provide long-term, low-cost, capital in the form of bonds, this funding should focus on those institutions that show the potential to scale up, as well as the willingness to restructure and adapt their business model in order to become sustainable. If, instead, this capital is spread among a large number of smaller regional institutions as politically directed credits, an opportunity for the sector to restructure will be wasted. Based on the proposed structure of the bond program, it is likely that many existing non-profit MFIs will be unable to participate in the program.

Conclusions

- Microfinance targeting the underserved arose internationally in mid-1980 and thru the 1990s, and began to commercialize in the 2000s. The U.S. industry rose over roughly the same period, did not become commercial, and remains dependent on subsidies from government sources, donors, and investors. CDFIs and other not-for profits are largely not fully self sufficient. Even the best performing and largest institutions do not fully cover their costs. A number of institutions in the sector could easily become fragile given the budget constraints that the federal government is likely to face in the years ahead.
- International microfinance has seen rapid growth. Recently, the sector has seen some overindebtedness and crises in individual markets, such as in India, Nicaragua, Pakistan, Morocco, and Bosnia. There have been no systemic crises similar to the banking crises in

Mexico and Argentina in the 1990s, the recent crisis in the United States, or in the euro zone currently. However, there is a clear advantage to being sustainable, since these institutions can access a variety of capital sources and are largely operating with declining subsidy (even the NGOs).

- Many international MFIs operating as regulated MF banks are able to mobilize deposits. Safe savings may be as or more important than credit. Large MFIs have been able to scale savings accounts rapidly.
- International MFIs have brought in technology, ATMs in native languages, and to a more limited extent, mobile banking, which has shown signs of taking off in the developing world and could potentially be an important tool for reaching remote rural populations in very poor countries such as in Africa. It remains to be seen whether or not mobile banking could also be a means of reaching out to these populations in the United States, filling the service gap. This will be the case only if banks or other financial intermediaries are willing to adopt and use this technology for the purpose of serving the underserved, as opposed to simply improving services for existing customers and as a marketing tool. At present, mobile payment systems, such as Pay Pal, are growing rapidly in the United States, and these might be the precursor to a shift to mobile banking by a younger generation of smart-phone users.
- The mission of international MFIs is to serve microentrepreneurs. The central or core product is plain vanilla working-capital loans, and, once they reach scale and are sustainable, MFIs begin to diversify into other products/services. The U.S. sector has done the reverse, largely because the mission of many CDFIs is defined somewhat differently – it is to serve those who are underserved by traditional financial institutions, whether it be in the form of micro or small business loans, affordable housing finance, or community fa-

cility lending. Thus, many community-based institutions provide an array of products and services tailored to the specific needs of their constituents versus products designed only for micro-entrepreneurs.

- One major difference between access to finance internationally and in the United States is the density of people living in poverty in developing countries, which makes it much easier to scale MFIs in these countries. However, the assumption that everyone living on US\$2 a day is a prospective microfinance client is overstated. Saturation has been reached at a much earlier stage in several markets. The size and existence of the formal financial sector in the U.S. is also a major difference—probably as important here as the size of the market.
- The big challenge in the United States is how to close the gap with respect to serving the underserved and fill it with institutions (whether non-profit or commercial) that can be financially self-sufficient or fully sustainable. The goal for these institutions would be to spend less time hunting for financial resources and, instead, rely over time on capital markets to fill more of their financing needs.
- While alternative financial institutions serve short-term or urgent financial needs, there is still a large gap for providing term financing for mortgages, home equity lines of credit, unsecured lending, and microbusiness.
- The non-profit sector in the United States, while mission driven and providing a host of services, has so far not proved to be scalable. Operators in the sector face many hurdles:

(1) Many lack sufficient equity financing and cannot attract it from capital markets as they are not self-sufficient and profitable.

(2) For the same reasons, they are unable to access debt in the capital markets.

(3) They lack operating scale.

(4) There are limited grant dollars which can be accessed by leading institutions for capacity-

building purposes which could help them remove barriers to scale.

(5) Their low interest rates, regulated by state statute, mandates from government funding sources, donor preferences, and to some degree by choice, leave them unable to cover their operating costs.

(6) Operating costs are high partly because of the salary levels required to attract professional staff in the United States, but also because of the variety of services offered, many of which are offered without compensation.

(7) They remain dependent on subsidized financing from government and foundations, much of which must be sourced every year and is not always available on a year-to-year basis. They are also funded by commercial banks and the foundations of these banks, which are required to finance the sector under CRA requirements.

(8) Capital and operating grants must be sourced each year from an often-changing group of donors, requiring an inordinate amount of staff time and cost.

(9) The non-profit CDFI industry is very atomized, with only a couple of players that aspire to have a larger national presence. While meeting community needs is a worthwhile goal and appropriate for non-profits mandated to focus on a particular community, the microfinance sector as a whole does not appear to meet market demand.

For all of these reasons the sector remains potentially fragile and unable to fill the gap in providing the financial services required by the underserved.

- Credit unions, the overlapping sets of low-income credit unions and CDFI certified credit unions, would seem to offer some possibility for future scale and development. Credit unions are member based and, by definition, need to operate sustainably. There is a regulator for the sector and minimum capital-ad-

equacy requirements must be met, or else a credit union can be intervened, as are banks. Low-income credit unions are also able to mobilize savings from outside their membership and can also mobilize other sources of secondary capital. Funding from the CDFI Fund has not been readily available to credit unions until recently. It would seem that due consideration should be given to credit unions willing and able to scale up, when and if the CDFI Fund Bond Program becomes operational.

- The CDFI Fund Guarantee Bond, if properly structured, could provide long-term financing to the industry and, as a consequence, reduce the amount of time spent each year on sourcing grant funding in order to build capital. Assuming the bond program moves forward and is well-structured, there is an opportunity to award bonds on a performance basis, which could begin to reform the industry. That is, funds should be concentrated with those players in the sector that appear to be viable. In addition, funding should not distinguish between non-profit and for-profit players.
- One reason that the U.S. sector is potentially fragile is that lending from the SBA and Treasury remains subject to budget appropriations. In 2013, post-elections at a minimum, this has the potential to be very problematic for the sector. In addition elimination of, or major modifications to, the CRA regulations could also adversely affect the sector.
- The new emerging for-profits have filled gaps in the market and are experimenting with different models. The advent of technology (internet, card-based, and eventually mobile) has allowed those in United States to reach less-dense areas of underserved populations. Those institutions which have so far been able and willing to charge appropriate interest rates, and are driven by private financing, look as if they could begin to scale up and

become viable market players. A large market void still exists, and a model that uses technology and charges appropriate interest rates could work.

- In the United States, the underserved have turned to alternative financiers (payday lenders, cheque cashers, and tax anticipators) that charge interest rates as high as 400% per annum, since no one else is filling the void. The payday lending sector is slowly shrinking because of interest rate caps that are being set on a state-by-state basis.

Recommendations

The authors recommend that U.S. microfinance industry leaders, investors, and regulators consider the following:

- **Non-profit CDFI loan funds:** Given the industry-accepted need to continue offering technical assistance and training at little to no cost, can these institutions re-orient themselves to focus on achieving financially self-sufficient or fully sustainable *lending* operations? Doing so would likely require an increase in interest rates and fees to levels of between 18% and 36% per annum depending on the institution, its cost structure and scale its able to reach, a change which would require a significant paradigm shift on the part of government agencies, donors, creditors, industry support organizations, those state regulators that set interest rate caps, and, in some cases, the management of the CDFI loan funds themselves. Capacity-building funds to help institutions lower operating costs could also play a very important role in the drive toward sustainable lending operations, particularly for those well-run entities whose missions allow them to expand beyond their current geographic reach as a way
- of attaining scale. If, for instance, high costs are due to client acquisition, then capacity-building funds could be used for credit scoring and MIS systems designed to reduce operating inefficiencies.
- **Low-income credit unions:** These institutions are well-structured to support microlending operations in that they are (1) already operating on a financially sustainable basis, (2) are community-based, (3) raise the majority of their funding from member depositors, but also have the wherewithal to raise deposits from outside their membership base, and (4) according to at least one industry leader, are “hugely scalable”. However, the financing of microentrepreneurs does not appear to have been a particular focus of the sector to date, with regulatory constraints likely to be a barrier to reaching scale. Does the current economic environment open up opportunities to make headway on this front? If so, are industry leaders willing and able to champion (and regulators willing to support) the case for increased levels of microfinance via these types of credit unions?
- **Emerging for-profits:** Are those for-profit institutions which are exclusively focused on the provision of small working-capital loans to main street businesses, well-positioned to reach profitability? If so, what can the government, donor, creditor, and regulatory communities do to support their efforts to reach underserved microentrepreneurs? In terms of those consumer-oriented for-profit entities which are seeing a portion of their loan proceeds used for business purposes, is there an opportunity for them to proactively target microentrepreneurs?
- **CDFI Bond Guarantee Fund:** To the extent that funders such as the CDFI Fund provide advantageous long-term, low cost capital in the form of bonds, there exists an opportunity to focus exclusively on those institutions (both non-profit and for-profit) that show

the potential to scale and reach profitability or at least achieve financially self-sufficient lending operations. If, instead, this capital is spread over a large number of smaller regional institutions as politically directed credits, an opportunity for the sector to restructure will be wasted.

- **Comprehensive database:** It would appear that there is a need to support efforts

by FIELD to develop a more comprehensive data base for the sector similar to that available in international microfinance through the MIX Market, an affiliate of CGAP. That would require substantial funding in the medium-term (three to five years). Ideally, some of the funders who have supported the MIX would also come to the table to support FIELD's efforts.

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6

Appendices

6.1 List of Interviews

Date	Organization	Person	Position
3/21/2012	A2F Consulting (formerly with LEDC)	Charlene Van Dijk	Consultant
4/26/2012	ACCION Texas, Inc.	Janie Barrera	Executive Director
4/26/2012	ACCION Texas, Inc.	Thomas Clausen	CFO
3/29/2012	ACCION U.S. Network	Gina Harman	Executive Director
3/28/2012	AEO (Association for Enterprise Opportunity)	Tammy Halevy	SVP Membership & New Initiatives
6/1/2012	Alterna Savings	Susan Henry	Manager, Corporate Social Responsibility
3/22/2012	Calvert Foundation	Catherine Godschalk	Manager, U.S. Investments
3/22/2012	Calvert Foundation	Jennifer Pryce	VP Strategic Initiatives
5/21/2012	Capital One Credit Cards	Nigel Morris	Co-founder
5/9/2012	Cash Store	Gord Reykdal	Chairman
4/23/2012	Citi Foundation	Bob Annibale	Global Director of Microfinance
4/30/2012	Citi Foundation	Laura Sparks	Director, Development Finance Initiatives
6/4/2012	Columbia University	Joe Stiglitz	Professor of International Economics
4/4/2012	Credit Builder's Association	Sarah Chenven	Innovations Director
3/28/2012	FIELD at the Aspen Institute	Joyce Klein	Senior Consultant
4/2/2012	Grameen America	Stephen Vogel	CEO
4/2/2012	Grameen America	Seema Gohil	VP Finance
4/2/2012	Grameen America	Katherine Rosenberg	VP Strategic Partnerships
5/1/2012	Justine PETERSEN	Rob Boyle	President & CEO
5/1/2012	Justine PETERSEN	Sheri Flanigan	COO
4/25/2012	Kiva	Miaka Hemphill	Project Manager, North America
4/25/2012	Kiva	Jonny Price	Project Manager, Kiva Zip
3/21/2012	Latino Economic Development Corporation (LEDC)	Manny Hidalgo	Executive Director
4/6/2012	National Federation of Community Development Credit Unions	Pablo DeFillipi	Director of Membership
5/25/2012	Netspend	Gene Lockhart	Past Chairman
5/16/2012	Omega Foundation	May Wong	Executive Director
5/16/2012	Omega Foundation	Martin Connell	Founder
4/30/2012	On Deck Capital	James Hobson	SVP, Strategic Partnerships and Platform
4/30/2012	On Deck Capital	Timothy Schuermer	Business Development Manager
5/7/2012	Opportunity Finance Network	Mark Pinsky	Executive Director
5/7/2012	Opportunity Finance Network	Christine Bare	Sr. Associate, Strategic Consulting
4/25/2012	Opportunity Fund	Eric Weaver	CEO
4/25/2012	Progreso Financiero	John Foxgrover	VP Capital Markets
4/25/2012	Progreso Financiero	Jonathan Coblentz	CFO
4/25/2012	Progreso Financiero	Kari Filerman	Project Manager
4/25/2012	Progreso Financiero	Jim McGinley	Sr. Director, Enterprise Analytics
4/25/2012	Progreso Financiero	Gustavo Lasala	Head Sales & Marketing
5/7/2012	Prosper Financial	Joe Toms	Chief Investment Officer
5/30/2012	Prosper Financial	Frank Rotman	Director
5/18/2012	SEDI	Liz Mulholland	CEO
4/24/2012	Self-Help Federal Credit Union	Steve Zuckerman	Managing Director
5/9/2012	Small Business Administration	Jody Raskind	Chief, Microenterprise Development Branch
5/16/2012	TBC Capital Asset Management	Christian Novak	Partner
4/30/2012	The Intersect Fund	Rohan Mathew	Executive Director
4/13/2012	ZestCash	Shawn Budde	Chief Risk Officer

6.2 List of Report Readers

Ms. Anais Conce, OMTRIX Management, Inc.
Ms. Catherine Godschalk, Senior Director U.S. Investments, Calvert Foundation
Ms. Lisa Hall, President and CEO, Calvert Foundation
Ms. Joyce Klein, Senior Consultant, FIELD at the Aspen Institute
Mr. Paul DiLeo, Managing Partner, Grass Roots/ Caspian Capital Partners
Mr. Shannon Mudd, PhD., Coordinator, Haverford College, Pennsylvania, MI3 (Microfinance and Impact Investing Initiative)

We would also like to thank the following for their comments on the draft final report:

Ms. Elaine Edgcomb, Director of FIELD at the Aspen Institute
Ms. Joyce Klein, Senior Consultant, FIELD at the Aspen Institute
Ms. Tammy Halevy, AEO, New Initiatives Director
Ms. Jody Raskind, Small Business Administration, Chief Microenterprise Development Branch

6.3 About the Sponsors

CALMEADOW is a registered Canadian NGO that for 20 years has supported innovative ideas in microfinance—ideas that promote greater levels of efficiency and outreach through the commercial provision of financial services to low-income borrowers and microentrepreneurs. Based in Toronto and with an operating base in Costa Rica, Calmeadow has focused its efforts on mobilizing and managing capital for direct investment in developing microfinance institutions in Latin America and Canada.

www.calmeadow.com

THE OMEGA FOUNDATION, since its establishment in 1992, has worked as a catalyst for change. The Foundation develops innovative partnerships and

approaches to ensure that Canadians have access to the financial tools that enable them to achieve self-sufficiency. A registered charitable foundation based in Toronto, Omega's Founder and President is leading philanthropist, Martin P. Connell.

www.theomegafoundation.ca

6.4 About the Authors

Ira W. Lieberman, Ph.D.

Dr. Lieberman is the president and CEO of LIPAM International, Inc. an advisory firm that assists governments, international financial institutions, non-profit institutions, and for-profit companies in emerging-market countries. Dr. Lieberman created the CGAP Secretariat and was its CEO from June 1995 to June 1999. He currently serves as Chairman of the Emergency Liquidity Facility for Latin America, a lender of last resort to MFIs in Latin America in the event of natural disaster, political, or financial/economic crisis. He is on the Board of Directors of Fintech Africa, a technical-assistance facility to assist MFIs in East and West Africa, and he is on the board of directors of PAMIGA, a network of East and West African rural/agricultural MFIs. He is on the advisory board of the Council of Microfinance Equity Funds. He is also on the Board of Directors of the Calvert Foundation, a social impact investor in the United States and internationally.

Jenifer Mudd

Jenifer is an independent consultant, working in the fields of community-development finance and microfinance. Her current clients include CARS, Inc., where she has served as a CARS™ analyst since 2006, assessing the financial strength and performance, as well as the social impact, of community development finance institutions across the United States. Since 2005, she has also provided various on-going services to the Calvert Foundation, including assistance with

the management of the international microfinance investment portfolio, underwriting investments for the same portfolio, managing sub-advisor relationships, and helping the foundation launch its MicroPlace.com initiative with eBay. Before establishing her consulting practice in 2005, Jenifer worked for the European Bank for Reconstruction and Development (EBRD) in London, where she managed a US\$150 million micro and small-business-lending facility channeled through the commercial banking sector in southeast Europe, Central Asia, and the Caucasus. Prior to her work for the EBRD, she lived in Russia and Slovakia, where she held several positions, either in the commercial banking sector or in small-business development. Jenifer began her banking career in Atlanta, Georgia, where she spent six years as a small-business lender at Wachovia Bank and Bank South.

Philip Goodeve

Mr. Goodeve has been a senior executive in international consumer financial services for more than 25

years. Most recently, he was Chief Financial Officer with FINCA International Inc.—one of the largest microfinance organizations in the world—which provides credit to the underserved in 21 countries. He was Executive Vice President in charge of strategy and corporate development for the Global Retail Bank at Bank of America. As Chief Financial Officer of Washington Mutual's Consumer Finance segment, he helped create one of the largest consumer finance companies in the world aimed at serving the underserved. Mr. Goodeve grew up in Canada and ultimately became the co-head of global financial services investment banking with the largest investment bank in Canada. He advised and worked with the Canadian Federal Department of Finance and most of the other key government bodies, including testifying before the Canadian Senate on industry developments. Mr. Goodeve has also worked internationally with leading investment and private equity firms as a consultant and senior operating executive, driving to create value at large companies in the financial services industry. Mr. Goodeve has also served on numerous public and private company boards internationally.

