

FIELD Funder Guide



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Scaling Microlending in a Changed Economy

Over the years, the U.S. microenterprise development field has grown. The most recent survey of the industry identified at least 250 programs offering microloans or other “microfinance” products. Although longitudinal data on a set of lenders that provided survey data in both 2002 and 2008 indicate that they have grown over time – with the aggregate number of loans made annually increasing by 21 percent and the value of loans disbursed annually growing by 68 percent – the size of most microlending programs remains small. In 2008, 139 microlenders who provided data made a median of 13 and mean of 44 loans.¹

In fact, much of the field’s growth in lending has been driven by a small number of lenders. These scaling lenders, which have worked systematically to scale their portfolios, have shown what others might achieve. As part of their work with the Scale Academy for Microenterprise Development, five of these lenders have been working to expand their microlending portfolios even more aggressively. Together they made 1,658 loans in FY 2009. This guide describes the key steps these lenders have taken in order to scale their lending and the implications of their experiences for funders interested in supporting greater scale.

Although the collective accomplishments of the Scale Academy lenders are impressive, the participating lenders have not grown equally rapidly, nor have they achieved the ambitious goals they set when they first joined the Academy. The Academy’s launch in 2007 corresponded with the early stages of the financial and economic crises that have since beset the nation. This larger economic context has affected the progress of the lenders, which have confronted dramatic changes in their target markets. The aspiring entrepreneurs now coming to their doors are a mix: some heavily indebted, others formerly “bankable,” but cut off from shrinking commercial capital, some unemployed looking to make a new start in business, and still others established businesses seeking help to survive rather than grow. While microlenders exist to work with those outside the mainstream, in the current context, lenders have found they must make loans judiciously and provide other services to strengthen their customers’ credit-worthiness and business skills.

The Scale Academy for Microenterprise Development ²

Grantee Microlenders

ACCION New Mexico•Arizona•Colorado –
Albuquerque, N.M.
ACCION USA – New York, N.Y.
Justine Petersen – St. Louis, Mo.
Mountain BizWorks – Asheville, N.C.
Opportunity Fund – San Jose, Calif.

How scaling microlenders have built themselves for growth

The scaling microlenders have invested in a set of organizational development activities that have supported their growth over the past three years and, importantly, created the infrastructure for future growth. These include:

Investing in market research and marketing

As the five Scale Academy lenders have grown, each at times has reached plateaus, exhausting the easiest-to-reach entrepreneurs. In response, they have invested considerable resources in market research and marketing. Their

¹ *Field-Wide Survey Data Highlights FY2008 Data* (Washington, D.C.: The Aspen Institute, 2010); <http://fieldus.org/Publications/HighlightsFY2008.pdf>; Internet.

² The Academy is an initiative of FIELD, managed in partnership with the Association for Enterprise Opportunity, and funded by the Charles Stewart Mott and Citi Foundations. The Academy provides organizational development grants, technical assistance, and peer learning opportunities to its members, and documents and disseminates member experiences and lessons learned. There are currently 12 members in the Academy. For more information on the Academy see <http://fieldus.org/Projects/ScaleAcademy.html>.

experiences underscore the importance of understanding specific market segments and channels, engaging in continuous market research, and connecting market research to pilot testing of promising strategies.

Developing new loan products

Scale Academy grantees have depended largely on a few core loan products to scale up. In fact, their core loan products (mostly term loans and some lines of credit) represent about 80 percent of the loans made by these lenders in 2008.³ Yet these lenders have also found value in new products launched in response to both funder interests and changing market conditions. Most notably, Scale Academy lenders have added or expanded credit-building products in response to deteriorating credit quality among their target markets. Two lenders have also introduced new “green” loan products responsive to specific needs in their communities.

Streamlining and strengthening underwriting and decisioning

All of the Scale Academy lenders have made changes in their underwriting as they have sought to respond to and capture increased demand. The changes are driven by three important goals: increasing efficiency, improving quality, and responding to their customers’ desires for loan processes that are clearer and smoother.

Toward those ends, the lenders have reduced staff or revised their roles in the underwriting and decisioning process; developed tools that offer an early signal to applicants regarding their prospects for loan approval; and standardized loan analysis, based on a careful understanding of credit behavior and past portfolio performance. Several organizations now use a statistical scorecard.

Reinforcing risk management

Both rapid growth and challenging economic circumstances bring increasing risk that can reveal underlying weaknesses in an organization’s risk management. Scale Academy lenders have reinforced their risk management capacity by:

- Revising lending policies and procedures to ensure that lending decisions are made on the basis of appropriate risk and build on an organization’s past performance;
- Improving the quality control structures and capacities applied in the loan review process, and in monitoring the portfolio;
- Training and incentivizing lending and collections staff to intervene early with risky clients; and
- Increasing their connections to clients through training and coaching services.

Focusing on customer service

Scale Academy microlenders have focused on customer service in order to ensure that the moves toward greater standardization do not undermine their customers’ experiences. To that end, they have created new ways to solicit customer feedback, trained employees in customer service and sought to improve employee satisfaction (as committed employees give better service). Through this work the lenders have found that, although technology and standardization may seem poor substitutes for direct client contact, in fact, they can enhance the customer experience by reducing response time, providing greater clarity and providing new tools for increasing the number of “customer touches.”

Attracting capital

Several of the Scale Academy lenders faced critical needs for new capital in order to support their growth. The capitalization efforts of the Academy lenders have ranged from more traditional approaches – such as accessing public financing and launching an equity capital campaign – to more groundbreaking efforts. On the latter front, one lender formed a limited liability company to attract a new type of capital and reduce the impact of debt on their balance sheet (see the case on last page). Two others are the first U.S. microlenders to participate with Kiva, the Web-based peer-to-peer lending program that matches individual lenders with microentrepreneurs.

Revising structure and staffing

As organizations scale, their structures evolve, and all of the microlenders have changed their structures over the last several years. Their experience suggests that there is no one “right” structure for greater scale, but rather that an effective

³ Several also fueled portfolio growth by increasing their loan limits (sometimes to include small business loans up to \$150,000 to \$200,000) and thereby their average loan size. While this strategy does not necessarily involve creating a new product, it often requires building the capacity to underwrite more complex loans.

structure must achieve a set of goals that includes: reflecting and supporting organizational values; managing greater volume; and enhancing the organization's outreach and visibility, development capacity, and quality.

The lenders have focused considerable attention on recruiting the right talent and supporting them with professional development and incentives to perform well. In structuring their organizations for scale, the lenders have reorganized their marketing, sales and underwriting functions to increase specialization. They have also increased attention to monitoring and compliance, customer service, and collections – steps they would recommend to all microlenders that are pursuing growth.

Identifying recession-ready strategies

The above investments in organizational capacity are critical for lenders seeking to scale in any kind of economic conditions. In a context in which many entrepreneurs are not well-positioned to take on additional debt, some growth strategies have performed better than others. The Scale Academy lenders have grown primarily through two strategies – adding financial education and credit-building services to their product mix, and expanding to new geographies.

Those using the first strategy offer education and counseling, often combined with a financing product such as an Individual Development Account or credit-building loan. But, Scale Academy microlenders also have learned that these initiatives do not necessarily produce more microenterprise loans – unless they are explicitly designed to attract aspiring entrepreneurs or create a clear pipeline to their microloan services.

Scale Academy microlenders have expanded geographically by moving into new counties or states, and, in one case, by national expansion via the Internet. As they have done so, they have learned that, although initial market research may enable them to launch and to easily pick up the most credit-ready applicants, deeper penetration requires investment in more detailed market research and marketing, and in technology that enables them to streamline staffing in new locations and connect remote staff to central operations.

What funders can do

The experiences of these high-volume lenders suggest important lessons for funders interested in supporting greater scale in U.S. microlending.

Support market research and marketing

Just as corporations engage continuously in market research and marketing, so must microlenders. The process is iterative, with each effort increasing the accuracy of an organization's targeting. Funding for market research and marketing is difficult for nonprofits to come by, and funders interested in scale should consider how they might support these key investments.

Be clear about when to encourage new product development

Often, funders encourage microlenders to create new products to serve target markets in which they have an interest. In some instances, these new products simply tweak features of a pre-existing product (like including a discounted interest rate for borrowers with specific characteristics). In other cases, new products – such as some of the “green” loans that Academy lenders have launched to help truckers buy more fuel-efficient vehicles – must be created from scratch. New products require new capacities and, therefore, can detract from standardization that leads to greater efficiency. Funders should explore with lenders both the benefits and costs of new product development, and assess whether the payoff, in terms of mission impact, increased volume and revenue generation, is sufficiently high to warrant the expenses.

Be cautious in placing restrictions on prices

Scaling microlenders face challenges in determining the “right” prices for their loans. Interest rates among Scale Academy microlenders range from 5 percent to 18 percent, and, in most instances, do not cover the operating costs associated with the loans. While Academy members hold differing opinions regarding the extent to which subsidy is required, they agree that customers should not be penalized for their inefficiencies as lenders. Further, they affirm that establishing the “right” price is complicated by a set of factors: lack of good market data on customers' assessment of interest rates; limited information on the costs of individual loan products; varying values among staff; and pricing constraints imposed by

funders on specific products. Funders can help lenders to make more informed decisions about pricing by helping them develop cost-accounting systems that can “unpack” the costs of lending. Funders also should proceed cautiously when placing limits on interest rates and fees charged by lenders.

Consider developing a large-scale capital fund

As the lenders have grown their capitalization, all have faced challenges in managing an increasing diversity of capital sources – because of the specific, and varying, requirements imposed by funders and investors. In some cases, progress toward scale has been slowed by the work entailed in being accountable to these requirements. Scale Academy microlenders believe that the time is ripe for more sophisticated, long-term investment vehicles. Scaling could occur more quickly if they could tap a single, appropriate and significant source of capital, thereby reducing their costs of reporting and relationship management, and releasing more resources for product development, marketing and market research. Funders may want to consider how they might collaborate to develop new funding mechanisms that are more supportive of organizations seeking to scale.

For more information

Findings from the Scale Academy – Forging Ahead: Early Lessons (Washington, D.C.: The Aspen Institute, 2009); <http://fieldus.org/Publications/ScaleApril09.pdf>.

More on the Scale Academy’s work and on each of the members can be found at <http://fieldus.org/Projects/ScaleAcademy.html>.

Forthcoming: *Dollars for Dreams: Scaling Microlending in the United States* at www.fieldus.org.

A Creative Approach to Capitalization

When ACCION New Mexico•Arizona•Colorado was seeking to increase its lending capital in anticipation of loan growth, management realized that its ratio of net assets to total assets made additional debt financing not only risky, but unlikely. One of the organization’s board members and funders, First Community Bank, thought that equity equivalent (EQ2) investments might provide an opportunity for growth that also could improve the organization’s equity position. An EQ2 investment is “unsecured debt that has some of the same advantages of equity because it is subordinate to all other debt and carries a rolling term, the investor has a limited right to accelerate payment, and interest is not tied to income. The investing bank also receives advantageous CRA credit.” *

To that end, ACCION New Mexico created a limited liability company (ACCION LLC), a 15-year structure in which ACCION New Mexico owns a 51 percent voting interest and First Community Bank, which made the EQ2 investment of \$1.2 million, owns 49 percent. When ACCION New Mexico’s financials are consolidated, these funds are booked as contributions from the LLC, which the organization controls, and add to the institution’s net assets. Because ACCION New Mexico can leverage net assets to secure more debt financing, the \$1.2 million allows an additional \$4.8 million to be leveraged.

ACCION New Mexico can access the funds for lending over the course of the year, by borrowing money from the LLC. The organization pays the LLC an interest rate and charges it a management fee, effectively canceling out the transaction. At this time, the LLC is achieving its original goal of shoring up the organization’s equity position and adding to its loan capital.

*The CDFI Data Project, *Providing Capital, Building Communities, Creating Impact*, Fiscal Year 2006, Sixth Edition (Philadelphia, Pa.: The Opportunity Finance Network), 17; available from www.fieldus.org/publications; Internet.

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