The OMEGA Foundation

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Omega Foundation-Sponsored Report on the State of Microfinance: Scale and Sustainability Achieved Globally, But Not Yet in North America.

U.S. Microfinance at the Crossroads – Scale and Sustainability: Can Lessons from International Experience Help Guide the U.S. Sector?
Calmeadow (Costa Rica) and Omega Foundation (Toronto)

In-depth research co-sponsored by Calmeadow and the Omega Foundation compares approaches to global and North American microfinance and identifies international innovations that are achieving scale and sustainability.

Under the guidance of Calmeadow's Executive Director Alex Silva, the study was conducted by Dr. Ira W. Lieberman, whose extensive experience in international microfinance includes his service as Chairman of the Emergency Liquidity Facility for Latin America and former CEO of the Consultative Group to Assist the Poorest (CGAP). Lieberman was assisted by Jenifer Mudd and Phil Goodeve.

The state of North American microfinance

In the 1990s and for nearly a decade, Calmeadow piloted some of Canada's earliest microlending experiments. From their experience developing successful microfinance programs in Latin America, Africa and elsewhere, organizers knew that for microfinance to flourish, it had to achieve a sustainable level of commercial viability: commercial scale that included a fair return to investors.

Evaluation by Calmeadow of their Canadian pilots concluded that based on issues such as a highly dispersed customer base, competing sources of commercial credit and reluctance to charge adequate interest, it was not possible to build sustainable programs of lending in the Canadian pilot areas: First Nations communities, rural Nova Scotia, Vancouver, Toronto and Halifax, without significant ongoing and sustained charitable subsidies. It was determined that a model that could cover direct costs, financial costs and collection costs would require an effective loan interest rate in excess of 50% per annum. The pilots used a charitable subsidy of approximately 30% to bring lending rates down to more acceptable levels.

In response to recent resurgence of interest in microfinance in Canada, Omega partnered with Calmeadow to commission this research to identify what new developments were helping microfinance programs to achieve scale and greater sustainability, particularly in the U.S., as a proxy for North American activity.

The report also provides an update on the status of global microfinance that confirms it has developed deep roots and now provides affordable and accessible financial services to millions of low-income largely self-employed microentrepreneurs. Capital to finance these institutions is now available primarily through local equity investment and deposits, complemented by international private, government for- and not-for-profit funding. Dedicated microfinance organizations manage and direct globally over $7 billion of targeted microfinance investment funds.

The report also provides a detailed analysis of the state of microfinance and credit in the U.S. Following a review of the status of the sector in Canada, it was determined that given a larger body of experience and richer variety of institutional development, research would focus on U.S. developments, understanding that many of the insights gained would be directly applicable to Canada. The researchers concluded that, in spite of some bright spots of innovation, specifically technological developments, the U.S. sector, after twenty years of experimentation and tens of millions of dollars of expenditures, remains generally tiny and trapped in a cycle of subsidy dependency.

"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."

From the report:

> "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."
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> "Across the country in 2008, FIELD estimates that 362 microfinance programs disbursed approximately 9,191 loans for a total of US$100 million. During 2010, output increased to an estimated 17,623 microloans totaling US$164 million, disbursed via 403 microlenders. The average number of loans disbursed per program increased between 2008 and 2010, from 25 to 44."
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> "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 microlending operations. For instance, in fiscal year (FY) 2010, the median rate of operational self-sufficiency among 15 reporting credit-led microfinance programs was 26%."
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> "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. Operations in the sector face many hurdles:
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> 1. They 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 very few grants 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 much 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."

The research finds that some technological changes taking place could lower costs and improve access for the target clientele, but identifies that it is premature to assume that this will lead to a substantial increase in the numbers of clients being reached. In the meantime there is growing capacity among new and existing commercial financial institutions to offer products that are reaching target customers. Here, unlike in the philanthropic model, interest rates and fees, often much higher than the non-profits would tolerate, are being charged to ensure scale and sustainability are reached. Their growth underlines the fact that the market appetite exists but accessing it requires significant financial resources and a degree of expertise in marketing and customer service not always available in the charitable sector.

The research identifies a number of promising, emerging initiatives from a diverse and growing list of commercial organizations ranging from Sam's Club to ZestCash.

From the report***:***

"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 microbusinesses 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.

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 ZestCash, are working to compete as fair and transparent substitutes to these alternative lenders. For instance, they are designing loan products to ensure that payments are relatively cheaper than payday loans and are also structured to avoid the prolonged debt cycles that often result from borrowers being unable to fully repay their loans at maturity."

The findings confirm that over the past 20 years little progress has been made within the non-profit microfinance sector in North America to align costs and revenues. Significant subsidies continue to be required to sustain the programs. While it has been identified that such activity creates local opportunities for job skills training and the development of some small, self-employed microentrepreneurs, cost-effectiveness is a question, given the level of subsidies required.

The research concludes that microfinance activity in North America is unlikely to expand or thrive in the absence of greater efforts to achieve financial sustainability, including pricing of loans and services sufficiently to cover costs at market rates. Promising developments in the commercial sector indicate the potential to create profitable businesses through the employment of targeted marketing, smart technological applications and market pricing. These strategies point the way forward to expanding access to financial services by low-income self-employed entrepreneurs.

The full report is attached.

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The Omega Foundation is a registered charitable public foundation based in Toronto. Since its incorporation in 1992, Omega has developed innovative partnerships to ensure that low-income Canadians have access to the financial services they need to achieve self-sufficiency. Omega works as a catalyst for change and engages partners in research, model development, evaluation and continuous improvement geared to maximize effectiveness, sustainability and learning. Omega has a long history of association with Calmeadow and is currently conducting a 3-year Toronto pilot to encourage education savings among lower-income families.