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Microenterprise



Growing Businesses, Assets and Markets

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2005 was the International Year of Microcredit. Around the world, governments, financial service providers, nonprofits, the United Nations and others partnered to address the pivotal question of how to build a more inclusive financial sector.

The Federal Reserve Bank of Dallas participated in this dialogue by co-hosting a conference with the World Affairs Council of Greater Dallas titled “Microenterprise: Building Assets in a Growing Market.”

The Nov. 4 conference offered insights into microenterprise as an emerging market for financial institutions and investors, how it fits into the field of microfinance, and the range of asset-building tools that help move low-wealth individuals and entrepreneurs into the mainstream financial sector.

Conference speakers identified opportunities and challenges for businesses and investors in microfinance and demonstrated how for-profit and nonprofit financial service providers contribute to the industry’s success. Their overall message was that microfinance strengthens communities and local economies.

This issue of Banking and Community Perspectives illustrates how tapping into undercapitalized markets is not simply about creating a niche but about building market share. We hope the conference findings presented here provoke further thought, dialogue and action on this topic.

Alfreda B. Norman
Community Affairs Officer
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Microfinance and Microenterprise

What Is Microfinance?

In the United States, microfinance refers to financial services and products that meet the market demands of low-wealth individuals. They include microloans, microenterprise development training, personal financial education, individual development accounts, second-chance accounts, stored-value cards, and asset-building check-cashing accounts and remittance services. These financial products, services and skills build wealth in communities, revitalizing them over the long term.

Microfinance creates opportunities for financial service providers, their customers and investors. For providers, it is a vehicle to expand their markets. For customers, it serves as an asset-building path out of poverty. For investors, it is an emerging domestic market.

What Is Microenterprise Development?

The developing world's model of microfinance emerged in the U.S. approximately 20 years ago and evolved into what we now know as microenterprise development. In this country, microenterprises are companies with five or fewer employees that need up to \$35,000 to start up or expand. Microenterprise borrowers are entrepreneurs who have insufficient credit history, need a loan smaller than the usual small business loan or do not meet other lending criteria of traditional financial service providers.

The Association for Enterprise Opportunity, an industry trade organization, puts the number of total U.S. microenterprises at 21.5 million. According to the Aspen Institute's Elaine Edgcomb, approximately 10 million of these microentrepreneurs are individuals who face barriers to mainstream finance and business development services. This group is largely composed of women, people of color, ethnic minorities, the disabled and individuals on welfare interested in starting a



business. In addition, an untold number of microentrepreneurs operate in the growing informal economy, the set of economic activities that are considered legal but not in accordance with industry regulations and tax laws. That economy is estimated to represent approximately 10 percent of the U.S. gross domestic product and includes both employed and self-employed individuals.

For more statistics on microenterprise development, see the box below. Note that the figures for Louisiana and New Mexico are for the entire state, not just for the parts that are in the Eleventh District.

Why Microfinance and Microenterprise Development Are Significant to Our Economy

An increasing number of companies are downsizing, hiring more temporary workers and outsourcing. The growth of nonpermanent jobs translates into a

shrinking financial safety net. This is especially true in rural communities, which continue to face economic decline. An aging U.S. population exacerbates this destabilization by reducing the size of the workforce while placing greater demands on the social infrastructure.

Microenterprise development helps address this destabilization by increasing employment among the unemployed and underemployed. These jobs are important beyond the paychecks they provide because they serve as a training ground for future employment. From a macro perspective, microenterprise is significant because it is the precursor to small business—the backbone of the U.S. economy—and generates 17.2 percent of the country's private employment.¹ An example of microenterprise development's impact is given in the case study of WESST Corp. (see box on next page).

Asset accumulation is another func-

Microenterprise Development in the United States

- 17.2 percent of private nonfarm employment is from microenterprises, translating into more than 28 million jobs.
- 650 microenterprise development programs
- 21.5 million microenterprises
- 175,000–250,000 microentrepreneurs served per year
- \$114.3 million in microloans to over 13,000 entrepreneurs
- 60 percent of microentrepreneurs are women (vs. 33 percent of all self-employed).
- 53 percent of microentrepreneurs are people of color or ethnic minorities (vs. 14.6 percent of all U.S. firms).
- The survival rate of microenterprises after five years is 49 percent, a rate common among similar but larger businesses.

SOURCES: "Microenterprise in the United States," Association for Enterprise Opportunity, 2002 data; "Highlights from the 2005 Data Collection Project," Microenterprise Fund for Innovation, Effectiveness, Learning and Dissemination, The Aspen Institute, <http://fieldus.org/directory/Highlights2005.pdf>; "Fast Facts," http://fieldus.org/Fast_Facts/index.htm; interview with staff.

Microenterprise Development in the Eleventh Federal Reserve District (Texas, Northern Louisiana, Southern New Mexico)

Texas

- 17.3 percent of private nonfarm employment is from microenterprise.
- 1.6 million microenterprises

Louisiana

- 16.9 percent of private nonfarm employment is from microenterprise.
- 305,244 microenterprises

New Mexico

- 17.2 percent of private nonfarm employment is from microenterprise.
- 126,516 microenterprises

SOURCE: Association for Enterprise Opportunity, 2002 data.

tion of microenterprise development. Microenterprises generate income for entrepreneurs and their families, enabling them to build their assets. According to the Aspen Institute's Self-Employment Learning Project (SELP), 72 percent of low-wealth entrepreneurs increased their income over five years, with the average change being from \$13,889 to \$22,374. The median change for these entrepreneurs was 91 percent. The average change in household assets was approximately \$16,000 over five years; the median change for these same entrepreneurs was \$13,140.²

One direct benefit of asset accumulation is the reduction of dependence on public assistance. SELP reports that of the low-wealth entrepreneurs it surveyed, 53 percent had moved above the poverty line. As a result, reliance on food stamps, Temporary Assistance for Needy Families and other forms of public assistance dropped an average of 61 percent.

As microenterprise helps decrease dependence on public assistance, it raises tax revenues by increasing the number of workers. ACCION Texas found that from 1994 through 2002, its \$22.2 million in direct lending generated \$2.4 million in public-sector revenues in Texas. The growth of microenterprises also increases sales for regional businesses that supply goods and services to microentrepreneurs and their households, further boosting sales tax revenues.

In addition to these quantifiable benefits, there is a wealth of qualifiable returns from microenterprise development. They include borrowers' improved economic literacy, business and financial skills; increased access to conventional sources of credit; and strengthened emotional capital, such as self-esteem, pride, sense of independence and financial security, and the feeling they can enjoy the privileges and rights of being active economic participants. As microentrepreneurs raise their households' standard of living, they tend to strengthen their family and community ties because entrepreneurship makes their schedules more flexible, shows them the benefits of increased neighborhood participation, and provides needed goods and services to the local community.

Moreover, entrepreneurs create intangible and tangible intergenerational wealth by involving their children in their business operations, discussing business at the kitchen table and transferring their assets to them.

The American Financial System

James Carr, senior vice president of the Fannie Mae Foundation, says that from an asset-building standpoint, the U.S. financial system is "bifurcated"—divided into two parts. On one side are mainstream financial service providers, such as banks and credit unions, whose products and services are asset-building. They enable consumers to save, invest, build credit histories and access fair credit. On the other side are alternative financial service providers, such as auto-title lenders, check cashers, payday lenders, pawnshops and rent-to-own stores. Their products and services impede asset accumulation because they routinely involve high or excessive interest rates and fees that can lead consumers into a cycle of debt, provide neither the incentive nor opportunity to save, and can further damage consumers' access to mainstream credit.



Carr says that some alternative financial services providers have begun to work with mainstream financial institutions to help consumers transition to more traditional bank products. He adds that many banks and credit unions are reaching out to the unbanked as a potential and important untapped market. But while some innovations are impressive and promising, the gap in access for millions of financially marginal consumers remains wide.

Individuals at all income levels and of all races use nonbank products and services, according to Jennifer Tescher of the Center for Financial Services Innovation at ShoreBank Advisory Services. When the center sur-



veyed low-wealth households in Chicago, Los Angeles and Washington, D.C., it found that almost two-thirds of banked individuals use these products.³ While banked consumers use them out of choice, individuals without a banking relationship tend to do so out of necessity. Among the reasons are poor history with financial service providers; inability

WESST Corp.: A Case Study

From 1990 to November 2005, WESST Corp. of Albuquerque, N.M., has made 307 loans totaling \$1.7 million, says Executive Director Agnes Noonan. Sixty percent of its loans are to low-income entrepreneurs, 70 percent to women and 45 percent to new microenterprises. Of these start-ups, 47 percent of the loans are to rural enterprises, and another 47 percent are to minority-owned businesses. In 2004 alone, WESST Corp. served 1,600 clients, providing business training to approximately 1,360 entrepreneurs and consulting services to almost 580. Altogether, WESST Corp.'s loans have generated 1,850 new businesses and over 2,800 jobs. From 2001 through October 2005, its clients' revenues totaled \$75 million.



The value of WESST Corp.'s products and services extends beyond its numbers. "In our case, because we're working with so many low-income women, raising self-esteem and helping build the confidence of entrepreneurs are critical factors," Noonan says. "In fact, one of the most common responses we have received over the years from clients has been, 'I could never have done this if it hadn't been for WESST Corp.'s support.' And, of course, support comes in a lot of different forms—not just the technical, business and financial support but the one-on-one support of working with someone who's facing an array of other challenges in their life. About eight years ago, we developed a video called *Fear of Success* to address some of the challenges our clients face as they start to achieve some level of success."

to meet minimum balance or credit requirements; language barriers; nontraditional work hours; and employers, bill collectors and others accepting only cash transactions. Other reasons for remaining unbanked include mistrust and lack of familiarity with the financial mainstream.

Expanding the Financial Sector

The Center for Responsible Lending estimates the nonbank financial services sector to be in the billions. For example, the center puts the payday lending market at \$3.4 billion annually. Due to its significant size and anticipated growth, the nonbank financial services sector has evolved from a niche to a market. Mainstream businesses and investors that have already established a low-wealth customer base are expanding their suite of products and services to tap this market. For example, H&R Block now sells individual retirement accounts and mortgages. Wal-Mart offers payroll check cashing, domestic and international money transfers, and money orders. 7-Eleven has self-service financial kiosks that provide check cashing and money order and transfer services.

Three for-profit financial service providers that have seen success in the microfinance market are Legacy Bancorp Inc., MicroFinance International Corp. (MFIC) and Pay Rent, Build Credit (PRBC). At the November Dallas Fed conference, company representatives explained how their business models generate income while helping build their clients' assets.

Legacy Bancorp

Margaret Henningsen, cofounder and vice president of Legacy Bank in Milwaukee, says her bank focuses on financial management and economic development. Legacy offers the Financial Liberty First Accounts product, which for many unbanked is a second-chance account. Legacy also partners with nonprofits to conduct small business training and a local university to provide



personal financial education courses.

Unbanked individuals who want to open an account apply for the Financial Liberty First Accounts product. If they are in ChexSystems, they start with savings accounts. If they maintain the account, they can open a checking account after successfully completing a personal financial education class called Get Checking.⁴

Individuals who are not in ChexSystems are not required to take the class. Henningsen reports that these accounts have yielded significant returns for both Legacy and its customers, who progressively save more and graduate into loan products. This business strategy has attracted the mainstream's attention; three major Milwaukee banks that previously rejected the concept of second-chance accounts now offer them.

Henningsen's motto—"No margin, no mission"—sums up Legacy's philosophy that providing financial products and services must be profitable to be sustainable. Henningsen emphasizes that her model of banking the unbanked is nothing new. It's the way banks used to be run before the era of major mergers and acquisitions, she says.

Legacy's financial success demonstrates low-income communities' potential as emerging domestic markets. The \$7 million-plus Henningsen and her partners raised in 1999 to create the bank had grown to \$102.8 million in assets by 2004. These assets represent more than 2,000 retail accounts and over 800 mortgage, commercial and small business loans, which have generated over 2,000 jobs. Consistent with its mission, Legacy partnered with the Wisconsin Housing and Economic Development Authority to form the Wisconsin Community Development Legacy Fund to apply for 2003–04 New Markets Tax Credits. The fund has disbursed its \$100 million allocation to economic development projects in distressed parts of Milwaukee and elsewhere in the state.

MicroFinance International Corp.

Daniel Weiss, chief strategy officer of MFIC, discussed how its retail financial service division, Alante Financial, serves as a one-stop shop for the Hispanic market. One of the first commercial microfi-

nance institutions in the U.S., Alante, which roughly translated means "moving forward," provides \$500 to \$3,000

microloans to underserved customers after analyzing their credit and employment history, credit score and track record with MFIC.

Alante partners with banks in the U.S. as well as microfinance institutions in Latin America to provide remittance services north of the U.S. border and facilitate microfinance south of it.⁵

Alante also offers personal financial education and check-cashing services. According to Weiss, Alante has over 5 percent of the U.S.–Bolivia remittance market. Over the past year, it has created seven branches and plans to expand to 13 by late 2006. Alante reports monthly revenue growth of 10 to 30 percent.

Pay Rent, Build Credit

PRBC functions as a fourth credit bureau that captures data uncollected by Equifax, Experian and TransUnion, three companies that provide credit reports and scores to lenders. Financial institutions and others use these reports and scores to help determine if

applicants meet lending criteria and if so, to establish financing terms. Michael Nathans, PRBC chairman and CEO, says he started the company to enable consumers with nonexistent, incomplete or poor credit histories to demonstrate their creditworthiness. His philosophy is that consumers should not have to build debt to build credit. Everyone pays bills and should be recognized for paying them on time. "This," he emphasizes, "is a sign of fiscal responsibility that can be measured and scored."

Upon consumer request, PRBC collects payment data if they have a Social Security number, individual tax identification number or employer identification number. PRBC tracks clients' regular payments, such as rent, utilities, phone, insurance, child support, remittances and microloans. It weighs these payments based on their size and records



the timeliness and percentage of each paid. The company sells its PRBC Bill Payment Score and Report, which comprises up to three years of payment history, to banks, credit unions and other financial institutions, landlords and other billers. With these data, consumers have better access to fair credit, while providers have improved risk assessments and securitization efficiencies.

Microfinance: An Emerging Domestic Market

Betsy Zeidman, director of the Milken Institute's Center for Emerging Domestic



Markets, observes that an increasing number of investors consider microfinance as a subgroup of emerging domestic markets. EDMs

include companies serving low-income households, ethnic and women-owned enterprises, inner cities and rural communities. Most investors tend to overlook them due to information gaps.

Investors' interest in microfinance is spurred by the projected growth in ethnic populations and their purchasing power and the number and sales of ethnic-owned firms. Hispanics currently account for about 13 percent of the population but are projected to account for 14 percent in 2010, 16 percent in 2020, 19 percent in 2030, 22 percent in 2040 and 25 percent in 2050. The Asian-American population is expected to increase by approximately 1 percent every 10 years for the next 45 years, while the African-American population is expected to rise 2 percent over the same period.

Taken together, these groups' purchasing power (in 1998 dollars) is an estimated \$1.6 trillion in 2005. It is projected to grow to \$2.1 trillion by 2015, \$2.7 trillion by 2025, \$3.5 trillion by 2035 and \$4.3 trillion by 2045.

From 1997 to 2002, the number of ethnic-owned firms rose by approximately 6 percent. The number of African-American firms grew by approximately 8 percent, Hispanic firms by 6 percent and

Asian-American firms by 4 percent. Within this time frame, African-American firms netted 5.4 percent growth in sales, Hispanics 4 percent and Asian-Americans 2.5 percent.

Michael Stegman, director of the Center for Community Capitalism at the University of North Carolina-Chapel Hill, observes that microfinance's transition into an emerging domestic market reflects the "blurring of the lines between community development finance and capital markets."



Stegman's model of community capitalism explains his perspective. "In community capitalism, business supported by the government and community sectors drives investment, job creation and economic opportunities in distressed communities. Urban neighborhoods are profiled by measure of economic strength rather than social pathologies. Promising inner city entrepreneurs have access to capital. . . [and] corporations make inner city investment decisions for business reasons, instead of charity."

This "marketization" of community development finance is occurring mostly because community development financial institutions' (CDFI) dollars are decreasing and community development finance systems are more return-driven. For example, the Low Income Housing Tax Credit program is "deep enough to 'make a market,'" while the newer New Markets Tax Credit program has "to have significant economic value prior to application of the tax credits in order to be feasible," Stegman says.

He points out other indicators of a more return-driven system: The community development financial industry is linking itself to the secondary market, and the Small Business Administration's emphasis on Small Business Investment Companies is dwindling. At the same time, the community development-venture capital industry has grown to over \$300 million.⁶ Moreover, financial and social-based ("double-bottom-line") private-equity funds in the socially responsible investment field are now worth over \$2.6 billion, and commercial private equity funds are focusing on EDMs. As a

result, there are new EDM-information providers, such as Social Compact, economist Michael Porter's Initiative for a Competitive Inner City and the Brookings Institution's Urban Markets Initiative.

In addition, Bank of America recently created the California Community Venture Funds, a fund of funds that invests Bank of America capital plus that of California's major state pension funds—California Public Employees' Retirement System and California State Teachers' Employee Retirement System—in smaller venture funds. The Bank of America fund is investing a total of \$195 million in smaller venture funds that are located in or do business in California and target investments in companies that are women- and minority-owned or in underinvested markets. Stegman currently is benchmarking the community impact of these investments.

Options for Investors in Microfinance

Arthur Hollingsworth, managing partner of Lone Star New Markets LP, and Shari Berenbach, executive director of the Calvert Foundation, told Dallas Fed conference participants how their organizations invest in emerging domestic markets.

A For-Profit Model

Hollingsworth is founder and partner of three private equity funds with community development goals: Lewis Hollingsworth LP, North Texas Opportunity Fund and Lone Star New Markets LP. The first fund invested more than \$40 million in 20 companies that generated \$124 million in investment profits, mostly in low- and moderate-income areas in Texas, from 1987 to November 2005.



The North Texas Opportunity Fund, established in 2000, focuses on southern Dallas. This \$26 million investment fund's strategy, Hollingsworth says, is to "provide economic development and quality job creation in underserved areas while generating attractive invest-

ment returns for the Fund's investors. [We] invest in companies willing to expand and/or relocate operations to underserved North Texas markets. . .and . . .invest in companies owned or managed by ethnic minorities and women." From 2000 to November 2005, the North Texas Opportunity Fund generated an 11 percent plus return for its investors, while facilitating the creation of almost 2,000 jobs in the economically challenged area of South Dallas. Among its investments is PrimeSource, one of the most prominent African-American woman-owned companies. In total, the fund's five investments report \$150 million in sales and 6,000 employees.

Lone Star New Markets is currently in formation. Its goal is to raise \$40 million and make \$1 million to \$10 million equity investments in Texas. Lone Star New Markets is the only Texas entity to have won a New Markets Tax Credit allocation that will be invested in Texas companies. Investors in the fund will receive \$10 million in tax credits.

Hollingsworth explains his and his partners' interest in small businesses (those reporting sales of \$10 million to \$50 million) by noting that 75 percent of all U.S. companies have sales in this range, but private-equity investors direct only 2 percent of their capital to them. This capital imbalance presents a significant investment opportunity.

A Nonprofit Model

While Hollingsworth illustrated the for-profit arm of investing in microfinance, Berenbach outlined the nonprofit arm, also known as the social capital market. The seven categories of investors in this market fall within a continuum; each focuses on a different type of capital (*Table 1*).



The Calvert Foundation refers to its business model as community investing, and its products and services focus on both social and financial capital. The foundation's portfolio of Community Investment Notes, Community Investment Partners and Calvert Giving Fund invests in microenterprises in the U.S. and abroad and in small businesses,

affordable housing, and community development programs such as infrastructure, day care and environmental programs in the U.S.

The Community Investment Notes program, launched in 1995, has nearly 2,400 investors and \$85 million in assets. The Calvert Foundation describes it as a low-risk, high-social-impact investment available to individual and institutional investors that want to provide flexible financing terms to community development corporations and CDFIs while earning a modest return. The Community Investment Partners program is 7 years old, has 700 investors and assets of \$18 million. It provides due diligence and structures, underwrites, and administers investments on behalf of foundations and socially responsible investors.

The Calvert Giving Fund, launched in 2001, has 210 donors and \$14.5 million in assets. It is a donor-advisory fund that offers socially responsible and community investment options, including Community Investment Notes, and has a web site that lists financial and social capital investment options. Berenbach emphasizes that altogether, these three vehicles serve the needs of the "whole spectrum of investors looking for a mixture of financial and social returns."

Conclusion

As speakers at the Dallas Fed conference demonstrated, the first step in building a more inclusive financial sector entails identifying the market potential of historically underserved markets. For-profit and nonprofit entities across

the nation have discovered this potential in microfinance and its offshoot, micro-enterprise development, particularly when they connect low-wealth individuals to the mainstream. The conference served as a platform to highlight these practitioners and generate discussion on how to build a sustainable path to this sector.

Lisa Servon, acting director of the Community Development Research Center at The New School University, proposes several ways to build scale and sustainability in



microenterprise development: restructure, innovate, standardize and accredit. Restructuring involves merging entities to increase reach, achieve economies of scale and reduce competition for scarce resources; separating business training from lending to allow for increased specialization and efficiency; and partnering with regional networks and financial institutions. Innovating microenterprise development entails expanding product lines and using technologies such as credit scoring, automated sourcing and web sites that provide access to loan managers. Servon recommends that the field standardize its processes, such as data collection, loan documentation, screening procedures and curriculum, and provide accreditation for organizations that meet industry standards. Funders, intermediaries and trade organizations must play a significant role in this process, she says, in order for it to move forward successfully.

Table 1 Social Capital Market Investors

Investor Category	Focus
Traditional foundation/philanthropy	Social capital: talent, time, networks
Venture/engaged philanthropy	Social capital: talent, time, networks
Community development lenders	Financial and social capital: debt, grants
Community development venture capitalists	Financial and social capital: equity, grants
Angels and social venture capitalists	Financial and social capital: equity
Socially responsible investors /mutual funds	Financial capital: equity
Traditional financial investors	Financial capital: equity

The Dallas Fed challenges banks, economists, public officials, community and economic development professionals, investors and others to further investigate how each can play an active role in microfinance. In doing so, each can more fully contribute to the vitality and vibrancy of the economy.

NOTES

¹“Microenterprise in the United States,” Association for Enterprise Opportunity, 2002 data.

² See *Opening Opportunities, Building Ownership: Fulfilling the Promise of Microenterprise in the United States*, by Elaine L. Edgcomb and Joyce A. Klein, Washington, D.C., The Aspen Institute, Febru-

ary 2005, <http://fieldus.org/publications/fulfillingthe promise.pdf>, and “Microenterprise and the Poor: Findings from the Self-Employment Learning Project Five Year Study of Microentrepreneurs,” by Peggy Clark and Amy Kays, Washington, D.C., The Aspen Institute, 1999, www.fieldus.org/publications/MEandPoorExecSummary.pdf.

³ “A Financial Services Survey of Low- and Moderate-Income Households,” by Ellen Seidman, Moez Hababou and Jennifer Kramer, Center for Financial Services Innovation, ShoreBank Advisory Services, July 2005, www.cfsinnovation.com/managed_documents/threecitysurvey.pdf. Note that this was a study of low- and moderate-income households in three cities; these data cannot be interpreted to mean that nationwide, two-thirds of all banked households also

use nonbank services.

⁴ For more information, go to www.getchecking.org.

⁵ Its Latin American banking partners are Accovi, Integral, AMC, Campo, Duarte and ALPIMED in El Salvador; BANHCAFE, FINSOL and ODEF in Honduras; FINDESA in Nicaragua; Bancosol and Agrocapital in Bolivia; HSBC in Mexico; and BANRURAL in Guatemala.

⁶ For more information, visit the Community Development Venture Capital Alliance web site, www.cdvca.org, or reference publications by industry expert Julia Sass Rubin at Rutgers, The State University of New Jersey, <http://policy.rutgers.edu/faculty/rubin.html>.

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