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Savings and Credit for Microentrepreneurs

This bulletin explores the integration of Individual Development Accounts (IDAs) and microenterprise development (MED) products and services to enhance asset accumulation among low-income entrepreneurs.[1] It provides members of State Microenterprise Associations (SMAs), microenterprise practitioners, and others with a more integrated method of providing these services. This bulletin includes an overview of the asset-based approach to poverty alleviation, the rationale for integration from the perspectives of practitioners and clients, effective integration practices, and preliminary observations about the potential benefits of an integrated approach.

Definitions:

Microenterprise Development: A strategy that provides loans, training, and technical assistance to help low- to moderate-income people to build income, assets, and economic self-sufficiency through entrepreneurship.

Individual Development Account: A financial and economic development tool that enables low- to moderate-income families to save and accumulate assets, specifically homes, businesses, and education.

Integration Spectrum:

- **Low integration.** Basic coordination of MED and IDA programs and referral of participants from one program to the other.
- **Medium integration.** MED and IDA program design, training, and staff resources that maximize synergies and participant transition.
- **High integration.** Complements medium integration with credit enhancements for borrowers that have completed IDA programs; these highly-integrated programs acknowledge that IDA program participation and completion reduces borrower risk. Therefore, IDA holders are rewarded with decreased loan requirements.

Overview of the Asset-Based Approach to Poverty Alleviation

Public policy in the United States has traditionally focused on maintaining or replacing the *incomes* of impoverished individuals, while in contrast, it has encouraged *asset accumulation* for the non-poor. U.S. policy subsidizes both savings and debt instruments for the accumulation of assets by members of the middle and upper classes through the deduction of mortgage interest expenses and the support of 401(k) retirement plans. Recently, policymakers have begun to recognize that, in addition to income maintenance, asset accumulation is also a viable approach to alleviating poverty.

Microenterprise Development and Individual Development Accounts

Two of the most important strategies for asset development among the poor are MED and IDAs.

Microenterprise Development

MED is a strategy for low- to moderate-income people to build income, assets, and economic self-sufficiency through entrepreneurship. A microenterprise is a sole proprietorship, partnership, or family business that has fewer than five employees. It is small enough to benefit from loans less than $35,000 and is generally too small or otherwise unable to access commercial banking services. MED programs have traditionally provided low- to moderate-income entrepreneurs with training, technical assistance, and small loans, or some combination of these services.

Two of the most important strategies for asset development among the poor are microenterprise development and Individual Development Accounts.

While IDA programs promote responsible savings behavior, MED programs promote responsible credit management—two complimentary sides of the asset-building coin.

Individual Development Accounts

IDAs were first proposed by Michael Sherraden in his pioneering work, *Assets and the Poor* (1991). Similar to 401(k)s, IDAs are a financial and economic development tool that enables low- to moderate-income families to save, build assets, and enter the financial mainstream. IDAs reward the monthly savings of individuals with matching funds (generally at a rate of $1 to $4 for every dollar saved) from a variety of private and public sources. IDAs have three primary uses: homeownership, education, and small business development or expansion (microenterprise). Depending on the specific program or funder, IDAs may have additional uses, such as computer or car purchase. Participation in IDA programs is voluntary, but is restricted to low- and moderate-income individuals through means and asset testing.

Most IDA programs include core financial literacy education and training specific to the particular asset the IDA holder is saving to acquire. For example, IDA holders saving for small business development receive entrepreneurial training. In fact, many of the community-based organizations that offer IDAs also run microenterprise development programs, providing loans, training, and technical assistance to low-income entrepreneurs.

Integrating IDAs and MED Products and Services

In the interest of maximizing natural synergies and minimizing program costs, the Corporation for Enterprise Development (CFED) is looking at integrated approaches to delivering IDA and MED products and services. Recently, CFED's research and development fund, the Local Capital Markets Investment Fund (LCMIF)—which invests in the development of products and services that expand financial resources, strengthen the portfolio performance, and enhance the economic impact of the development finance industry—began exploring the potential of an integrated approach.

In October 2001, LCMIF invested in the First State Community Loan Fund (FSCLF) to conduct pioneering research on current integration practices and to evaluate the performance of an integrated IDA-MED program and product design delivered through FSCLF and its partners in the statewide Delawareans Save! IDA Collaborative. The first year of this investment produced a conceptual framework for integrated program and product design and preliminary findings on current integration practice in the United States. The results include profiles of a number of MED and IDA programs with integrated elements (see page 4).

Why Integrate

IDAs and microenterprise-based strategies share common goals and methodologies. They support the accumulation of human and financial assets by the poor. While IDA programs promote responsible savings behavior, MED programs promote responsible credit management—two complimentary sides of the asset-building coin.

Currently, MED and IDA services are loosely linked, as MED programs offer IDAs and IDA programs provide MED services. Asset-specific training for IDA holders saving for small business development often resembles, or is identical to, MED training for microenterprise borrowers in both content and design. However, despite the potential synergies between IDA and MED programs, relatively little has been done by either practitioners or researchers to explicitly link these strategies.

Potential Benefits of Integration

Preliminary research conducted by CFED and FSCLF has identified potential benefits of integration including:

- Avoiding duplication in enrollment, intake, training, and counseling;
- Increasing deployment of and demand for loan capital by improving credit status and capital structures of microenterprises; and
- Mitigating lender risk by building equity through IDAs.

Avoiding Duplication. Organizations that operate both IDA and MED programs as independent, stand-alone entities may not only be missing opportunities to maximize synergies, but they are likely to be duplicating efforts, thereby incurring unnecessary program costs and subjecting clients to unnecessary requirements and time commitments. Areas of duplication may include enrollment or intake, eligibility assessments, training and counseling, or one-on-one technical assistance.

Increasing Deployment of Loan Capital. Although microentrepreneurs in the United States have expressed a desire to access credit, levels of demand for and deployment of microenterprise loan capital have been much lower than anticipated. Low deployment has serious consequences for the sustainability of microenterprise finance given that programs depend on interest and fee income from loan portfolios to cover operating costs. According to the Aspen Institute's Microenterprise Fund for Innovation, Effectiveness, Learning, and Innovation (FIELD), there are four primary reasons for low rates of deployment of loan capital (Clark & Kays, 1999):

1. Client aversion to debt
2. Poor or no credit history
3. Access to other sources of credit
4. Lack of equity capital

By integrating IDA and MED products and services, programs ensure that clients have access to financial literacy education, credit repair opportunities, and IDA equity capital, which are valued as credit enhancements when MED programs evaluate and underwrite microenterprise loans. Credit enhancements come in the form of decreased loan requirements and acknowledge that participation in IDA programs contributes to a reduction in borrower risk. In this way, integration has the potential to address the majority of barriers to low demand and deployment of debt capital, including debt aversion, credit history, and equity gaps.

Promoting Healthy Capital Structures and Mitigating Lender Risk. Historically, low-income microentrepreneurs rarely have had access to the equity capital that mainstream financial institutions require to reduce the risk of a loan. Instead microenterprise institutions both in the United States and abroad have provided loans to capitalize microenterprises. To compensate for the increased risk, these microenterprise lenders provide training and technical assistance to support borrowers and their businesses—boosting the capacity to operate the business and repay the loan. By integrating the IDA savings process into microenterprise lending, organizations can help a microentrepreneur develop a healthier capital structure that balances debt with equity, reduces the lender's exposure to risk, and enhances a growing business' chances of survival.

IDA-MED Integration Benefits

Clients

- One-stop shopping
- Decreased transaction costs (more streamlined process, fewer duplicative requirements)
- Increased credit-worthiness and access to loan capital
- Improved capital structure for business: enhanced business security and sustainability
- Increased household income and assets

Programs

- Increased recruitment and retention
- Increased targeting (of lower-income clients for microenterprise)
- Decreased costs per outcome (business started, loan deployed)
- Enhanced savings performance
- Increased loan volume
- Reduced credit risk
- Increased impact: client business sustainability/performance, household income and asset levels
- Decreased programmatic resources required (in comparison to starting and maintaining two stand-alone programs)

Defining Integration: LCMIF Research Findings

Rather than distinguish between non-integrated and integrated programs, findings show that it is helpful to define an integration spectrum. This spectrum ranges from:

Low integration. Basic coordination and referral of participants from one program to the other;

Medium integration. MED and IDA program design, training, and staff resources that maximize synergies and participant transition; and

High integration. Complements medium integration with credit enhancements for borrowers that have completed IDA programs; as discussed, these highly-integrated programs acknowledge that IDA program participation and completion reduces borrower risk. Therefore, IDA holders are rewarded with decreased loan requirements.[2]

The integration spectrum is often, but not always, cumulative so that programs move from low to high degrees of integration. High integration is not for all programs and depends on the individual needs of a target market and core competencies of a program.

IDA-MED Integration Practices

Low Integration

New York Association for New Americans, Inc. (NYANA)
New York, New York
A refugee services organization

IDA Income Eligibility	IDA Match Rate	Maximum Match $
At or below 200 percent of poverty	2:1	$2,000 per individual; $4,000 per household

Cumulative Microenterprise IDAs	Cumulative IDA Holders with Microloans	IDA Program Start Date
41	9	Oct. 1999

NYANA offers programs to aid refugees in their efforts to achieve financial independence.

Programs in NYANA's Business Center provide microloans, financial literacy training, and IDAs. They also provide referrals to other microlenders and financial institutions. NYANA's MED program serves all foreign-born individuals. However, only refugees, asylees, and Haitian and Cuban entrants may enroll in the IDA program. IDA savings may be used for microenterprise, homeownership, postsecondary education, home repair, or computer purchase.

NYANA requires microenterprise clients in its IDA program to attend 18 hours of management training workshops, which include instruction on how to write a business plan and six hours of training on money and assets. All training is conducted by NYANA staff. Clients also receive business counseling and complete a two-page business plan and financial projections. No special underwriting considerations are given to IDA holders in the microloan program. However, some microloan customers have enrolled in IDAs subsequent to enrolling in the MED program. NYANA receives funding from the U.S. Office of Refugee Resettlement (ORR).

Medium Integration

Jewish Family Services (JFS)
Columbus, Ohio
A social services agency

IDA Income Eligibility	IDA Match Rate	Maximum Match $
At or below 200 percent of poverty	2:1	$4,000

Cumulative Microenterprise IDAs	Cumulative IDA Holders with Microloans	IDA Program Start Date
183	15	1999

In keeping with the Jewish tradition of helping one's community, JFS provides social services to individuals and families of all backgrounds. JFS offers MED, IDA, and financial literacy training programs for both low-income and refugee populations in the Greater Columbus Metropolitan area and assists participants in building relationships with local banks. IDA savings may be used for microenterprise, homeownership, postsecondary education, home repair, transportation, or computer purchase.

Participants in the IDA program must attend four, two-hour training sessions and microenterprise clients must complete and submit a business plan before receiving matching funds. The microenterprise IDA program at JFS is linked to a microloan program. IDAs are treated as credit enhancements and IDA holders receive technical assistance. Microenterprise clients are encouraged to save in IDAs. JFS is funded by various institutions, including ORR and several banks.

High Integration

IDA-EDG
Arlington, Virginia
A refugee services organization

IDA Income Eligibility	IDA Match Rate	Maximum Match $
Refugees with income at or below 200 percent of poverty	2:1	$2,000 per individual; $4,000 per household

Cumulative Microenterprise IDAs	Cumulative IDA Holders with Microloans	IDA Program Start Date
11	1	Oct. 2000

IDA-EDG, housed at the Ethiopian Community Development Council, Inc., focuses primarily on asset building for refugees. IDA-EDG provides IDAs, financial literacy, and MED training in-house. It partners with other organizations to provide microloans. IDA savings may be used for microenterprise, homeownership, postsecondary education, home repair, transportation, or computer purchase.

IDA holders of IDA-EDG must attend five, two-hour classes in financial literacy and asset building and automatically qualify for microloans. These loans are available to IDA holders at a reduced interest rate. IDA savings may also be used to fulfill equity requirements for microloans. This program is funded through ORR.

Justine Petersen Housing & Reinvestment Corporation (JPHRC)
St. Louis, Missouri
A community development organization

IDA Income Eligibility	IDA Match Rate	Maximum Match $
At or below 200 percent of poverty; Or income below 80 percent area median	2:1(general); 1:1 (below 80 percent area median; for transportation	$600 annually

Cumulative Microenterprise IDAs	Cumulative IDA Holders with Microloans	IDA Program Start Date
75	Approx. 30 percent	Aug. 1999

The mission of JPHRC is to match institutional resources to the needs of low- and moderate-income families. JPHRC is a U.S. Small Business Administration intermediary lender that specializes in asset development and housing programs. JPHRC provides financial literacy training, MED training, and microloans in-house. JPHRC offers IDAs for microenterprise, homeownership, transportation, home repairs, or postsecondary education.

JPHRC offers two tracks of training for MED and IDA programs, both of which focus on loan readiness. Clients in the "Fast Track" program prepare business plans with minimal assistance from a loan counselor. In the "Technical Assistance Track," JPHRC counselors assist clients in completing a business plan questionnaire, market analysis, and cash flow projections. At JPHRC, participation in the IDA program is correlated with approval of a microloan application. For IDA holders with a low level of readiness, the IDA program creates and reinforces savings habits to ensure a buffer for cash flow issues. IDAs provide initial equity of $600 to $900 (including savings and match funds) to microentrepreneurs after six months of participation and help JPHRC establish relationships with potential borrowers. After six months, IDA holders with a moderate level of readiness qualify for a "Step" loan of $500 to $2,500. A "Next Step" loan of $2,501 to $5,000 is available, based upon the borrower's ability to repay the first loan and to save in the IDA program. For those with a high level of readiness, IDAs are paired with microloans and borrowers receive matching funds without restrictions. JPHRC receives funding from the United Way of St. Louis, the U.S. Department of Health and Human Services, the federal Assets for Independence Act, and Missouri State Tax Credits.

Preliminary Observations

The following preliminary observations were made during initial research:

- **A number of organizations have made the link.** In some cases, program managers indicated a desire or intent to make a more explicit connection.
- **Integration is not for everyone.** Depending on an organization's target market, microentrepreneurs served may prefer to save for their businesses rather than accumulate additional debt. Some program managers cited the need to give everyone an "equal opportunity" to access a loan, and rejected the idea of "privileging" IDA holders. Still others cited funding requirements as a barrier to integration.
- **One size does not fit all.** Some program managers assert that IDA participation should be mandatory for potential microborrowers. Others merely think that aspiring borrowers should be rewarded for credit-worthy behavior at the end of the day. Still others cited the IDA savings process and integration itself as a way to level the "borrowing playing field." Depending on the risk tolerance of the organization, a microloan may be provided up front or only after successful completion of the IDA program. IDA participation may fulfill or decrease loan requirements. Or it may have no effect.
- **Integration goes both ways.** Although the focus has been on bridging the gap between IDAs and microloans for IDA holders, there is some evidence that micro-borrowers also benefit from entering IDA programs, which can improve both the human capacity to operate the business and the financial capacity to repay the loan. Microborrowers can access the equity missing from their businesses' largely debt-dependent structures. Lenders benefit by decreasing their own exposure to risk.

It has become increasingly clear that low-income entrepreneurs, like their higher-income counterparts, need a variety of financial and non-financial services to support and grow their businesses. Like mainstream financial institutions, organizations providing IDAs and microenterprise services are beginning to test the benefits of integrating savings and credit instruments. There appear to be institutional benefits that come in the form of decreased exposure to risk and, potentially, increased loan volume with minimal underwriting costs. There are a variety of potential customer benefits, including increased access to capital, decreased transaction costs, and healthier capital structures for enterprises.

Based on preliminary research and product testing, CFED is in the process of expanding its investment in the development of integrated IDA-MED program and product designs. If you are currently implementing an integrated approach to delivering IDA and MED services, are interested in participating in this effort, or would like more information about IDA-MED integration, please contact Eliza Mahony at CFED, 202.408.9788 or eliza@cfed.org.

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[1] This bulletin is based on a more complete discussion of the integration of IDA and MED products and services in the following article: Glackin, Caroline E.W. and Eliza G. Mahony. (2002). "Savings and Credit for U.S. Microenterprises: Integrating Individual Development Accounts and Loans for Microenterprise." *Journal of Microfinance,* vol. 4, no. 2, pp. 93-124.

[2] For a more detailed discussion of credit enhancements, and some examples from 16 MED programs, see Glackin and Mahony (2002).

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