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# Microcredit 3.0: The Potential of Financing Business Assets for Financially Excluded Entrepreneurs


By: Joseph Curran

Mentor: Keith Douglass Warner, OFM

Reader: Naomi Andrews

# Abstract

Microcredit -- the provision of small loans to underserved micro-entrepreneurs -- intends to address the problem of financial exclusion by enabling business investments that increase borrowers' incomes. However, randomized evaluations indicate that microcredit in the form of small cash-based loans fails to significantly increase borrowers' incomes because loans are used for consumption or business investments that do not become profitable. While innovations identified as "Microcredit 2.0" have improved loans to better fit the reality of low-income markets, cash-based loans that require immediate repayment discourage long-term business investments. Therefore, there is the need for continued improvement through a "Microcredit 3.0" development that helps borrowers make long-term investments that increase their incomes.

A promising mechanism for "Microcredit 3.0" is financing the purchase of an income generating asset for specific sectors of financially excluded micro-entrepreneurs. GSBI® alumni social enterprises Tugende, Three Wheels United, and Juhudi Kilimo provide examples of "Microcredit 3.0" that demonstrate how clients can use revenue derived from the assets to facilitate repayment and, upon ownership, use the assets to increase their incomes. While "Microcredit 3.0" has potential, it necessitates sufficiently low interest rates to avoid predatory lending, strong customer care to foster a positive reputation, and the use of technology to lower operational costs. Furthermore, expectations for the transformative power of microcredit should be modest because underserved micro-entrepreneurs are constrained by limited market opportunities. Nevertheless, findings indicate that investments into "Microcredit 3.0" are prudent; however, funders must recognize that high interest rates have adverse effects on clients and provide capital accordingly. Further research is needed to determine how well "Microcredit 3.0" helps clients improve their lives and the lives of their dependents and to discern viable markets for asset-based financing.

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## Introduction

This study defines microcredit in accordance with Abdul Latif Jameel Poverty Action Lab (J-PAL) and Innovations for Poverty Action (IPA) as the provision of "small loans to underserved entrepreneurs."[1] The term "microfinance" is used to refer to the broad spectrum of financial services provided to low-income people, such as insurance and savings, in addition to loans. Employed as a tool for poverty alleviation, microcredit intends to enable borrowers to make business investments that increase their incomes. However, randomized evaluations reviewed by J-PAL and IPA indicate that microcredit in the form of small cash-based loans fails to do so. In order to explain why access to microcredit does not significantly increase borrowers' incomes, this paper traces two stages in the provision of microcredit, categorized as "Microcredit 1.0" and "Microcredit 2.0." An examination of these stages demonstrates that while innovations have improved loans to better fit the reality of low-income markets, cash-based loans that require immediate repayment prompt clients to spend on consumption and business investments that do not become profitable. Therefore, there is the need for microcredit products that facilitate long-term profitable business investments. Financing the purchase of specific business assets for financially excluded entrepreneurs, identified as "Microcredit 3.0," is presented as a response to this need. GSBI® alumni social enterprises Tugende, Three Wheels United, and Juhudi Kilimo provide examples of "Microcredit 3.0" that demonstrate its advantages and promising outcomes, as well as the challenges that it faces. This essay does not present "Microcredit 3.0" as a panacea, but rather argues that if interest rates are low enough to avoid predatory lending, strong customer care fosters a positive reputation among clients, and technology is used to effectively scale, it has the potential to help specific sectors of financially excluded entrepreneurs improve their lives and the lives of the people they care for.

[1] "Where Credit Is Due," Abdul Latif Jameel Poverty Action Lab (J-PAL) and Innovations *for Poverty Action (IPA)* J-PAL and IPA Policy Bulletin (2015): 2.

# The Outcomes of Microcredit: A Disconnect between Theory and Practice

## The Intended Effect of Microcredit

Microcredit responds to the problem of financial exclusion and aims to enable borrowers to make business investments that increase their sales and profits, thereby increasing their incomes. With increased incomes, borrowers are believed to enjoy other standard of living improvements, such as increased savings and spending on education, health, and other assets, as well as increased satisfaction with life and social empowerment.[2]

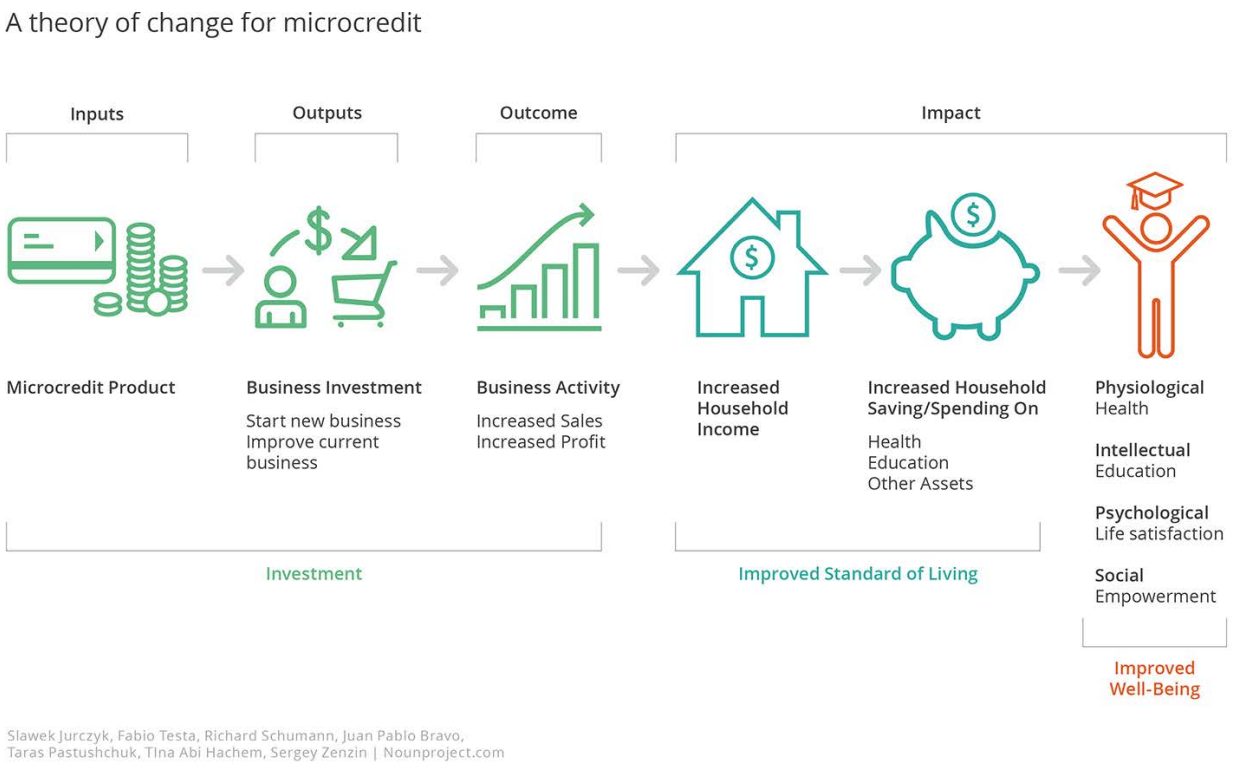


**Figure 1:** A Theory of Change for Microcredit[3]

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[2] "Microcredit: Impacts and Limitations," *The Abdul Latif Jameel Poverty Action Lab*, April 2018; Morduch, Jonathan, "The Microfinance Promise," *Journal of Economic Literature* 37, no. 4 (December 1999): 1570.

[3] "Where Credit is Due," 6.

## The Findings of Randomized Evaluations: Scant Evidence of Increased Incomes

Despite the intention to increase household incomes, evidence suggests that microcredit in the form of small cash-based loans does not effectively do so. J-PAL and IPA reviewed seven randomized evaluations of microcredit programs and reported, "none of the seven studies found a significant impact on average household income for borrowers."[4] Furthermore, while increased incomes are theorized to increase spending on education, "in the six studies in which it was measured, microcredit access did not increase children's schooling."[5] In addition to not increasing incomes or education spending, microcredit has received criticism for causing borrowers to fall into debt and increasing stress and depression levels. For example, the government of Andhra Pradesh in India blamed SKS for the suicide of 57 farmers, accusing loan officers of compelling clients to over-borrow and engaging in forceful recovery practices.[6] Furthermore, half of borrowers in a 2013 Cambodian study reported that they struggle to repay loans and that in order to repay they "reduced the quality of their meals, took out new loans, postponed medical care, and sold or pawned belongings. Borrowers also sent family members away to work."[7] In his review of 6 studies, Abhijit V. Banerjee found that some borrowers borrow more and at higher rates than they should; however, the J-PAL and IPA review found no evidence that microcredit causes households to overextend themselves and fall into debt.[8] While the J-PAL and IPA review has different conclusions about the negative effects of microcredit than the Indian government and the Cambodian study, there is consensus about the need for improvement.

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[4] Ibid., 1.

[5] Ibid., 13.

[6] Banerjee, Abhijit V., and Esther Duflo. Poor Economics: A Radical Rethinking of the Way to *Fight Global Poverty*. New York, New York: Public Affairs, 2011: 169, 176.

[7] Bylander, Maryann, and Eula Biss, "A Conflict of Interest: Microcredit's rhetoric of empowerment masks what is really an investment in poverty," *The Baffler*, February 5, 2019.

[8] Banerjee, Abhijit V., "Microcredit Under the Microscope: What Have We Learned in the Past Two Decades, and What Do We Need to Know?" *Annual Review of Economics* 5, no. 1 (2013): 513; "Where Credit Is Due," 13.

# The Innovations and Limitations of Microcredit Developments: A Need for Continued Improvement

## The Innovations of "Microcredit 1.0" and "Microcredit 2.0"

Muhammad Yunus and Grameen Bank popularized microcredit, establishing a foundation that has been built upon as innovations have worked to address deficiencies and better fit products to the realities of clients' lives. In the 1950s, it became popular for countries to include the provision of subsidized credit in their development strategies to alleviate poverty. However, it was not especially effective because it was common for loan repayments rates to drop lower than 50 percent and for credit to end up in the hands of individuals with political power, rather than the intended recipients.[9] In the mid 1970s, Muhammad Yunus learned through conversing with villagers in Bangladesh that the poor often lack access to credit from financial institutions and are left with little choice but to borrow at unreasonably high rates. In response, he piloted a project in which he loaned small amounts to poor families. His model proved successful in terms of repayment and in 1983 he started Grameen Bank.[10]

### Excursus: Ancient Forms of Microcredit

Microcredit was reinvented and became a modern tool for poverty alleviation in the 1970s and 1980s, but its history begins well before then. In the Middle Ages, the Franciscan Friars – in partnership with lay Franciscans -- established lending institutions called *monti di pietà* in response to the prevalence of usury. The *monti di pietà* aimed to provide financial support without being charity and refrained from charging interest but included an administrative fee to cover operational costs. Other religious orders critiqued the *monti di pietà*, claiming that they were nothing more than

[9] Morduch, "The Microfinance Promise," 1570.

[10] Yunus, Muhammad, *Banker to the Poor: Micro-Lending and the Battle against World Poverty*. New York, New York: PublicAffairs, 2007: 47; "'Microfinance 2.0': New Tools, New Goals and New Ways to Lift People out of Poverty." *Wharton School of the University of Pennsylvania*, April 4, 2007.

a guise for usury. The institutions faced the challenge of financial sustainability and were eventually ordered by powerful families to make larger loans to wealthier clients. Thereby, the *monti di pietà* grew into "a financial arm of the state with administrative structures that were set to evolve into a modern banking institution."[11]

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The Grameen Bank model represents "Microcredit 1.0": the provision of small loans to groups of poor, majority female borrowers with joint liability to repay on a weekly basis. Joint liability refers to how borrowers sign a group lending contract and become co-signers to each other's loans.[12] Group lending contracts were designed in response to borrowers' lack of collateral and provide an incentive for borrowers to avoid defaults and help each other solve and prevent problems.[13] Groups are typically composed of five members and if one member defaults, the whole group is denied subsequent loans.[14] An elected chairperson manages each group, screens loan requests, and reports to the bank.[15] The groups meet and repay on a weekly basis beginning right after loan dispersal, and loans are typically repaid over one year and have a nominal interest rate of 20 percent.[16] Grameen Bank justifies the 20% interest rate because it is lower than the rates of informal lenders and the fixed interest rate for government-run microcredit in Bangladesh.[17] Yunus explains that the majority of borrowers are women because women "constitute the majority of the poor, the underemployed, and the

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[11] Bader-Saye, Scott, "Disinterested Money: Islamic Banking, Monti di Pietà, and the Possibility of Moral Finance," *Journal of the Society of Christian Ethics*, 33, no. 1, (2013): 127-128.

[12] Mendoza, Ronald U., and Brandon C. Vick, "From Revolution to Evolution: Charting the Main Features of Microfinance 2.0," SSRN Scholarly Paper. Bronx, New York: Fordham University, Department of Economics Discussion Paper No. 2008-03, February 1, 2008: 4; Morduch, "The Microfinance Promise," 1570.

[13] Yunus, Banker to the Poor, 66.

[14] Morduch, "The Microfinance Promise," 1575.

[15] Yunus, Banker to the Poor, 66.

[16] Morduch, "The Microfinance Promise," 1575, 1584.

[17] "Interest Rate," Grameen Bank- Bank for the Poor, 2019.

economically and socially disadvantaged" and because they are more successful than men at improving "the welfare of both children and men." Since the founding of Grameen Bank, microfinance institutions (MFIs) have altered and updated the ways in which they provide microcredit.[18]

In 2007, Alex Counts, CEO of Grameen Foundation, outlined "Microfinance 2.0 — a new generation of more accurate tools that can be used to overhaul the loan making system and apply the infrastructure of microfinance to other social woes."[19] Within "Microfinance 2.0," this paper identifies reforms aiming to improve microcredit products to better fit the reality of low-income markets as "Microcredit 2.0." For some MFIs, this entailed a transition from group lending towards individual-based systems that are more flexible.[20] In addition to flexibility, some MFIs started targeting their products to entrepreneurs to help ensure loans are used for business investments.[21] Overall, "Microcredit 2.0" represents a step in the right direction. However, as subsequent sections demonstrate, more steps are needed.

## The Problem of Using Loans for Consumption: A Consideration of Targeting Entrepreneurs

Restricting borrowing to entrepreneurs represents one mechanism to help ensure loans are used on business investments, but alone it does not sufficiently address why small cash-based loans fail to substantially increase incomes. In three out of the seven evaluations reviewed by J-PAL and IPA, MFIs did not target entrepreneurs. For these MFIs, evidence suggests that some borrowers use part of their loans for non-business expenses.[22] For example, the Banerjee et al. (2010b) randomized evaluation of

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[18] Yunus, *Banker to the Poor*, 73.

[19] "Microfinance 2.0."

[20] Mendoza and Vick, "From Revolution to Evolution," 7, 17.

[21] "Where Credit Is Due," 4.

[22] "Where Credit Is Due," 4.

Spandana's group-based microlending program, which is not restricted to entrepreneurs, found that "30 percent reported using a portion of their loans to repay existing loans, 15 percent to buy durable household goods, and 15 percent to smooth household consumption."[23] The other four MFIs reviewed by J-PAL and IPA target their products to entrepreneurs by requiring prospective clients to own or want to start a business, and, in one case, to have a business plan.[24] However, self-reported data from three of these evaluations indicates that some people still borrowed for non-business expenses.[25] If loans are used for consumption or repaying other loans, borrowers amass a debt they have to pay off without benefiting from an increased income that can help them do so.

One explanation for why borrowers use loans for consumption is that they do not want to be entrepreneurs. Entrepreneurship is risky, and many people desire more stability, which is demonstrated by how 80% of surveyed parents in India, when asked what occupation they want for their children, said a government job and no one mentioned starting a business.[26] However, the testimony of a Cambodian seamstress suggests another reason: she "wouldn't dare take a loan to expand or build a business" because it would not be "profitable enough to ensure monthly repayment."[27] While an advocate for microcredit, she reported using the loans for household expenses and facilitating repayment with money her children earn in Thailand.[28] This is indicative of a structural deficiency in microcredit products.

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[23] Ibid., 8

[24] Ibid., 4.

[25] Ibid., 8.

[26] Banerjee, "Microcredit Under the Microscope," 512.

[27] Bylander and Biss, "A Conflict of Interest."

[28] Ibid.

## The Problem of Unprofitable Business Investments: How the Structure of Loans Discourages Long-term Investments

Despite the use of loans for consumption, J-PAL and IPA evaluations found that access to microcredit results in increased business activity in most cases; however, business investments rarely become profitable. Specifically, in five out of the seven evaluations microcredit access correlated to an increase in business activity, but resulted in higher business profits in only two. Furthermore, the businesses that achieved higher profits were the "larger, pre-existing, or already profitable" ones.[29] Therefore, the crucial question is why microcredit does not help borrowers increase their profits. An examination of the evolution of microcredit indicates that the requirement of immediate repayment for cash-based loans discourages larger, long-term business investments that have the potential to increase profits.

"Microcredit 1.0," conscious of the psychological and financial difficulty for lower income people to pay a large sum at one time, instigated a weekly repayment schedule in which clients pay 2 percent of the loan each week for 50 weeks.[30] "Microcredit 2.0," in acknowledgement that weekly repayments are difficult for people with variable incomes, took a "client-oriented approach that focuses on the characteristics of local consumers."[31] Grameen II, for example, allowed staff members to design the loan product to better fit clients' needs and added a "flexible loan" option for borrowers who face trouble repaying, allowing them to pay less each week for a longer period of time.[32]However, a key discontinuity between the structure of microcredit products and the intended outcomes remains: repayment begins immediately, but it often takes time for a business investment to pay off. The Banerjee et al. (2010b) study ran for three years to discern whether a lack of increased income among borrowers was the result

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[29] "Where Credit Is Due," 10.

[30] Yunus, Banker to the Poor, 61.

[31] Mendoza and Vick, "From Revolution to Evolution," 7, 17.

[32] Yunus, Banker to the Poor, 238-240.

of long-term investments, but, similar to the other 6 studies, it found a lack of increased incomes.[33]

Immediate repayment not only requires borrowers to have an additional source of income to repay, but also discourages taking risks because there is not enough time to recover in case investments do not work out. While this helps ensure high repayment rates, it fails to catalyze profitable business investments that are inherently risky. In addition to immediate repayment, Banerjee notes that the small loan sizes limit the investment options of borrowers.[34] This helps inform the use of loans for consumption, the lack of increased business profits, and the overall limited demand for microcredit, which is indicated by the fact that only between 13 and 31 percent of individuals offered microcredit products in four studies took up microloans.[35] In response to these problems, Banerjee asks, "Is it possible to help borrowers make better use of the loan?"[36]

# A Response to Roadblocks in "Microcredit 3.0": Asset-based Financing for Financially Excluded Entrepreneurs

## How Three GSBI® Alumni Help Clients Achieve Ownership of Business Assets

"Microcredit 3.0," by financing the purchase of an income-generating asset for specific sectors of financially excluded entrepreneurs, facilitates a long-term business investment and addresses Banerjee's call to help borrowers make better use of loans.

[33] "Microcredit: Impacts and Limitations."

[34] Banerjee, "Microcredit Under the Microscope," 511.

[35] "Where Credit Is Due," 7.

[36] Banerjee, "Microcredit Under the Microscope," 515.

In this way, it builds on the trend of tailoring products to clients' needs and provides a mechanism to realize the vision for "Microfinance 3.0," which calls MFIs to offer a diversity of products aimed at specific client needs.[37]

## Excursus: Ancient Forms of Microcredit

The identification of this development as "Microcredit 3.0" is in some ways deceiving because it is not an entirely new innovation; rather, it is informed by Murabaha, an Islamic microfinance contract. Islamic finance, guided by the precepts that money has no intrinsic worth and that fund providers must share risks with borrowers, prohibits "practices considered unfair or exploitative, forbids the use of interest rates, and stipulates that "investments may be made only in real, durable assets."[38] As microcredit became increasingly popular, Islamic microfinance contracts, such as Murabaha, were developed so financially excluded Muslims could receive loans.[39] Murabaha is an asset-based sale in which clients request a specific commodity for purchase and the financier buys the asset and resells it to the client at a marked-up price. The markup is fixed and not affected by the length of repayment; furthermore, the financer owns the asset until the client pays in full, which is typically accomplished through equal installments.[40] While most Murabaha clients have existing businesses, some Murabaha contracts differ from "Microcredit 3.0" because they may be for a commodity that is not a business asset.[41]

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[37] Adler, Matthias, "'Microfinance 3.0' – Perspectives for Sustainable Financial Service Delivery," In *Microfinance 3.0: Reconciling Sustainability with Social Outreach and Responsible Delivery*. Springer Publications, 2013: 129.

[38] Karim, Nimrah, Michael Tarazi, and Xavier Reille, "Islamic Microfinance: An Emerging Market Niche," *CGAP*, 2009: 1-2.

[39] Ibid., 1-2.

[40] Ibid., 3.

[41] Obaidullah, Mohammed, and Tariqullah Khan. "Islamic Microfinance Development: Challenges and Initiatives." Policy Dialogue Paper No. 2. Islamic Research & Training Institute, May 1, 2008: 20.

Tugende, Three Wheels United (TWU), and Juhudi Kilimo, three GSBI® alumni social enterprises, provide examples of "Microcredit 3.0." Tugende addresses the problem that 70% of the 800,000 motorcycle taxi drivers in East Africa rent their motorcycles because banks and other MFIs refuse to lend to them because of their credit risk and inability to put up collateral. This creates an equilibrium in which drivers are stuck renting, which results in reduced take-home income and job insecurity. In response, Tugende offers a lease-to-own motorcycle financing package.[42] TWU addresses a similar problem to Tugende: in India, 50% of the 12 million auto rickshaw drivers rent their vehicles because of unaffordable and inaccessible financing options, which reduces their take-home incomes. TWU provides affordable loans for the purchase of vehicles that are more fuel efficient and emit less CO2 than standard auto rickshaws.[43] Juhudi Kilimo, addressing the lack of financial services available to rural smallholder farmers in East Africa, provides loans to purchase agricultural assets and partners with local suppliers to coordinate and track the purchase.[44] Juhudi Kilimo has three categories of asset-based loans: farm animal loans, crop farming loans, and farm equipment loans.[45]

These social enterprises address the problem of immediate repayment because borrowers can use part of the income they derive from the assets to service the loan. For example, the respective clients of Tugende and TWU receive a motorcycle or rickshaw that they start driving and generating income from immediately. Similarly, many of the assets Juhudi Kilimo finances, such as cows and poultry, generate immediate and consistent income. Upon full repayment, ownership is transferred to the clients of Tugende, TWU, and Juhudi Kilimo. In addition to helping clients achieve ownership of business assets, "Microcredit 3.0" enables social enterprises to tailor

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[42] Tugende, "Tugende Company Presentation," Miller Center for Social Entrepreneurship, March 2018.

[43] Three Wheels United, "Three Wheels United: Poverty and Pollution Reduction through Green Asset Financing," Miller Center for Social Entrepreneurship, August 2018.

[44] Raube, Kristiana, "Juhudi Kilimo: Designing Microfinance Staff Incentive Plans (A)," University of California Berkeley Haas School of Business Berkeley-Haas Case Series (February 19, 2014): 2.

[45] "Products and Services," Juhudi Kilimo, 2017.

business trainings to the specific sectors of entrepreneurs and use the assets as the primary form of collateral, as is subsequently considered. The main differences between “Microcredit 1.0,” “Microcredit 2.0,” and “Microcredit 3.0” are summarized in Table 1.

**Table 1.** Differences between Microcredit Stages

| **Attributes** | **Microcredit 1.0** | **Microcredit 2.0** | **Microcredit 3.0** |
|---|---|---|---|
| Clients are entrepreneurs | ? | + | + |
| Loans are used for profitable business investments | ? | ? | + |
| Long-term business investments are incentivized | - | - | + |
| Trainings and auxiliary services are tailored to clients’ businesses | - | - | + |
| Clients’ business investments work as collateral for the loans | - | - | + |
| Loans increase clients’ incomes | - | - | + |

## The Benefits of Sector-Specific Business Trainings

The evolution from general microcredit products to asset-financing for specific sectors of entrepreneurs increases the degree and sophistication of trainings provided to borrowers. Basic financial literacy trainings have accompanied the provision of microcredit throughout modern microcredit developments. While the effectiveness of trainings has been questioned, a 2007 randomized control trial conducted by Karlan and Valdivia found that “training leads to increased business knowledge, practices and

revenues for the program participants."[46] "Microcredit 3.0," benefiting from sector specific customer segments, can provide trainings and auxiliary services tailored to their customers' businesses. For example, Tugende, in addition to financial literacy trainings, has mandatory trainings on road safety and customer service.[47] Likewise, Juhudi Kilimo, on top of business management and financial literacy trainings, provides technical trainings in agricultural practices and animal husbandry.[48] These trainings, if conducted effectively, can help borrowers maximize the use of their assets.

## The Advantages of Using Assets as Collateral

"Microcredit 3.0," by using assets as the primary form of collateral, enables the provision of secured loans to entrepreneurs unable to put up significant amounts of cash for collateral. In the event of default, assets can be repossessed and clients are left roughly at the same level of poverty as before receiving the loans, which is more advantageous than putting them further into debt or poverty.[49]

## The Outcomes of Asset Ownership

Financing the purchase of a productive business asset represents an improvement that, while by no means a magic bullet, has potential for increasing the incomes of specific sectors of financially excluded entrepreneurs. Research on the effect of asset-based finance on business growth is currently being conducted in Pakistan, but available evidence on the impact of GSBI® alumni is promising.[50]

Research on the outcomes of motorcycle ownership was conducted by 2018 Global Social Benefit Fellows Curran and Hsia, who surveyed 301 Tugende clients that have

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[46] Mendoza and Vick, "From Revolution to Evolution," 19-20.

[47] "Our Approach," Tugende, 2019.

[48] "Training," Juhudi Kilimo, 2017.

[49] Tandong, Cedrick, "Three Wheels United Presentation as a Part of GSBI Accelerator In Residence," Santa Clara, CA, August 2018; Raube, "Juhudi Kilimo," 4.

[50] "Asset-Based Finance for Microenterprises in Pakistan." *Innovations for Poverty Action*, 2016.

completed at least one lease.[51] The study found that ownership increased the incomes of 51% of drivers because of the elimination of renal fees equal to about 2.65 USD per day, while 45% of customers leveraged their newly owned assets to create new revenue streams. Of the 45%, 23% sold their motorcycles and used the earnings to make investments in land, agriculture, and other businesses, while 22% reported that they rent out their motorcycles. Furthermore, self-reported data suggests that increased incomes help clients support an average of 7.1 dependents and pay school fees for an average of 2.6 students. Tugende customers also said that ownership has enabled them to create and invest in other businesses, most prominently in agriculture and retail. Overall, customer testimonials suggest that ownership increases opportunities; for examples, one client said, "I am targeting bigger dreams and Tugende is my way to achieve my dreams."[52]

TWU, addressing a similar problem to Tugende, reports that the elimination of rental fees doubles clients' incomes.[53] Juhudi Kilimo estimates that every $1 of asset-worth loaned to customers provides a social-economic value of $46 in a country with an annual per capita income of $1,800. This is because access to animals, fertilizers, seeds, and other agricultural inputs increases the size, diversification, and productivity of clients' farms. Juhudi Kilimo reports that after 5 or 6 loans, clients are able to put their children through school and employ several people to take care of their farms.[54]

While the outcomes of "Microcredit 3.0" have yet to be subject to randomized trials, available evidence suggests that it increases clients' incomes. At the very least, it demonstrates an ability to help borrowers make a long-term and potentially high-return investment. Nevertheless, it still faces challenges.

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[51] Curran, Joseph, and Anne Hsia, "A Vehicle Out of Poverty," Miller Center for Social Entrepreneurship, 2018.

[52] Ibid.

[53] "The Impact," Three Wheels United, 2015.

[54] Raube, "Juhudi Kilimo," 4.

## Saturated Markets: A Cause for Concern

Low-income entrepreneurs often own businesses in saturated markets, which makes it difficult for them to increase their profits.[55] While asset-based financing is a promising mechanism to help underserved entrepreneurs increase their incomes, it is constrained by this problem. For example, there are thousands of other drivers that offer services similar to the clients' of Tugende and TWU and if their services are not differentiated from their competitors, getting more clients or charging higher prices is unlikely.[56] While asset ownership eliminates rental fees and creates new revenue streams, consideration of the market limitations that underserved entrepreneurs face helps inform realistic expectations for the transformative potential of microcredit.

# Recommendations for "Microcredit 3.0"

## Avoid Predatory Lending

Tugende, TWU, and Juhudi Kilimo are all for profit social enterprises that, in order to finance the purchase of assets, require a considerable amount of capital. While the promise of higher financial returns may help attract investment, it is necessary to consider the effect this has on the amount customers end up paying because, as Maryann Bylander points out, "returns come out of their pockets."[57] SKS, for example, was quite successful from a financial standpoint given that it achieved billion dollar valuations; however, it did so by charging its customers high interest rates.[58] In order to ensure that "Microcredit 3.0" social enterprises do not become predatory lenders, the pursuit of financial sustainability must be balanced with interest rates and lease terms that allow borrowers to achieve ownership at low costs. The prospect of falling asset

[55] "Where Credit Is Due," 10.

[56] Ibid.

[57] Bylander and Biss, "A Conflict of Interest."

[58] Sunderasan, S. "SKS Microfinance: The Sour Taste of Success." *Richard Ivey School of Business* (2012): 2.

prices and the effect of external factors, such as changes in the amount drivers and farmers receive for their services and goods, respectively, and gas prices for Tugende and TWU clients, must also be considered.

## Focus on Customer Care and Human Resources

While "Microcredit 3.0" shows promise in its ability to help clients increase their incomes, strong customer care is necessary to ensure a positive reputation. Given that referrals are the main channels in which new clients are attracted to Tugende, TWU, and Juhudi Kilimo, a positive reputation is pivotal.[59] For Juhudi Kilimo, it has proven vital to build trust and credibility because many farmers, informed by experiences in which loan sharks and money lending institutions took advantage of them through high interest rates, are initially distrustful. However, once some farmers have positive experiences with Juhudi Kilimo, the word spreads and demand for its products increases significantly.[60] Strong customer care has the potential to demonstrate that "Microcredit 3.0" social enterprises are invested in the success of their clients. It also provides a mechanism for extending resources to help clients maximize the use of their asset. Nat Robinson, former CEO of Juhudi Kilimo, explains how this manifests in practice, saying, "The loan officers make sure the farmer has enough land to grow feed for the cow and have good markets where they can sell the milk… Then they help manage those repayments for the group and do follow-ups if someone is not paying and try to advise if they need help finding agriculture experts or better markets or have questions."[61]

Strong customer care is largely dependent on the hiring, training, and workload of loan officers and the other employees that interact with clients. Tugende, TWU, and Juhudi Kilimo all have aggressive growth strategies, which necessitates significant investment

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[59] Raube, "Juhudi Kilimo," 6-7; Tandong, "Three Wheels United Presentation"; "Tugende Company Presentation."

[60] Raube, "Juhudi Kilimo," 6-7

[61] Ibid., 7.

in human resources in order to maintain high standards of customer care.[62] While the pursuit of funding may take a significant amount of time and energy, it is important to not overlook the challenge of hiring, training, and supporting new employees. TWU, for example, projected the need to hire 500 people in its first year of growth, equating to four hires per each current employee.[63] It is crucial to develop hiring criteria that ensures new employees are aligned with the social mission and that training modules both equip hires with the requisite skills and establish customer treatment standards. Furthermore, continued evaluation of the effect of high targets on the nature of customers relations is of utmost importance. A set of company values, which were established by Tugende, can also help shape a company culture.

## Boost Efficiency Through Technology

Replacing cash repayments with mobile-money transfers can reduce operational costs and enable effective scaling. All three GSBI alumni take advantage of mobile money: Juhudi Kilimo employs mobile money transfers, Tugende uses a combination of mobile money and other digital payment channels, and TWU has the goal to move entirely to mobile money and is currently at 50%.[64]

Mobile technology can also reduce paperwork in the vetting process, provide up to date accounting information for officers in the field, and enhance trainings. For example, in 2013 Juhudi Kilimo started supplying its loan officers with tablets and found it helped officers input client information and identify who has paid. It also enabled them to provide more technical trainings and show testimonials of other farmers to enhance branding.[65]

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[62] "Tugende Company Presentation"; "Three Wheels United: Poverty and Pollution Reduction through Green Asset Financing"; Juhudi Kilimo, "Juhudi Kilimo," Miller Center for Social Entrepreneurship, 2013.

[63] Tandong, "Three Wheels United Presentation."

[64] "About Us," Juhudi Kilimo, 2017; "Our Approach"; Tandong, "Three Wheels United Presentation."

[65] Raube, "Juhudi Kilimo," 8.

Of the three GSBI alumni, TWU has invested the most in mobile technology through developing its own mobile application that serves a number of purposes. On the client side, the app hosts a virtual game of cricket in which groups of drivers compete against each other, introducing an aspect of social competition. It also provides GPS technology for its clients to optimize their routes. For collections agents, it uses repayment data collected over time to prioritize drivers that require more attention. Eventually, it aims to use this data to better understand the behavior patterns of drivers and improve its product. The app also enables TWU to have training capability in different languages. Furthermore, TWU has a kill switch in case it needs to recover a vehicle due to default.[66]

While the effectiveness of aspects of TWU's app, such as the cricket game, is unknown, the transition to mobile money and the adoption of mobile technology reduces paperwork and provide employees with up to date information throughout the vetting and collections processes. Furthermore, the training capacity of mobile technology may, depending on the content of trainings, help customer's increase their profits.

## Conclusion

This essay, by tracing microcredit developments, identifies a key problem facing microcredit in the form of small, cash-based loans: small loan sizes and immediate repayment discourage long-term, profitable business investments. These limitations prompt borrowers to use loans for consumption or on business investments that do not become profitable, which fails to increase their incomes. "Microcredit 3.0," by financing the purchase of an income generating asset, addresses this problem and demonstrates promise in its ability to help clients' increase their incomes. However, it is

[66] Tandong, "Three Wheels United Presentation."

important to have modest expectations for its transformative power given the limited market opportunities for underserved entrepreneurs.

In order for “Microcredit 3.0” to avoid predatory lending, funders must recognize that high financial returns place an undue burden on clients. Furthermore, while rapid growth helps “Microcredit 3.0” social enterprises reach economies of scale, it is crucial to consider the human resource requirements and not sacrifice customer care. Finally, investments into mobile technology, especially the adoption of mobile money transfers, can reduce operational costs.

Future research should evaluate how well “Microcredit 3.0” helps clients improve their lives and the lives of their dependents in a variety of contexts and determine what sectors of micro-entrepreneurs are appropriate customer segments.

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Photo credit: Santa Clara University

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