The Journal of Extension

Volume 53 | Number 2 | Article 15

4-1-2015

An Extension Case Study in Institutional Innovation: Microfinance Intermediary Formation

Mark A. Edelman
Iowa State University, medelman@iastate.edu

Recommended Citation
Edelman, M. A. (2015). An Extension Case Study in Institutional Innovation: Microfinance Intermediary Formation. *The Journal of Extension, 53*(2), Article 15. https://tigerprints.clemson.edu/joe/vol53/iss2/15

April 2015
Volume 53
Number 2
Article # 2FEA4
Feature

An Extension Case Study in Institutional Innovation: Microfinance Intermediary Formation

Abstract

An institutional innovation process led by Extension created a statewide microfinance intermediary. The intermediary provides business technical assistance and microloans to entrepreneurs having difficulty securing conventional credit but having workable business plans. The process included (1) gathering indicators of a problem; (2) formation of a steering committee of relevant interests to study the concerns; (3) a search for alternative solutions and assessment of probable consequences; and (4) emergence of an institutional strategy for addressing gaps. A business plan was implemented over 5 years. The collaboration created new opportunities on multiple levels for Extension problem-solving impacts and outcomes.

Mark A. Edelman
Professor of Economics
Extension Public Policy Specialist
Community Vitality Center Director
Iowa State University
Ames, Iowa
medelman@iastate.edu

Economic downturns can lead to policy changes for financial institutions and gaps in access to capital for the business sector. This phenomenon widely occurred in the 1930s following the onset of the Great Depression. It also occurred during the more recent Great Recession. Economic shocks in 2008 and subsequent policy adjustments by local financial institutions and their regulatory examiners changed loan-underwriting standards faced by many entrepreneurs. The new standards required more equity per dollar of debt in conventional commercial loan project applications. Changed standards were among the factors creating gaps in capital access faced by many existing and potential entrepreneurs.

A university Extension center (1) gathered indicators of emerging gaps in entrepreneurial access to capital; (2) formed a steering committee of diverse relevant interests to study the concerns and verify the gaps; (3) searched for alternative solutions and assessed the probable consequences; and (4) built consensus and capacity for a preferred institutional strategy to address the problem. A statewide microfinance intermediary was organized to provide business technical assistance and microloans to entrepreneurs with workable business plans after difficulty in obtaining conventional credit. In 5 years of lending, the institutional innovation created new opportunities on multiple levels for Extension problem-solving impacts. The case study herein reports several insights and outcomes.

Review of Literature

The U.S. Small Business Administration (SBA) defines microenterprise as a small business with five or fewer employees, including the owner. The Association for Enterprise Opportunity, a national trade association of entities providing loans, training, and technical assistance to small entrepreneurs, uses the SBA definition and estimates that 26.4 million or 88.9% of all U.S. businesses are microenterprises (AEO, 2013). While micro-enterprises represent the vast majority of business entities in the U.S., they only account for 22.5% of the nonfarm workforce (AEO, 2013). A majority of microenterprises are home-based enterprises.

Schmidt, Kolodinsky, Flint, and Whitney (2006) have examined the benefits of microenterprise training and development on low-income clients. A recent study (Burhouse, Osaki, & Sarna, 2013) found that 28% of national survey respondent households were "unbanked" or "underbanked." The "unbanked" category households lack minimum balances to open checking or savings accounts in a financial institution. The "underbanked" category used nontraditional financial services such as "payday loans" offered outside the banking system. Both groups are characterized as low income.

Rural Policy Research Institution studies (Freshwater, Barkley, Markley, Rubin, & Shaffer, 2001) found rural gaps and rural-urban differential access by entrepreneurs to seed and equity capital markets. The rural seed and equity markets were described as being spotty, diverse, more informal, and requiring patient capital accepting of lower returns, while metropolitan markets were described as being more formal and requiring higher returns with defined exit strategies.

Federal policies and programs are developed periodically to address capital access issues. Many agricultural and rural entrepreneurs enjoy preferential access to loan capital at below-market interest rates from USDA. More recent policy innovations such as the Community Reinvestment Act, Community Development Financial Institution Fund, and New Market Tax Credits have been designed to address capital access by defining criteria for low-income, economic distressed, and population decline census tracts (U.S. Treasury Dept., 2014). Still, as gaps emerge locally, a relevant group of leaders must become aware of the available tools and be willing to adjust existing services or develop new institutional mechanisms to enable benefits for local constituents.

Bassono and McConnon examined how strategic partnerships can enhance Extension's community-based entrepreneurship programs (Bassono & McConnon, 2011). The opportunity for innovation often occurs when the educational and technical assistance support institutions such as Extension are also simultaneously experiencing fiscal stress. Institutional innovation often occurs 2 to 5 years subsequent to the economic downturn (Otto & Edelman, 1990). Their research found that economic downturns often result in lagged contractions in public revenues, which can induce institutional innovation in provision of local services. Alternative approaches for induced innovation included reconfigured services, functional consolidations, geographic consolidations, outsourcing of services, adoption of new technologies, and creation of new special purpose entities.

Disruptive innovation (Franz & Cox, 2012) is defined as a process to purposefully organize outside-in analysis to identify gaps and opportunities, search for alternative solutions, and create implementation plans with institutional innovations to address the gaps in the current context of stakeholder and institutional circumstances. Disruption can also be caused by any number of internal or external shocks to the socio-economic system and/or institutional regime. For example, this theory implies the "2008 Great Recession" might have created a change in expectations and "disrupted the trajectory of traditional improvement" for many Extension clienteles that in turn instigated a search for relevance in Extension institutions and programs.

Gap Analysis and Institutional Innovation Planning Process

Gap analysis represents one tool that was used to initiate and manage a process for disruptive innovation. Comments from entrepreneurs and their support networks in 2006 led two university Extension-oriented centers to examine Iowa's entrepreneurial development system. The Community Vitality Center staff received feedback from Iowa Small Business Development Centers (SBDCs) that small entrepreneurs who received SBDC technical assistance were having difficulty in accessing loans from local financial institutions. Similarly, staff at the Leopold Center for Sustainable Agriculture received feedback from local food system entrepreneurs with unique enterprises who were having similar difficulty accessing loans from local lenders.

Organization of Steering Committee

The two centers formed a statewide steering committee to conduct a gap analysis. The steering committee included 16 representatives from urban and rural entrepreneurial networks, financial institutions, and entrepreneurial support organizations, including Extension, university entrepreneurial centers, community colleges, local development corporations, and nonprofit organizations focusing on low-income entrepreneurs.

The steering committee met monthly. A series of interviews were conducted with coordinators of entrepreneur assistance networks. A survey of bankers was conducted by the Community Vitality Center and Iowa Bankers Association. The study identified four gaps: (1) entrepreneurs experienced difficulty in accessing business loans of $50,000 or less; (2) a disconnect existed between local entrepreneurs and regional entrepreneur assistance networks; (3) entrepreneurs with unique enterprises experienced some difficulty accessing loans up to $250,000 due to lack of underwriting expertise for unique enterprises; and (4) some interest was expressed for improving access to equity capital.

Directional Consensus and Search for Solutions

The steering committee agreed by consensus that a specialized loan fund targeted to small entrepreneurs was needed to address the gaps. Several alternative models were explored. Historically, Extension facilitated nonprofit farm business associations, crop-improvement associations, and dairy-herd improvement associations. During the 1990s, Extension facilitated formation of an agricultural value-added business development cooperative and rural angel investor network called Ag Ventures Alliance (AgVA, 2014). Other university-based nonprofit entrepreneurial assistance boards and loan programs were examined, including ISU's nonprofit Research Park and Iowa Energy Center Loan

Program. Discussions were held with the Rural Entrepreneur Assistance Program (REAP) leaders in Nebraska about their use of the SBA Microloan Program. A delegation visited Northern Initiatives Inc., a nonprofit microloan and business technical assistance provider developed in partnership with the University of Northern Michigan.

Nonprofit Action Plan Development

Private sector committee members insisted that duplication be avoided by asking existing organizations to consider program expansion to address the gaps before consideration is given to forming any new organization. Inquiries were made with several organizations that declined. Each mentioned higher priorities for achieving their missions, such as housing, regional focus, or technical assistance. Siouxland Economic Development Corporation (SEDC) is an example of entities contacted. SEDC possessed a successful 15-year track record with the SBA MicroLoan program. However, SEDC's mission was to serve entrepreneurs and businesses in its six county metro-trade area. In the final analysis, a 5-year business plan was developed for creation of a new nonprofit with a statewide mission. The SEDC executive director agreed to collaborate and serve as the Board Chair of the new statewide venture so that entrepreneurs in the remaining 93 counties could access a microloan program. The steering committee morphed into the founding board of directors.

Assembling the financial resources for launching the new entity was facilitated with contributions from steering committee organizations and commitments from the Community Foundation of Greater Des Moines, Northwest Area Foundation, and congressionally directed appropriations from the ISU Community Vitality Center via the U.S. Department of Agriculture. Beginning in March 2008, Articles of Organization, application for charitable nonprofit status, and application for SBA Microloan intermediary status were filed for the new entity called the Iowa Foundation for Microenterprise and Community Vitality. Iowa MicroLoan is the program name for marketing purposes. A former community banker with 27 years of experience was hired as President to lead the new nonprofit. A marketing initiative preceded lending operations, which began with the first loan approval in February 2009.

Impact Assessment After Five Years of Operations

Iowa MicroLoan currently provides loans of $5,000 to $50,000 for up to 6 years at an annual percentage interest rate of 8.125%. Iowa MicroLoan is a statewide intermediary for the Small Business Administration (SBA) Microloan Program and Department of Agriculture (USDA) Rural Microentrepreneur Assistance Program (RMAP). Iowa Microloan underwriting standards are similar but more flexible than those of conventional lenders. During 5 years of lending, Iowa MicroLoan approved more than 75 loans to small entrepreneurs with viable business plans. Each previously experienced difficulty accessing conventional credit.

Early in the startup process, a strategic decision was made for rural and urban interests to support one statewide nonprofit microloan intermediary to avoid unproductive rural-urban debates that may have emerged from separate rural and urban initiatives. The bottom line for entrepreneurial opportunity hinges on whether the loan review committee believes the client has put together a workable business plan with market access, business acumen, capacity, and cash flow for successful implementation and loan repayment—regardless of whether the client is from a rural or urban area.

The average loan repayment rate for microlenders nationally is 92.5%, but many reported repayment rates of 70% to 80% during the recent recession. Iowa Microloan's repayment rate for operations since 2009 is 96.2%. A higher repayment rate is due to underwriting standards, quality of technical assistance coaching, and collections. To be sustainable, a startup microloan intermediary cannot afford a high rate of client business failures. Due to application issues with credit history, business plans, and financials, the loan review committee sees more than twice as many applications than are approved.

Iowa Microloan provides most of its technical assistance during quarterly site visits to the client's business after loan approval and during the loan term. MicroLoan coaches are employed by and accountable to the Iowa MicroLoan President. MicroLoan coaches work with each approved loan client to develop a technical assistance (TA) plan. The initial TA plan is based on a review of the business plan in the client's application. During quarterly visits with clients, MicroLoan coaches review financial statements, assess whether the client is on track with their business plan, and discuss possible strategies and resources for any emerging problems identified. TA plans are updated annually. Iowa MicroLoan provides up to $500 annually for technical assistance grants to each client for pre-approved expense reimbursement based on the client's TA plan.

Iowa Microloan coaches collaborate with other local coaches who may be working with a client. MicroLoan clients benefit from communication with area Extension specialists and/or SBDC staff who are providing training and technical assistance. With client approval, local coaches participate in the MicroLoan coaching visits to the client's business. Regular coaching visits help clients address potential problems before they become business failures. Iowa MicroLoan's capital is at risk for loan losses, so the nonprofit has a direct interest in the business success of each loan client.

Distribution and Demographics

The diverse enterprises in Iowa Microloan's portfolio include: hair salons, computer repair, local food enterprises, farm equipment repairs, building supplies, lawn care, music lessons, recording studios, home inspection services, yard and play equipment, shoes and clothing stores, coffee shops, cleaning and health services, financial and management services, lodging, and transportation services. Local food enterprises were an initial focus during Iowa MicroLoan startup. Today, agricultural value-added enterprises represent about 20% of the portfolio; however, this segment alone does not present sufficient demand to sustain the nonprofit. Emphasis on portfolio diversification was added early to grow loan volume and improve risk management.

MicroLoan clients have come from 27 of Iowa's 99 counties, with 54% from metro and 46% from rural counties. Clients have come from all over the state, including the border counties of Dubuque, Lee, Pottawatomie, and Woodbury. Since 2009, lending 54% of loan clients were female, and 46% were male. However during 2013, 69% of loan clients approved were female and 31% male (Downs, 2014). This finding has had relevance for Iowa's media, which recently reported that Iowa metrics for women entrepreneurship are near the bottom of states nationally. In addition since 2009, 8% of Iowa Microloan clients were minorities, and 4% were persons with disabilities. Latest available income data show 50% of MicroLoan clients were below Department of Housing and Urban Development (HUD) low-income levels, 38% were below 150% of the Department of Health and Human Services (HHS) poverty standard, and 19% were below 100% of the HHS poverty standard.

Extension Local Affiliate Programs

Interest in forming local affiliate microloan programs came initially from an Extension-led local food producer support network called the Northeast Iowa Food and Fitness Initiative (NIFFI). The process involved creating a local point of contact and coach, marketing for awareness, and organizing a three-member loan application review committee. These programs can operate under the liability umbrella and legal auspices of the statewide 501(c)(3) nonprofit intermediary or a willing local agency or nonprofit.

Local Extension staff have since organized two additional Microloan affiliate programs. A startup business assisted by the Wapello County Affiliate organized by Extension made national media attention (Hedrick, 2012). Tortilleria Los Twins was organized by a Hispanic entrepreneur who spoke very little English. With the aid of an Extension Hispanic business specialist, an Iowa Microloan application in Spanish, and collaboration in coaching visits, the enterprise became a startup success serving local market demand and has since fully repaid its microloan.

Another affiliate was organized by Lee County Extension. It started operations by sponsoring a business plan development training series in collaboration with a regional SBDC. Alternative financing tools were discussed as part of the curriculum. The training series was followed by a business plan competition awards program to attract entrepreneurs who wanted to move to implementation and to attract other entrepreneurs who may be interested in putting a plan together for competition. The business plan competition was made possible by a USDA grant. The $5,000 competition award provided technical assistance that helped a local beekeeping business startup. The award was divided into quarterly installments over a 1-year startup period and was distributed during quarterly coaching visits to verify that benchmarks in the business plan were met.

Client Outcomes

Not all microenterprises succeed. On one end of the spectrum, Iowa MicroLoan has experienced a few business failures as previously noted, but loan losses have been held to rates below the average loss rates for microloan intermediaries nationally.

In contrast, successful startups generate appreciative clients and loyal supporters. One Iowa Microloan client wrote a testimonial that her business provides:

> Home-health services (both medical and non-medical) and medical staffing to nursing homes, assisted-living facilities, and independent facilities throughout Iowa. My business was provided with a loan for the purpose of expanding into other areas throughout Iowa, securing an office and office equipment that was necessary to expand as well as capital to be able to pay my employees and contractors while waiting on invoices and payments from clients. My dad originally comes from Mexico, so I am not only considered a minority but am also a female. I am a big supporter of providing loan opportunities to those who might be in my same shoes. I

> think that more women need to experience the empowerment and pride that you can feel when you are an owner of a successful business. I am thankful for programs like Iowa Microloan and excited to see what the future brings for my business thanks to their help and support.

Another African-American startup entrepreneur wrote that her business:

> Provides financial planning and loan transaction management services to municipal governments. We provide advice on the appropriate tax rates or user fees required to maintain financial sustainability, as well as, the proper structure and timing for loans initiated to fund public infrastructure projects. Iowa Microloan has provided me with a loan used to reduce software costs, as well as technical assistance related to preparing financials and how to best position the business for potential conventional lenders. This assistance has been critical in our longer-term planning, and the loan itself came at a crucial time in our first year of operation, ultimately allowing us to reduce costs and achieve greater financial security. The assistance has been invaluable to the success of our firm, and I think all entrepreneurs would benefit greatly from both the expertise and resources that Iowa Microloan as to offer.

Conclusions

After 5 years of operation, the Iowa MicroLoan collaboration has invested $1.2 million in small businesses and generated 120 jobs directly and 200 total jobs based on employment multipliers used by ISU economists. In addition, each $1 of charitable contribution to Iowa MicroLoan leverages an additional $3 to $7 of agency loan and technical assistance funds and $1 of private funds. A community foundation endowment was established to support ongoing sustainability. Interest in sustaining a microloan intermediary with contributions and affiliate matching funds has emerged among several leaders. This Extension collaboration has expanded business and job creation impacts and enhanced the opportunity to report new performance metrics to policymakers and stakeholders.

The Extension mission is more than a century old and has experienced many changes in popular society. Extension clientele have faced many circumstances that have led to new applications of research-based information for solving business related challenges. Occasionally the conditions may lead to institutional innovations for addressing gaps in capital and technical assistance, such as the one reported herein.

References

AgVA (Ag Ventures Alliance). (2014). *About AgVA*. Retrieved from: http://www.agventuresalliance.com/en/about_agva/organizational_supporters/

AEO (Association for Enterprise Opportunity). (2013). *Microbusiness statistics in the United States 2011*. Retrieved from: http://www.aeoworks.org/pdf/statistics/US%20MEBS%202011.pdf

AEO (Association for Enterprise Opportunity). (2013). *Microbusiness employment statistics in the United States 2011*. Retrieved from: http://www.aeoworks.org/pdf/statistics/US%20MEES%202011.pdf

Bassono, L., & McConnon, J. (2011). Strategic partnerships that strengthen Extension's community-based entrepreneurship programs: An example from Maine. *Journal of Extension* [On-line]. 49(5), Article 5FEA3. Available at: http://www.joe.org/joe/2011october/a3.php

Burhouse, S., Osaki, Y., & Sarna A. (2013) *FDIC national survey of unbanked and underbanked households—Use of alternative financial services*. Federal Deposit Insurance Corporation. Retrieved from: https://www.fdic.gov/householdsurvey/2013_AFSAddendum_web.pdf

Downs, C. (2014). *Iowa MicroLoan annual report for 2013*. Retrieved from: http://iowamicroloan.org

Franz, N., & Cox, R. (2012). Extension's future: A time for disruptive innovation. *Journal of Extension* [On-line]. 50(2), Article 2COM1. Available at: http://www.joe.org/joe/2012april/comm1.php

Freshwater, D., Barkley, D., Markley, D., Rubin, J., & Shaffer, R. (2001). *Nontraditional venture capital institutions: Filling a financial market gap*. Rural Policy Research Institute P2001-11B. Retrieved from: http://www.rupri.org/Forms/Filling%20a%20Gap.pdf

Hedrick, T. (2012). Ottumwa business makes national headlines. *Heartland Connection*. Retrieved from: http://www.heartlandconnection.com/sports/story.aspx?id=831236#emailStoryWindow

Otto, D., & Edelman, M. (1990). Innovation in structural change of local government. *American Journal of Agricultural Economics*. p.1074-1080.

Schmidt, M., Kolodinsky, J., Flint, C., & Whitney, B. (2006). The impact of microenterprise development training on low-income clients. Journal of Extension [On-line]. 44(2), Feature Articles 2FEA1. Available at: http://www.joe.org/joe/2006april/a1.php

U. S. Treasury Department. (2014) *Community development financial institutions fund*. Retrieved from: http://www.cdfifund.gov/
