The Relentless Pursuit of Financial Capital for Micro-entreprises: Importance of Trust and Social Capital

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Abstract – Entrepreneurs in developing countries often struggle with accessing financial capital to start small businesses. Formal lending practices meet the needs of small business owners who approach microfinance institutions (MFIs) for capital to expand their businesses, but they do not typically lend money to unproven entrepreneurs interested in starting new businesses. This gap is increasingly being met by informal lending and credit markets. These markets are growing fast, and few research initiatives have explored the mechanics and intricacies of this system. Instead of decomposing the microfinance industry into a binary relationship between MFIs and their clients, this paper discusses the interdependencies within the multi-actor financial system in Kenya that encompasses informal lenders, rotating savings and credit associations, solidarity groups, savings and credit cooperatives and microfinance institutions. This exploratory paper delves into the dynamics between these actors and describes the role of trust and social capital in their complex relationships. Insights into these relationships can help venture teams develop appropriate business strategies that make their products affordable and accessible to micro-entrepreneurs in resource-constrained settings.

Index Terms – financial capital, trust, social capital, micro-entreprises

INTRODUCTION

Billions of people in developing countries earn their living through small-scale businesses. Recent studies that combine thirteen World Bank Living Standards Measurement Surveys find that, on average (across countries), 21.9% of households living on less than US $1 per person per day and 24.1% of households living on less than US $2 per day have at least one self-employed household member. In Kenya, employment in small to medium enterprises (SMEs) has been
estimated to account for more than 20% of adult employment and for 12-14% of national GDP. Consequently, several governmental programs, as well as non-profits, have emerged to enable and empower these small-scale entrepreneurs. The different avenues that these individuals use to access capital are explored in this paper. Figures 1-6 illustrate various micro-enterprises one might encounter in developing country like Kenya.

**FIGURE 1**
These women agro-entrepreneurs sell fruits and vegetables in a small community market. The young lady in front purchases bananas from the stall (behind) and travels from home to home selling bananas.

**FIGURE 2**
These three entrepreneurs run a small entertainment center where customers can listen to music for a small fee; the music system runs on car batteries that need to be recharged every week.

**FIGURE 3**
This man runs a small pharmacy at a community center in Kenya. He borrowed US $150 from various family members to start this business.

**FIGURE 4**
This bicycle mechanic fixes bikes at a community center. The capital needed to start a similar business is about US $80.
Our team interviewed approximately 100 individuals including small-scale entrepreneurs, aspiring entrepreneurs, MFI officials, and members of small ‘solidarity’ groups to learn how micro-entrepreneurs in Kenya access financial capital to start small businesses like the ones shown above. It was discovered that the social dynamics of access are actually very intricate and complicated with trust and social capital playing a critical role in the pursuit of financial capital. The first section of this paper outlines the academic context and the social networking venture, WishVast, which provided the foundation for this study and the resulting series of observations. The second section documents the various societal constructs that affect access to capital. The third section documents the process one Kenyan micro-entrepreneur followed in pursuit of financial capital, the various sources of financial capital, and the role of trust and social capital in accessing these sources. The paper concludes with a discussion on implications for entrepreneurs developing products and services for developing communities in Kenya and beyond.

**Academic Context**

The Humanitarian Engineering and Social Entrepreneurship (HESE) program at Penn State University challenges students and faculty from across the University to break down the barriers between their disciplines and truly collaborate to develop technology-based solutions to address problems facing humanity. The HESE program has several ongoing ventures in East Africa including a telemedicine startup, low-cost appropriate technologies like solar dryers, greenhouses and biogas digesters and a cellphone-based social networking system. The work described in this paper was conducted while working on one of these ventures in Kenya. While working on these technology-based ventures, the goal for the students is to truly understand the indigenous culture and context and work with project partners to develop appropriate business models and implementation strategies to commercialize the products. Studying access to capital for micro-
entrepreneurs is important to commercializing these technologies and helping these entrepreneurs improve their quality of life through improved livelihoods.

According to the latest data from the United Nations Telecommunications Agency, there are over 5.28 billion cellphone users worldwide. It is estimated that 97% of people in Tanzania have access to cellphones. The pervasiveness of cellphones is very similar in Kenya. Millions of people do not have internet access but can be reached by cell phone. The ability to reach people in geographically dispersed places increases with the rapid growth in cell phone accessibility. Cellphones present a great opportunity to connect people, develop trusting relationships and allow for new opportunities. A study of the social networks of women agro-entrepreneurs in northern Tanzania suggested that the most compelling opportunities for sustainable value creation and self-determined development in Africa exist at the intersection of cellphones, social networks and entrepreneurship, with the necessary condition that trust, the glue that holds these elements together, is present. The study suggested that women value long-term business relationships and base these relationships on trust and respect. Loyalty and the maintenance of inter-personal relationships are more important than price in these women’s business-related decision-making. The data indicated that women developed good business relationships with individuals who were honest (95%) and reliable (90%), further supporting the salience of trust in business relationships. The women had confidence in nearly all (97%) of the people with whom they conducted business, believing that there was nothing to be unsure or afraid of in their relationship with these business contacts. Despite limited access to financial resources for individuals in developing regions, trust was more important than price, logistics, and other factors when conducting business.

Further, this study shed light on the requirements, opportunities and challenges of a ‘social network support system’ that can enable cooperatives and their champions to utilize, strengthen and expand their social networks. It revealed that in Tanzania, individuals tend to do business with members of a geographically bound social network in part because isolation limits their options. These observations led to the development of an entrepreneurial venture called WishVast: Building Trust and Social Capital Using Cellphones. WishVast leverages cellphones to allow users to form and join groups of local relevance to transmit information, meet new people, and build trusting relationships via group SMS text messages. WishVast can be used by many different users for many different things. For example, employers can use the system to find employees and produce farmers can find potential customers. Upon the completion of an interaction over the WishVast network, users can exchange points to rate the quality of their interactions. This is similar to eBay’s current model of collecting buyer/seller feedback. Over time, these points add up, allowing people to build a digital reputation. The observations documented in this paper were made while working on the validation of the WishVast venture.

The Context for Pursuing Financial Capital

In developing countries, where there are many opportunities for growth and improvements, practical ideas are abundant to help solve many pressing issues. Would-be entrepreneurs need to navigate complex financial systems to fund their ideas. The financial system in most developing countries can be broadly broken down into the informal and formal sectors. The informal sector includes individuals such as moneylenders, relatives, friends, neighbors, landlords, and traders
dealing mostly with the “traditional, rural, subsistence-oriented branch of the economy” that have no established formal credit histories. The formal sector, servicing established businesses and individuals, consists of the central bank, commercial banks, development banks, savings banks, social security schemes and insurance companies.\textsuperscript{12}

When doing any type of business in this context, the first consideration is trust. Micro-entrepreneurs begin their pursuit of capital with their network. In East Africa, "who-you-know" network knowledge systems are prevalent and extend beyond an individual’s immediate social network to a larger collective network that may provide a useful advantage in social, political or economic situations.\textsuperscript{13} These social networks play a significant role in micro-enterprise development, and the effective management of these sprawling social networks can serve as a springboard for an entrepreneur’s small business. To illustrate this point, consider Paul, a micro-entrepreneur who makes a living running a bike repair shop. While Paul has ample business sent his way, he is limited to the daylight hours to conduct his business; losing out on valuable income for his family. Paul would like to borrow US $40 for a battery that would allow him to power a lamp to continue to repair bikes for 2.5 hours more per day, making over US $3.50 more per week. Paul has borrowed a dollar here and there from friends and family for tools and supplies, but has no one in his close social network that can lend him that much money. He has approached moneylenders but with no borrowing history or collateral, they might charge interest as high as 60%. The interest rate would consume the entire additional profit he would make from the extra time working. If Paul could somehow leverage his positive reputation, it would greatly enhance his ability to get the loan he needs. Cell phones can help Paul connect with the individuals or organizations that can lend him the money.

Cellphones have essentially become the identity of most micro-entrepreneurs. They facilitate communication between aspiring entrepreneurs and their geographically dispersed friends and family. Cellphones enable long-distance business and social connections and reduce dependency on local relationships. As the category of casual (weak-tie) friendship emerges, this group comes to encompass an ever-larger share of the total number of an individual’s social contacts. The new weak social ties may be very beneficial because weak social ties often lead to new resources and larger networks.\textsuperscript{14} A symbiotic relationship exists between social and economic capital. Social capital arises from the existence of trust in a society which, in turn, encourages cooperation in the generation of economic capital. Given this relationship, most micro-entrepreneurs begin their financial pursuit in the informal sector. Figure 7 shows the relationship between the strength of a connection and the level of trust involved in order to access different types of financial capital. Each of these types of capital is described in more detail in the following section. An increase in the level of social capital and trust between individuals can help to improve their chances of accessing larger amount (and more types) of financial capital.
A study by the Namibian Economic Policy Research Unit suggests that most formal financial services do not reach the poor due to scattered demand, lack of usable collateral, lack of contract enforcement and the poor people’s general reliance on seasonal farming. Additionally, being formal brings additional costs such as taxes, regulatory compliance and potential bribery to government officials. Thus, the majority of the African population make little to no use of formal savings and lending institutions. The first stop in the relentless pursuit of financial capital for a micro-entrepreneur is with family and close friends. Entrepreneurs across the world, and particularly first-timers rely on family and friends for immediate access to capital. The entrepreneur has taken the time to build trust and social capital with these individuals. Therefore, a high level of trust and mutual understanding exists between these parties. In this context, mutual understanding is defined as each party being able to share reciprocal ideas and understand undesirable circumstances that may arise throughout the life of the loan. Mutual understanding, similar to trust, is the belief that the other party always has good intentions. Friends and family are best able to make proper judgment of character and financial ability of the borrower, avoiding unnecessary time and money spent by the lender and resulting in significantly lower transaction costs.
The nature of informal lending requires a high degree of trust and mutual understanding amongst its participants. In the previously referenced study in Tanzania, the interviewed women trusted 96% and respected 100% of the people with whom they worked (N=92). The data reflected that the women valued long-term business relationships based on respect and trust. Within these relationships, price was secondary to loyalty and relationships. The women generally distrusted individuals they did not know at the outset, and trust was something only gradually built over time. Sub-Saharan African financial systems have historically taken on a dualistic nature, with little overlap of formalized banking and informal agents (including their clientele). Since poor infrastructure limits accessibility to formal financial institutions, informal intermediaries provide the best financial linkage to the bulk of the population. These informal financial institutions finance SMEs beyond the reach of formal financial systems. There are several advantages that the informal lending community enjoys due to the nature of its borrowers and lenders:

- Informal moneylenders have local information which helps them appraise credit needs and credit worthiness of the client.
- Informal moneylenders profit from social sanctions such as those that may exist between members of a family. Those sanctions may serve as a substitute for legal enforcement.
- Informal moneylenders use specific incentives to stimulate repayment, such as repeat lending to borrowers who repay promptly, with gradually increasing loan size.

While informal lending has its benefits, there are basic limiting factors. Informal credit is generally conducted at the local level where the market is segmented and information does not flow freely. The trust built in the informal community is not being leveraged to branch out and access more capital; the transaction remains solely between the borrower and lender. The borrower would like to leverage the trust built between him and the lender as a form of collateral to access more capital from other sources.

**Rotating Savings Credit Associations (RoSCAs)**

Recent research in the Philippines in 2005 and in Kenya in 2006 suggests that the poor, like everyone else, have problems resisting the temptation of spending money that they have on hand. Most self-employed individuals in rural Kenya do not have a formal bank account. The main reasons given for not possessing an account are that formal banks typically have large opening fees and have minimum balance requirements (often as high as 500 KES, or US $7.70). Instead, individuals typically save in the form of animals or durable goods, or in cash at their homes. One of the most secure ways to save money in the informal sector is through the use of Rotating Savings and Credit Associations (RoSCAs), commonly referred to as merry-go-rounds. Most RoSCAs have periodic meetings at which members make contributions to the shared saving pool. The entire pot of money is then given to one member every period. RoSCA participation in Kenya is high, especially among women, and many people are active in multiple RoSCAs. In general, RoSCA participants use the funds for their larger periodic expenses such as school fees for children or other large one-time expenses such as starting a business or buying livestock. Surfacing around the world when cultural norms lead to pressure on friends to give
and lend money, RoSCAs can be found in at least 70 countries around Africa, Asia, and Latin America, and go by many different names.

<table>
<thead>
<tr>
<th>Africa</th>
<th>Latin America, Caribbean and Pacifics</th>
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<tbody>
<tr>
<td>Benin: Asusu, Yissirou, Ndjou, Tontine</td>
<td>Bahamas: Esu</td>
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<tr>
<td>Botswana: Motshelo, beer parties</td>
<td>Barbados: Meetings</td>
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<td>Burkina Faso: Tontine, Tibissiligi, Pari, Song-0aaba</td>
<td>Belize: Syndicate, Tanda</td>
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<td>Burundi: Upato (in Kiswahili)</td>
<td>Bolivia: Pasanacu</td>
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<td>Cameroon: Jangi, Ujangi, Djama, Mandjon, Djapa, Tontine, Djanggi, Njanggi, Ngwa, Nichwa</td>
<td>Brazil: Consorcio, Pandero, Syndicates</td>
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<td>Egypt: Gameya, Jam'iyya</td>
<td>Curacao: Sam, Hunga sam</td>
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<td>Ethiopia: Ekub, Ikub</td>
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<td>Jamaica: Partners, (Throw a) Box, Susu</td>
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<td>Ivory Coast: Tonton, Tontine, Moni, Diou Moni, War Moni, Djige Moni, Safina, Akpole wule, Susu, Aposumbo, Kukule, a tche le sezu, Komite, n'detie, m'bgli sika, Monu, mon</td>
<td>Mauritius: Pool, Cycle, Sheet</td>
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| Kenya: Mabati, Nyakinyua, Itega, Mukatano ya wanwake, Mukatano ya wazee | Mexico: Tanda, Cundina, Mutualista ...
| Liberia: Esusu, susu, sau | Panama: Pandero |
| Malagasy: Fokontany | Peru: Pandero |
| Mali: Pari | Surinam: Kasmonie |
| Mozambique: Upato, Xitique | Tobago: Susu |
| Niger: Adasse, Tomtine, Asusu | Trinidad: (Es)susu, Sou sou, Hui, Chitty |
| Nigeria: Esusu, Osusu, Enusu, Ajo (Yoruba), Cha (Ibo), Oha, Oja, Adashi (Haussa, Tiv), Bam (Tiv), Isusu (Ot), Uto (Ibo), Dashi (Nupe), Efe (Ibogios), Oku (Kalabari Ijawas), Mitiri, Compiri, Club (Ibo) | West Indies: Susu |
| Congo, PR: Temo, Kitemo, Ikilemba, Kikidimba, Kikirimbahu, Likilimba, Efongo Eambongo, Otabaka, Ekori, Otabi | Western Samoa: Pelagolagomai |
| Senegal: Tontine, Nath | Bangladesh: Samity |
| | Cambodia: Tontine |
| | China: Lun-hui, Yao-hui, Piao-hui, Hui, Ho-hui, Foei-Tsijing |
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| | Indonesia: Arisan, Paketan Daging, Paketan Kawinan, Mapalus, Bajulo Julio, Jula-jula, Mengandelek |
| | Japan: Ko, Kou, Miyin, Mujin, Musin, Tanamoshi |
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| | Lebanon: Al-tawfir el medawar |
| | Malaysia: Kutu, Kootu, Kongs, Tontine, Hui, Main, Kut |
Sierra Leone: Asusu, Esusu
Somalia: Haghad, Shaloongo, Aiuto
South Africa: Chita, Chitu, Stokfel, Stockfair, Mahodisana, Motshelo, Umangelo
Sudan: Khatta, Sanduk, Sandook Box
Swaziland: Stokfel
Tanzania: Upato, Fongongo
Tchad: Pare
Togo: Soo, Tonton, Sodzodo, Sodyodyo, Abo
Tunisia: Noufi, Sanduk
Uganda: Chilomba, Kiremba, Upato, Kwegatta
Zaire: Ikelemba, Osassa, Bandoi, Kitemo, Kitwadi, Adashi, Tontine, Bandal
Zambia: Icilibma, Upato, Chilenba
Zimbabwe: Chilomba, Stockfair, Kutunderra

Nepal: Dhikur, Dhituti
Pakistan: Committee, Bisi, Kistuna
Papua New Guinea: Hui, Sande
Philippines: Paluwagan, Turnohan
Singapore: Tontine, Kutu
Sri Lanka: Chit Funds, Cheetu/Sheetu, Sittu Danawa, Sittu Mudal, Sittu Wendesiya
Taiwan: Hui
Thailand: Chaer, Hui, Hue, Pia Huey, Len Chaer
Vietnam: Hui, Hui Thao, Hui hue hong, Hui bac (ho), Yi hui
Yemen: Hacba

FIGURE 8
NAMES FOR ROSCA GROUPS FROM AROUND THE WORLD

There is wide variation amongst RoSCAs regarding the order of allotment (random, bidding process, seniority, etc.), frequency of meetings, and amount contributed. Anderson and Baland, in a study of Africa’s largest slum, Kibera (Kenya), discovered the following statistics on the local merry-go-rounds.23

- Have 15.8 members, on average
- Have existed for two years and 4 months, on average
- Most commonly contribute every month (49%), followed closely by weekly contributions (35%)
- Have a median cycle that lasts 6 months
- Comprised of only women (65%), or both men and women (30%)
- Were started by friends, relatives, or neighbors (85%)

Interestingly, on average, an individual will receive the entire merry-go-round fund before he could have completely saved the amount on his own. This allows bulk purchases to occur before they normally would.24 While participation in a RoSCA does not necessarily provide a micro-entrepreneur to capital that wasn’t already hers to begin with, it is certainly part of the pursuit because it allows for a larger sum of money to be accessed for a new idea while without participation that money would be frittered away. The RoSCA meeting serves as a venue for
social exchange and dialog, strengthening personal (professional) relationships and building a tight-knit community.

Figures 9-14 illustrate the social dynamics of merry-go-rounds in Kenya.

**FIGURE 9**
This picture shows a merry-go-round meeting in progress at a small community in western Kenya. A number of group members are older women and hence this younger lady goes from person to person, collects their money and drops it in the plastic bowl.

**FIGURE 10**
When funds from all the members are collected, they are handed over to the recipient of that week's merry-go-round. Since this group is geographically dispersed, they meet on a bi-weekly basis. Each group has different times and rules.

**FIGURE 11**
Tea is being prepared for all the members of this merry-go-round group. The members take turns hosting the merry-go-round; the host foots the bill for the refreshments which consist of tea and sliced bread.

**FIGURE 12**
The funds pooled by each member in this particular bi-weekly merry-go-round total 300 Kenyan shillings (KES). The cost of the tea and bread was approximately 550 KES!
FIGURE 13
THE FINANCIAL TRANSACTIONS WERE COMPLETED IN ABOUT 30 MINUTES; THE REFRESHMENTS AND SOCIALIZING CONTINUED FOR ABOUT TWO HOURS THEREAFTER. THE CONVERSATIONS FOCUSED ON LIVELIHOODS, LOCAL SOCIAL ISSUES AND LOCAL POLITICS.

FIGURE 14
ONE YOUNG LADY WORKS AS AN HIV/AIDS COUNSELOR AND NARRATED HOW SHE WAS ABLE TO SAVE MONEY THROUGH THE MERRY-GO-ROUND AND WAS ABLE TO BUY A GOAT AFTER EVERY CYCLE. SHE NOW HAS THREE MILKING GOATS THAT PROVIDE ADDITIONAL INCOME.

SOLIDARITY GROUPS

After exhausting informal lending opportunities and participation in RoSCAs, micro-entrepreneurs advance to weak-tie relationships in their pursuit of capital. Solidarity groups are groups of individuals who come together to mutually guarantee the repayment of a microfinance loan. Individual members of groups have generally been working together in different businesses for a significant portion of time allowing them to build enough trust to take the risk of loaning money. It is common for solidarity groups to come together to access capital in which all the members are mutually liable for each individual’s loan, building an alternative to normal loan collateral requirements (which the poor inherently cannot fulfill). Montgomery notes that “From the lenders’ perspective, such joint liability lending enables a transfer of default risk from the institution to the borrower, and can reduce the transaction cost of providing a large number of small loans (by concentrating clientele in groups at regular village-based meetings rather than dealing with individual borrowers at different times).”

The driving forces in solidarity groups are trust, mutual understanding and peer pressure to ensure all individuals goals are aligned. Dr. Muhammad Yunus expands on this concept, stating, “Group membership not only creates support and protection but also smoothes out the erratic behavior patterns of individual members, making each borrower more reliable in the process. Subtle and at times not-so-subtle peer pressure keeps each group member in line with the broader objectives of the credit program. Since the group approves the loan request of each member, the group assumes moral responsibility for the loan. If any member of the group gets into trouble, the group usually comes forward to help.” There are additional profound social implications, as evidenced in a study of solidarity group schemes in several different continents. The peer group itself becomes the building block to a broader social network. The social objectives of mutual self-help and poverty alleviation, remain fundamental to the broader goals of these peer group lending schemes.
Our first encounter with a solidarity group in Kenya was a group of business owners who came together, in their own words as “friends of friends of friends”. Each member of the solidarity group owned and operated a unique business within a variety of industry spaces (a variety of retail, agriculture, and value-add businesses). After existing as a group sustained by the monies generated in a RoSCA, the group approached a microfinance institution for more capital. Twelve business owners (eight women, four men, and three children) were present at the weekly meeting. The tone of the meeting was extremely casual, and the members of the solidarity group were delighted to share information about the mechanics of their group as well as short anecdotes about their experiences working with each other. When business resumed, the accountant of the group collected payments and updated a log book containing every transaction the solidarity group has done internally and with their MFI. The members agreed that the ideal size of a solidarity group is 12 to 18 members and felt that there would be no additional financial benefit to expanding the size of group. Instead, the members suggested, the benefit is in expanding the social network of each member and sharing those contacts in order to promote the growth of each other’s business.

For example, a member owning a small business that buys tomatoes to manufacture canned tomato sauce refers his supplier to a solidarity group member that owns a repair shop to fix broken tractors. Several times throughout the meeting, the members of the group mentioned that their biggest challenge (next to collateral and debilitating securities) is finding new customers to help sustain and grow their businesses. “Markets are entirely too saturated… in everything! Where do I look for new opportunities? We need access to new markets. It’s the close social ties we have that bring in customers from other towns and from far away,” mentioned one member.

FIGURE 15
THIS PICTURE SHOWS A YOUNG KENYAN CARPENTER. IN ORDER TO EXPAND HIS BUSINESS, HE HAS JOINED A SOLIDARITY GROUP WITH THE OBJECTIVE OF GETTING ACCESS TO MORE FINANCIAL CAPITAL.

SAVINGS AND CREDIT COOPERATIVES (SACCOs)
After achieving a critical mass of clients and capital, solidarity groups often come together to build a formalized financial institution like a Savings and Credit Cooperative (SACCO). SACCOs, like modern western credit unions, are member-owned and hence they understand the financial conditions and circumstances (higher degree of mutual understanding) in which the organization operates. Members are directly involved in SACCO decisions, and they elect directors who handle the day-to-day operations. All members attend status meetings every two weeks. Regular attendance in meetings is viewed as a critical aspect of SACCO participation. SACCOs encourage saving, provide credit at reasonable rates, and offer various other financial services; all of it while promoting social networking opportunities over a geographically dispersed region. There are typically two types of SACCOs, employer-based (generally urban) and cash crop/agriculture-allied activities (generally rural). The services usually provided by SACCOs include selling shares, offering credit facilities and savings. Deposit facilities are available to both members and non-members with interest pegged at 3% below commercial banks. The savings provisions are extremely attractive, with non-members generally making up a large portion. However, taking loans is restricted to SACCO members. Once someone has been a member for six months (depending on rules), he or she is eligible to apply for a loan.

Loans are usually classified as “development” loans (e.g. housing) or “social loans” (e.g. emergencies and school fees) and are generally granted at ~1%/month. In Kenya, the number of rural SACCOs was over 155 at the start of 2005, up from 100 in 1999. Likewise, the outstanding loan portfolio increased to 2.3 billion Kenyan shillings (KES) from 1.5 billion KES over the same time period. The growth in outstanding loans by both quantity and size “is good evidence of the savings potential and utilization that exists among small savers.” Each SACCO has its own unique purpose and rules, but one of the most popular type is for matatus (share taxis). One popular matatu (public transport van) SACCO (600 members) member reported that she had to pay 500 KES to apply to be a member, needed four references, and needed to surrender the title to her matatu as collateral. Now that she has been accepted as a member, she enjoys the benefits of loan opportunities and has expanded her social network. She is lucky that she had the necessary collateral to join, but for many individuals this steep price is a barrier to entry and they cannot join SACCOs. Information is rarely shared between SACCOs and the qualifications for trustworthiness can be captured by the widely reported phrase “we know the person”.

**FORMAL LENDING: MICROFINANCE INSTITUTIONS**

Originally developed to correct the flaws in the formal financial system when targeting the poor, microfinance is an extension of modern formal financial services to low-income clients who cannot access commercial bank loans that are appropriate to their needs (principal, interest, collateral, etc). The range of financial services includes loans, savings, insurance, leasing and money transfers. Grameen Bank, considered to be a model MFI, was developed in 1983 as a specialized bank. Dr. Muhammad Yunus intended Grameen to interact directly with the poor, lending directly and empowering self-employed micro enterprises with the opportunity to pull oneself from poverty. Today the bank has ~7.8 million members, ~ US $8 billion in cumulative loans dispersed and ~98% repayment rate. The Grameen principles are as follows:

- The bank would lend only to the poorest of the poor in rural areas
• The bank would remain woman-focused, 97% of its customers are women
• These loans would be without collateral or security
• The borrower – and not the bank – would decide the business activity for which the loan will be utilized
• The bank would help support the borrower in succeeding
• Borrowers will pay as little or as much interest required to keep the bank self-reliant (that is, not dependent on grants or donations)

Individuals receive small loans (usually less than US $100) that they repay in 50 weekly installments. While loans are made to individuals, everyone in the group is liable, thus leveraging peer pressure. Grameen’s group-based lending is geared to minimize inherent risks of lending for both the lender and borrower. Substantial attention has been paid to relieving credit market constraints among small entrepreneurs, particularly through MFIs. However, the impact of microcredit schemes on business outcomes, especially for the very poor, is still largely unknown, and many banks that target the poor realize low or negative profits. Microfinance is now a social buzzword. A common myth observed repeatedly by our team is the perception that microfinance loans are easily available to poor people and can be used to access capital to purchase goods and start small businesses. The fact is that only 8-14% of the market demand for microfinance is currently being met, and fewer than 20% of SMEs in Kenya have ever received credit from formal financial institutions. A major challenge facing lenders is assessing SME risk in a cost-effective manner. Lenders in Kenya address this risk-assessment problem either by not lending to SMEs at all or by requiring collateral and charging high interest rates. Microfinance has been gradually moving towards lending exclusively to ventures that focus on relatively richer clientele.

Microfinance was designed to enable individuals who “would not or could not pay the fixed cost associated (with start-up business) without borrowing, to become entrepreneurs,” but it is being utilized almost exclusively for established business to expand their operations. Grameen’s labor intensive model (a lot of work goes into researching borrowers and keeping tabs on extremely small loans) has caused many of the major microfinance organizations to stray from the original MFI principles. Extremely high interest rates result from a lack of credible information, meaning the lender has less information regarding the borrower’s ability and likeliness to repay his or her debts. This imperfect information affects both the supply and demand sides of the formal credit market. For the supply side, the lender must expend significant time and energy to determine the borrower’s credit worthiness in an environment where this information is not easily ascertainable. The screening costs involved are “further enhanced by moral hazard—any source of information has to be further screened for reliability.” On the demand side, the lack of market transparency hinders borrowers from screening competing loan rates for the best price.

MFIs now heavily favor lending money to more established businesses and solidarity groups in an effort to scale up business and avoid the problems of new borrowers’ credibility. A study by the Namibian Economic Policy Research Unit points out that, while the emergence of MFIs twenty-five years ago was to fill the gap left by banking institutions, MFIs over the last decade have largely neglected rural finance. In fact, not a single one of the MFIs the WishVast team personally interviewed funded start-up companies. There are obvious benefits to this scaling
mechanism: fewer loans means less time/monitoring, higher returns on economies of scale and more established credit history. However, this is at the expense of the needs of rural entrepreneurs and their SME goals. As MFIs continue to demand more collateral before approving loans, they become less and less like the Grameen model and become more like commercial banks.

Mutual Dependence between Capital Sources

A 2002 study of MFIs in Bangladesh (where there are often as many as 10 different MFIs offering loans) states that “their share in transaction-flow is less than 15% of the total” versus largely informal lending. As discussed earlier, only 8-14% of the market demand for microfinance is currently being met and less than 20% of SMEs in Kenya have ever received credit from formal financial institutions. This is largely due to their relative lack of flexibility and reliability when compared to established businesses. If MFIs choose not to (or are unable to) offer financial services to poor people, then the poor are forced to use the informal sector, but the informal sector cannot meet 100% of their demands either. To date, most of the research in this space has focused on the binary relationship between MFIs and solidarity groups. Generally, the common wisdom has been that informal finance offers one lessons to the design of microfinance. However, none of the research studies examined have discussed the huge potential for informal lending, ROSCAs, solidarity groups, SACCOs, and MFIs to form a multiple-actor system that is mutually dependant and beneficial to each other. Brau and Woller, in a comprehensive assessment of over 200 peer-reviewed articles related to microfinance, posed outside interaction of MFIs and solidarity groups as one of topics that needs to be explored in this field.

While the benefits of capital that MFIs and solidarity groups could provide to the informal lending community are obvious, the potential power such a large group of motivated individuals has to benefit the MFIs and solidarity groups is often overlooked. As MFIs scale their businesses, the gap for access to capital slows start-up growth. This is where the informal lending community comes in, allowing start-ups the ability to develop the scale to be eligible for MFI-size loans. Other potential interactions include MFIs reaching out to solidarity groups (current clients) for “character loans,” and inquiring into who they work with outside their solidarity groups (informally) that could be candidates for microfinance loans. Here, MFIs could prep groups of informal borrowers for microfinance money.

Hawala, for example, is a system used in India for fast, effective transfer of funds between locations (usually across long distances) through brokers. This system is entirely based on trust as individuals give money to these brokers (Hawaladars) without any formal promissory notes or regulations. This informality leads to its success because it is cheaper than any other means of money transfer. The opportunities for MFIs to gain additional success lie in their willingness to embrace trust and social capital as a means of evaluating clients. It is estimated that MFIs are missing out on a $19 billion opportunity by not adequately funding women entrepreneurs in Africa. For example, in Uganda, women own approximately 40% of businesses, yet receive only 9% of commercial credit.
The diffusion of innovation happens through social networks and people you trust, so the more that people learn about other social systems and related finance systems through their individual network, the more formal organizations have to build trust with the informal organizations to keep the flow of people (customers). Individuals will attempt to access the capital that is most readily available to them, often drawing from multiple sources. This is not a lifestyle choice, but rather their livelihoods. For individuals who survive on a daily economy, the norm is not to borrow money solely through any one channel; it is part of a complex web that includes many different options – informal lending, RoSCAs, solidarity groups, SACCOS, and MFIs. Individuals interviewed in Nyeri were extremely interested in brainstorming new ways to gain better access to capital, but in many ways they were frustrated and felt they were already exhausting every possible outlet they knew.

**DISCUSSION AND GUIDELINES FOR ENTREPRENEURS**

Muhammad Yunus once said, “Worst of all, economists have failed to understand the social power of credit. In economic theory, credit is seen as merely a means with which to lubricate the wheels of trade, commerce and industry. At the same time, credit creates economic power, which quickly translates into social power.” It is necessary for developing world innovators to understand the difficult journey that micro-entrepreneurs must take to access financial capital. Practical strategies to make this process easier and allow entrepreneurs to leverage their social capital and trusting relationships for access to financial capital would help them advance their ideas and realize their ventures. The ability of entrepreneurs to leverage trust and social capital amongst those they don’t know can serve to increase informal lending opportunities, RoSCAs, solidarity groups, and SACCOS. Opportunities for trustworthy individuals would increase with an effective, reliable and formalized mechanism for accruing and utilizing social capital. This could also help reduce corruption and build a stronger civil society.

At the same time, the onus is on the entrepreneur to help (potential) customers get access to capital if necessary. For example, an entrepreneur that manufactures affordable greenhouses or irrigation systems needs to develop effective strategies and partnerships to help customers get access to the capital needed to purchase the technology. These partnerships can take various forms including non-profit or for-profit organization partners that have the market linkages to lease the technologies to the entrepreneur so that they can own it over time. A leading greenhouse company in East Africa has several financing partners (local banks and MFIs) as well as an insurance partner that lowers risk. These partnerships are vital to growing the customer base and hence to the company’s success. However, this is a fairly sophisticated and expensive technology which is within reach of the limited people who can afford it and can get access to capital through the banks, facilitated by the greenhouse manufacturer. If the greenhouse’s cost was one-tenth of the current cost, it would be affordable to a whole new set of people at lower rungs of the socio-economic pyramid. In that case, a different set of partnerships with informal financial systems would have to be developed to increase the uptake of the technology. The informal system would likely be based on trust and present unique challenges to the entrepreneur.

Consider, another appropriate technology – solar dryers. An entrepreneur could buy five solar dryers that are leased to farmers in a rural community, with the farmers paying the entrepreneur...
for use of the dryers as well as give her a portion of the money from what they dry. Another model would be to make the entrepreneurs service providers, where they would go about building the technologies (solar dryers in this case) directly for people who want them, and thus avoid the access to capital problem. This could actually be a more lucrative model as the currently agricultural-based economy develops into a knowledge economy. Social capital, in this case, would be important to scale up the businesses by finding more potential customers. The entrepreneur would need capital to jumpstart this venture and it would likely come from informal lending as opposed to MFIs.

In order for MFIs to survive and scale-up, they need to be able to reach out to micro-entrepreneurs, who are currently reliant on informal lending. This presents a risk to MFIs since they do not really know the entrepreneur that well and are apprehensive in investing their funds in knowing people who might borrow very small sums of money. Finding new and innovative ways to quantify values such as social capital and trust will help MFIs to continue to make inroads in reaching new entrepreneurs at lower socio-economic strata.

**Conclusion**

Currently the path to getting financial capital is very convoluted and involves many different means including informal lending, RoSCAs, solidarity groups, SACCOs and MFIs. Access to capital is important for fueling new ideas and innovation and eventually alleviating poverty, but building trust and social capital is potentially more important as its ramifications reach far beyond just finance. For university-affiliated social entrepreneurship ventures in developing countries, it is essential for teams to understand the financial landscape for their projects to be successful. Given that micro and small enterprises contribute to economic growth through many pathways, by truly understanding the dynamics of how people access capital and the way people manage their budgets, there are more opportunities to solve the root problems and help people. With only 8-14% of the market demand for microfinance currently being met, and less than 20% of SMEs in Kenya having ever received credit from formal financial institutions, there are several opportunities for co-creating value with the entrepreneurs through effective business strategies and partnerships. The importance of trust and social capital are evident in every form of lending, and understanding these dynamics will help craft innovative strategies to help individuals in developing communities fully participate in the economy and realize their entrepreneurial dreams.
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