FUNDUSZMIKRO

An experiment in

partnership-based

microfinance:

1998-2002

BY WITOLD SZWAJKOWSKI

A PUBLICATION OF THE

DEVELOPMENT FINANCE FORUM

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An experiment in partnership-based microfinance

Fundusz Mikro's experience in learning to play a pro-active role in Poland's changing economic climate

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EXECUTIVE SUMMARY

Fundusz Mikro's evolution has to be understood in the context of Poland's emergence from communism during the 1990s. For businesses, the challenge of that time was not merely to learn new skills, but to unlearn old habits and attitudes while at the same time taking on new ones appropriate to a market economy. Because of this shift, Fundusz Mikro (FM) found that it had to do more than lend money; it had to learn to play a more pro-active role in changing the culture in which business took place. The financial crisis of 1998 and the harder economic times since then were an added incentive for FM to adapt its approach, products, and finally its mission.

Fundusz Mikro found that it had to do more than lend money in post-communist Poland; it had to learn to play a more pro-active role in changing the culture in which business took place.

This paper describes the seven-year learning process that resulted in Fundusz Mikro's innovative support system for entrepreneurs. At the heart of the system is the Fundusz Mikro mission statement: **Create opportunities for the development of business talents by providing access to capital on the basis of an assessment of entrepreneurs' intentions and abilities.**

The paper describes how FM has developed and adapted this mission and, consequently, its products, based on a growing understanding of Polish entrepreneurs. The essence of these findings is that a large number of Polish entrepreneurs were (and to some extent remain) quite closed and secretive about their businesses and their knowledge. For FM to do solid assessment and risk analysis, it required getting behind this barrier, hence the organization's growing conviction that it had to develop relationships based on trust and not on sanctions.

Typical borrowers are carpenters, hairdressers, stonemasons, metal workers, car repair mechanics, taxi drivers, bookkeeping consultants, and shopkeepers.

FM's innovative loan product ("Partnership Finance") is the result, and is described in the last section of this paper. That section explains how the product emerged from FM's learning and how its advantages facilitate FM's evolving emphasis on business education and "culture change." The paper is presented in the spirit of experience sharing and mutual learning.

CHAPTER 1

A brief introduction to Fundusz Mikro

Fundusz Mikro's Beginnings, Legal Status, and Customers

Fundusz Mikro (FM) was founded in 1994 with a US$20 million loan capital investment by the Polish-American Enterprise Fund. FM was registered as a limited liability company, the only non-bank institutional form in Poland that can make interest-bearing loans. A USAID grant covered initial operating costs. From its inception through July 2003, Fundusz Mikro disbursed US$110 million, making 57,000 unsecured microloans to 29,000 owners of microbusinesses who could not access financial products from commercial institutions. The initial loan capital has been preserved and is still available to borrowers. FM now has over 8,000 active customers with outstanding loan balances of over US$13 million. Typical borrowers are carpenters, hairdressers, stonemasons, metal workers, car repair mechanics, taxi drivers, bookkeeping consultants, and shopkeepers. Most employ less than five people. Loan values are tailored to customer needs and can increase with successive loans. The average first loan is US$1,200, and this can gradually increase to US$8,000. Cumulated loan losses since inception are US$1.2 million. Fifty-three percent of the loans have been to repeat customers, some of whom are on their ninth loan.

Fundusz Mikro now has over 8,000 active customers—and outstanding loan balances of over US$13 million.

Expansion of the Institution

From the start FM aimed to provide services nationwide. In the first year of the pilot phase, we opened three branches, testing individual loans in Starogard

The key to the Fundusz Mikro lender-borrower relationship is a sense of mutual trust.

Gdański (30,000 inhabitants) and Toruń (200,000), and group loans in Łódź (800,000). Each branch worked with local volunteer loan committees. Several other methodologies were tried, including cooperation with credit unions and other local organizations. After several months we concluded that the best solution was to create a network of FM branches and employ staff that would make decisions on behalf of the firm. It took two years, until 1998, to build a 30 branch network. After 1998 several branches in cities that were too small were consolidated.

Economic Environment and Fundusz Mikro's Response

Fundusz Mikro's branch network was built during a period of rapid economic growth and the formation and development of many small firms. Inflation was high but falling, small-scale trade with the former Soviet Republics was developing, and there was strong demand for consumer credit and strong spending. Rapid business growth was achieved simply by increasing inventories or broadening the range of goods sold. Entrepreneurs' need to expand their working capital to meet this growth drove strong demand for FM's loans. Many entrepreneurs were keen to borrow money and motivated to repay so they could obtain new, larger loans to build their businesses further.

Fundusz Mikro's greatest early achievement was launching the group loan concept in Poland against considerable resistance.

Fundusz Mikro took full advantage of the favorable economic climate using the best micro-loan experience available and supplementing this with its own innovative solutions. FM's greatest early achievement was launching the group loan concept in Poland against considerable resistance. This obstacle was overcome by incorporating two innovations into the traditional group lending methodology: presenting loan groups as an additional valuable service rather than a burdensome requirement, and linking interest rates to the group size, with the highest interest rates charged on individual loans and the lowest applied to groups of at least four. These innovations were also adopted by other micro-loan programs in Central and Eastern Europe.

The economic situation in Poland worsened dramatically with the Russian financial crisis in August 1998. Declining disposable income led to reduced sales for small commercial companies. In addition, multinational companies began rapidly developing large surface discount stores, with approximately 200 built in Poland between 1999 and 2002, and still increasing. These have taken away an enormous number of customers from the

smallest commercial and service firms. There has been a dramatic fall in demand for working capital loans, dropping from 70 percent of FM loans granted in 1996 to 30 percent in 2003.

We had to maintain interest rates in order to achieve operational break-even, which we succeeded in doing. But at the same time, bank interest rates dropped considerably, reducing the attractiveness of our products. In order to improve portfolio security and deal with FM's growing recognition of the gaps in business skills among its customers, we began to stress building good long-term relationships with customers as the basis of FM policy, and eventually of its mission. FM had to ensure that customers would want to repay their loans even when they could not see any possibility for the development of their businesses and would not be planning to obtain any new loans. This situation presented a challenge for FM and its employees, demanding, among other things, more careful selection of borrowers.

The Evolution of Fundusz Mikro's Products

Standard Loans. The standard loan product is up to US$2,500 for the first loan, although the typical first loan amount averages US$1,500. Once repaid, the entrepreneur may request a loan 50 percent larger then the preceding loan, provided her firm justifies this request and all installments of the preceding loan were punctually repaid. The maximum sum of a standard loan is US$7,000.

The standard loan product is up to US$2,500 for the first loan, although the typical first loan amount averages US$1,500. Once repaid, the entrepreneur may request a loan 50 percent larger then the preceding loan.

The maximum loan term is one year, with a grace period of up to three months. Interest rates average 20 percent per annum, but depend on the length of the period of cooperation with the borrower and are decided by branch managers. Borrowers also pay an administrative fee of 2 percent of the loan at the time of disbursement. This fee is reduced to 1 percent in subsequent loans if the preceding loan has been repaid on time.

"Rolled Over" Loans. Regular customers who have drawn several loans and repaid punctually may take advantage of larger, rolled-over loans (a subsequent loan before the former loan is fully repaid).

Collateral and Repayment Terms. For both individual and group loans, at least three persons must co-sign as guarantors. In the case of individual loans, the three guarantors

With group loans, all guarantors are simultaneously borrowers. Each receives her own loan and is simultaneously a guarantor for all other loans granted to the group.

must have high enough incomes to lend assistance to the borrower if she or he experiences any repayment problems. With group loans, all guarantors are simultaneously borrowers. Each receives her own loan and is simultaneously a guarantor for all other loans granted to the group. Groups can consist of four to seven people. Loans within the group framework can be of various sums and repayment periods, but all group members must guarantee all loans to group members throughout their duration.

Group members must know, and have confidence in, each other and must convince the loan officer that they will help each other out in the event any of them experiences repayment problems. Fundusz Mikro does not assist in group creation. Members of groups can be acquaintances as well as members of the same family, on the condition that each of them has separate assets at her or his disposal.

In the event of any delay in the repayment of loans, FM does not grant further loans to the affected group. FM does not charge penalty payments. Thirty-three days after the loan repayment date, a notice is served on loans that are not repaid. No restructuring is allowed.

Loan disbursements are paid directly into borrowers' bank accounts from FM's account. Repayments of loans are made monthly into FM's bank account. Loan installments include capital and interest. All borrowers must have a bank account.

Partnership Finance. By 2001, partnership finance had become the new basis of Fundusz Mikro's operation. Described in detail in Section 5, partnership finance still functions as a loan repaid in standard monthly installments, but uses a new way of charging for the use of the borrowed capital. The charges are not fixed by the lender, but determined by the borrower. And the process is based on information that emerges from the relationship established during the assessment process. The key to that relationship is a sense of mutual trust.

CHAPTER 2

The need to bridge the gap between old attitudes and a new business culture

Research conducted in 2001 for Fundusz Mikro by the CASE Foundation (Center for Social and Economic Research) found that 60 percent of Poland's 1.6 million micro-enterprises (firms employing up to five individuals) declare that they have never raised, and do not intend to raise, loans from any institution. This may be due to the legacy of Poland's 50 years of communism, resulting in a poor grasp of market economics. Many entrepreneurs do not see loans as a source of finance for the development of their operations, but rather as a hedge in the event of sudden problems. Moreover, Polish micro-entrepreneurs are often unable to specify, even roughly, the expected return from an investment for which they must raise a loan. In periods of a healthy economic climate, they make good decisions based on intuition, but during an unfavorable economic climate, their lack of business assessment skills becomes a liability and they are often afraid to take any risks, whether with their own or borrowed money.

Many entrepreneurs see loans as a hedge in the event of sudden problems rather than an ongoing source of funds for their businesses' development.

The recent poor economic climate made it plain to FM that old attitudes and the lack of business assessment skills had to be dealt with. But the deteriorating economic situation also posed challenges for our own internal operations. The fall in inflation and the lowering of bank interest rates to about 13–15 percent meant that FM's products (with interest rates exceeding 22 percent) began to appear relatively unattractive. Customers expected FM to lower its interest rates in line

Sixty percent of Poland's 1.6 million micro-enterprises declare that they have never raised, and do not intend to raise, loans from any institution.

with bank rates, and when we did not, many people left. Customers with business problems expected us to accept late repayments, as they believed that FM had earned a lot from them in the past. More people began to perceive FM as a commercial institution that generated considerable profit under the guise of small enterprise assistance. The number of newspaper articles, formerly favorable to us as a "non-profit" organization, declined. Customers without good business plans found the interest rate issue a good excuse for not developing their businesses, and besides not recommending FM to new customers, sometimes deliberately damaged its image. Altogether, recruiting new borrowers became more difficult. At the same time, we began to see our objectives more holistically, leading us to emphasize building trusting relationships in our borrower outreach, selection, and assessment process. Our standards became even more stringent.

In Fundusz Mikro's early years, loans were granted to practically anyone whose business looked like it had potential to grow and to be a customer for new loans in the future.

In FM's first few years, during the time of Poland's rapid economic development, loans were granted to practically anyone whose business looked like it had potential to grow and to be a customer for new loans in the future. FM's approach was the standard one of believing entrepreneurs would repay relatively unsecured loans because they wanted access to larger loans in the future. Its initial objectives were to:

- Assist as many entrepreneurs with growth potential as possible.
- Minimize the rate of loan default through rigorous screening of loan applications and rigorous follow-up.

FM now realized that in order to avoid huge loan losses, which had begun to occur in some branches, its objectives needed to be expanded on at least two fronts:

- Build potential partnership relationships, which, through joint assessment/calculation of investment plans, business returns and risks, would teach clients business assessment skills.
- Support social capital by encouraging successful entrepreneurs who benefited from micro-loans to act in a mentoring capacity to other new entrepreneurs.

Successive "filters" through which every borrower must pass had to be developed.

Soon after the economic breakdown in 1998, when it became clear that not all firms could develop and not all entrepreneurs would want to seek subsequent larger loans,

FM began accepting those who intended to repay loans even if they were not likely to need a subsequent loan. Our policy began to emphasize only lending to borrowers who would repay their loans because they were convinced of the need to discharge the obligations arising from a business agreement. This required the additional effort of assessing entrepreneurs' intentions and establishing suitable relations based on partnership.

Gradually, Fundusz Mikro realized that in order to avoid huge loan losses, successive "filters" through which every borrower must pass had to be developed.

When we realized that many entrepreneurs lacked financial know-how and especially the experience of running a business during a recession, and went simply by intuition, unable to do suitable calculations or analyze the likely effects of the loan, another filter was applied. This filter accepts those who have the analytical capacity to learn the business skills needed to use a loan to advance their business.

Finally, we began applying an additional filter to identify applicants who understood Fundusz Mikro's mission and the full nature of the help it provides. We began doing this when we realized that some entrepreneurs saw FM as providing a purely commercial service for a market price, and thus felt they could take advantage of FM's services and have additional claims against FM. Thus, understanding the true nature of our services became a precondition for any long-term cooperation with a borrower.

Fundusz Mikro's Gradual Recognition of the Importance of Customer Attitudes about Business and about Helping Others

Under the old regime in Poland, assistance to those in need, like virtually everything else, was centrally organized and managed. Not only was this system wasteful, the resentment caused by an enforced sharing of one's resources with those in need effectively extinguished the desire to give spontaneous assistance. An erosion of the individual's natural instinct to help those who, through no fault of their own, are in difficulty is another legacy of communism. As we came to see partnership as the core of FM's new approach to skills enhancement and business culture, the significance of different attitudes among our customers became clearer. A brief typology of these different attitudes follows:

1. Those who have never taken advantage of any assistance and have no obligations that would awaken in them a need to assist others.

As we came to see partnership as the core of Fundusz Mikro's new approach to skills enhancement and business culture, we strengthened our resolve to find and select borrowers as much on the basis of their character and attitudes as on the prospects of their businesses.

2. Those who have had various forms of assistance from private individuals, but not from an institution. They have certain private obligations, but no "institutional" obligations.

3. Those who appreciate the chance that institutional assistance has given them to develop their business. They are ready to work as partners in offering various forms of assistance to others.

4. Those who view institutional assistance as the mere buying of a market product. They feel themselves to be customers with no obligations to anyone.

5. Those who think that if assistance comes from an institution, they have an automatic right to it. They accept help without any thought of its purpose, and have no desire to assist anybody else.

6. Those who think they require permanent assistance from the state or other organizations. If left to their own devices, they would not want to run a business. Permanent subsidy seems natural to them.

Rebuilding Social Capital and Creating a Culture of Honest Trading

Acknowledging these different attitudes confirmed for us that financial assistance, important as it is, was not enough. If the business culture of the country was to change, knowledge needed to be transferred: theoretical knowledge on how to run a business, practical knowledge of operations in a given environment, knowledge of trade connections, and knowledge of the market. We also saw the need to provide "cultural" assistance in changing certain habits of mind that impede rational business thinking. We believe such assistance can also involve convincing business people of the need to extend their economic knowledge to others. But only those entrepreneurs who are successful, experienced, and who fully understand their mentoring role, will have enough authority to make it work. Thus we strengthened our resolve to find and select borrowers as much on the basis of their character and attitudes as on the prospects of their businesses.

These non-financial kinds of support are also valuable in an environment like Poland's because they play a key role in building confidence in the economy. Confidence is an

indispensable factor in the development of a market economy. Trust in one's trading partners is a precondition for the development of market-oriented firms, and is a necessary adjunct to capital and the right economic climate.

Those who value this confidence the most are entrepreneurs who themselves profit from trust-based relationships with their trading partners, where confidence in one's partner is the basis for building relations. They know that the existence of such relationships lowers transactions costs and makes it possible to win customers by taking on obligations that they can only fulfill with honest partners. These relationships help the development of their businesses. Well-run microfinance institutions (MFI) in emerging market countries ought explicitly to foster the development of honest trading as a business norm.

Finally, given the difficult economic climate in Poland over the last few years, it may seem counter-intuitive for an MFI like Fundusz Mikro to try deliberately to restrict its market of potential customers. In thinking about this we have realized there is an additional ethical dimension to be noted. Much has been written about the deep differences between microfinance programs and fully commercial financial institutions. Increasingly practitioners and observers of microfinance recognize that the goals are more long-term and complex; almost everywhere microfinance is a developmental tool, but in emerging markets like Poland the field has to take on additional objectives, as this paper describes. The literature also acknowledges that because of these other agendas, many microfinance programs require subsidies. And one of the consequences of that fact is a general push in our field to achieve sustainability, which in the first instance is taken to mean even more outreach and expansion. But the literature does not say too much about the ethical dangers in this approach. Too often we make the mistake of focusing on the size of the market for our product and the most effective ways of selling it. We tend to forget that encouraging an entrepreneur to take a loan he cannot or should not take is not only unethical, but could also prove damaging for the borrower.

Too often we make the mistake of focusing on the size of the market for our product and the most effective ways of selling it—and forget that encouraging an entrepreneur to take a loan he cannot or should not take is not only unethical, but could also prove damaging for the borrower.

CHAPTER 3

Changing Fundusz Mikro's microfinance product: from "hard lending" to equity investment

Fundusz Mikro's core microfinance product is a hybrid: a mixture of a loan and an equity investment. It requires the establishment of a partnership relationship between lender and borrower, similar to that which exists between partners in a smoothly running enterprise.

As we began thinking about partnership relationships, we went back to basics and analyzed three main features of lending operations in order to see more clearly the kind of microfinance "space" we needed to occupy:

- the way the loan is secured (collateral);
- the form of financial benefit obtained by the lender; and
- the basis for establishing relations between the lender and borrower.

Loan Security/Collateral

Currently there are three basic ways of securing a loan, beginning with the "hard lending" approach used by commercial banks:

1. **A pledge of an asset**, the best kind of collateral from the commercial bank standpoint, requires the preparation of appropriate legal documentation and evaluation of the

Fundusz Mikro's core microfinance product is a mixture of a loan and an equity investment, requiring the establishment of a partnership relationship between lender and borrower.

In thinking about partnership relationships, we went back to basics and analyzed lending operations by how the loan is secured, the form of financial benefit to the lender, and the basis for establishing relations between the lender and the borrower.

object of the pledge, along with its registration in the appointed institution, all of which considerably increase the cost of the loan. Obviously many people cannot afford to secure loans by pledging assets, simply because they do not have them.

2. **A guarantee** involves another person taking on the obligation of repaying the loan should the borrower fail to do so herself. The guarantee is slightly more risky for lenders than the pledge, but allows loans to be raised by those who do not have appropriate assets. A guarantee is cheaper than a pledge, since it does not require costly legal documentation.

3. **A mutual guarantee** by several borrowers who jointly take responsibility for one another's payments, a form of collateral (also known as a "group loan") that has been the basis for the evolution of microfinance. For commercial financial institutions, such a form of security is not acceptable because it means granting the whole group a loan without any security. From the point of view of the lender, the mutual guarantee is a greater risk than a pledge or an individual guarantee. However, from the point of view of the borrower, it is considerably cheaper and creates an additional possibility for those entrepreneurs whose "only" resource is their good relations with other entrepreneurs.

FM has created a fourth way, a version of #2 above. We call this an **honor-based guarantee**. The guarantor does not have to sign any documents that would be the basis on which FM could take legal action. If the guarantor enjoys a good reputation in her circle, FM expects that the guarantor will be naturally obliged to assist the borrower who is unable to repay. The guarantor does not have to sign the loan agreement; it is sufficient that she explicitly express her intention to support the borrower by, for example, signing an appropriate letter of intention. If the borrower fails to repay the loan, our only recourse is to the guarantor's promise. Her refusal to fulfill her promise of assistance will damage her reputation but will not expose her to any direct costs. An honor-based guarantee is even more risky for the lender, but more convenient for the borrower.

If an honor-based guarantee can work as security for a loan, then it is equally easy to imagine a fifth approach: a loan secured by nothing more than the **reputation of the borrower's firm**. In such a case the lender must be convinced that the borrower has

every intention of repaying, and should she be unable, will turn to acquaintances able to assist her. Clearly, such a security measure is the riskiest for the lender, but it is also the simplest and cheapest for the borrower.

From the lender's point of view, then, collateral types run the gamut from the safest to the riskiest, from pledge to borrower's reputation. With regard to the effectiveness of the security, all except the first—the pledging of an asset—lie somewhere between commercial loans and capital investments, while the last of these five types—the reputation of the borrower—is similar to a capital investor putting equity into the borrower's business.

From the lender's point of view, collateral types run the gamut from the safest to the riskiest. The riskiest for the lender is also the simplest and cheapest for the borrower.

The Form of Financial Benefit for the Lender

The second loan feature to consider is the form of financial benefit that the lender obtains. Again we begin with the "hard lending" approach.

The most typical form of financial benefit for the lender is **contractual interest**, calculated on the loan amount, usually set in the loan agreement. This is not dependent on the borrower's financial capabilities. Thus it is the safest form for the lender and good for the borrower if his firm is providing a healthy income, but not, obviously, if his firm has much lower income than anticipated.

Interest is often seen as an inseparable feature of cash loans, a natural and obvious component. The amount of interest is usually the first thing a borrower wants to know. Interest is often treated as a synonym for the loan's price, and has the advantage of permitting, in theory, a rapid comparison of various loans on offer. In fact, it is only one of many ways of specifying the price of a cash loan. In practice, some lenders have different ways of stating their interest rate so that the supposed price of a loan is presented to look attractive.

Lenders can also split their earnings into interest (regardless of the borrower's earnings) and a "contingent" payment if the borrower achieves certain profit targets. This solution is safer for the borrower in the event of her or his attaining only small earnings, but is riskier for the lender. Such a risk may be worth taking, however, if the overall expected

return has a chance of exceeding the expected return from contractual interest alone. This approach can be called **partial contractual interest**.

One may go a step further and assume that all "interest" is paid voluntarily by the borrower if a profit target is achieved—**non-contractual interest**. This solution is the least risky for the borrower but the riskiest for the lender because it makes obtaining any financial benefit dependent on the borrower's profit. If, however, the expected return is greater than the contractual interest and, in the lender's assessment, the firm is profitable, the lender may decide to take the risk.

Moving towards investor lending types of arrangements, the form of financial benefit to the investor/lender may take the form of a fee paid to the investor as a partner in the business, a **partnership fee contingent on profits**, or simply a percentage of the profits—**profit sharing**.

From the lender's point of view, both risk and financial return increase as the lending arrangement moves from hard lending to equity investment.

We listed these five forms in order of increasing risk and financial return from the lender's point of view:

- Contractual interest
- Partial contractual interest
- Non-contractual interest
- Partnership fee contingent on profits
- Profit sharing

They are also listed in order of the progression from straight lending to equity investment. Currently most financial institutions offer only loans with interest specified in the agreement. However, hybrid solutions are possible and indeed are applied in practice.

One can imagine various financial products arising from combinations of the two features discussed so far (type of collateral and the form of financial benefit to the lender). One example may be a loan secured by a pledge with contractual interest. This is low-risk both in terms of repayment and the predictability of interest earnings. A loan with an additional "contingent" payment secured by a pledge has a higher earnings risk but lower repayment risk. A loan with contractual interest secured by an honor-based guarantee will fix the lenders return up front, but involves higher repayment risk.

The Basis for Establishing a Good Relationship

As old-fashioned banks in small communities used to know, looking only at collateral and the form of financial benefit is too limiting a way of examining a potential loan. Old-fashioned community banks knew that they first needed to establish an appropriate relationship with the borrower.

Documented information is the standard first step in establishing a good relationship. The lender needs access to officially confirmed documents, on the basis of which she can assess the borrower and her firm. At this level, the relationship with the borrower is built exclusively on the basis of documents. This is the typical relationship in formal bank loans.

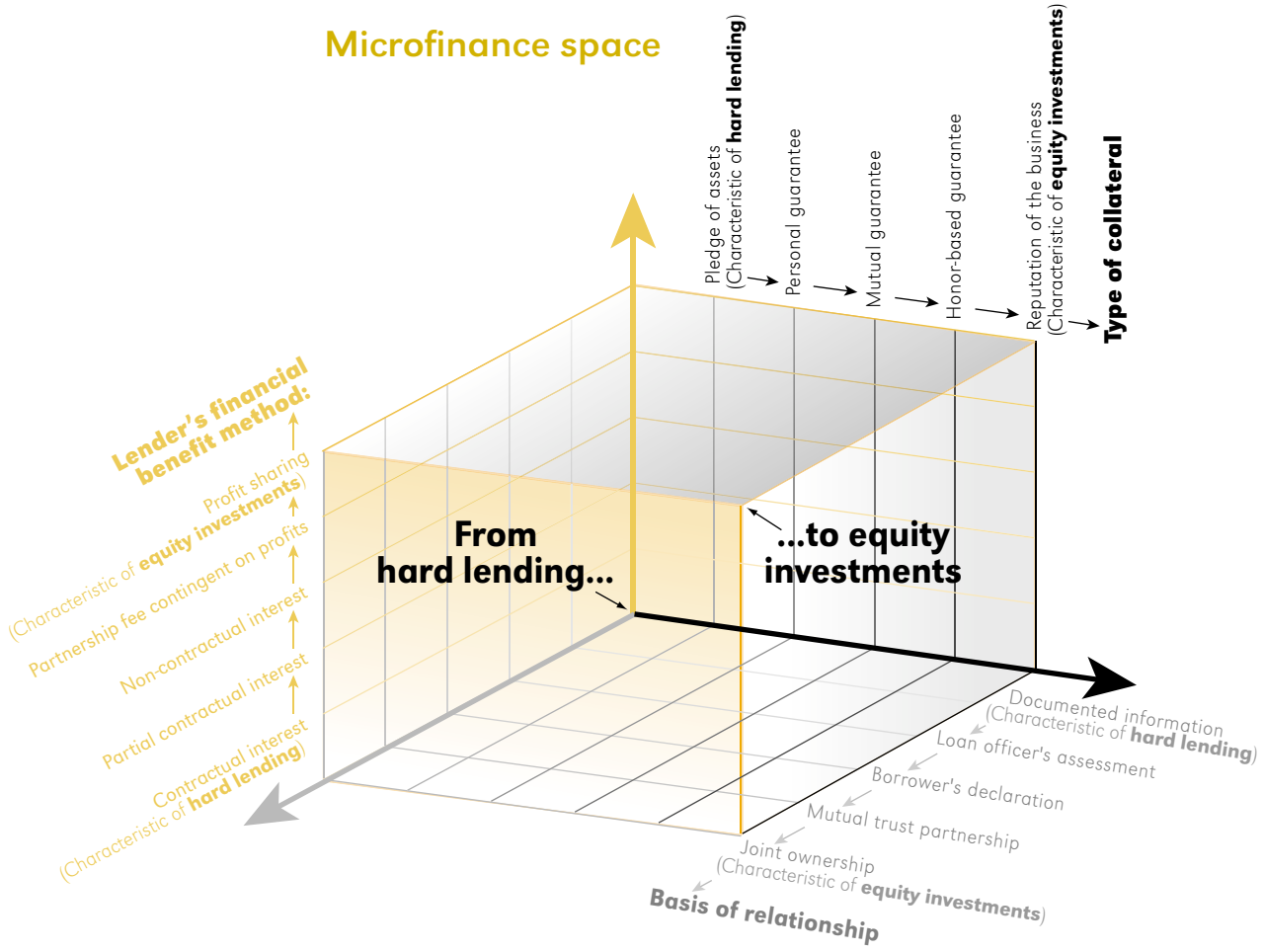
The next step in building a relationship is the **loan officer's assessment**. This requires the lender to possess relationship-building skills that encourage the borrower to provide access to additional information, which in turn enable the lender to draw additional conclusions.

The lender may also develop such good relations with the borrower that she will be able to rely fully on the latter's declaration. The acceptance of the **borrower's declaration** is the next step up the relationship ladder.

Even stronger relationships occur in a **mutual trust partnership**, where the borrower provides the lender with her plans and intentions and the premises on which they are based, that is, her commercial "secrets." The lender will then be able to obtain information that provides a better basis for forecasting the borrower's financial condition, which the lender can then take into consideration when specifying the conditions of the loan. The highest step is **joint ownership**—the basis of a full partnership.

The essence of a microfinance product is this: its various features may always be found located somewhere between the typical features for a "hard" loan and the features that characterize an equity investment. This is what defines the uniqueness of Fundusz Mikro's microfinance "space" *(see illustration, next page).* The more the finance product resembles an equity investment, the greater the importance of being able to establish a good relationship with the borrower. In short, relationship building needs to become part of the assessment process.

The more the finance product resembles an equity investment, the greater the importance of being able to establish a good relationship with the borrower.


Microfinance space
Pledge of assets (Characteristic of hard lending)
Personal guarantee
Mutual guarantee
Honor-based guarantee
Reputation of the business (Characteristic of equity investments)
Type of collateral
Lender's financial benefit method:
Profit sharing (Characteristic of equity investments)
Partnership fee contingent on profits
Non-contractual interest
Partial contractual interest
Contractual interest (Characteristic of hard lending)
From hard lending...
...to equity investments
Documented information (Characteristic of hard lending)
Loan officer's assessment
Borrower's declaration
Mutual trust partnership
Joint ownership (Characteristic of equity investments)
Basis of relationship

CHAPTER 4

The assessment process

Assessment is the process conducted by lenders who are experienced and trained in analyzing the risks of a business. Assessment is conducted through observation of borrowers' behavior, business operations, and their relationship with customers. Lenders must have the authority and ability to make honest decisions on behalf of the organization.

Good Loan Decisions Begin with MFI Employees Who Consciously take Personal Responsibility

Many microfinance organizations do not in fact trust employees to be fully responsible for the decisions they make. Part of the evidence for this statement is that responsibility is often transferred to systems of carefully specified criteria under the guise of "methodology." In other cases, responsibility is diluted with decisions being made by loan committees. In FM, because we wanted to create an atmosphere of genuinely full responsibility for decisions and for their alignment with our mission, employees needed to accept that their work would be assessed on the basis of the organization's general principles, rather than on precisely specified criteria. By using general principles aligned with the organization's mission, and not strictly specified criteria, no potential borrower will be automatically excluded for failing to fulfill inflexible pre-established criteria. In the final analysis, the loan officer who builds a relationship with the borrower and is in regular and direct contact with him, always has the best basis for making the decision.

No potential borrower will be automatically excluded for failing to fulfill inflexible pre-established criteria.

Assessment is conducted through observation of borrowers' behavior, business operations, and their relationship with customers.

Building good borrower relationships is a highly individualized process that depends not only on the borrowers' good will, temperament, way of thinking, and values, but also on the predispositions and skills of the microfinance institution's loan officers.

There can be no manual on how to establish relationships between microfinance institutions and their borrowers. This is a highly individualized process that depends not only on the borrowers' good will, temperament, way of thinking, and values, but also on the predispositions and skills of the microfinance institution's loan officers. Building good borrower relationships cannot be standardized. The microfinance institution must simply rely on its employees. It must be convinced of their honesty and give them possibilities to gain experience and increase their knowledge. Above all, staff must understand the overarching purpose of the organization.

As for the borrower's understanding of the organization and its product, FM has found that the borrower must feel he is dealing with a fellow human being, and also understand that the person making the decision on the loan is doing so in accordance with the organization's mission—that he is authorized to make the decision, and is fully responsible for it. The borrower must believe that this person wants to find ways to take advantage of the product's possibilities for the benefit of the borrower's particular needs. Finally, the borrower, as early as possible, needs to become convinced that it is worth being a partner of the lending institution.

Risk Analysis and Accurate Information

As FM grew, we found that the risk in many of our microfinance decisions arose because of limited opportunities to understand the borrower's *real* intentions and the *real* condition of his business. Establishing trust-based relationships with the borrower increased these opportunities. Such trust is especially necessary in an emerging market economy like Poland's, as Anthony Levitas, writing about the relationship between trust, knowledge, and money in Poland, made clear in an interesting paper from 1995.

Levitas offered the following poignant example of a Polish backyard producer of small diesel-driven electrical generators who applies for a loan from a bank: The backyard producer has provided to the bank whatever documents he has available, but they do not show profits promising enough to warrant the kind of expansion the entrepreneur says he wants. The entrepreneur tries to reassure the banker that the equipment he is making is (and will be) in high demand in Poland, if only he could expand. But the banker's knowledge of the Polish market is at odds with this, since he believes (correctly)

that Poland is moving away from the kind of cheaply made primitive equipment the entrepreneur provides. Not surprisingly, the bank indicates it is going to refuse the loan. Now the entrepreneur is caught in a dilemma. *Should he tell the banker the truth about his business?* For the fact is, his business is booming. He does not sell to Poles, but to Ukrainians who cross the border and buy his generators *because* they are primitive and thus cheap. Moreover, half his turnover and employment is off the books to avoid taxes. In fact what the entrepreneur really wants is advice on how to legitimize his business and begin producing better quality goods for the Polish market. He wants to ask the banker:

> *"whether it is true that if he officially imports the machinery he wants to buy with the loan, he can then amortize the investment and reduce his taxes. He thinks then it might even pay to legally register all his activities. But he doesn't ask because he has figured out by this time that he is not going to get the loan. Driving home, he is angry, more mistrustful of the banks than before, and even more sure that it's him against the world."*[1]

Levitas reminds his readers of the point of accurate information, and draws some interesting conclusions about the extra effort necessary in a country like Poland to get it:

> *"The lender ... wants to know as much about the borrower and the potential endeavor as is possible. And the borrower needs to know how to satisfy the lender's requirements for this information if they are to reach an agreement. Moreover, both want to know as much as they can about future circumstances that many affect the realization of the project and the repayment of the loan.*
>
> *The problem is that getting all this information, or indeed creating it, has costs, costs that may be so high that neither side is willing or able to bear them.* ***The less established the lender-borrower relationship, and the more unstable the environment in which they operate, the more effort it will take to generate the information*** *[Editor's emphasis]. On the one hand, without this information people will find it impossible to trust each other enough to engage in long-term, mutually advantageous forms of cooperation. On the other hand, the costs of getting this information can be prohibitively high for either or both of the concerned parties. ...*

As Fundusz Mikro grew, the risk in many of our decisions arose because of limited opportunities to understand the borrower's *real* intentions and the *real* condition of his business. Establishing trust-based relationships with the borrower increased these opportunities.

[1] Levitas, Anthony, "What Makes Credit Guarantee Programs Work? Growing Trust, Knowledge and Money in an Unstable Environment," in Levitas, Anthony and Gesicka, Grazyna, Editors: *Local Guarantee Funds,* Resources Development Foundation, Warsaw, 1995. pp. 12-13.

The problems created for cooperation by uncertainty and costly information appear everywhere and haunt, to a greater or lesser degree, all economies. They are, however, particularly acute in newly emerging market economies where there are complications at every turn. Here [in Poland], small businesses not only lack the skills necessary to generate the information that banks need to trust them, but they are often unaware of why this information is important or how it might allow them to improve their operations. Without being able to generate this information they will remain historyless strangers, forever outside the standard practices and culture of finance capital."[2]

We realize that we had to begin the process with questions not about the business, but rather about the borrower's understanding of the relationship he or she is about to enter into.

Recognizing the challenge so well put by Levitas, FM began to realize that we had to begin the process with questions not about the business, but rather about the borrower's understanding of the relationship he or she is about to enter into. Thus, in the case of a new borrower, FM's initial questions are:

- Does the borrower understand that the loan is more than a loan? Does the borrower understand that the loan is the nexus of a relationship between FM and the borrower, through which the borrower can improve his or her business skills, gain greater confidence, have access to other entrepreneurs and ultimately grow the business, and not merely his or her income?

If the borrower understands this, then the process may continue to the classic questions usually asked:

- Will the borrower be able to make good use of the money borrowed?
- Will the borrower voluntarily fulfill his obligations?
- Will the borrower's enterprise allow for the proper use of the loan and for its repayment?

But if, in the lender's assessment, the borrower does not understand (or cannot learn to understand) the larger purpose of the microfinance product, then the chances of establishing a trust-based relationship are very poor and the remaining questions will be of little use.

The majority of entrepreneurs who apply to Fundusz Mikro find it hard to understand that the key question is what benefit *they* expect to obtain from the loan and not what benefit the lender will obtain (as expressed in the price of the loan).

[2] Ibid. pp. 19-20.

This tendency is compounded by the unspoken "psychological structure" implied in the act of borrowing money—the inequality of the parties; in effect the lender has more money than he needs and the borrower less, and even though the borrower is poorer, he must repay the money plus interest. However, if the starting point in the process can be the benefit the borrower obtains and not the price he pays, the inequality of the parties is neutralized, and FM and its borrowers begin the relationship on the same level. And that is the first step in establishing trust.

If the starting point can be the benefit the borrower obtains and not the price he pays, the inequality of the parties is neutralized, and Fundusz Mikro and its borrowers begin the relationship on the same level. That is the first step in establishing trust.

But establishing such an equitable relationship does not mean abandoning the lender's emphasis on rigorous analysis. Indeed the next step in the assessment process is getting at the details of the business, its prospects, and the assumptions upon which the borrower has estimated those prospects. The difference between FM and commercial banks lies here, for it is not FM's job to figure these things out, but the borrower's. We both want the borrower to convince FM of the rationality of his or her case, *and* we want to help him or her to do so. This is again where trust comes into the picture. Many of FM's prospective borrowers are not only unable to undertake this kind of analysis, but, as Levitas indicated in the above quotation, do not even understand why it is necessary. Furthermore, they are reluctant to share more than superficial details of what they do and how they do it. In order for FM to help them make a convincing and rational case, our borrowers need to feel comfortable enough with us to share what they do know in full.

At the same time, if, despite Fundusz Mikro's best efforts, the borrower does not wish to discuss the business, or the longer-term benefits he expects to obtain from the loan, and seems unable to appreciate the process of building towards partnership, then he is advised not to take the loan, even though he might be otherwise qualified.

The next question we ask is: will the borrower voluntarily fulfill his obligations? Commercial financial institutions deem it so difficult to answer this that they do not even ask the question. Instead they substitute formal collateral, or systems for applying pressure on the borrower. But in FM, the relationship with the borrower provides a useful context for the question. Through it the lender can get not just the requisite information about the borrower as business owner, but can also arrive at conclusions about the borrower's intentions and convictions. An understanding of the need to fulfill one's obligations usually goes hand in hand with the ability and willingness to establish relationships

The next question we ask is: will the borrower voluntarily fulfill his obligations? There is no magic formula for assessing a borrower's motivation to fulfill his obligations. It depends on the life experience, insight, powers of observation, and temperament of the person making the assessment.

based on trust. Thus, the borrower with whom FM is able to establish easy contact, and who understands the essence of FM's microfinance product, will probably be more convinced of the need to repay loans on time. Of course, even the strongest convictions can change when circumstances change. This makes the assessment task harder still, for it requires that the source of the borrower's intentions and convictions be understood as well. For example, if the intention to fulfill obligations arises from the borrower's wish to be able to contract a similar obligation in the future, one has to ask: what will happen when the borrower needs no further loans?

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Borrowers Who See Repayment as a Value in Itself

Ryszard Kapuściński, in *Ebony* offers this seemingly strange description of bartering between African tribes:

> *In this part of Africa, trading relations called dumb trading had existed since time immemorial between the people of the Sahara and the settler tribes of Sahel and the green Savannah. The people of the Sahara sold their salt and obtained gold in return. This salt (an invaluable and highly sought after commodity, especially in the tropics) was transported from the central Sahara, on the heads of black slaves, by the Tuaregs and Arabs, probably to the river Niger, where the whole transaction took place: "When the Negroes come to the river, they do the following," says XV, the ancient Venetian trader Alvise da Circa da Mosto, "each of them sets out his pile of the salt they have brought, marks it and then walks away from this row of salt piles and retreats to a spot about half a day's journey away, in the direction from which they came. The next to arrive are people from another Negro tribe, who never show themselves to or speak with strangers: they arrive on large boats, probably from some island, land at the same spot on the bank and having examined the salt, place against each pile a certain amount of gold and then retire, leaving both salt and gold in place. Once they have gone, those who brought the salt may now return and if they consider the amount of gold sufficient, take it and leave the salt; if they are not satisfied they leave both salt and gold and again retire. Then the other tribe once again comes forward and*

removes the salt from those piles beside which they find no gold; in the case of the other piles, they place more gold if they consider it justified and leave the salt. It is precisely in this way they conduct their trade, neither seeing nor talking to each other at all. This has been going on for ages and although it seems incredible, I can assure you that it is the truth." (Translated by Joanna Szymanowska.)[3]

FM offers its microfinance product in a similar spirit of trust. Our products are aimed at entrepreneurs who are keen to build a good business reputation and to fulfill their agreements—not through fear of sanctions but from their own conviction about the wisdom of such conduct.

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Many practitioners believe that borrowers' willingness to repay a loan should be bolstered by a number of additional measures. For example, loan repayments should be small and regular amounts, paid as often as possible. This principle is based on the assumption that borrowers become accustomed to repaying small sums that are not too painful and thus develop the habit of paying loan installments within specified deadlines. In many societies, the educational aspect of this approach cannot be underestimated. Another principle maintains that the funds from which micro-loans are granted should come from the savings of members from the same social group to which the borrower belongs. If loans are funded from rich sponsors, they are more likely to be treated as a gift, an attitude that weakens the repayment motivation. Similarly, where the interest rate is lower than prevailing commercial rates, this too may result in the loan being treated as a gift that does not have to be repaid. Microfinance organizations that apply the above principles show good results.

Fundusz Mikro has convincing evidence that a different approach also works. *We grant loans only to those who are convinced of the need to repay and who do so voluntarily.* Such people repay because they value their reputation or because it is part of their value system. FM strengthens this conviction by demonstrating its confidence in the borrower by reducing its reliance on collateral (although not completely). Clearly, FM needs contingency plans if the borrower's intentions have been incorrectly assessed. However, in our system, members of the loan group or the loan guarantors fulfill a different role. Their task does not involve applying pressure to the borrower to repay

[3] Kapuściński, Ryszard, *Ebony,* 4th edition. Czytelnik, Warsaw in 2001. p. 298.

but rather providing assistance when, despite the best intentions, he is unable to do so on his own.

Peer support is more difficult to apply than peer pressure. But FM's mission is the creation of development possibilities for entrepreneurs who voluntarily fulfill their agreements. This is considerably more effective than the creation of opportunities for those who need additional motivation to repay or do so through fear of penalties. Entrepreneurs who voluntarily fulfill their agreements not only build a good reputation for their business quickly, leading to more customers, but also find it easier to find capital partners—a precondition for their enterprise's development.

A precondition for the proper and effective use of the microfinance product is the establishment of strong partnership relationships between the organization and the borrower. These relationships with borrowers, and with their guarantors, should result from specific confidence-building activities. Building these relationships involves observing, creating, and even provoking situations in which the borrower can make real decisions that demonstrate his intentions, attitudes, and stated values. Such activities constitute the basis for convincing the lender that the borrower wants to fulfill his obligations and that the guarantors mean to assist him if necessary.

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Entrepreneurs' Experience and Abilities

The most important entrepreneurial abilities are: to adapt to changes, to identify and use available resources, to identify and assess risks, to make prudent decisions, and to develop business relationships with partners and customers.

Analysis of a borrower's abilities requires an assessment of the value of the observations he has developed through experience. The best experience is gained from failures and mistakes. It is unlikely that somebody will share their failures with someone they do not trust. In the early phase of cooperation, many entrepreneurs are convinced that discussing their failures will have a negative effect on their image as borrowers. It is extremely hard to convince them that conclusions correctly based on past failures are strengths. For the same reason, borrowers often try to avoid questions about the main risks facing their businesses. They find it hard to appreciate that, rather than understating the risks, it far

better to show that they have identified all the risks, assessed them properly, and taken appropriate measures to mitigate those risks.

Risk constitutes a vital element in any definition of business operations, and the essence of entrepreneurship is the courage to weigh and take risks. If the entrepreneur doesn't understand this, he will not bother to analyze threats and will not take the necessary precautions. Some entrepreneurs jump to conclusions on the basis of the results of their past operations. Entrepreneurs who have achieved spectacular success often believe it is because of their own abilities, underestimating the importance of other factors, including luck, over which they had no control, and of which they were perhaps not even aware. It is difficult to establish cooperation with such partners, because they often underestimate the risks connected with carrying out their new ideas.

When discussing the business risks with the borrower, the loan officer needs to adapt to the borrower's mindset and to understand his language. This is the opposite of the "form filling" approach, where forms are filled in using the language of the institution, thus often leading the borrower to think: "What should I enter here to make my business look good?"

Additional Synergies Resulting from the Assessment Process

Not surprisingly, once we began the work of building trust-based relationships with borrowers as potential partners, we found certain synergies came about almost automatically. For example, some successful entrepreneurs who benefited from working with Fundusz Mikro were interested in supporting us in creating opportunities for other entrepreneurs or in doing so on their own. And those entrepreneurs who understood FM's objectives and intentions best were also the easiest for FM to understand. We also found a positive feedback effect: the assessment process, being built on a relationship based on mutual confidence, enhances the borrower's already good intentions.

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CHAPTER 5

Partnership finance

Partnership finance is the approach that emerged from Fundusz Mikro's experience. The partnership finance loan is repaid in monthly installments, like a standard loan. The difference lies in the way the borrowed capital is charged.

The new product is unique in that the borrower participates in setting the loan terms and profit-sharing with the lender. One goal of the product is to teach borrowers to evaluate potential profits in a difficult market rather than focusing on the loan cost. Borrowers estimate the profit they will earn from the loan, then they determine the amount they will repay to us.

Fundusz Mikro's partnership finance approach is unique in that the borrower participates in setting the loan terms and profit-sharing with the lender.

The first part of the finance charge is pre-determined and is deducted from the loan on disbursement (the charge is equivalent to what the loan funds would earn in a bank savings account). Before specifying the second part of the charge, the borrower provides estimates of the expected financial returns from the loan and the assumptions used. If these are realistic and the risks acceptable, then the loan decision is made before the second part of the finance charge is determined.

The borrower himself specifies how much of his prospective return will be paid as the second part of the finance charge. In this way he treats the lender like a partner. The second part of the finance charge is repaid in installments together with the principal. If, after repayment of the loan principal, the borrower finds that he did not obtain the anticipated return, the second part of the charge will be refunded to him in its entirety.

One goal of Fundusz Mikro's approach is to teach borrowers to evaluate potential profits rather than focusing on the loan cost.

Because borrowers recognize that they are investing in a long-term relationship with a financial institution that cares about them, most of them set the variable finance charge higher than the prevailing regular interest rate.

FM risks that the borrower will not pay the second part of the charge at all, or that this part of the charge will be small. However, because borrowers recognize that they are investing in a long-term relationship with a financial institution that cares about them, most of them set the variable finance charge higher than the prevailing regular interest rate.

The Advantages of Partnership Finance

1. **Sharing the risk with the lender.** Some entrepreneurs decide that it is worth declaring more for the variable finance charge than the standard interest charge since any economic adversity will reduce his payment obligation.

2. **The possibility of greater access to capital in the future.** The entrepreneur may decide that it is worth paying more because he has the chance to build a better relationship with the lender, which may be useful when the lender has capital constraints. In some ways, such a relationship resembles an insurance policy; by paying more today, the borrower increases his chances of access to capital tomorrow.

3. **Offering assistance to others.** One of the most important advantages, from the point of view of both the businessperson and the organization, is the opportunity to be of service to other entrepreneurs. When FM successfully creates development opportunities for a group of entrepreneurs, we expect some of the group to pay something back in the form of helping others.

4. **Business education.** Borrowers are helped to develop realistic business plans, which they are highly motivated to carry out. Partnership finance works as an excellent educational tool both for entrepreneurs and for FM employees. By discussing the manner of estimating the expected return on investment and the assumptions, our employees create a "case study" which enables them to identify the entrepreneur's educational needs. In addition, it breaks down entrepreneurs' passive attitudes to investment decisions. Entrepreneurs begin to focus on their expected profit from the investment, rather than on the cost of the loan. This approach helps many people break through psychological barriers that can prevent them from making rational investment decisions.

5. **Facilitation of relationship building.** Partnership finance demonstrates confidence in borrowers and helps borrowers understand FM better. Permitting borrowers to

specify their finance charges and sharing the risk with them is an excellent tool for building relationships. Personnel having direct contacts with borrowers receive exceptionally valuable information about the entrepreneur. However, entrepreneurs often do not have the possibility or the necessary skills to analyze this information and communicate their conclusions to others without the kind of assistance that FM staff offer.

6. **Facilitation of the identification of borrower's abilities and resources.** Partnership finance encourages the borrower to provide complete and honest information to justify the business plan. It motivates entrepreneurs to provide honest information because the loan decision depends on the expected economic returns and risks and on the assumptions used.

Conclusion: The Initial Experience of Fundusz Mikro's Partnership Finance Looks Promising

Though we are at the early stages of partnership finance, we are discovering that it enables us to get a much richer picture of the attitudes of entrepreneurs, their knowledge, and skills, than was ever possible through our standard loan system (FM has already made some 50,000 standard loans). That picture is helping us to see three ingredients as essential in the building of a new business culture in Poland:

1. an entrepreneur's business knowledge—an ability to assess the effectiveness of an investment;
2. a sense of enterprise—the skill to foresee changes and adapt to them, the ability to perceive new possibilities, and a determination to attain one's goals; and
3. a social attitude—the desire to establish, and the ability to build, good relationships with business partners.

The most interesting of these ingredients is the social attitude of entrepreneurs. There are of course a large number of potential FM borrowers who have no desire whatsoever to establish a financial partnership. They are not interested in either long-term cooperation or establishing a good relationship. However, there are also entrepreneurs who understand partnership financing perfectly and see it as similar to loans from family or friends. They understand the long-term advantages of such a form of cooperation. They appreciate the confidence shown in them. This group includes entrepreneurs who require help in

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expressing their plans and making the appropriate calculations. While time-consuming, it is worth helping them because they can appreciate the importance of this assistance, and they are often those with an inclination to help others, quite frequently through FM's mentoring program.

At the writing of this paper in 2003, Fundusz Mikro does not have enough data for a quantitative assessment of the various attitudes of entrepreneurs. What we do know so far is that in a group of first-time borrowers, we were only able to offer partnership finance to 10 percent of the applicants (including those who wanted to pay less than they would pay for a standard loan). Significantly, a comparison of the first 100 partnership finance loans made to first-time borrowers and a sample of 100 first-time regular loans of similar size and duration showed no difference in repayment rates. And yet, because of the nature of the relationship, partnership borrowers on average committed themselves to finance charges 5 percent higher than they would have paid for a standard loan.

About the author:

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