

**International Leaders' Forum on Development Finance**

**FUNDUSZ MIKRO'S  
SECRETS AND DISCOVERIES**

A brief history of Fundusz Mikro  
with findings and conclusions  
regarding directions of product development

*Witold Szwajkowski*

## Table of Contents

<b>EXECUTIVE SUMMARY</b>	<b>3</b>
<b>1. BACKGROUND</b>	<b>4</b>
1.1 Fundusz Mikro's beginnings and legal status.....	4
1.2 Borrowers .....	4
1.3 Development of the institution .....	4
1.4 Economic environment .....	4
1.5 Product development .....	5
<b>2. FINDINGS</b>	<b>7</b>
2.1 Findings regarding entrepreneurs' attitudes.....	7
2.2 Findings regarding Fundusz Mikro's role .....	8
<b>3. FUNDUSZ MIKRO'S OBJECTIVES</b>	<b>10</b>
<b>4. SECRETS AND DISCOVERIES</b>	<b>12</b>
4.1 Opportunities for development .....	12
4.2 Business talents .....	14
4.3 Access provided .....	14
4.4 Microfinance product .....	16
4.4.1 Collateral .....	16
4.4.2 The form of financial benefit.....	17
4.4.3 The basis for establishing a good relationship.....	19
4.5 Assessment process .....	20
4.5.1 People who make decisions .....	20
4.5.2 Risk analysis .....	21
4.6 Entrepreneurs' intentions .....	24
4.7 Entrepreneurs' abilities .....	25
4.8 Other discoveries .....	27
<b>5. PARTNERSHIP FINANCE</b>	<b>28</b>
5.1 Product write up .....	28
5.2 Benefits for the borrower .....	28
5.3 Advantages of partnership finance .....	29
5.4 Relations with entrepreneurs .....	29
5.5 The initial experience of Fundusz Mikro .....	29

## **EXECUTIVE SUMMARY**

This paper presents Fundusz Mikro's innovative support system for entrepreneurs. The paper is presented to facilitate experience sharing and mutual learning.

At the heart of the system is the Fundusz Mikro's (FM) mission statement derived over a seven-year learning curve. The paper outlines the roots of FM's objectives and the most important findings regarding entrepreneurs and Fundusz Mikro's role in the process of providing assistance.

The main points and conclusions are in the diagram boxes "Secrets" and "Discoveries". They are not prioritized in order to give readers a holistic view, showing how different ideas are linked and interact with each other, making the system alive. The ideas are discussed in more detail in the chapter titled "Secrets and Discoveries".

FM's innovative loan product is described in the last chapter ("Partnership Finance"). This sets out the way the product was derived from FM's findings and how its advantages facilitate the system (illustrated in the bottom of the diagram). The presentation is a trade-off between clarity and complexity. We hope that we have managed to strike the right balance.

## **1. BACKGROUND**

### **1.1 Fundusz Mikro's beginnings and legal status**

Fundusz Mikro was founded in 1994 by the Polish-American Enterprise Fund, which invested US\$20 million of loan capital. A USAID grant covered initial operating costs. From its inception through October 2002, Fundusz Mikro has disbursed US\$96 million, granting 50,000 unsecured microloans. This has created new economic opportunities for 26,500 owners of microbusinesses who could not afford to buy financial products from commercial institutions. The initial loan capital has been preserved and is still available to borrowers. FM now has over 8,500 active customers with outstanding loan balances of over US\$13.5 million. Cumulated loan losses since inception are US\$1.2 million. Fifty-three percent of the loans were distributed to repeat customers, some of whom are on their ninth loan. Most loans help develop borrowers businesses and create new jobs.

Fundusz Mikro was registered as a limited liability company, because this is the only non-bank institutional form that can grant interest-bearing loans.

### **1.2 Borrowers**

Most borrowers employ less than 5 staff. Typical occupations are carpenters, hairdressers, stonemasons, metal workers, car repair mechanics, taxi drivers, bookkeeping consultants, stall and shopkeepers. Loan values are tailored to customer needs and can increase with consecutive loans. The average first loan is US\$1,200 and this can gradually increase to US\$8,000.

### **1.3 Development of the institution**

From the start FM aimed to provide services nationwide. In the first year of the pilot phase, FM opened three branches: one in Starogard Gdański (30,000 inhabitants), Toruń (200,000), and Łódź (800,000). Individual loans were tested in Starogard and Toruń, group loans in Łódź. 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 it was concluded that the best Polish solution was to create a network of FM branches and employ staffs that would make decisions on behalf of the firm.

It took two years, ending in 1998, to build a 5-7-branch network in regions identified earlier. Thereafter several branches in cities that were too small were consolidated with neighboring branches.

### **1.4 Economic environment**

Fortunately the Fundusz Mikro 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 turnover growth was achieved by simply increasing shops' inventories or broadening the range of goods sold. FM experienced strong demand for working capital. Many entrepreneurs were keen to borrow money and the chief motivation for repaying loans was the desire to obtain new, larger loans to fund the further development of the borrower's business.

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 achievement was launching the group loan concept in Poland. At first the concept was treated with

considerable reserve. FM managed to convince its customers by presenting loan groups as an additional valuable service rather than a loan requirement. Another innovation to motivate group formation was linking interest rates to the group size. Highest interest rates were charged on individual loans and the lowest rate applied to groups of at least four. These innovations benefited other micro-loan programs in Central and Eastern Europe.

The economic situation worsened dramatically with the Russian financial crisis in August 1998. Declining disposable income led to reduced turnover for small commercial companies. In addition, there was a rapid development of supermarkets by international networks. In the last 3 years, approximately 200 were built in Poland and their number is still growing. These have taken away an enormous quantity of customers from the smallest commercial and service firms. There has been a dramatic fall in demand for working capital loans, dropping from 70% of FM loans granted to 20%.

Fundusz Mikro had to maintain its lending rates in order to achieve operational break-even, which it succeeded in doing. At this time, bank interest rates dropped considerably and this too reduced the attractiveness of FM products. In order to improve portfolio security it was necessary to change FM policy to stress building good long-term relationships with customers. 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 was a difficult task for FM employees, demanding more effort and better selection of borrowers.

## **1.5 Product development**

### Standard loans

Under the standard loan product, customers may borrow up to US\$2,500 for their first loan, although the typical first loan amount averages US\$1,500. Once repaid, the entrepreneur may request a loan that is 50% larger, provided his/her firm justifies this request and all installments of the preceding loan were punctually repaid.

Loans are granted for a period not longer than 1 year. A grace period or payment suspension of up to 3 months is possible. Interest rates average 20% per annum, but depend on the length of the period of cooperation with the borrower and are decided by branch managers. The maximum sum of a loan in the standard offer is US\$7,000. In addition to interest, borrowers also pay an administrative fee of 2% of the loan at the time of loan disbursement. This fee is reduced to 1% in subsequent loans if the preceding loan has been repaid on time.

### Partnership loans

Regular customers who have drawn several loans and produced evidence of their punctual repayments may take advantage of larger, rolled-over loans (a subsequent loan before the former loan is fully repaid).

### Partnership finance

This is a loan repaid in standard monthly installments, however with a new way of charging for the use of the borrowed capital (described in Chapter 5).

### Collateral

Loan security is provided by co-signer guarantees from at least three persons. This refers both to individual and group loans. In the case of individual loans, the three guarantors must have incomes

making it possible for them to lend assistance to the borrower if he experiences any problems with his repayments. Within the framework of group loans, all guarantors are simultaneously borrowers. Each of them receives his own loan and is simultaneously a guarantor for all other loans granted to the group. Groups can consist of 4 to 7 people. Loans within the group framework can have various repayment periods and various sums, but all group members must guarantee all group loans throughout their duration.

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

In the event of any delay in the repayment of loans, Fundusz Mikro does not grant further loans. FM does not charge penalty payments or interest. Thirty-three days after the time limit for their repayment, a notice is served on loans that are not repaid. No restructuring is allowed.

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

## 2. FINDINGS

### 2.1 Findings regarding entrepreneurs' attitude

The poor economic climate has negatively affected entrepreneurs' attitudes toward the risk associated with financial investment. The fall in inflation and the lowering of bank interest rates to about 13 - 15% means that Fundusz Mikro's products (interest rates exceeding 22%,) appear relatively unfavorable. Many people perceive Fundusz Mikro as a commercial institution that, behind the guise of a program to assist small enterprises, is generating considerable profits. This makes the recruitment of new borrowers more difficult. It also made marketing more difficult than in the past when complimentary press articles presented FM as a "non-profit" organization.

FM customers who were convinced that they paid market rates expected the interest on FM loans to drop due to the lowering of bank interest rates. Since FM could not lower its rates, they become disappointed and many of them left. Those who have problems with their businesses expected FM to accept late repayments, as they believe that FM had earned a lot from them in the past. Customers without good business plans found the interest rate issue a good excuse for not developing their businesses. They don't recommend FM to new customers and sometimes damage its image.

Research conducted for FM by the CASE Foundation (Center for Social and Economic Research) found that in Poland over 60% of the 1.6 million micro-enterprises (firms employing up to 5 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 normal source of finance for the development of their operations, but rather as an aid in the event of sudden problems. Micro-entrepreneurs are often unable to even roughly specify their 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, they are often afraid to take any risks with respect to investing borrowed money or their own capital.

The research also confirmed that if these entrepreneurs really must borrow, they prefer to do so from families and friends on "softer" terms. This usually results in the lender sharing the business risk with the entrepreneur. The lender usually keeps his title to a nominal sum of the loan, but the price for taking advantage of this capital depends on how well the borrower has succeeded in using the loan.

FM has identified the following entrepreneurs' attitudes to assistance from development institutions. This was done by observing entrepreneurs' reactions to FM's product offering.

1. Entrepreneurs who have never taken advantage of any assistance and may not have any obligations that would awaken in them a need to assist others. This is a very small group.
2. Entrepreneurs who have had various forms of assistance from private individuals, but have never obtained assistance from any institution. They have certain private obligations, but no "institutional" obligations.
3. Entrepreneurs who have had institutional assistance and who appreciate that they have had the chance to develop their business. They accept that somebody may, in turn, expect assistance from them and they are ready to cooperate with an institution by offering various forms of assistance to others.
4. Entrepreneurs who are too ambitious to accept any help from an institution. However, they accept such assistance because they do not consider it permanent. They believe the assistance "only"

enables them to develop their talents and realize their full potential. As entrepreneurs, they will in the long run have to make a positive contribution to the economy. They are able to show gratitude for the help obtained by participating in the creation of opportunities for other entrepreneurs.

5. Entrepreneurs who are too ambitious to accept any assistance from an institution, but at the same time are too greedy to pass up the opportunity. They are able to justify taking advantage of an institution by saying that since they are paying the same rate as charged by a bank, they are not getting any assistance, but only buying a market product. They feel themselves to be customers with no obligations to anyone. They behave like customers who want to pay and in turn make demands, something that improves their self-confidence.
6. Entrepreneurs who think that if assistance originates from an institution this means that they have the right to it. Taking advantage of assistance is simply a measure of their entrepreneurship. They accept help without any thought of the source of such assistance or its purpose. They are not concerned with whether they are entitled to this assistance. Naturally they also have no desire to assist anybody else.
7. Entrepreneurs who think they require permanent assistance from the state or other organizations. They could not or would not want to run a business if they were left to their own devices. Taking advantage of permanent subsidies does not worry them in the least and, at most, they may be anxious about whether such subsidies will be available in the future.

## **2.2 Findings regarding Fundusz Mikro's role**

Unfortunately, the legacy of a centrally controlled economy is a deeply rooted universal belief that assistance to those in need should be centrally organized and managed. However, centrally operated assistance is often enormously wasteful and very little reaches those really in need. However, this is not the greatest evil of centralized assistance. Far worse is the destruction of the natural human need to support those who, through no fault of their own, are in difficulty. The burdens imposed on citizens by inefficient support systems create in many people a justifiable reluctance to provide any other help on their own initiative. Enforced sharing of one's resources with those in need effectively extinguishes any desire to give spontaneous assistance, which would be more effective and considerably better addressed.

We believe that micro-financing, by creating opportunities, may be one of the factors that is rebuilding in people the need to provide help to others. Such help may take various forms, such as:

1. Financial assistance. This could be a gift in the form of money or objects, an interest-free loan or a soft loan, or the loan of an object or premises. This is assistance that directly improves the beneficiary's financial situation. It is the most straightforward form of assistance, requiring the least amount of effort from the person providing it.
2. Educational assistance. This involves providing theoretical knowledge on how to run a business, practical knowledge of operations in a given environment, trade connections, and knowledge of the market. This form of assistance is considerably more difficult to provide than financial assistance.
3. "Psychological" assistance. This assistance breaks habits and stereotypes in the beneficiary's thought patterns. Such assistance improves the beneficiary's understanding of the businessman's role and helps overcome attitudes that impede rational business development thinking. This also involves convincing the businessman of the need to extend his economic knowledge. Providing such assistance is exceptionally difficult and can only be provided by experienced successful entrepreneurs who enjoy a high degree of authority in their environment and who fully understand their role.

Any of the above support is enormously valuable. This sort of help involves the creation of opportunities for others by those who previously took advantage of just such opportunities.

Confidence in the economy does not develop spontaneously. The process of building confidence needs to be initiated by someone who must be the first to show confidence, assessing the risks, and then establishing the confidence based relations.

Confidence is an indispensable factor in the development of the market economy. Trust in one's trading partners is a precondition for the development of a firm. Of course, it is not sufficient on its own. Also needed is the owner's sense of enterprise, capital, a suitable economic system, and the right economic climate.

FM believes its role is to create chances for entrepreneurs to develop by providing capital and showing confidence in them. Those who value this most are entrepreneurs who themselves profit from trust-based relationships with their trading partners. 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 fulfil with honest partners. These relationships help the development of their businesses. Well run microfinance institutions encourage the development of honest trading as a norm and not a sensational exception, as well as confidence in one's partner as the basis for building relations.

### 3. FUNDUSZ MIKRO'S OBJECTIVES

The objectives of Fundusz Mikro were initially defined as:

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

In the light of the experience described above, FM realized that its objectives needed to be expanded by at least two points:

- Support the education process for entrepreneurs through joint assessment of investment plans and calculation of business returns and risks.
- Support social capital by encouraging successful entrepreneurs who benefited from micro-loans to act in a mentoring capacity to other new entrepreneurs and to promote the micro-finance concept more widely.

Development of the Fundusz Mikro's products and the unique method of contacting entrepreneurs has involved the creation and application of successive "filters" through which every borrower must pass. New filters have been added in the course of meeting entrepreneurs and crystallizing FM's support role.

1. The first filter lets through all those who want to borrow money and whose results convince FM that they are willing and able to develop their businesses and raise new loans in the future. For the first three years, FM granted loans to practically everybody who passed this filter. This was during the time of the country's rapid economic development, when most businesses were developing and foresaw the need for additional capital in future. FM believed entrepreneurs would repay practically unsecured loans because they wanted access to larger loans in the future.
2. The second filter lets through those who intend to repay loans even if they are not likely to need a subsequent loan. FM applied this filter with the economic breakdown in 1998. It became clear at that time that not all firms will develop and not all entrepreneurs will want to raise further, larger loans. Thus money should only be lent to those who want to repay their loans voluntarily, because they are 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.
3. The third filter accepts those who know how to use a loan to the concrete advantage of their business. The third filter was applied after FM found many entrepreneurs use their intuition to invest loans. They did not do suitable calculations or analyze the expected effects of the investment. This was due to poor economic knowledge and lack of practical experience in managing a small business in a recession. Thus despite their intention and ability to repay, the loan could not only fail to advance their business, but could even set it back. FM conscious provision of such loans would be unethical and would increase the number of dissatisfied customers.
4. The fourth filter identifies applicants who understand Fundusz Mikro's mission and the help it provides. The filter resulted from observations and an analysis of the attitudes of entrepreneurs who believed they were taking advantage of a commercial offer and were paying the market price. Taking advantage of FM's services was contributing to their deprivation and the formation of pretentious attitudes. The entrepreneur's understanding of the true nature of FM's service is a precondition for any long-term cooperation with him and for increasing the number of actively participating Fundusz Mikro borrowers.

The current FM mission statement is:

**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 components of this sentence/system are shown in Diagram 1. Related findings and observations are briefly described in the blue boxes, titled “Secrets” above the main sentence marked in gray. More detailed explanations and supporting findings are contained in the following chapters with corresponding titles. The green boxes below the sentence contain “Discoveries”, derived from Fundusz Mikro’s practice. Discoveries link elements of the system. These discoveries, along with other observations, helped FM develop a new loan product – in fact a new lending approach – described in the chapter titled “Partnership finance”. This is represented by the purple box on the diagram. Advantages of partnership finance, listed in yellow boxes, link partnership finance with the system.

## 4. SECRETS AND DISCOVERIES

### 4.1 Opportunities of development

*„Create opportunities for development...”*

Opportunity creation is the policy that makes beneficiaries of the system aware that they take advantage of an opportunity created by an organization dedicated to help them.
---

FM helps entrepreneurs by creating new business opportunities. This should not be of a permanent nature, because entrepreneurs should accumulate funds to help those who cannot cope on their own. Assistance for entrepreneurs only has any sense where it permits them to develop their potential and possibilities, enabling them to return to the economy more than they received (in the form of taxes and/or by giving voluntary assistance to others).

However, both entrepreneurs who have had assistance and those who have managed without assistance pay the same taxes. Receiving assistance should awaken a moral obligation or desire to provide assistance to others. This should, of course, take place only once they are in a position to provide such assistance.

Assistance for entrepreneurs can be seen as an investment in social capital. Each such investment only makes any sense when it gives a greater return than the original outlay. Investment in social capital should bear fruit by motivating entrepreneurs to give assistance to others when they have such a possibility. If it fails to motivate them, such investment should be considered a failure.

The effectiveness of capital investment can easily be objectively measured in the financial return. It is well known that there are successful financial investments and also less successful investments. Similarly, investments in social capital have varying results. However, it is difficult to find information about unsuccessful investments in social capital. This does not mean that they are all successful; rather it reflects a lack of critical and honest reflection. This is a pity, because the dissemination of such knowledge would permit others to avoid similar mistakes.

FM found that for its investment in social capital (i.e. assistance for entrepreneurs) to be successful, entrepreneurs must understand that they are receiving assistance and why. FM has encountered organizations specializing in assistance for entrepreneurs with subsidized loans that believe entrepreneurs, especially the smallest, are not interested in the true nature of the assistance offered and not capable of understanding it. These organizations believe it is not necessary to explain to entrepreneurs that they are receiving assistance. Entrepreneurs only need to know the terms of services offered (how much they have to pay and what they will get for this payment). This approach results in entrepreneurs being led to believe (incorrectly) that the assistance provided (soft loans) is a permanent feature of the economic environment. This view goes on to suggest that maintaining this lie is a good idea because it will convince entrepreneurs that they are managing on their own in a free market (even though they not), and this will motivate them and build their confidence.

The following arguments refute this approach:

1. This is a patronizing attitude toward entrepreneurs. Perhaps, amongst the smallest entrepreneurs, there are many who will not be able to grasp the nature and purpose of support offered. However, the

effort should be made to help them understand. The attitude that it is not worth explaining shows one does not take these people seriously. Entrepreneurs, especially the smallest, deserve respect and serious treatment not only because they drive the economy, but also because they display an unusual sense of responsibility for their existence and that of their families and the courage to take enormous risk. Presenting them with real information on the nature and purpose of the services offered is just one expression of such respect.

2. Entrepreneurs who can understand the nature and intention of the support offered may interpret the lack of explanation as manipulation. People who feel manipulated begin to respond in a similar manner. They are tempted to manipulate information on the condition and capability of their firms, making good loan decisions more difficult. This may lead to loans that do not assist these firms and may even contribute to their downfall or to loans that will not be repaid.
3. A patronizing attitude makes it hard to evaluate the entrepreneur's intentions. When providing loans to the smallest entrepreneurs, loan decisions are often made on the basis of an evaluation of the borrower's intentions. Intentions are evaluated on the basis of many factors, including the borrower's behavior in different situations. This is not possible if the lender does not know exactly what the borrower understands of the goal of the organization.
4. A patronizing approach will deter potentially interested entrepreneurs from taking advantage of the support offered. All commercial firms guard their image jealously and make every effort to ensure their customers understand the nature of the product they are buying. If the product is much more expensive than other, similar products, then it is in the firm's interest to explain to customers what they are getting for the higher price. Customers often find it difficult to appreciate the value of a product at the moment of its purchase. If they are convinced that they are paying more for the product's high quality and its durability, they may recommend this firm to others or at least not discourage others from using it. If they get the impression that they have paid too much and that somebody has "deceived" them or used their monopoly position, they will probably discourage other potential customers. Entrepreneurs taking advantage of subsidized loans can also get the impression that they are paying too much and, as a result of their frustration, may discourage others from taking advantage of these loans. It is unlikely that someone who fully understands the nature and purpose of a good deal will discourage others from accessing it.
5. This approach contributes to some entrepreneurs developing a hostile attitude that results in spurious legal claims against the organization. Instead of their being motivated to provide assistance to others in the future, it causes them to demand even more assistance for themselves. This attitude can demoralize potentially good entrepreneurs.
6. This approach sends false economic signals to entrepreneurs. An entrepreneur, not understanding that his business is subsidized, can be excused for believing that his business is profitable and may begin investing in expansion instead of seeking out really profitable activities. While the difficulty of diversifying out of agriculture may justify subsidy, convincing a subsidized basket seller that his business is profitable not only discourages him from searching for profitable lines, but also causes him to send the wrong signal to basket manufacturers. The main competitive advantage small firms have over larger ones is their ability to very quickly react to market changes. Causing them to relax their vigilance in this respect, by sending false economic signals, strikes at their very right to exist. Thus, such activity is exceptionally irresponsible and damaging to the economy.
7. This approach undermines the creation of rational, natural systems of self-assistance for entrepreneurs—systems that eventually would not require any external subsidies. Credit unions represent one such system. Credit union members understand the union's intentions and the nature of

its support. They know their loans come from other member's savings, resulting in very good loan repayment rates. However, credit unions require members to save first, a form of insurance for those with surplus cash who know they may need a loan some day. Many entrepreneurs are unable to save and, without capital, their talent and potential will be wasted. They can only promise that if they succeed in putting the assistance they receive to good use, then **in the future** they too will create opportunities for others. In order to determine how many such people exist, it is important to both give them a chance to understand what such a system would involve and also to evaluate their intentions.

## 4.2 Business talents

*“...of business talents...”*

Peoples' business talents are one of the most important assets of every society. Development of talents needs support and favorable environment
---

The microfinance product is targeted to people who already have, or may develop, the talents and characteristics of entrepreneurs. These are people who, through no fault of their own, cannot afford to take advantage of commercial financing sources, and are thus unable to develop their enterprises.

These are people who have no opportunity to compete in a free market and employ others. Microfinance is aimed at the owners of the smallest firms because the more developed firms can usually already afford commercial finance. The developed firms often have property that can be used as collateral and employees who can handle the formalities of a more complex firm.

The size of a firm should not however constitute a criterion for access to microfinance. The main criterion should be the expected effect of using this finance. Microfinance should firstly be available to those entrepreneurs who can use it best for the development of their enterprises.

It requires courage and a strong belief in the wisdom of this approach to refuse assistance to an entrepreneur whose firm is going bankrupt and then grant a loan to that entrepreneur who can manage without assistance. It is very easy to forget the primary role of microfinance, namely to **create opportunities for development** and not to simply lend assistance. Lending and distributing assistance is handled by other institutions financed from the taxes paid by healthy enterprises.

## 4.3 Access provided

*“...by providing access...”*

The access provided is an interim form between selling products at market prices and making free grants. It meets the needs of entrepreneurs who neither deserve support in the form of grants nor have access to commercial markets.
---

Many people believe that microfinance programs are simply a part of the financial system composed of, for example, banks, leasing firms, lending institutions and investment funds. The above-mentioned institutions also offer financing to firms that lack capital. However, the purpose of commercial financial

institutions is to **generate profit** and their products are derived from this purpose. The purpose behind microfinance operations is different. FM believes that the task of micro-financing is to **create opportunities for economic development**. As a result, microfinance shares greater similarities with a library than commercial financial institutions.

The main purpose of a library is to **provide access to books** and not to generate profit. Libraries do not have costly marketing campaigns to attract the largest possible number of readers. Likewise, nobody would seriously say that libraries destroy the publishing market: the public's borrowing of books does not result in the purchase of fewer books. Libraries are based on the correct assumption that it is worth spending public money on institutions ensuring everybody access to books because the social good obtained in this way considerably exceeds the costs incurred. One may say that access to libraries is a natural, unquestioned civil right, despite the fact that only 20 percent of society makes use of the service.

In terms of its mission, Fundusz Mikro is more like a library than a bank or other financial institution. Instead of books, it lends money. In their initial phase, many microfinance programs require subsidies. Some have attained, or have a strong chance of attaining, financial self-sufficiency. However, among the several thousand microfinance institutions operating world-wide, very few are commercially profitable. If it were so, the microfinance markets would have long ago been dominated by banks and other strong financial institutions with the appropriate systems and resources at their disposal to simply buy know-how in this sphere.

Despite this, microfinance institutions are often evaluated in the same way as commercial financial institutions. Commercial institutions **sell products on a market** so as to be profitable. Thus the evaluation of commercial institution boils down to:

- the effectiveness of sales (distribution, promotion, advertising, etc.),
- the product and pricing,
- the market demand for the product and competition, and
- the company's profitability

Unfortunately, sales, products and marketing are often used as criteria for evaluating microfinance operations. Microfinance loans, even though they are mostly subsidized, have all the features of market products. Their price (interest rate) often exceeds that of seemingly similar products, such as bank loans. Since they closely resemble market products, it seems reasonable to ask about the size of the market for this product and the most effective ways of selling it. However, encouraging an entrepreneur to take a loan he cannot/should not take is not only unethical, but could also prove damaging for the borrower.

However there is one obvious difference between a library and a microfinance institution. Libraries have been around for hundreds of years; everyone knows what they are and what they do. People may not know where they are located, but if they wanted to use the library they would have no problem finding it. So there is no need to conduct a campaign to explain the purpose and sense of libraries.

The concept of non credit union microfinance operations has been with us for 25 years, though in Poland for only just a few. Most entrepreneurs simply do not know or understand the concept. Thus microfinance institutions must **inform** entrepreneurs of the possibilities created by microfinance and of the potential benefits of micro loans. If the concept of microfinance becomes widely known and understood, promotion will no longer be necessary and the scale of microfinance operations should then be adapted to the actual existing needs.

The micro-financing concept is hard to understand for someone who has never been an entrepreneur without access to capital. Many talented entrepreneurs never take advantage of micro-financing because the appropriate information never reaches them. This is due to the high cost of information campaigns, which would have to be passed on to those entrepreneurs currently taking advantage of the product. FM does not do aggressive promotion since it would be unethical and would strengthen the false perception of micro-financing as a commercial operation.

#### 4.4 Microfinance product

*“...to capital...”*

Borrowers access more flexible financial products that combine the features of two extreme forms of financing: hard loans and equity.

FM's 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 those that exist between partners in a smoothly running enterprise.

The essence of a micro loan can be explained by using the concept of a three-dimensional microfinance space (Diagram 2). However, an understanding of this concept requires some knowledge of geometry as well as spatial imagination, and for this reason an exact description is necessary.

We look at the micro loan by analyzing its three main features:

- the way the loan is secured (the alternative repayment, should the debtor fail to repay);
- the form of financial benefit obtained by the lender; and
- the basis for establishing relations between the lender and borrower.

These three features of the loan may be considered separately. For this reason, they are shown as three axes delineating a three-dimensional microfinance space.

##### 4.4.1 Collateral

There are many ways of securing a loan. The best, on the axis pointing right, is the **pledge**. The pledge is the most reliable collateral for a lender but at the same time, the most awkward for the borrower. In addition, it requires the preparation of appropriate legal documentation and evaluation of the subject of the pledge, along with its registration in the appointed institution, all of which considerably increases the costs. Not everybody can afford to raise loans secured by pledges because they do not have or cannot afford the objects that can serve as a pledge.

For this reason, other ways of securing the lender's interests have been invented. An example may be the **guarantee**. The guarantee involves another person taking on the obligation of repaying the loan should the borrower fail to do so himself. The guarantee is slightly more risky for lenders than the pledge, but allows loans to be raised by those who themselves do not have the appropriate property. It is also cheaper than a pledge, since it does not require costly legal documentation.

Microfinance institutions accept a **mutual guarantee** of loans by several borrowers who jointly take responsibility for their payment. For commercial financial institutions, such a form of security is not

acceptable because it means granting the whole group a loan without any security. Many micro-lending organizations have proved that mutual guarantees from groups of borrowers are as effective or more than conventional security. This idea, also known as a "group loan," has been the basis for the development of micro-financing. There is no doubt that for the lender, the mutual guarantee is an even 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 – relations that allow them to raise a loan secured by mutual guarantee.

FM also implemented another type of guarantee. The guarantor does not have to sign any documents that would be the basis for FM to take legal action. If the guarantor enjoys a good reputation in his circles, FM may decide that the guarantor will be naturally obliged to assist the borrower who is unable to repay. Such a guarantor does not have to sign the loan agreement; it is sufficient that he explicitly expresses his intention to support the borrower by, for example, signing an appropriate letter of intention. If the borrower fails to repay the loan, FM may only resort to the guarantor's promise. His refusal to fulfil his promise of assistance will damage his reputation but will not expose him to any direct costs. Such a guarantee may be called an **honor-based guarantee**. It is even more risky for the lender, but convenient for the borrower and very cheap.

If we can imagine an honor-based guarantee as security for a loan, then it is equally easy to imagine a loan secured by nothing more than the **reputation of the borrower's firm**. The lender may be convinced that the borrower wants to repay and should he be unable, will turn to acquaintances able to assist him. Naturally, such a security measure is the riskiest for the lender, but it is also simplest and cheapest for the borrower.

To summarize, the following is a list of all loan security measures mentioned:

- Pledge
- Guarantee
- Mutual guarantee
- Honor based guarantee
- Reputation of the borrower's firm

These correspond with the points on the axis marking the microfinance space, which is directed towards the right-hand side of the diagram.

From the lender's point of view, security measures run the gamut from the safest to the riskiest, from pledge to borrower's reputation. With regard to the effectiveness of the security measure, the last of these solutions is similar to a capital investment by the lender in the borrower's business. We can therefore say that from the point of view of the risk connected with the effectiveness of the means of security, micro loans lie somewhere between loans from commercial institutions and capital investments.

#### 4.4.2 The form of financial benefit

The second feature of the loan that must be considered is the **form of financial benefit** that the borrower obtains from it. Various forms of this benefit are marked on the second horizontal axis.

The most typical form of financial benefit for the lender is **contractual interest**, calculated on the sum of the loan. The loan agreement sets out the amount of interest due to the lender. This is not dependent on the borrower's financial capabilities. Thus it is the safest form for the lender and also one that is good for

the borrower if his firm is providing a healthy income. It is, however, inconvenient for the borrower if his firm has no income.

It is worth noting here that interest is often seen as an inseparable feature of money loans, a natural and obvious component. The amount of interest is usually the first question posed by a borrower wishing to raise a loan. Interest is often treated as a synonym for the loan's price. In fact, it is only one of many ways of specifying the price of a money-based loan. It is the method most commonly used, the most convenient, and at least theoretically permits a rapid comparison of various loans offered. In practice, some lenders have different ways of stating their interest rate so that the price of a loan presented in that way looks attractive. The price for using a loan may however also be specified in another form. This may be a sum of money specified ahead of time, a bottle of cognac, or a box of chocolates. It may also be an obligation for the borrower to recompense the lender by means of a similar loan granted at some unspecified time in the future.

Lenders can also split their earnings into interest (regardless of the borrower's earnings) and a voluntary payment if the borrower achieves certain profit targets. This solution is safer for the borrower in the event of her attaining only small earnings but is riskiest for the lender. This risk may be worth taking, however, if the expected sum of interest paid in this way has a chance of exceeding the contractual interest. This form is marked on the graph as **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. This is shown on the graph as **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.

The following includes all the above-mentioned forms of financial benefit in the order in which they are entered on the graph's axis:

- Contractual interest
- Partial contractual interest
- Non contractual interest
- Voluntary partnership fee
- Profit sharing

From the point of view of the lender, these solutions are listed in order of increasing risk and financial return. Moving along the axis from left to right, the solutions gradually change from loans 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.

The type of collateral and the form of financial benefit are the **features of the financial product**. One can imagine various financial products arising from combinations of these two features. One example may be a loan secured by a pledge, with contractual interest. This is low risk both in respect of repayment and the predictability of interest earnings. A loan with an additional voluntary 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.

#### 4.4.3 The basis for establishing a good relationship

Thus we cannot evaluate financial products exclusively from the point of view of collateral and the form of financial benefit (the two characteristics on the graph's horizontal axis). This is a flat way of examining a case and one that fails to take an extremely important factor into account: namely, the lender's ability to establish an appropriate relationship with the borrower.

Beginning at the bottom, **documented information** is the first step in establishing a good relationship. The lender needs access to officially confirmed documents, on the basis of which he can assess the borrower and his 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 make additional conclusions.

The lender may also develop the skill to establish such good relations with the borrower that he will be able to fully rely on the latter's declaration, without the need for any analysis of records or independent evaluation of the information obtained. **The borrower's declaration** is entered on the perpendicular axis as the next step up the relationship ladder between the borrower and the lender.

Even stronger relationships are indicated by **mutual trust partnership**, where the borrower provides the lender with his plans and intentions and the premises on which they are based, that is, his 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 relations occurring between partners.

In the cube-shaped microfinance space in Diagram 2, we can differentiate two points lying at the ends of one of the diagonals passing through its center. One of these points corresponds to a list of the following characteristics: the pledge of property as collateral, contractual interest as a form of financial benefit, and documented information as the basis for relations with the borrower. This point is marked with the box "From Hard Lending..." and corresponds to a "clean" loan. The second point corresponds to the following list of characteristics: the firm's reputation as the loan's security, profit sharing as a form of financial benefit, and joint ownership as a basis for building good relations. This is marked with the box "to Equity Investments", which mean capital investments, since it is precisely these three features that characterize the same.

The essence of the microfinance product is precisely this: its various features may always be found located somewhere between the typical features for a "clean" loan and the features that specify capital investment. Thus we may say that microfinance products are in essence an indirect form between a loan and capital investment. Naturally, the various features of particular products may to a differing degree appear like the features of capital investment but the point in space corresponding to all three features of a given product is always to be found within the cube constituting our microfinance space. However, in each case the microfinance product requires the lender's skill in establishing a good relationship with the borrower. The more the finance product resembles a capital investment, the greater the importance of being able to establish a good relationship with the borrower.

## 4.5 Assessment process

*“...on the basis of assessment...”*

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.

### 4.5.1 People who make decisions

In Fundusz Mikro, decisions must be made by people who consciously take personal responsibility.

Micro loans should not be granted on the basis of strictly specified criteria, but according to general principles. The absence of strict criteria is to ensure that no person to whom the product is addressed will be automatically excluded for failing to fulfil any of these criteria. Employees of microfinance institutions should treat each application individually and without bias. They should seek the best ways to assist the entrepreneur as long as they have positively assessed the possibility of his plans succeeding and have established a good relationship with him. However, all applicants should appreciate that a negative decision may result and it may not be altered. Such a decision may result from hard facts but could also be derived from intuition and general experience. If this decision is changeable by a third party, the lender becomes a clerk checking whether certain criteria have been fulfilled rather than an equal partner with the entrepreneur, with whom he must establish a relationship based on trust.

The relationship-based approach flows from the nature of microfinance. Another key element of microfinance products is the way they are communicated to potential borrowers. It is not possible to draw up a manual on how to establish relationships between microfinance institutions and their borrowers. This is a highly individual process that depends not only on the borrower's good will, temperament, way of thinking and value system, but also on the individual predisposition and skills of the microfinance institution's representative. The most important work of a microfinance institution, namely 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 the possibility to continuously increase their knowledge and gain experience. Success depends first and foremost on how well staffs understand the purpose of their operation and how efficiently they achieve its objectives.

FM has found that in order for its product to be understood by the borrower, he must feel that he is not speaking with an organization represented by a representative, but with a **human being who represents** the organization. He must also understand that this person is a decision maker in accordance with the organization's mission, that he is authorized to make decisions, and is fully responsible for them. The borrower must believe that this person wants to find ways in which to take advantage of the product's possibilities and try to adapt it to his particular needs. He should also, as early as possible, become convinced that it is well worth being a partner of this institution.

In order to create an atmosphere of complete responsibility for decisions and for their conformity with the mission, the principle of uniformity for all aspects of the applied policy should be enforced in the organization. An employee should accept the fact that his work will be assessed on the basis of his supervisor's general principles, observations, knowledge and experience, and also on his inner conviction, but not on precisely specified criteria.

The establishment of good relations with employees is the most difficult aspect of the microfinance institution's activity. In practice, few organizations trust employees to be fully responsible for the decisions they make. Part of this responsibility is transferred to carefully specified systems of criteria that are sometimes called methodology. In other cases, the responsibility is diluted with decisions being made by large groups, often called loan committees. In the final analysis, the lender who builds a relationship with the borrower and is in regular direct contact with him always has the best basis for making the decision.

#### 4.5.2 Risk analysis

Fundusz Mikro believes that the risk in microfinance decisions mostly arises from the limited opportunities to understand the borrower's real intentions and the real condition of his enterprise. Establishing relationships with the borrower based on trust may increase these opportunities.

A person making a micro loan decision—a decision to commence or continue a long-term co-operation—should be aware of the risks involved in such a decision. Commencing co-operation with an unknown borrower requires first finding the answers to several questions:

- Does the borrower understand the purpose of the microfinance product?
- Will the borrower be able to make good use of the money borrowed?
- Will the borrower voluntarily fulfil his obligations?
- Will the borrower's enterprise allow for the proper use of the loan and for its repayment?

Usually, the loan decision must be made on the basis of a limited number of premises that may aid in answering these questions, with only a little time for analysis. For this reason, it is best to answer to the first question first. If, in the lender's assessment, the borrower does not understand the purpose of the microfinance product, the chances of establishing a trust-based relationship are very poor and the remaining questions are pointless.

The borrower's understanding of the product's purpose may seem unnecessary from the point of view of the risk of a single loan. If the answers to the remaining three questions are decidedly positive, one may be justified in assuming that the loan will be repaid. However, by omitting an analysis of the borrower's understanding and acceptance of the microfinance mission, a lender only interested in repayment risk will not create opportunities for enterprises to develop. In order to do so effectively, one must understand the enterprises long-term development plan and how access to the microfinance product may be of assistance. This is only possible when the right type of relationship has been established, that is, when the borrower develops sufficient trust in the lender to discuss his business plans. A necessary precondition for commencing such a process of building trust is the borrower's understanding of the purpose behind the microfinance product. This is a difficult, thankless task without any immediate results both for the borrower and lender, for which reason there is a temptation to omit it.

In order to avoid such a situation, the lender must discuss the purpose of the loan and the way it is to be used by the borrower. The borrower should convince the lender that the loan would give him financial benefits that exceed the loan repayment several times over. This is because the people to whom microfinance is addressed are those entrepreneurs who show that they will be best able to take advantage of it. This is hard to explain, because the majority of entrepreneurs apply to Fundusz Mikro precisely in order to purchase loans, not realizing what exact purpose the product is intended to serve. They therefore only want to learn about its price and all remaining conditions. They find it hard to understand that the

key question is what benefit **they** expect to obtain from the loan and not the benefit that the lender will obtain (expressed as the price of the loan).

This is compounded by the common unspoken "psychological theory" of borrowing of money, which assumes the inequality of the parties to loan agreements. Supporters of this "theory" assume that a borrower borrows because he needs money and the lender lends him the money because he has too much. Thus the borrower is poorer than the lender, but, despite this fact, must **repay** the borrowed money plus interest. The result: he who has too much money will have even more. This contradicts many people's idea of justice and equality, particularly in situations where the lender demands payment of the debt from a borrower who does not have the money to repay him and, especially, where the lender is an institution.

If however we adopt as our starting point the **benefit** the borrower obtains and not the **price**, the inequality of the parties is reversed. The borrower may be the one who not only has more money, but also can make more profit on the capital in his possession. Thus, in this respect, he is taking advantage of the lender's weakness and pays him for using the loan a price that is less than the benefit he himself gains from it. From the economic point of view, a loan only makes sense if it brings benefits to the borrower. But too much emphasis has always been focused on the financial benefit to the lender since this is the most visible benefit and is obtained "without effort". This benefit is in the form of interest, which is an element of the product offered and is always considered too high – a direct consequence of adopting the assumption that the parties are unequal. Borrowers themselves are only too glad to concentrate on the price they have to pay for using loans, conveniently ignoring the benefit they are to obtain. This is their right if they are paying a commercial price for their loans.

In the case of microfinance operations, a specification of the borrower's financial benefit is essential in order to commence the process of establishing co-operation. What is more, the borrower himself should be able to specify the benefit and identify the assumptions on which it is based. He should also convince the lender of the rationality of the assumptions. Naturally, very few people are able, without preparation, to present such a justification or even understand the need for it. In many cases, entrepreneurs applying for loans prefer to rely on their intuition. Any discussion of the benefit they will derive from the loan is awkward but necessary, for it constitutes a practical opportunity to begin building a relationship. If the borrower does not wish to discuss the benefit he is to obtain from the loan and despite efforts made by the lender, is unable to appreciate the purpose of the microfinance product, he most decidedly should not take advantage of such a product, even if granting him a loan is entirely safe.

Of course, it is difficult to detect whether a borrower has understood the purpose of the microfinance product. Relying purely on his declaration could be a mistake. The decision to co-operate, therefore, involves the risk that he has not understood the product's purpose. This risk should be minimized by building a strong relationship from the first meeting.

Once the borrower understands the purpose of the product and has reliable expectations with regard to his financial benefit, an attempt should be made to answer the next question: will the borrower voluntarily fulfil his obligations? This aspect of the loan's security is the most important and most difficult to assess. Commercial financial institutions often deem this factor impossible to assess and substitute formal collateral or systems for applying pressure on the borrower. However, in microfinance operations, this analysis is essential. It requires establishing a suitable relationship with the borrower, as a result of which he will provide information or demonstrate attitudes and opinions that will help in arriving at conclusions concerning his intentions and convictions. This refers not only to his intention to fulfil his obligations where he is able to do so, but also his intention to apply for assistance from guarantors in the event that he is unable to repay the loan himself. An understanding of the need to fulfil one's obligations usually goes hand in hand with the ability and willingness to establish relationships based on trust. Thus, the borrower with whom we are able to establish easy contact, with regards to learning the benefits he may obtain and

who understands the essence of the microfinance product, will probably be more convinced of the need to repay loans on time.

Making the effort to establish proper relationships right from the first contact allows one to make many observations that may be useful in assessing the borrower's intentions and convictions. It allows one to consider the borrower's ability to objectively assess the benefits obtained by the parties to an agreement, his ability to make forecasts on the basis of assumptions, and his ability to formulate assumptions themselves. If the borrower is convinced of the need to fulfil contractual obligations, then the building of relations based on trust should only strengthen this conviction.

There is no magic formula for assessing a borrower's motivation to fulfil his obligations. It depends on the life experience, insight, powers of observation and the temperament of the person making the assessment. However, even the strongest convictions can change as a result of new circumstances. Thus, one should consider not only whether the borrower is convinced of the need to fulfil his obligations, but also the source of this conviction. If the main source is fear of losing a good local reputation, then the risk of moving to another town should be assessed. If the intention to fulfil obligations arises from the borrower's wish to be able to contract a similar obligation in the future, the question arises: what will happen when the borrower needs no further loans?

Another factor motivating repayment is a borrower's loyalty towards individual staff members. This is particularly important because in strong trust-based relationships it is easy to blur the distinction between the professional and the personal. By crossing this line, the staff member may be more effective and improve his reputation, but the borrower's motivation to repay may worsen if a new staff member is assigned to deal with him.

Motivation cannot be assessed exclusively from borrower statements or behavior. It is necessary to ask **why** the person behaves in this way. Driving at the legal speed limit does not prove a driver's conviction of the need to comply with the rules of the road. Of course, this conviction cannot be ruled out, but other explanations are also possible: fear of speed traps, mechanical problems with the car, searching for an address, or simply daydreaming. Of course we could find out from the driver, on condition that he wanted to tell us – in other words, if he trusted us.

If the assessment of the borrower's motivation to fulfil his obligations is negative, or the risk of his losing motivation is too great, further risk analysis is unnecessary. This is another difficult moment in the relationship with a potential borrower. On learning that he may not receive a loan the common response is: "Why, which condition don't I fulfil? After all, you have not even learnt anything about my firm or my property!"

It is difficult to tell an applicant that he has not convinced you of his **desire** to repay a loan. Thinking about personal responsibility is quite hard for many people. Often, they simply do not understand the question of whether they will want to fulfil their obligation. This is because they do not feel they are an active party to the agreement – a party on whom its fulfillment depends. It is as if they stand aside assuming that the agreement is not with them but with factors over which they have little influence. This is best illustrated by applicants who respond to the question about the **desire** to repay by referring to the **source** of repayment, e.g. "I have so much property that in case of need, I will be able to sell something", or: "The firm's turnover is such that I will have no problem in scraping up the money". Rarely do they point out that in case of need they can turn to their guarantors for assistance. In practice, when repayment problems arise, they most often look for assistance from the lender. If their turnover falls unexpectedly, some borrowers no longer feel obliged to repay their loan because they perceive their loan agreement to be concluded not with them but with their firm's turnover.

## 4.6 Entrepreneurs' intentions

“...entrepreneurs' intentions...”

Entrepreneurs are honest people, who want to benefit from contributing to the economy and do it at their own risk. They have intentions to pay the loan back, to develop the business, to develop partnership with the lending organization and to participate in creating opportunities for other entrepreneurs in the future.

An entrepreneur is somebody who earns a living by contributing (or hoping to contribute) more to the economy he takes from it. He differs from an employee in that he acts at his own risk. Unlike an employee, the entrepreneur bears costs without any assurance that he will see a return on these costs. The employee concluding a contract of employment does not bear any risk, because from the outset he is assured of a reward for the work that he is about to carry out.

FM's microfinance product is addressed at entrepreneurs who are keen to build a good business reputation and to fulfil their agreements – not through fear of sanctions but from their own conviction about the wisdom of such conduct. This attitude towards fulfilling agreements is the most difficult feature to evaluate, analyse and verify. It can be said that an entrepreneur's acceptance of a microfinance offer is in itself an ongoing verification of his respect for the principle of complying with agreements.

An excellent illustration of this principle is the description of bartering between African tribes in "Heban" - Ebony, by Ryszard Kapuściński.

*"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)."*

Many practitioners believe that borrowers' willingness to repay a loan should be increased 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 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. There is also a theory that borrowers should believe they pay commercial interest rates. Where the interest rate is lower, this may also result in the loan being treated as a gift that does not have to be repaid. In many cases this is true. Micro-loan organizations that apply the above principles show good results.

Fundusz Mikro has convincing evidence that a different approach also works. FM grants 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 in 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 its system, members of the loan group or the loan guarantors fulfil a different role. Their task **does not involve applying pressure** to the borrower to repay but rather providing **assistance** when, despite the best intentions, he is unable to do so on his own.

Peer support, rather than peer pressure, is much more difficult than motivating debtors to repay their liabilities. However, FM's mission is creation of development possibilities for entrepreneurs who voluntarily fulfil 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 fulfil their agreements not only build a good reputation for their company 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 their guarantors should result from specific confidence-building activities. Building these relationships involves observing, creating, and even provoking situations in which the partner 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 fulfil his obligations and that the guarantors mean to assist him if necessary.

#### 4.7 Entrepreneurs' abilities

*“...and abilities.”*

The most important entrepreneurs' 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.
---

In the event of a positive assessment of the borrower's intentions, FM concentrates on the next step: the borrower's abilities. During conversations with the borrower on the financial benefits expected from the loan, a great deal of information can be obtained about his abilities. Entrepreneurs must be able to make precise forecasts from available information and use rational assumptions. However, very few micro-entrepreneurs have mastered these skills. Mostly they rely on intuition, knowing what needs to be done to get results but not why. Thus FM's task is to assess the risk involved in their intuition. Naturally, this risk drops with experience in the chosen field and the general running of a business. There is only a tenuous connection between the amount and quality of experience gained. A person who has worked in a grocery shop for 20 years may have little experience in running a retail food business. Analysis of a borrower's

abilities requires an assessment of the quality and wisdom of the observations he has developed through experience.

Here too, trust-based relationships are very helpful. 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 co-operation, 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 precautions.

Risk constitutes a vital element in any definition of business operations and the essence of the same 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; in other words, he is not the kind of entrepreneur whom FM would lend to. Some entrepreneurs jump to conclusions on the basis of the results of their past operations. Entrepreneurs who have achieved spectacular success often believe this is due to their own abilities, underestimating the importance of many other factors, including luck, over which they had no control and of which they were perhaps not even aware. It is difficult to establish co-operation with such partners, because they often underestimate the risks connected with carrying out their new ideas.

Sometimes first impressions are misleading. In essence, entrepreneurs analyze and assess risk and protect themselves totally by intuition. When questioned about risk, they reply that there is none; they do not see any risk against which they have not protected themselves. This requires the microfinance institution's representative to make considerable efforts to adapt to the borrower's mindset and to understand his language. This approach is the opposite of the "form filling philosophy", where forms are filled in the language and manner specified by the institution, usually leading to the question: "What should I enter here to make it look good?"

It is difficult to learn about a micro-entrepreneur's business without learning the owner's private language. Yet this is essential in order to analyze the company's risk profile.

There is no point in progressing to the enterprise risk analysis unless the borrower abilities and experience are satisfactory. This is usually a very fluid process because the firm's value and risk profile are largely reflected in the person of the entrepreneur. For example, an independent sculptor-craftsperson has a unique value and risk profile. One could say that he **is** the enterprise and the key enterprise risk is his ability to carry on working.

The value of a firm often depends on the owner's relationships with other firms, based on results and integrity (e.g., advertising agencies). When such a firm is taken over by another person, these relationships must be rebuilt – hard work without any guarantee of success. However, when a firm's value is independent of the owner's identity (e.g., a newsagent on busy street), one may assume that its customers are not particularly interested in the owner's contacts and qualifications.

By their nature, microfinance institutions make many small loan decisions without detailed analysis; there simply is not the time. That is why it is so important to answer the questions presented at the beginning of the chapter, in the order in which they are introduced. Starting the risk analysis by assessing the enterprise is a waste of time if it turns out that the firm's owner does not understand her risk profile or its mitigation. It is extremely important to start the process by building a good relationship. Analysis of the enterprise and the entrepreneur's abilities, experience, and intentions requires active co-operation on her part – impossible without a trust-based relationship. This is often forgotten, despite the fact that the

microfinance institution is well placed to initiate the process; it intends entrusting its money to an unknown borrower without conventional security. If this cooperation is not forthcoming, it is because the microfinance institution did not do its selection properly.

#### **4.8 Other discoveries**

FM also discovered that:

- Successful entrepreneurs who benefited from the opportunity offered by FM may want to support FM in creating opportunities for other entrepreneurs or may do so on their own.
- Where entrepreneurs fully understand FM's objectives and intentions, it is easier for FM to understand their intentions. This mitigates the risk of lending.
- FM's assessment of investment plans, business risk, and return facilitates the education process of entrepreneurs.
- The assessment process builds a relationship between the entrepreneurs and FM that is based on mutual confidence. This relationship has a positive influence on borrowers intentions.
- The essence of FM's support is linking capital to borrowers' abilities and resources through smart relationships.

To facilitate these findings, Fundusz Mikro introduced a new microfinance approach that we named Partnership Finance. Advantages of partnership finance enhance the above findings.

## 5. PARTNERSHIP FINANCE

### 5.1 Product write up

Fundusz Mikro's new approach is called **partnership finance**. This 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 educate 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 suggest the amount they will repay the lender.

The first part of the finance charge is pre-determined and is deducted from the loan on disbursement (the charge equivalent to what the loan 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 principle. If, after repayment of the loan principle the borrower declares that he did not obtain the anticipated return, the second part of the charge will be refunded.

The lender 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 buying a long-term relationship with a caring financial institution, most of them set the variable finance charge higher than the prevailing, regular interest rate.

The loan procedure is shown on the Diagram 3.

### 5.2 Benefits for the borrower

#### Sharing the risk with the lender.

The entrepreneur may 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.

#### The possibility for actively building relations with the microfinance institution.

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.

#### Lending assistance to others.

However, the most important advantage, both from the point of view of the businessperson and the organization, is the possibility of **satisfying the need to help others**. Helping others is a universal need. Considering only the financial dimension, one sees many different forms in which this need is satisfied: from giving alms to beggars, voluntary donations to organizations helping the needy, to obligatory assistance (tax). It is worth noting that increased enforced assistance reduces many people's need to give voluntary assistance. The need and readiness to help others does not depend on the individual's wealth.

So when FM has created development opportunities for a group of entrepreneurs, we expect some of the group to pay something back, in the form of helping others.

### **5.3 Advantages of partnership finance**

FM has found that partnership finance has the following advantages:

1. Gives borrowers a real chance to contribute, in the form of fees, to the process of creating opportunities for other entrepreneurs.
2. Helps demonstrate FM's intentions and helps assess borrowers' intentions immediately after the loan decision is made, by means of a borrower determined finance charge.
3. Helps educate borrowers to develop realistic investment plans, which they are highly motivated to carry out. It constitutes 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, FM 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' fixation on the loan cost is replaced with the focus on their expected profit from the investment. This approach helps many people break through the psychological barrier that prevented them from making rational investment decisions.
4. Facilitates relationship building by demonstrating 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. It is also an excellent illustration of the nature of microfinance operations.
5. Facilitates identification of borrower's abilities and resources, encouraging the borrower to provide complete and honest information to justify the investment plan. It motivates entrepreneurs to provide honest information because the loan decision depends on the expected economic return and the assumptions used.

### **5.4 Relations with entrepreneurs**

This approach improves FM's understanding of entrepreneurs, their way of thinking, motivation and requirements. This is especially important because building relationships takes place between the entrepreneur and FM's employee and is usually inaccessible to outsiders. Personnel having direct contacts with borrowers are on the receiving end of exceptionally valuable information on the entrepreneur. However, entrepreneurs often do not have the possibility or the necessary skills to analyze this information and communicate their conclusions to others. Their communication skills are weak.

### **5.5 The initial experience of Fundusz Mikro**

Fundusz Mikro has attempted to evaluate the partnership finance concept described above. The first important discovery we made after introducing this system is that the discussion of financing based on partnership brings to light a whole range of interesting information on the attitudes of entrepreneurs, their knowledge and skills. This information would be hard to obtain when offering only standard loans, and FM has already granted some 50,000 standard loans.

There are three key elements: an entrepreneur's **economic knowledge**—an ability to assess the effectiveness of investment; 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 a **social attitude**—the desire to establish and the ability to build good relationships with business partners.

The most interesting is the social attitude of entrepreneurs. Some have no desire whatsoever to establish a financial partnership. They are only concerned with the price of a loan. They are not interested in either long-term cooperation or establishing a good relationship. Neither are they interested in FM's mission or that they are benefiting from a subsidized service (they probably do not even realize that this is the case). There are those who only see financing based on partnership as a way to raise cheaper loans. Others appear interested in the service itself, but don't trust it enough to provide information on planned earnings. Others, again, do not want to discuss their real incomes because they are so much higher than the cost of the loan. They pretend not to understand and for this reason prefer standard loans. Many such individuals are intrigued by the offer. They do not really understand why Fundusz Mikro should decide to undertake what they see as a greater risk. Some suspect that FM is busy with some sort of deception.

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 and are even able to define them. They appreciate the confidence shown in them. This group includes entrepreneurs who require help in expressing their plans and making the appropriate calculations. While time consuming, it is worth helping them because they appreciate the importance of this assistance. This group often includes those with a need to help others, quite frequently through the microfinance institution.

FM has observed that it is considerably easier to talk about financing based on partnership with new borrowers, rather than those accustomed to standard loans. However, long-standing regular customers are also offered this new form of finance and we have observed their reactions. FM now has a tool that permits us to see into the previously inaccessible relationship between the borrower and our employee. This sometimes reveals that a borrower of many years good standing, who punctually repaid several loans, has completely failed to understand the nature of this cooperation with FM or is unable to specify what concrete advantage he has obtained by using the capital lent him. With this knowledge FM now has the opportunity to repair the relationship before the customer defaults on a loan.

Fundusz Mikro still has too little data for a quantitative assessment of the various attitudes of entrepreneurs. In a group of first-time borrowers, we were only able to offer partnership finance to 10 percent of the applicants (this includes those who wanted to pay less than they would pay for a standard loan). A comparison of the first 100 partnership finance loans made to first-time borrowers and a sample of regular loans of similar size and duration made by the same people showed no difference in repayment rates. For taking advantage of our capital, borrowers on average committed themselves to finance charges 5% higher than they would have paid for a standard loan. More data will be available soon.