Microcredit

From Theory To Practice

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Foreword

Microcredit is a special field, which is becoming a more and more widely used tool to finance businesses. It basically means the provision of loans to people who intend to engage in gainful employment, but cannot have access to small loans granted by the main players of the money market, i.e. commercial banks. It is blessed by some and cursed by others, but the majority of people completely misunderstand the essence of this activity. There are a lot of organizations dealing with the provision of microcredit with various methods and results all over the world. Due to its expected positive social impact more and more public funds are allocated for the provision of microcredit by the specific states and by the European Union itself.

As microcredit is an increasingly widespread activity carried out by tens of thousands of organizations around the world, with significant investment by the European Union itself, there is a growing demand for training microcredit professionals in higher education. In response to this need, the Spanish University of Cádíz and the Hungarian Regional Foundation for Enterprise Promotion of the Town of Székesfehérvár, with decades of professional experience and international recognition, developed a post-graduate course fully based on e-learning, which allows students to obtain a MASTER's degree accredited in Spain.

Some of the lecturers of the MASTER course at a conference called Microfinance and Sustainable Development Goals. November 2019, Jerez Spain, UCA Campus



Left to right: Tibor Szekfü, Esther Puertas Cristobal, Péter Vonnák, Mercedes Diaz Rodriguez, Maria del Rosario Carmona Luque, Elena Torres Maestro

One of the main modules of the Master's course called *Microfinance, human rights and entrepreneurship development* - currently available in the English and Spanish languages - is Microfinance.
Upon the completion of the module independently, students can obtain an international microfinance expert diploma. The curriculum presents the various types of microcredit, their microeconomic background and the practical issues related to the launch of the specific microcredit schemes by providing a very wide range of knowledge. This textbook is part of the curriculum, and it introduces the theoretical basics and practical issues related to the launch and operation of microcredit programmes. The Hungarian version of the book was published in print, while the English and Spanish versions are available in electronic form.

Covering issues concerning the creation and operation of publicly funded microcredit programmes fills a gap in course materials on microcredit, which received special attention in this course. We consider this to be of paramount importance because in case of publicly funded programmes it is a vital requirement that the programme should have a positive social impact and it should focus specifically on achieving this positive social goal. In this respect this book is unique because no other curriculum is available in the topic of publicly funded microcredit.

In addition to the University of Cádiz, students can also learn about this topic in Hungary, at the National University of Public Service, which offers a subject called Microfinance from Public Funds as from 2020. The subject is based on this book and it is taught by Tibor Szekfü, who is one of the authors of the book. This textbook includes the curriculum of university programmes, but we recommend it to anybody who is interested in the topic. In our opinion it is inevitable that people working in the field of microcredit should be familiar with this curriculum. This knowledge is especially important for everyone working with public funds, in particular in decision-making positions.

Székesfehérvár, November 2020
The Authors

About the Authors

Tibor Szekfü

Mechanical Engineer, Engineer-Economist

Tibor Szekfü is a microfinance practitioner, whose theoretical work in the field of microcredit is also significant. He is the top manager of two non-profit microfinance institutions. Formerly a development engineer with a number of educational degrees, he came into contact with microcredit in the early 1990s as the microcredit manager of the Regional Foundation for Enterprise Promotion of the Town of Székesfehérvár. He participated in all phases of the lending activity, from loan assessment to claims management. Later on, he started managing the microcredit activity as a finance director, and has been dealing with it as a managing director for more than a decade.

He has gained significant experience and achieved great results since he began his professional career decades ago. In addition to the Phare Microcredit Scheme in Hungary launched in 1992, he was the first to develop the policies, procedures and IT background of an alternative local microcredit scheme. The developed policies and procedures proved to be a professional benchmark, because they provided the basis for the non-profit Hungarian microfinance providers, i.e. by the enterprise promotion foundations operating in the counties and the capital city of Budapest to create local microcredit programmes. The credit scoring system developed by him is not only used by the foundations but also by several profit-oriented financial companies to rate customers, and its methodology is already included in the practical curriculum of several universities.

As one of the owners of Credinfo Kft, he and his colleagues performed the complete digitalization of the lending process ahead of his time, and introduced a fully digitalized lending procedure at his microfinance institution, for which he has received international recognition. The Internet-based service-providing and loan assessment management system of Fejér Enterprise Agency® was included among the five best practices by the scientific committee in the **Microfinance Best Practices "Europe" Award 2009** announced by the Milan-based Giordano Dell'Amore Foundation and the Paris-based European Microfinance Network (EMN) in the topic of *innovation and sustainability* in microfinance.



Veszprém County Enterprise Development Foundation, President
Regional Foundation for Enterprise Promotion of the Town of Székesfehérvár (also referred to as Fejér Enterprise Agency), Managing Director
National University of Public Service, Hungary, university lecturer
University of Cádiz, Spain, university lecturer

In 2011, the Foundation won the **Investment and innovation in microfinance europe award** in the category of *Innovative Use of Technology*. The category winners were announced in London at an international conference.

The system has been presented at several international conferences, and has been fully implemented in Norway. The digitalized Hungarian procedure is still listed in the database of the European Microfinance Network collecting good practices.

The Norwegian practice was included among the international good practices in 2019 as a successful in-

ternational adaptation of the innovative Hungarian system.

(http://microfinancegoodpractices.com/2019/01/22/implementation-of-credinfo-it-system-for-mfis-in-norwegian-context/;

https://www.european-microfinance.org/publication/implementation-credinfo-it-system-mfis-norwegian-context)

In addition to the development of several lending policies and loan schemes, Tibor Szekfü was actively involved in the work related to the regulation of microcredit in Hungary. Representing the Hungarian non-profit microfinance sector, he participated in the development of the European Code of Good Conduct for Microcredit Provision as a professional consultant in the "pilot" phase of the programme. He played an important role in the development of the professional directives (Budapest 2013; Rome 2016) issued by the national microfinance networks (IPFI, MicroFiNET) bringing together European microfinance institutions. He has developed and implemented international programmes to exchange professional experience. The most significant of these is the project called Access to Microfinance for Small and Medium-sized Enterprises (ATM for SMEs Interreg Europe), during which the Regional Foundation for Enterprise Promotion of the Town of Székesfehérvár implemented perhaps the largest European professional exchange programme as the lead partner of an international consortium (professional organizations and managing authorities) in the field of microfinance. Partly related to this programme, he has launched international websites (www.microfinancegoodpracices.com and www.microfinancecommunity.com), which share good microcredit practices internationally.

In 2019, in collaboration with lecturers from the Spanish University of Cádiz, he participated in the development of a fully online university MASTER course. Upon completion of one of the major modules of the programme, participants will receive an international microfinance expert diploma. In addition to the fact that the course can be done in the English and Spanish languages, the entire IT background and electronic curriculum of the MASTER course consisting of three large modules were developed by Fejér Enterprise Agency. Tibor Szekfü also participated in the development of the scientific knowledge with his colleague, Péter Vonnák, as co-author. This material was included in the curriculum as a separate sub-module called Microcrediting – From Theory To Practice.

During his career as a microfinance practitioner, his organization has disbursed nearly HUF 5 billion to more than five thousand clients. This means lending to the most vulnerable, high-risk clients that have low creditworthiness with commercial banks in such a manner that the expected losses on lending relative to the granted loans did not exceed 1.7%.

He also has great experience in developing business development services closely related to microcredit. Together with his colleagues and the businesses connected to the **FEA Group Business Development Consortium**, they provide different profit-oriented services for businesses. These services include video based business communication (the production of corporate image films, brand building videos, educational videos related to internal and customer training), the development of e-learning systems, digital marketing consultancy and real estate marketing services (www.ingatlanmarketing.hu; www.ingatlanportal.hu). In order to promote the success of businesses, he and his colleagues have created portals to disseminate professional information in the form of a scientific journal called **Nyereség és Üzlet Tudományos Ismeretterjesztő Magazin** (www.nyeresegesuzlet.hu) and a business TV (www.uzleti.tv).



Péter Vonnák

Péter Vonnák graduated as a Computer Science Engineer at the University of Óbuda, then began his career at the Regional Foundation of Enterprise Promotion for the Town of Székesfehérvár, a microfinance institution, in 2014. To further explore this socially important area, he completed the online course of the Université libre de Bruxelles ('Commercial aspect of social enterprises: How can we avoid mission distortion?'), while training to be an engineer-economist at the Budapest University of Economics. He wrote his Thesis in a topic related to microfinance, the manuscript of which was published in Hungary under the title 'Microcrediting in Hungary: How can we optimize the social usefulness of microcredit schemes?' In addition to microcredit, he attaches great importance to business development services. He went on to study at the Budapest Metropolitan University, and obtained his third degree in digital marketing. Connected to his sphere of interest, as a co-author of the book and a guest lecturer at the University of Cádiz, he developed a curriculum on the topic of customer outreach. As a multi-graduate professional with entrepreneurial experience, he is able to provide assistance in solving the problems of entrepreneurs who turn to him and developing their businesses.

Giampietro Pizzo

APresident and founding partner of Microfinanza Srl, Giampietro Pizzo is a microfinance specialist with 30 years of experience in coordinating and implementing technical assistance activities, evaluations, and research initiatives for numerous international and bilateral entities. His primary areas of expertise include financial inclusion frameworks as well as rural and SME finance. He has been involved in feasibility studies for credit systems for SMEs, Microfinance Institutions and the setting up of Guarantee Funds. He has experience in different rural credit and microfinance schemes (solidarity credit, village banks, savings and credit unions, etc.). He has taken part in numerous Technical Assistance and Training projects for Financial and Banking Institutions as well as in the conduct of several field surveys on the themes of impact assessment Prior to Microfinanza, Giampietro worked for the Italian Ministry of Foreign Affairs and other development cooperation clients (including the EC). His global experience spans some 25 countries, most notably in sub-Saharan Africa and Latin America, but also in North Africa and the Middle East. Giampietro is the current president of the Italian Microfinance Network (RITMI) and former vice president of the European Microfinance Network (EMN).





Professional principles relating to the development and operation of microcredit schemes

Author: ©Tibor SZEKFÜ

1. Introduction

In this training module we will discuss the most important knowledge and principles necessary for the creation of microcredit schemes (programmes). This is extremely important because the goal of our microcredit scheme cannot always be reached without the conscious planning of these principles. We consider the positive social impact of the schemes as a predominant criterion. That is why we will focus on how and under what conditions social impact can be maximized. We will discuss the basic concepts because we need to understand what we mean by a specific concept when we talk about it.

We will tell you about the principles one must be aware of if we are to achieve the desired social impact. We will provide an overview of the positive and negative phenomena related to microcredit and their economic background. We will look at how we can organize the various microcredit programmes so that it can be established - through their analysis - whether the given programme indeed satisfies positive social goals and has positive impact, or only the operators of the programme claim it. We will review the international directives and recommendations developed by European microfinance network professionals for decision-makers to optimize the positive social impact of publicly funded microcredit schemes. We will also focus on the rules of microcredit schemes funded and launched from public money. The operation of profit-oriented programmes funded by private investors is basically regulated by the rules of the market, therefore we will not spend too much time on it.



In this field it is extremely important how public money is used. It is inevitable that the programme should have a positive impact on society. That is why we will examine thoroughly and in great detail under what conditions we can provide this effect. We will

briefly discuss the regulatory attempt and funding practice of the European Union, and provide positive and negative examples.

We will also give you a brief insight into the principles that should be used to establish the internal regulation of an MFI.

We will then deal with practical issues, such as the lending process. In particular, we will deal with the requirements and operational aspects set for the most up-to-date Internet-based loan assessment management systems to manage this process.

We will look at the practical implementation of loan assessment, and how we can create our own credit scoring system. We will give you a brief insight into how the various collaterals can be assessed where they are required. In addition, we will provide a very short overview of the indicators that can be used to assess and analyse the loan portfolio, briefly describing the most frequent errors of interpretation.

During the last week of the course, we will have a look at the requirements a modern electronic Management Information System has to meet in the field of microcredit.

We will look at practical ways to measure the social impact of microloans, explaining the methodology and discussing the connected business development services, which help to maximize the social impact of the microcredit.

At the end of the block, there is a separate chapter concerning customer (client) outreach.

We will briefly present the most up-to-date methods of contacting prospective customers and involving them in microcredit.

13 May 2016. Székesfehérvár, Hungary. The representatives of significant European national microfinance networks.



Left to right: Joerg Shoolmann, Deutsches Mikrofinanz Institut (DMI) member of the board of directors, Germany; Jaime Manuel Durán Navarro, Asociación Espanola de Microfinanzas (AEM) President, Spain; Péter Vonnák Hungarian Microfinance Network (HMN) Vice-President and Tibor Szekfü President, Hungary; Unni Beate SEKKESÆTER, Microfinance Norway President, Norway; Giampietro Pizzo, Rete Italiana di Microfinanza (RITMI) President, Italy

2. Terminology – definitions



2.1. Credit

Credit is an economic term. It refers to the temporary transfer of goods or money in return for interest payments.

2.2. Lending activity

The lending activity assumes the conclusion of a contract, upon which a loan is not necessarily made available or disbursed. The creditor only undertakes to maintain a certain credit line (envelope) for the debtor in return for a commission, based on which – if the relevant contractual terms are satisfied – the creditor concludes a loan agreement with the debtor up to the credit line.

2.3. Granting of loans

The granting of loans means that the creditor makes the relevant amount available for the debtor (hands it over in person, or transfers/disburses it), which must be paid back by the debtor at the time specified in the contract (in return for or without interest).

2.4. Credit risk

The basic risk of creditors is that debtors cannot pay back the loan and the interest at maturity, or they do not pay at all. This risk is the so-called credit risk or repayment risk. Creditors try to assess in advance whether the borrowers are capable of repaying the credit and the interest. It can happen that they make a mistake when judging a borrower's creditworthiness, and as a result, they make a loss in the course of the lending activity. In order to prevent this, credit institutions must develop a Credit Scoring System to rate debtors.

2.5. Coverage

It is an economic term. It is often confused with the legal collateral of the loan. The coverage of the credit (loan) is an existing or future asset that secures the repayment of the loan by the debtor. In case of business credit, ideally this asset is the future cash flow coming from the revenues of the entrepreneur. In an unwelcome event, it is the income coming from the legal collaterals (e.g. the sale of the real security).

2.6. Legal collateral

The legal collateral – *which is a legal term* – is an accessory obligation that is stipulated in conjunction with the primary obligation. In practice, the primary obligation usually means the proper performance of a specific credit contract. When granting loans, creditors try to reduce their risks to the smallest possi-



ble level, and protect their lending position from the possible changes that might affect the financial situation of the debtors negatively.

The tools used for this purpose are called legal collaterals. Ideally, the loan is repaid from the future revenues of the debtor (this provides *coverage* for the repayment of the loan). In the event the debtor is unable to repay the loan, the creditor tries to enforce his claims through the enforcement of the accessory obligations, (e.g. in case of a real security by selling the assets). Thus, in this case the legal collaterals will provide the actual coverage to secure the loan.

2.7. Loan portfolio

The word portfolio is of Italian origin. It means dossier and it refers to all the documents selected based on certain criteria. In terms of genre, it is a collection. It is also a well-known term in the world of business and art. The loan portfolio is the total of principal claims which arise from the credit contracts owned by the creditor at a given time.

2.8. Principal

It is part of the repayment instalment of the loan, the amount of which reduces the outstanding debt.

2.9. Interest

It is the cost of borrowing money, i.e. it is the fee charged for using the money expressed as a percentage. The interest rate is expressed as an annual rate even if the loan has to be repaid within one year.

2.10. Duration

It is a period of time specified in the credit contract concluded between the creditor and the debtor, during which period the debtor has to repay the granted loan, including all the fees, interests and charges. The duration may be modified by amending the original contract.

2.11. Grace period or moratorium on principal repayments

When repayment begins, it is a period of time during which the debtor only pays the interest and handling fee (if any) but not the principal itself. When the grace period expires, the debtor has to start repaying the principal, including all the additional costs.

2.12. Microcredit

Microcredit and micro-lending have no generally accepted definition at international level. As a result, creditors may call any credit as microcredit.

When this curriculum is written, the European Union considers credit under EUR 25 000 promoting self-employment as microcredit.

The European Microfinance Network and the Microfinance Centre, the two European networks representing the interests of the microfinance industry in Europe have provided a definition of microcredit for European Union programmes.

- a **loan of small amount** (usually smaller than the EU per capita GDP);
- proposed f**or the creation or expansion of income-generating and job-creating activities or microenterprises**, in other words the financing of investments and/or working capital;
- offered to socially or financially **excluded people** (generally without collateral or credit history) lacking access to mainstream sources of finance;
- with **a social and financial inclusion objective,** on terms adapted to the analysed repayment capacity (to prevent over-indebtedness);
- and coupled with access to high-quality **business development services**.

According to this definition, microcredit is:
In this course material, we mainly focus on **social purpose microcredit and micro-lending.**

Microcredit is a loan of small amount granted to clients who do not have or have only limited access to loans/credits granted by profit-oriented commercial banks but wish to pursue an independent income-generating activity or business. This reduced creditworthiness could be attributed to the small borrowing requirement of the clients, the inadequate number of legal collaterals offered by them, or to the fact that they are start-ups, and as a result, they have no entrepreneurial past that could be evaluated.

One of the most important aspects of social purpose microcredit is the non-profit aspect, because in case of this type of credit the achieved social impact is more important than making profit. Microcredit must be coupled with intensive and efficient mentoring activities and technical assistance, as well as high-quality business development services.

2.13. Sustainable development

A Sustainable development is to be based on three pillars: economic, social and environmental, and all the three factors must be considered when developing various development strategies and programmes, as well as in the specific actions and measures.

This process of development "meets the needs of the present without compromising the ability of future generations to meet their own needs". *(Brundtland Report, 1987, United Nations[1]).*

An important factor that should be overcome is the deterioration of the environment, which should be achieved by not giving up on economic development or the need for social equality and justice.



- Sustainable development means allowing economic growth and the conservation of environmental conditions in order to achieve and maintain social progress *(decent living conditions, social welfare).*
- It recognizes and regards it as an objective to ensure equal rights to adequate standard of living of the successive generations, as well as the satisfaction of related obligations.

To sum up:

For more information see: Lester R. Brown: „Building a Sustainable Society", 1981.[2]

2.14. Sustainable society

"*Sustainability means meeting the current needs of humanity and maintaining the environment and natural resources for future generations.*" (Transition to Sustainability; Statement of the World's Scientific Academies, Tokyo, 2000).

- **social justice,** the basis of which is ensuring equal access to opportunities and sharing social burdens;
- striving for the continuous improvement of the **quality of life;** which includes health – complete physical, mental and social well-being – and the related material prosperity, healthy environmental conditions, democratic rights, security, education for everybody, etc.;
- the sustainable use of **natural resources,** the achievement of which requires the society to demonstrate an environmentally conscious and ethical attitude;
- preserving **environmental quality;**
- systemic approach and governance, which is embodied on an institutional, governance level by the institutional system integrating all the dimensions of sustainable development.

The basic requirements of sustainable society:
In order to achieve the set objectives there is a need for educational, awareness-raising and communications activities in each sub-area of sustainable devel-

opment.



3. Microcredit in general

3.1. Misunderstandings about microcredit

It occurs to a lot of people whether microcredit is a good or a bad thing. Despite the fact that there are a lot of microcredit programmes that function well from a social point of view, the phenomenon described as the crisis of the microfinance sector is well-known in many countries of the world. In certain countries, the majority of microcredit clients viewed microcredit as a tool that contributed to their insolvency instead of improving their material well-being. That is why a lot of clients committed suicide. Also, a lot of protests were organized against microcredit, and coalitions were set up demanding a ban of microcredit.

This detrimental social phenomenon cannot be explained with the crisis of the sector due to the fact that there is no uniform microfinance sector. The phenomenon is a consequence of a natural market process, which we call market mechanism. Putting it simply, the point is that in market areas where there is a lot of disposable income continuously, supply is also likely to appear, leading to price equilibrium. It is considered as market failure if supply does not appear and no price equilibrium occurs.

It must also be noted that it is very important to differentiate between microfinance programmes funded (e.g. from public money) to achieve social goals and programmes serving the interests of the investors as well as the financial interest of the entities involved. Every microfinance programme aims to achieve social goals, at the same time it is completely obvious that the actual operation in certain cases only serves the financial gain of the entities involved.

3.1.1. Market mechanism

Let us go through briefly what market mechanism is.

Basic terms belonging to the topic:

- **Market**: In economic terms, it is the place where supply and demand meet; it is the whole of commodity exchanges. In generic terms, it is the place where sellers and buyers meet, where selling and buying takes place. Its main factors are: *demand, supply, price and income.*
- **Demand**: consumers' demand supported by money.
- **Supply**: possible or intended production or service provision by the producer/service provider.
- **Money and capital market**: It is one type of the market. Securities and foreign currency may be purchased, credits may be taken out. *On the money market* – for a period shorter than one year. *On the capital market* – for a period longer than one year.
- **Market competition in case of the capital market**: creditors compete for the best lending opportunities; borrowers for the cheap credits. The competition is good for both retail customers and businesses.
- **Market mechanism**: a form of economic organisation in which consumers and business organisations interact with one another through the markets to solve the three central problems of economic organisation: What? How? For whom?
- **Market failures**: places in the market processes when government intervention is required in order to maintain undisturbed operation. It also includes incomplete markets, where the private market does not produce the assets in the required quantity or under the required conditions. Certain capital markets can be like this.
- **Monopoly**: the production or services of only one company covers the entire market, excluding others.
- **Oligopolistic market**: only a few big companies rule the market.
- **Demand curve**: representation of the relationship between the quantity of the demand for a given product or service and the price of the product or service.
- **Supply curve**: it expresses the quantity offered by the producers – service providers at various prices.
- **Equilibrium price**: the market price at which the demand and supply quantity of the product – service equals.
- **Free price**: price fixed by the business partners.
- **Price fixed by the authorities**: fixed prices listed by the price act.
- **Nominal income**: income in actual currency terms.
- **Real income**: the purchasing power of the nominal income.



The market is a kind of "procedure" during which buyers and sellers interact with one another to establish the price and quantity of a certain product or service (stock). *The basic task of the market is* to establish contact between consumers and producers/service providers, to harmonize the needs of the society with production, and to create an economic balance. In market mechanism, the distribution of resources takes place as a result of *individual bargaining processes* between the owners of the production factors and customers, and on a voluntary basis it is realized in the mutually advantageous exchange. The conditions under which the products and services of a business can be sold become apparent in the market.

In modern market economies a third actor, i.e. the *state* also appears in the market in addition to consumers and entrepreneurs. Its active presence provides a kind of regulation for spontaneous market processes. Self-regulating (market) co-ordination and bureaucratic co-ordination are two basic forms, and there are significant differences between them concerning their content. In case of *market co-ordination* the market has two players: the seller and the buyer, and only commodity-money relations exist between them. The market players create their own norms of conduct, so this market is also called norm-creating market. The players are autonomous, and the balance is achieved through the independent movement of the market. The players may only achieve economic advantage with market competition. The most important basic assumption of this theory is that the players make their decisions rationally, maximizing their own profit. The essence of rationality for the consumer is to satisfy his own needs to the maximum, that is why he acquires the most appealing goods from his disposable income. The essence of rationality for the producers and businesses is to maximize their income.

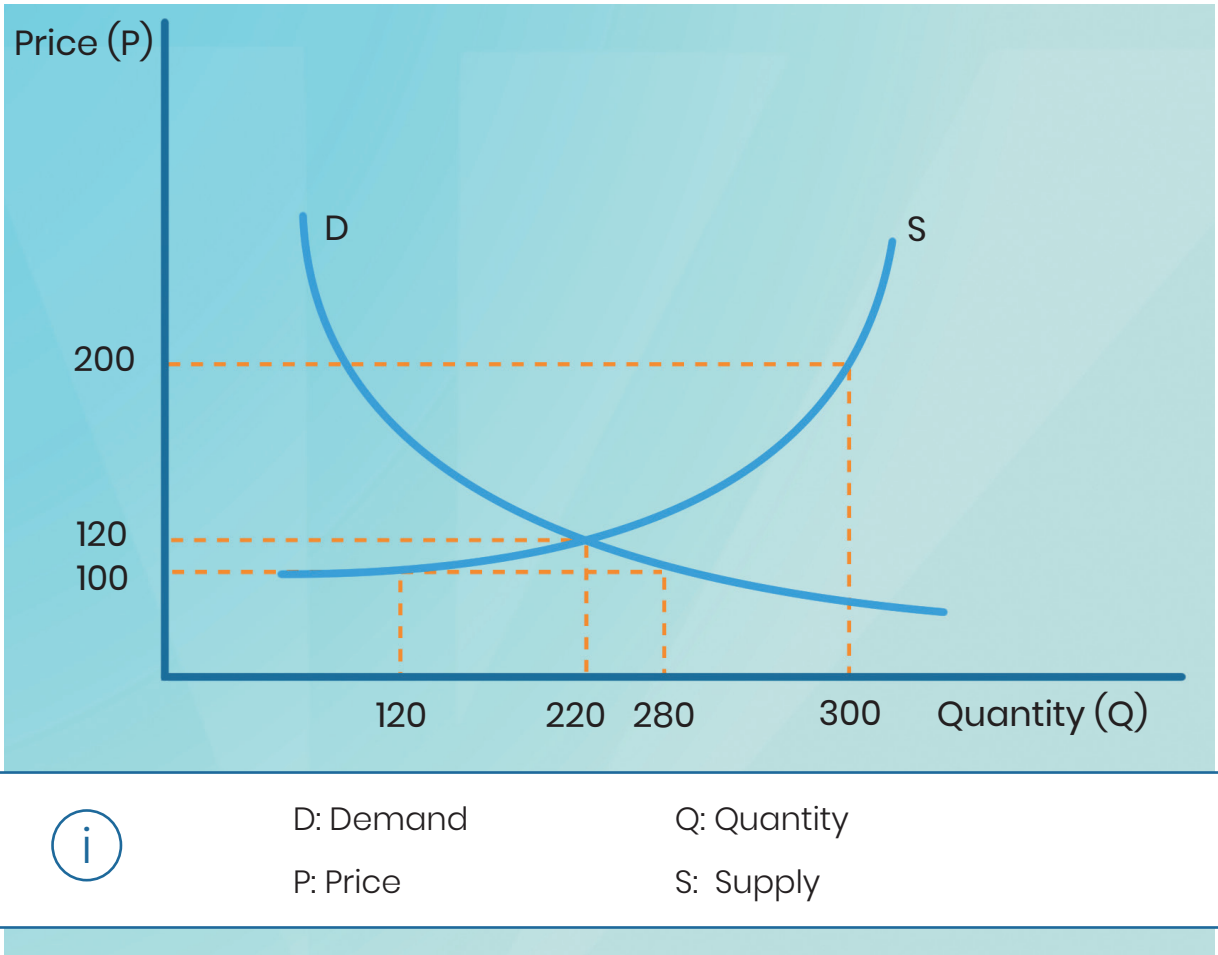
In case of *bureaucratic co-ordination* a co-ordinator enters between the two basic players of the market, who replaces the market with instructions, regulations, etc. This time the presence of goods and money relations is not necessary, the *interest of the players is not profit-oriented.* The players are not autonomous, their conduct on the market and the rules concerning their behaviour are embodied by the norms issued by the co-ordinator, so this formation is also called as *norm-accepting market.* The market players pursue a so-called administrative competition in order to gain advantage, in other words their success depends on gaining the favour of the "main authority". The co-ordinator replaces the independent movement of the market with pre, post and in transit regulation.

Demand means that the consumer is willing to and able to purchase a product or service (e.g. loan). *Therefore, demand is a need that can be supported and realized by money. Supply* means that the company (or credit institution - bank) is willing to and able to produce a product or service (or in case of the money market to lend money to a specific market group).

The *demand relationship curve* reflects the correlation between the price of the specific product and the quantity demanded, in other words it expresses the amount of solvent demand for a given product in relation to the price of the product. It does not represent actual purchases but the total of prices and quantities demanded, which can theoretically be realized on the market of a good. If a good has very high price, it may not have any customers. The demand curve typically has a downward slope, in other words, *the lower the price, the higher the quantity demanded and the higher the price, the lower the quantity demanded.*

The *supply relationship curve* demonstrates the quantities that will be sold by the producers at various prices. The higher the price, the higher the quantity supplied. The demand and supply relationship curves characterize the whole market of a product together. These two curves can also be illustrated in the same co-ordination system. In both cases the price of the product is the independent variable, and the quantity of the supplied and demanded goods refer to the same product, and it is in the same dimension.

The mutual diagram of supply and demand is also known as the Marshallian Cross. The work of A. Marshall provided the basis for the microeconomic explanation of the market phenomenon.



i

D: Demand
P: Price
Q: Quantity
S: Supply

Equilibrium price: Demand equals supply, in other words, there is no surplus or shortage at a given price. (The quantity of goods and services sought by buyers is equal to the quantity of goods and services produced by sellers.)

Excess demand: in case of a price that is lower than the equilibrium price the demand for a product is greater than the supply (shortage).

Excess supply: in case of a price that is higher than the equilibrium price the demand for a product is smaller than the supply (surplus). In the longer term – in case of perfect competition – only the equilibrium price of a product may survive. In case of other prices significant movements and rearrangements may be expected either on the demand or on the supply side. These movements push both the price and the quantity on the demand and supply side towards the equilibrium, because the change of one factor changes all of the other factors.

Operation of the market mechanism:
In case of *shortage,* the producers observe that there is greater demand for their products than what they can satisfy, therefore they raise their prices. Due to the higher prices, the supply increases and demand decreases, and the price moves closer towards the equilibrium price.

In case of *surplus,* the producers cannot sell their products, therefore they are forced to reduce their prices. Due to the lower prices, the demand increases, the supply decreases, and the price moves closer towards the equilibrium price.

Basically, the market is moved by the competition of the market players, which plays a significant role in the process of aligning demand and supply. Market players try to achieve their own goals – by taking advantage of the opportunities provided by the demand and supply – by competing with one another.

Market competition can take various forms, which is greatly affected by how the size, the power and economic weight of the players relate to one another. In this approach a variety of the actual market can be seen between the two extreme cases, i.e. the perfectly competing market and the monopoly market.

3.1.2. Theory of market failures

If the market mechanism does not function properly for any reason, and the problem of excess demand or excess supply is not solved, we talk about *market failure. Such cases may justify government intervention.*

Such failure is when the money market and capital market players fail to satisfy the funding requirements of certain groups. One reason for the reduced creditworthiness can be the small loan requirement of the clients, the inadequate quantity of the legal collaterals, or the fact that they have no entrepreneurial history. This is also considered as market failure because the arising demand is not met by adequate supply, and the group having the funding requirement remains unserved.

3.1.3. The necessity of government intervention

The problem of the above-mentioned market failure – the group having an unmet funding requirement – justifies the intervention of the government due to its harmful social consequences.

If the government fails to intervene and market players responding to the unsatisfied permanent demand appear with very high prices and take advantage of the vulnerability of the target clients, it can have extremely damaging social effects, which will also require the intervention of the government.

Thus, as an effect of the above described market processes, a *financial service providing sector,* whose activity is classified as micro-lending, emerged in those countries where there is a great number of poor and vulnerable people who are able to pay – even at great sacrifice – the operating costs, the losses and the extra profit expectation of the investors by paying a high risk premium (since they have no other choice if they want to survive) due to the internal legislation of the specific country (the leniency or the deficiency of the legislation). Some people call the consequence of this spontaneous, but completely natural market process as the crisis of the sector. Governments can basically do two things in the field of legislation to avoid the harmful social impact of the phenomenon. On the one hand, they can limit the maximum interest rate that can be applied by the market players with administrative regulatory tools, and on the other hand, they create artificial supply with limited interest rates by involving public money and donations. To generate this supply, one of the best and most efficient models is the creation of revolving microcredit funds, which could be used to operate microcredit schemes achieving positive social goals through non-profit organizations.

3.2. Why is positive social impact important?

When we want to develop a tool to tackle a social problem, at first we have to analyse the problem, and then select the most suitable tools to solve that problem. In our case the main social problem is that there are a lot of people – even in industrialized countries – who cannot have access to small bank loans if they want to pursue an independent, income-generating activity. The main reason for this is that the risk related to these loans is usually so high that it cannot be undertaken by the banks operating under strict money market regulations.

So-called microfinance institutions were set up to satisfy these financing needs. An excellent tool to handle this problem is to provide access to microcredit through social microfinance institutions.

It might appear obvious that if we support and develop this microfinance sector, we will be able to solve this social problem.

This, however, is only partly true because the microfinance sector is far from being uniform. It has two branches operating with substantially different criteria and objectives. On the one hand, it consists of the non-profit funders, such as foundations, and on the other hand, the profit-oriented financial enterprises falling under the scope of money market regulations.

Non-profit foundations – if it is permitted by the legislation of the specific country, like in Hungary – operate outside the scope of the regulations of the money market.

The operation of the two sectors differ from each other significantly. The primary goal of the profit-oriented sector is not to solve the above-mentioned social problem but to obtain as much profit as possible. This sector basically follows the rules of the market, thus their operation should be regulated at national decision-making level. For us non-profit microfinance is more important because the actors giving priority to social goals operate in this field.

Where public money is used to solve a social problem, it is inevitable that this social goal is given priority. Therefore, it is important to bear in mind that the development of microfinance from public money is only a tool used for solving a social problem and not the goal itself.

The European Union plays an important role in financing the most successful microcredit schemes. At the same time, we believe that **the positive social impact can be further increased.** The success of the E*uropean Code of Good Conduct for Microcredit Provision* (CoGC) published for microfinance institutions failed to come up to the expectations despite the positive objectives. When this curriculum is drafted, the CoGC basically contains standards that are typical of the operation of profit-oriented microfinance institutions having an investor's perspective. The majority of non-profit microfinance institutions will only meet these standards if they introduce a profit-oriented approach in their operation, after which it will be very difficult for them to achieve the original social goals.

When writing these notes, unfortunately the European Union only provides central funding for microfinance institutions that meet these standards. Therefore, the European Union *acts as a profit-oriented investor when managing public money that was made available for microfinance, and funds microfinance institutions operating with a profit-oriented perspective.* It does not focus on solving the social problem but on funding microfinance institutions operating in compliance with the standards. Unfortunately, this attitude can also be experienced at the level of the specific member states. We must see that this practice is not the best to tackle the problem since a considerable number of people cannot have access to sources at these profit-oriented financial enterprises also dealing with micro-lending either. Mainly because they do not have adequate legal collaterals, and the degree of risk assumed by these financial enterprises is legally limited by the financial regulations.

When analysing the good practices examined within the scope of the "Access to Microfinance – ATM for SME's" project financed by the Interreg Europe programme we found that giving priority to social goals often has a detrimental effect on the financial result. Therefore, it is very important that these microfinance institutions should be given more attention and support by the state. Those good practices that we managed to explore and present in the course of the project mainly come from the field of non-profit microfinance.

http://microfinancegoodpractices.com/[3]

ATM for SMEs
Interreg Europe

It is essential that the European Union and the national authorities should set up new programmes in the form of guarantees, debt and equity, completed with subsidies and grants. In addition to the European Investment Bank group, new complementary channels should also be considered so that social microfinance institutions may also access the central funds. It is important that the investment of public money provided by the authorities should promote social return, and the authorities should not set unrealistic financial expectations for the sector.

The most important lesson learnt is that we must focus on the solution of the social problem, and the two microfinance sectors must be treated separately.

The funding practice of the EU having an investor's perspective should be transformed and we must return to and operate non-profit local revolving microcredit funds that were successfully operated by the EU earlier. It is extremely important that when making decisions related to microfinance, the authorities should consider the professional recommendations of the professional organizations regarding the most important professional expectations in order to maximize social impact.

The professional recommendations described in this course material provide the best reference for making professional decisions. If decision-makers act accordingly, they will not have to wait long for social success.



4. The effect of borrowing conditions and operating characteristics on social impact



As concluded in the previous chapter, we view microfinance as a tool that tackles a social problem, therefore its positive social impact cannot be overlooked. It is especially important if schemes are funded from public money.

Next, we will examine how the borrowing conditions and operating characteristics applied in practice influence the positive social impact we wish to achieve. In order to better understand the following information, let us go through the key factors which have an effect on the social impact of micro-lending again. We may only make the conclusions once we understand the logical relationships described below.

Determining the most important factors that should be taken into consideration when creating publicly funded microcredit programmes

1. Social need

A segment of society needs a small loan amount in order to be able to pursue an independent income-generating activity.

2. Social interest:

To satisfy the social need

! **Why is it important to satisfy this social need?**

In terms of the concerned people:

- the person will be able to sustain himself,
- will have a decent standard of living and satisfaction
- it reduces the chances of psychological and mental deterioration

In terms of the society as a whole:

- the people concerned will no longer be dependent on social assistance and they will not put a burden on society
- they require other social benefits to a lesser extent (e.g. to treat various illnesses resulting from mental deterioration)
- they pay taxes, by which they contribute to financing the common needs of society
- they have disposable income, by which they make the economy work
- they create jobs and create tax payers
- they create value and contribute to the GDP

3. Market failure

Although it would be in the interest of the society, the concerned people do not have access to loans at the main profit-oriented actors of the money market (commercial banks), in other words, *the demand generated by them is not satisfied by the money market actors.*

4. Main reasons of the market failure

! **The profit-oriented players of the money market (basically commercial banks) do not finance the concerned segment of the society because:**

It is TOO RISKY to finance them because

- they do not have entrepreneurial experience that could be evaluated
- they have no credit history
- and they cannot offer legal collaterals.

It is NOT PROFITABLE to finance them because

- it is expensive to finance relatively small loan amounts the solvency of the clients limits the payment of high interest rates that would compensate for the high risk and ensure the expected profit.

5. The government intervenes in the operation of the market

For the government intervention to be successful, i.e. the social need under point 1 is satisfied and the desired positive social impact is achieved, i.e. the social interest under point 2 is enforced, the intervention must focus on 2 key factors. These are

- **Risk-taking and profit expectations.**

The main reason for **market failure** mentioned above (there is not enough supply to satisfy the demands that would create price equilibrium) is that the high **credit risk is not assumed** by the main actors of the money market (e.g. commercial banks). Also, the solvency of the affected customers does not allow for the compensation of the expected high **credit losses**, and the expected revenues do not fully cover the **operating costs**.

Thus, as I mentioned, this lending - under normal operating conditions - cannot satisfy the **profit expectations** of the shareholders of the banks either. (Also, in most countries the banking act does not allow such risky funding either in order to protect the interests of the depositors and shareholders.)

Accordingly, it must be accepted that to achieve the desired positive social impact the **high risk associated with lending must be assumed** by the state, in other words, clients not having an entrepreneurial past that can be evaluated, or not having adequate legal collaterals should also be able to access the sources. Consequently, it must also be accepted that the revenues coming from *the lending activity will probably not cover the credit losses and the operating costs fully.*

! **When setting up a new publicly funded microcredit scheme, in terms of the achievement of the positive social goal it is crucial *who bears the risk of lending* (how credit risks are accounted for and financed), and *who and from what sources covers the operating costs.***

4.1. Can profit-oriented microcredit have a positive social impact?

All microfinance institutions state that their activity is socially beneficial. To answer this questions, it is worth thinking the following through.

financial sustainability = revenues > operating costs + credit losses + inflation

The nominal value of the sources available for micro-lending may only be maintained if the revenues reach at least the total sum of operating costs and credit losses. If we are to maintain the real value of the sources, revenues must compensate for the inflation as well. If the organization is profit-oriented, the revenues must also cover the profit expectations of the investors.

If we look at it differently, clients who are able to pay the interest (and other fees)

- "pay back" the granted loans instead of the non-paying clients (since they are the ones who finance the written-off capital losses),
- finance all the operating costs,
- finance the profit expectations of the investors and owners, and
- compensate for the inflation of the sources of their investors.

In order to maximize profit, profit-oriented microfinance providers may apply several methods to reduce the high risk (and to cover the expected high loss). Such methods include, but not limited to, the following:

- charging extremely high interest ("pricing" the high risk),
- involving legal collaterals,
- applying strict claims management and collection procedures,
- maximum duration is 1 to 3 years,
- weekly interest payment collected in person,
- putting psychological pressure on the client,
- lobbying for state sources and interest subsidy at the public authorities, etc.

As we have already mentioned, the ability of this clientele to pay high interest rates may be very limited.

Basically, there are two reasons why a client fails to pay back the loan or the interest. Either

- they are unable or
- simply do not want to pay it back.

The majority of clients consider this issue prior to taking out the loan. If they see that they will be unable to generate enough income to cover the expected interest and fees, they do not apply for the loan. Also, if they can afford to pay the interest, but find it too high (or unfair), and they have another alternative (which can be a different loan or a different solution), they do not apply for the loan. All in all, only clients who are vulnerable and have no other alternatives try to pay the sometimes very high interest rates *(which can be 100 – 400% per annum in certain countries!)* and loans.

In the event there are no alternatives in a given country for the vulnerable to ensure livelihood, in the absence of adequate state regulation, shameless investors may request extremely high interest rates *taking advantage of the vulnerability of the people concerned.* This *may be accompanied by undesirable phenomenon* such as the inability of clients to make ends meet due to the high level of indebtedness, mental decline, or even suicide.

Naturally, such phenomena can be considered as *negative social impacts.*

In the event the investors show "ethical conduct" (in other words they are not greedy and do not have extremely high profit expectations), the expected profit may be smaller than in the previously mentioned cases. To sum up, the loan may only be deemed to have positive social impact if

- it does not take advantage of the vulnerability of the potential clients,
- it ensures good quality of life, welfare and satisfaction,
- it is a bearable burden,
- the possible failure does not make the clients unable to make ends meet,
- and it does not cause a mental decline.

How it is perceived strongly depends on the society. The achieved social impact must definitely be taken into consideration and also compared to the alternatives which are available for the potential clients to provide livelihood.

At the same time, if the lending activity is accompanied by any negative social phenomenon, the REAL social utility of the specific programme must be examined thoroughly.

Later on we will introduce an analysing option, where a so-called interest matrix helps to determine whether the given microcredit system is capable of achieving positive social impact.



4.2. The role of risk-assumption and operation-financing in achieving social impact

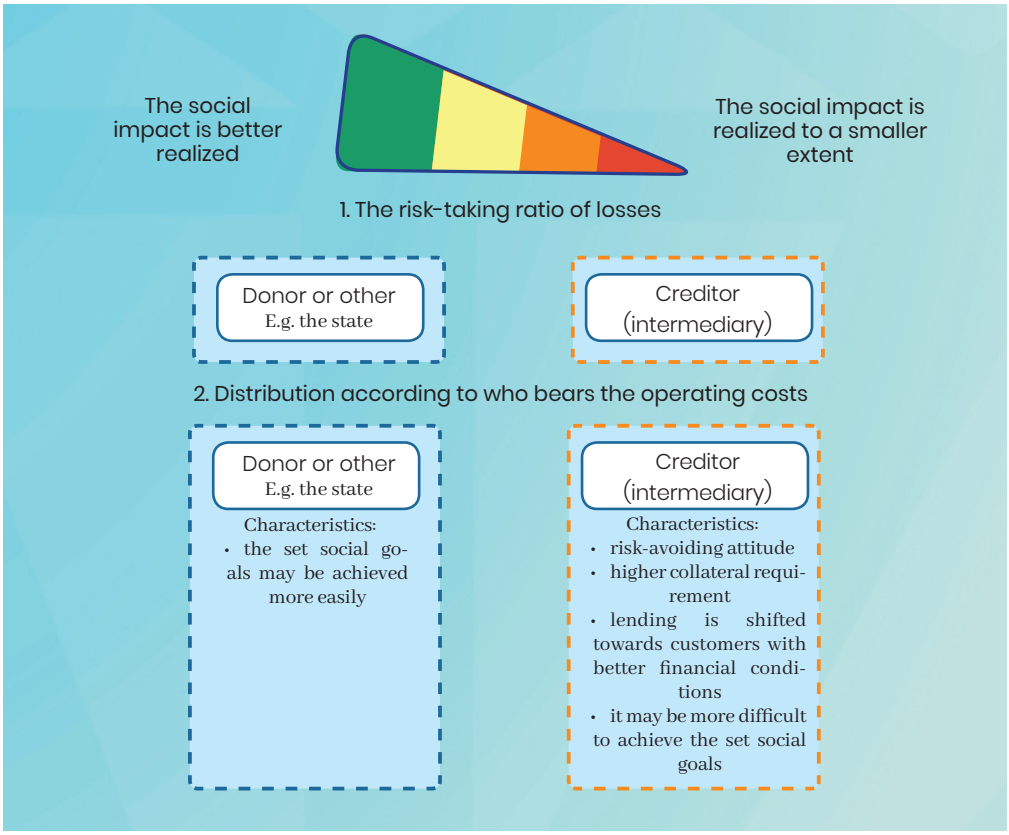
Now let us have a look at the factors that have an effect on the achievement of the expected positive social impact in case of publicly funded programmes that already exist or are to be launched in the future.

As deducted before, we must focus on two key factors. One of them is the *issue of risk-assumption*, the other one is the issue of *financing the operation.*

> **Funding the socially important target group of microcredit poses very high credit risk. Therefore, every circumstance that forces the key actors of the microcredit scheme to avoid this *high risk* prevents the programme from channelling the sources to the target group.**

Financing the operation is somewhat similar. If microcredit providers are expected to generate enough income to cover the operating costs, they will *focus on profitability,* which may result in *avoiding risks* (to reduce the expected losses, which has an effect on financial effectiveness). Also, they may take measures similar to those taken by profit-oriented microcredit providers, e.g. they increase their interest rates, or the extent of the expected legal collaterals, they apply stricter collection procedures, etc. As a result, microcredit *providers avoid the target group whom these public funds should be channelled to due to their social importance.*

Risk-taking and financing the operating costs



Given the above logical relationships, we hope that it will be more understandable what and why we consider to be the factors influencing the social impact of microcredit in case of the lending factors briefly described below.

4.3. Correlations of financial sustainability and social impact

The foregoing clearly raises the issue of *financial sustainability*. As explained earlier, *financial sustainability can only be achieved if the incomes exceed the total amount of operating costs and credit risks* (if we are to maintain the real value of the sources, inflation also has to be taken into account). If the two sides are equal, the operation breaks even (i.e. non-profit). Thus, in absolute terms, the expectation of financial sustainability means an operation breaking even.

This, however, only happens "by chance", since it is influenced by factors that cannot be planned in advance under such conditions. (For example, the assumption of the very high risk increases expected losses, the extent of which cannot be determined in advance, and due to the deteriorating portfolio the costs of claims management and collection as well as mentoring also increase.) We can only influence these factors indirectly and hope that our actions will bring the expected result. The objective of these actions may be the reduction of risks and expected losses as well as the increase of incomes, which basically immediately prevents the sources from being channelled to the original target group.

It can be seen clearly that although the expectation of financial sustainability also seems like a rational idea in case of publicly funded microcredit schemes, it could cause social damage by diverting the schemes from their original goal.

> ! **In case of publicly funded microcredit schemes the return on the funds made available must be achieved on a wider social level and not on the level of sources made available, in accordance with the criteria set for sustainable society.**

Therefore, when publicly funded revolving microcredit funds are set up, it is more appropriate to connect the sustainability requirement to a time interval (e.g. the revolving fund has to be allocated for the provision of microcredit for a period of 10 years), and to allow for the writing-off of losses and the partial financing of the operating costs – *in addition to the interests and fees paid by the clients* – from the fund. It further secures the achievement of social goals if the funds are replenished periodically, which requires significantly less money than the initially delivered amount.

4.4. Socio-economic factors affecting financial sustainability and social impact

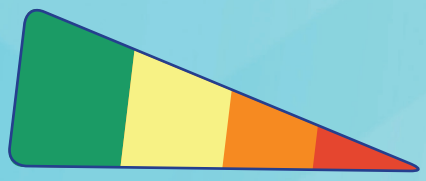
We will describe some of the factors (without providing a full list and a detailed explanation) that might affect financial sustainability and the expected social impact. In the latter case we will concentrate on factors that can divert the sources from the target group the reaching of which would be desirable in terms of the social goal. Financial sustainability is improved by any factor that contributes to the increase in income or cost reduction in the course of the operation of the programme.

Interest charged

As we have already mentioned, higher interest rates result in higher income, which can *improve financial sustainability.* At the same time, the increase in the interest may be limited by administrative (legal) obstacles, alternative sources of credit (market competition) and the solvency of clients. Higher interest rates may be achieved in case of vulnerable clients. Since lower interest rates are less burdensome and clients are less exposed to the creditors, they are more favourable in terms of the expected positive social impact.

Socio-economic factors affecting financial sustainability and social impact

It improves financial sustainability



It impairs financial sustainability

1. Interest that can be realized (relationship between demand and supply)

High interest rate

Characteristics:
- high exposure of the potential clients
- the absence of possible alternative sources of credit

Low interest rate

Characteristics:
- lower exposure of the potential clients
- possible alternative sources of credit
- interest maximized by the donor

2. Repayment intention – repayment morale

High repayment rate

Characteristics:
- strong social (or religious) "pressure" to repay the credit
- other strong community "pressure" (e.g. credit group) to repay the credit

Low repayment rate

Characteristics:
- generally low social morale
- general escape from the undertaking of burdens, tendency to trickery

3. Repayment ability and the general economic, regulatory environment

High repayment rate

Characteristics:
- the government should let the citizens live
- self-employment and micro entrepreneur friendly taxation and accounting rules

Low repayment rate

Characteristics:
- complicated tax system and accounting requirements
- high taxes
- severe control and sanctions, low level of tolerance

4. Social assistance

High repayment rate

Characteristics:
- involving volunteers to help micro entrepreneurs
- mentoring, publicly funded advisory programmes

Low repayment rate

Characteristics:
- clients left alone

Repayment intention, repayment morale

This factor significantly depends on society. Naturally, a higher repayment morale is more favourable to financial sustainability. For example, social pressure that creates fear of humiliation in the client has a positive impact on repayment. Religious belief, for example, can encourage clients to be truthful, because the client would be ashamed if he did not pay back his debt. In case of group lending, the fear of humiliation and loss of trust before the group members might also be a psychological factor improving repayment morale.

However, in a socio-cultural environment where circumventing obligations is a folk tradition, and people who do this are thought to be "smart" rather than dishonest, certain legal collaterals should also be requested when microcredit is provided. (For example, the fear of losing an asset can compensate for the intention to get out of making payments to a certain extent.) Such a cultural environment naturally reduces the chances of financial sustainability.

Requiring legal collaterals to a higher extent and more stringently might have a dissuasive effect on the original target group we intend to reach, therefore it might affect the achievement of the desired positive social impact negatively.

Repayment ability and the general economic–regulatory environment

Evidently, the business of the client must be operational and its solvency must be maintained in order to satisfy its payment obligations related to the microcredit. However, an unfavourable regulatory, economic environment – due to the attitude of the state – may significantly reduce the repayment ability of the client, and in return the financial sustainability of the programme.

For example, the unfavourable taxation rules, the harsh procedures applied to the collection of rates and taxes, high penalties, over-bureaucratic accounting rules make it difficult for the enterprises to survive.

Where the state supports such enterprises with regulations, e.g. it gives 1 or 2-year tax moratorium for start-ups, applies simplified taxation and tax returns, and in general it *"lets people live"*, the chances of repayment are better, which affects the financial sustainability of the programme positively.

This factor is of vital importance if we are to achieve social efficiency.

Social assistance

Clients who are left alone after receiving the microcredit are more likely to become insolvent than those who are offered continuous mentoring and assistance. Therefore, it is extremely important that the lending activity should be coupled with management consultancy and mentoring activities.

This, however, leads to additional cost increase, which reduces financial sustainability, if the amount involved has to be paid by the microfinance provider from the revenues of the lending activities. That is why it would be important to connect additional consultancy programmes financed from separate sources to the publicly funded microcredit schemes. Obviously, this further increases the need for public funding.

This may include the involvement of volunteers, which, if coupled with the assistance provided to the customers, may significantly improve the chances of survival for businesses without significantly increasing the expenses of the microfinance institution. Volunteers may also play an important role in improving customer outreach, which acts as a cost-cutting factor for the financing of the microfinance institution.

All in all, the assistance provided to the customers by the society affects financial sustainability and the achievement of the desired social impact positively. In this respect, volunteers could play a very important role.

5. Opportunity to systematize microcredit programmes, analysing interests and processes

The practice of micro-lending in the world may seem extremely chaotic to an outside observer. That is because it IS. What we see is a mix of different types of credit institutions, different microfinance providers, different target groups and loan amounts, different cultures and societies. It is not always possible to find a "common denominator" because practically everybody calls microcredit as they wish. (That is why we do not give a specific definition for microcredit, but rather say what we consider microcredit.)

To mention as an example, a Central European state bank dealing with export-import financing called its credit of EUR 125 thousand granted to support export activities as "microcredit", and a state investment bank of high status of the same country called its credit line providing credit up to EUR 455 thousand as "microcredit". Or a non-profit organization in the same country is only willing to grant "microcredit" with the involvement of a legal collateral, which is a property free of any encumbrances the value of which is minimum twice the amount of the loan provided thereby (EUR 91 thousand).

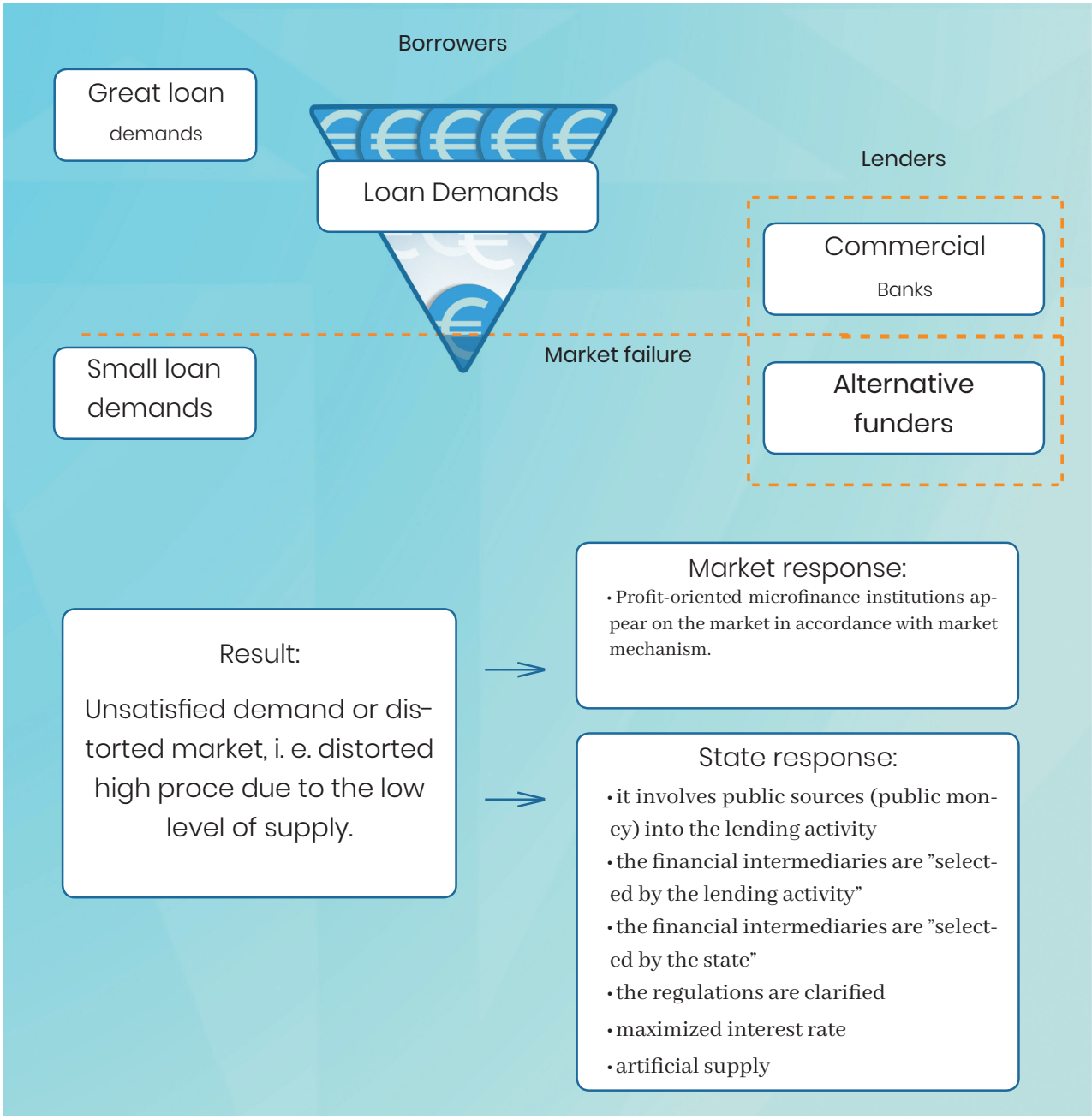
We would not like to judge these lending practices in this document, though according to the "definition" given earlier, we cannot consider it microcredit at all.

However, we would like to highlight that in order to have sufficient insight into the micro-lending practices applied in the world, and to be able to analyse these practices in terms of social utility, we must systematize them somehow. This knowledge is important because when we wish to set up a new microcredit scheme, we must understand the operating characteristics that may affect the social utility of the created programme and the achievement of the positive social goals significantly. It must be highlighted that each microcredit scheme is operated along different interests.

These interests greatly affect the operation and social utility of each microcredit scheme, that is why these interests must also be analysed.



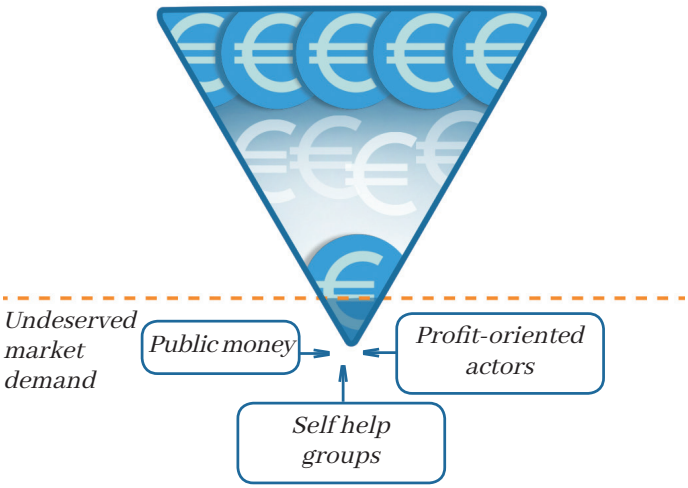
5.1 Determining the systematization aspects of microcredit schemes in terms of the money market approach



In order to determine the main aspects of the systematization of microcredit programmes, we will first look at the money market position and financing position of the microcredit actors. The following figure illustrates the market position of the actors relevant in terms of micro-lending and the possible market processes. As illustrated in the figure, the majority of borrowing requirements appearing on the money market are satisfied by the Commercial Banks. At the same time, a great part of the small loan amounts having relatively high costs and risk remain unsatisfied, and *market failure* occurs. According to the *market mechanism,* a supply appears on the side of the alternative profit-oriented microfinance institutions, but due to its limited nature the demand-supply equilibrium described earlier is not fully achieved. As a result, there is a high level of *unsatisfied demand* and a *distorted high price*. In the optimal case, the state intervenes in accordance with the concept of sustainable society. On the one hand, it limits the maximum interest rates with *administrative and legal means*, and regulates the operation of microfinance institutions. On the other hand, *it creates artificial supply* with the *involvement* of public funds *(public money)*.

It sets up revolving social microcredit funds from public sources, from which (ideally non-profit) microfinance institutions selected thereby perform micro-lending activities. Examining the phenomenon further, we can conclude that the extremely diverse microcredit activity that can be found in the world can be basically put into the following main groups based on the type of socio-market response given to the mentioned market failure:

- the emergence of alternative profit-oriented market players (speculators or 'ethical' social enterprises) to exploit the market gap, sometimes with the hope of achieving high profit;
- the formation of self-help microcredit groups;
- government intervention through funding (and regulatory) instruments.



It is quite obvious that we need to distinguish among the three types of operational financing, especially between non-profit microcredit programmes (e.g. financed from public funds or donations) focusing on social goals and profit-oriented microcredit programmes serving the interests of investors (speculators). At the same time it must also be noted that the non-profit and for-profit financing sectors operate according to very different principles, have different operational objectives, and operational standards - as well as social expectations - and *therefore no uniform standards can be applied for their operation.* The curriculum of the aforementioned University of Cádiz mainly presents the operation and characteristics of the Muhammad Yunus (Nobel Peace Prize winner economist) model for self-help groups through the lectures of Jaime Duran Navarro university lecturer, honorary president of the Spanish Microfinance Network and the former Vice-President of the European Microfinance Network. The necessity, principles, professional background and characteristics of government intervention as well as the practical issues of programme creation are presented by me together with my colleague, Péter Vonnák. To sum up, the following main aspects and characteristics may be determined to systematize microcredit schemes:

The funder may be:
- a private investor,
- a private donor,
- the state

Hence the source of funding may be:
- private money;
- public money

The microfinance institution (intermediary) may be:
- a profit-oriented organization,
- a non-profit organization.

The actual purpose of micro-lending may be:
- to make profit
- to achieve positive social impact.

In order to be able to assess whether a microcredit scheme is likely to have adequate (or actual) positive social impact, it is necessary to examine the interests of, and the relationships and processes between the actors of the specific (or planned) microcredit scheme.

The **interest matrix** is a great tool for this analysis.

5.2. Analysis of the actors of the lending process and the interests – interest matrix

The essence of the analytical method is to arrange the actors and factors relevant in terms of the social goals of the credit scheme in a matrix, and to indicate the factor that is valid for that programme. When marking the characteristics, it is essential that we do not record the characteristics declared by the actors but the real situation resulting from the actual interests. The interest matrix compiled from the marked factors demonstrates the real nature of the programme as a "fingerprint" of the programme. When launching a new microcredit

scheme, this may provide serious assistance to determine the interest of the actors, the roles and processes related to lending to maximize the positive social impact expected from the programme. The analysis method will be introduced through a case study.



5.3. Case study – analysing an actual microcredit programme with the help of the interest matrix

(Author: ©2016 - Péter VONNÁK)[4]

Presenting the analysing method through the example of the IBM loan product for small entrepreneurs.

I wish to present the method of analysis carried out with the help of the interest matrix through one of the good practices of Fejér Enterprise Agency (hereinafter referred to as FEA). This is the IBM loan product for small entrepreneurs, which was granted from private capital, and produced clear positive social impact. Before analysing the figure I would like to give a general overview of how and why the IBM loan product for small entrepreneurs was created.

On 20 November 2002 IBM Storage Products Ltd (hereinafter referred to as IBM), the local government of Székesfehérvár as well as FEA signed an agreement on the launch of the above-mentioned loan product in order to support the former IBM employees who became unemployed as a result of the closure of the IBM factory.

The loan product could only be required by enterprises who had formerly been employed by IBM or who were willing to employ a former IBM employee for at least two years.

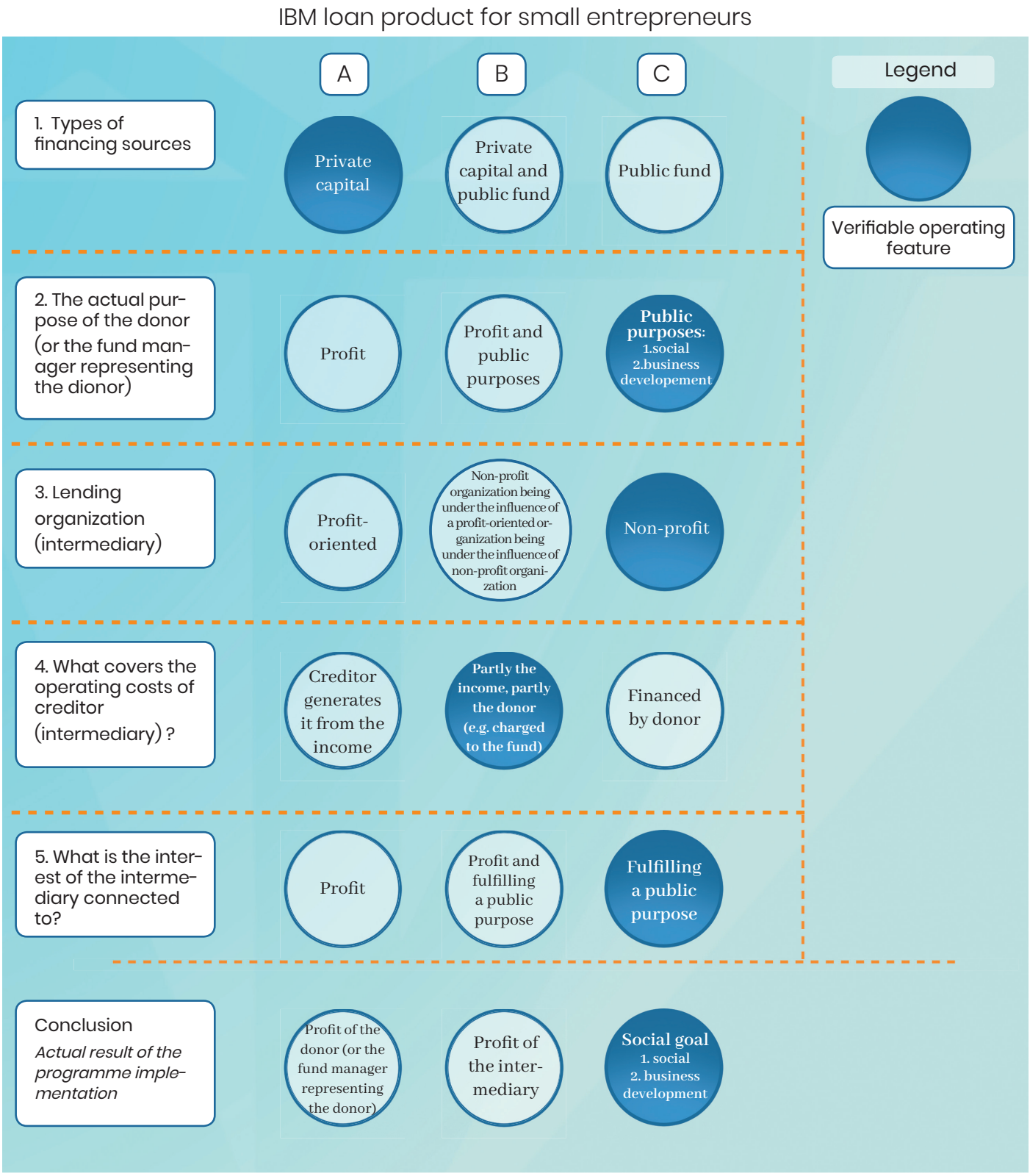
It must be stressed that this specific example has been selected due to the fact that it actually achieved positive social impact owing to the lending conditions. This example proves that a profit-oriented organization is also able to provide the intermediary with a funding source that is capable of achieving its social and business development goals under certain conditions. It can be seen that although the source was provided by a profit-oriented organization, it did not necessarily expect profit during the implementation of the programme. If a multinational profit-oriented corporation was able to develop a programme that achieved positive social impact, programmes implemented from public money should even more do so.

The interest matrix will be used to examine the operating model of the developed concept in order to prove this.

2015 European Social Business Forum. Norwey, Kolbotn



Left to right: Péter Vonnák, Hungarian Microfinance Network, Vice-President, Nobel laureate Prof. Muhammad Yunus Economist, Unni Beate Sekkesæter, President of the Norwegian Microfinance Network



Analysis of the IBM loan product for small entrepreneurs with the interest matrix.

As it can be seen from the interest matrix, the IBM loan product for small entrepreneurs was implemented from private capital. The capital was provided by IBM in order to support the former employees who became unemployed and to stimulate business development. For the implementation of the programme, IBM made an agreement with FEA, which is a non-profit organization, and is interested in achieving positive social impact and fulfilling a public purpose. It could achieve this aim because the operating costs were partly covered by the interest earned and the fund provided by IBM. It must be noted that IBM was fully aware of the fact that the fund provided thereby would decrease over time. The fund was provided as a donation, so IBM did not expect any returns. As

a result, the microfinance institution was not exposed to the donor. It was not expected to make extra profit, so it managed to achieve positive social impact successfully. Another important characteristic was that the beneficiaries obtained the loan at an interest rate which was lower than the bank rate published by the Hungarian central bank. Also, the fund provided by IBM was a revolving fund, which ensured that the amounts paid back by the beneficiaries could be granted again. This multiplied the positive social impact of the fund both in the fields of welfare and business development. From the internal documents of FEA it can be clearly stated that the HUF 300 million provided by IBM was granted many times, and during the operation of the fund approximately HUF 676 million was disbursed to 178 clients. (The figures come from the internal documents of FEA.)



Excerpt from the study called Microcrediting in Hungary - How can we optimize the social usefulness of microcredit schemes? written by Péter Vonnák, 2015. ISBN 9789631258455.

5.4. Lessons learnt

In case of a new microcredit scheme, the correct definition of the interest of the actors in the new programme is essential for the future social effectiveness of the programme.

! **It is important to take into account that the personal interests of the persons involved in the programme have a continuous effect on the operation of the programme. The programmes may change or become distorted in the course of time, the programme may deviate significantly from the original goals, and thus the social impact may remain below the expected level. It is important to see that the will of the most influential people will always prevail, so they are the factors that most affect the programme.**

¡ To illustrate the possible distortions of the programme and the goal, we will present a real story without naming the actors.

The microcredit programme in question was launched in a Central European country at the beginning of the 90's from Community funds. Revolving local funds were set up, which were used to grant microcredit by non-profit foundations. The credit risk was entirely assumed by the fund, and the credit losses could be written off. The foundations covered the costs of the operations partly from the interests paid by the clients and partly from the fund. The sources were channelled to the foundations through a "central" intermediary. This organization monitored the programme on behalf of the funder. The lending organization was **not allowed to demand legal collaterals from the clients** other than the tools purchased from the credit. The satisfaction of this condition was checked by the funder directly.

With regard to the fact that microfinance institutions needed cost reimbursements and commissions to sustain their activity, as well as to the fact that these funds were operated as revolving funds, the stakeholders were interested to maintain the fund as long as possible. One way to do this was by reducing losses, and losses may be reduced by involving additional legal collaterals. The rule under which no collaterals other than the purchased tools may

have been requested from the client was abolished. Obviously, it was justified by the reduction of losses and the increase of efficiency. Since the minimum extent of the required legal collateral was not specified in an administrative manner, creditors could adjust it flexibly to the capacities of the specific clients. Consequence: although more loan applications were rejected than earlier, the sources were still channelled to non-bankable clients, and the repayment rate improved. Despite the restrictions, the result can be described as rather positive. It is true that more clients were rejected (and as a result the original social goal became distorted). However, the sources could be used several times due to the better return, and the sources could be channelled to more clients for a longer period of time. During this period, this practice was considered as **the best practice in europe** by an international comparative study.

Later on, the coordinator managing the central sources became obsolete because the sources were not replaced in the programme. At the same time, due to its significant influence the organization achieved that the previously set up operating structure was completely changed. It centralised the sources that previously operated as a local revolving microcredit fund, and it continued to act as a lender in the whole country. In order to maintain the funds, among others, it introduced the rule that the client had to offer a property free of any encumbrances the value of which was minimum twice as much as the loan amount as collateral to receive the loan. They reasoned that "it was in the interest of the state to preserve these public funds", which could only be done if all the sources were managed by them centrally. The consequences were that the loans did not reach the target clients, which would have been important from a social point of view, and the operating costs increased greatly.

As can be seen from the example, it is really important that **in case of publicly funded programmes decision-makers** should set such operating rules which ensure that the interests of the specific players cannot divert the programme from the positive social goals.



6. Harmonization of the legal background, sustainability and social objectives in terms of the International Professional Directives

6.1. Historical background

A Interested Parties on Financial Inclusion (IPFI) was set up by the European Microfinance Network (EMN) in Stockholm in summer 2013 to provide a consultation platform for the European microfinance networks.

2013. 25th September, Budapest - IPFI group



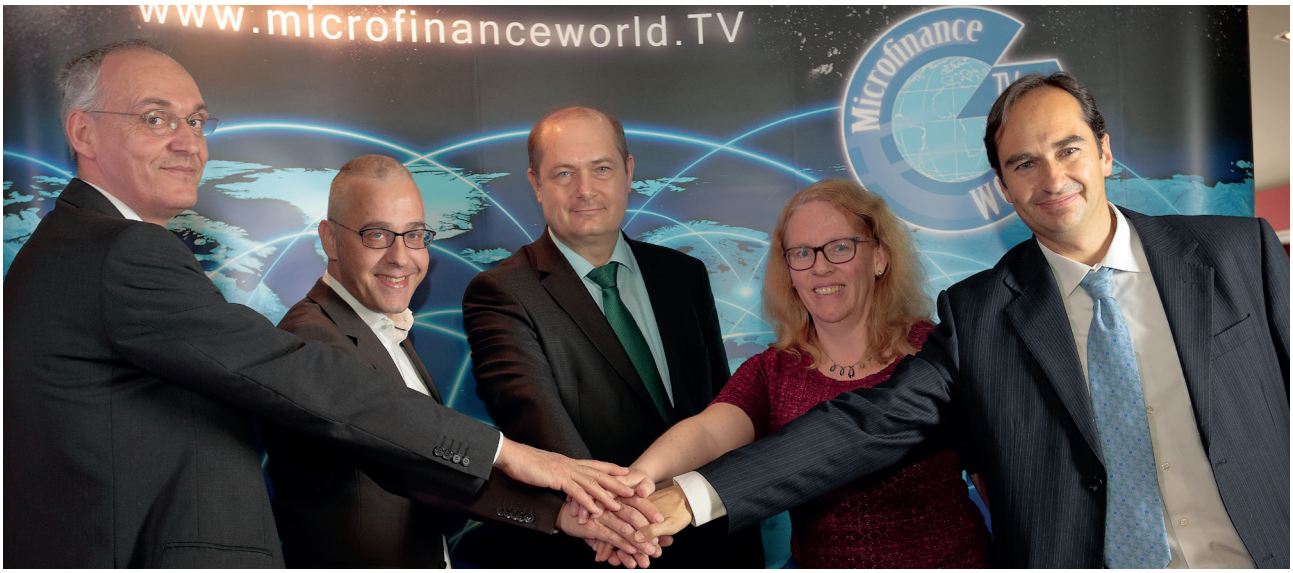
From left to right: Ben HUGHES, United Kingdom (President of the CDFA); Hajo WINKLER, Germany, (DMI); Zsófia GÖDE (HMN); András Nagy (HMN); Eloina GONZÁLEZ FERNANDEZ, Spain, (PEM); Tibor SZEKFÜ, Hungary, (President of the Hungarian Microfinance Network - HMN); Unni Beate SEKKESÆTER, Norway, (President of the NMN); Jaime DURÁN NAVARRO, Spain (President of the AEM); Tine OSAER, Belgium, (FEBEA); Jorge RAMIREZ PUERTO, Belgium (Executive Director of the EMN); Maria Cristina NEGRO, Italy, (RITMI).

The members of the group held a meeting in Budapest on 25 September 2013, and approved of the directives drafted after careful preparatory work based on international experience (the author of this curriculum played a decisive role in developing the recommendations), which were recommended for Hungarian decision-makers concerning microcrediting and the regulation thereof. On 13 May 2016, as a continuation of IPFI activities, representatives of the European national microfinance networks operating in a unified organization set up their **Committee of National Microfinance Networks – Microfinet** in Székesfehérvár, Hungary. This group works under the auspices of EMN.

The founders of the group are as follows:

- **Regional Foundation for Enterprise Promotion of the Town of Székesfehérvár (Fejér Enterprise Agency®-FEA),** as the consortium leader of the Hungarian Microfinance Network, represented by: **Tibor SZEKFÜ Managing Director of Fejér Enterprise Agency and the President of the Hungarian Microfinance Network)HUNGARY;**
- **Asociación Espanola de Microfinanzas (AEM** represented by: **Jaime DURÁN NAVARRO President) SPAIN;**
- **Community Development Finance Association (CDFA),** represented by: **Jennifer TANKARD Chief Executive), UNITED KINGDOM;**
- **Deutsches Mikrofinanz Institut (DMI),** represented by: **Joerg SCHOOLMANN Member of the Board) GERMANY;**
- **Microfinance Norway,** represented by: **Unni Beate SEKKESÆTER President) NORWAY;** and
- **Rete Italiana di Microfinanza - RITMI** represented by **Giampietro Pizzo President), ITALY**

13 May 2016, Székesfehérvár, HUNGARY. Setting up Microfinet



From the left: Giampietro PIZZO (RITMI); Joerg SCHOOLMANN (DMI), Tibor SZEKFÜ (HMN), Unni Beate SEKKESÆTER (Microfinance Norway), Jaime DURÁN NAVARRO (AEM).

A Members of **Microfinet** signed a document called *Professional recomendations for european decision-makers regarding the legislation of microfinance* (hereinafter referred to as Rome Directives) on 29 September 2016 in Rome. This document contains the professional recommendations – directives, compliance with which is essential to achieve the positive social impact of publicly funded microcredit programmes. Due to their importance, we will describe these directives in detail.



PROFESSIONAL RECOMMENDATIONS FOR EUROPEAN DECISION MAKERS REGARDING THE LEGISLATION OF MICROFINANCE

Foreword

The participants of the Committee of National Microfinance Networks (MICROFINET) hosted by the European Microfinance Network (EMN) have studied the situation of the European microfinance sector and unanimously defined the following international professional recommendations and directives based on the international professional experience.

PROFESSIONAL RECOMMENDATIONS

Legal and regulatory area

Financing

Rome, 29 September 2016

Guillem ARÍS, Asociación Espanola de Microfinanzas (AEM), SPAIN
Jennifer TANKARD, Responsible Finance, UNITED KINGDOM
Giampietro PIZZO, Rete Italiana di Microfinanza (RITMI), ITALY
Unni Beate SEKKESÆTER, Microfinance Norway (MFN), NORWAY
Tibor SZEKFÜ, FEA, Hungarian Microfinance Network, HUNGARY
Hajo WINKLER, Deutsches Mikrofinanz Institut (DMI), GERMANY

6.2. Interpretation of the directives and their specific professional fields

The European professional bodies drafted their professional recommendations in two main fields. These are:

- Legal and regulatory field
- Financing field

Please find below the detailed description of the recommendations belonging to the specific fields.

Legal and regulatory field

The Committee drafted its recommendations concerning the legal and regulatory fields in two main logical groups:

- **Institutional background regulation** (Directives 1; 1.1; 1.2)
- **Client protection** (Directives 2; 3)

6.2.1. Recommendations concerning the optimum legislation of the institutional background (legislation of MFIs)

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Directive 1: 'Non-bank' credit institutions should also be allowed to perform lending activities with the authorization defined in the Act.

Directive 1.1: The establishment of financial enterprises that do not take deposits, are specifically specialized in micro lending, fulfil positive social purposes and are entitled to pursue lending activities and to provide micro loans not exceeding the individual microcredit limit specified by the member state and/or the European Union per transaction should have lower founding capital requirement and their records should be kept separately.

Directive 1.2: Non-profit foundations or foundations that do not take deposits and fulfil positive social purposes specifically from donations and public money, which are prepared to pursue such an activity, should be allowed to pursue microlending activity and to provide micro loans not exceeding the individual microcredit limit specified by the member state and / or the European Union per transaction.



It must be noted that microfinance has two main sectors. On the one hand, there are *profit-oriented microfinance providers* operating under market conditions (this is basically profit-oriented microlending funded by profit-oriented investors) and *non-profit microfinance providers.* Non-profit microcredits may be granted from private money (donations) and public money.

It is important to know that the "banking acts" of the specific member states mainly ensure the *protection of depositors,* and are regulated by the rules of the profit-oriented *money and capital market.*

The essence of the above-mentioned **Directive 1** is that separate legislation is needed for credit institutions not taking deposits (since the protection of depositors is not an issue in their case).

Specifically, the essence of **Directive 1.1** is that the establishment and registration of *"financial enterprises"* that do not engage in deposit-taking, but who are active in money market (in a profit-oriented manner) and wish to provide specifically microloans should be facilitated with lower seed capital and their records should be kept separately.

Directive 1.2 aims to promote non-profit microcredit delivering positive social goals *outside the money market* by proposing microcredit activities for such non-profit organizations – foundations – not taking deposits under separate legislation.

Therefore, if the microcredit scheme is implemented by a specialized microfinance institution – a non-profit foundation - which

- **does not deal with deposit-taking,**
- distributes the sources to the target group intended to be supported under the conditions set by the donor,
- performs its lending activity in the interest of the public and its **goals are not profit-oriented,**

it is not legally justified for its microlending activity to be subject to the "banking act" in force in the specific country.

6.2.2. Client protection

Directives 2 and 3 call for the protection of clients constituting the target group of microcredit schemes with legal instruments. **Directive 2** proposes the application of direct, whereas **Directive 3** recommends indirect legal protection.

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Directive 2: The opportunity to abuse the situation of the vulnerable social strata should be limited with regulatory and financing instruments.

Despite the fact that the financing of the clientele interested in microcredit is usually uneconomical for the actors of the profit-oriented financial market, and therefore an unserved market is generated in spite of the existing demand *(See: the economic theory of market failures explained previously),* unethical funders, who work with high usurers' capital and use and abuse the situation of highly vulnerable people, may also appear. In order to prevent this phenomenon and its harmful social impact it is highly recommended that:

- the interests and fees that can be charged by the market actors should be limited by law at the level of the specific member state;
- an 'artificial supply' should be generated for the target group with microcredit schemes – *implemented through non-profit intermediaries* – which are financed from public money and have a fixed ethical interest level.

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Directive 3: An 'entrepreneur friendly' regulatory system should be created.

It is important for the state to 'let live" the target group that it wants to support with microcredit. Excessive taxes and contributions, administrative burdens, and intolerant control and fining practices may hamper economic growth, and make it extremely difficult for businesses, in particular for start-up micro enterprises, to live. Therefore, assistance should also be reflected in correct and tolerant state legislation, with special regard to undertakings younger than three years of age.

Financing field

The committee placed great emphasis on drafting the most important regulatory guidelines concerning the financing field. As we have already mentioned, we find it extremely important that microfinance programmes should have a positive impact on society.

In case of publicly funded programmes this is a basic requirement! That is why the funding conditions, rules and procedures of such programmes must be defined carefully, otherwise we miss the target and the expected positive social impact is not realized.

Furthermore, we must note that due to the above-mentioned reasons it is highly recommended that publicly funded microcredit schemes are introduced and maintained in those states where

- government intervention is needed for the creation of an 'artificial supply' adjusted to the existing demand in unserved markets, in order to fulfil positive social purposes (social and/or enterprise promotion-economic development objectives);
- government intervention is needed in order to force back the appearance of unethical funders working with high usurers' capital, using and abusing the situation of highly vulnerable people.

The recommendations concerning the financing field can be put into four main logical groups:

- the principle of social utility and its precedence over financial gain
- ensuring the achievement of positive social goals with various funding terms,
- funding terms of client protection,
- principles of financial efficiency.



6.2.3. Principle of social utility – positive social impact enjoys precedence over financial gain

In order to comply with the principle of social utility, it is essential to take into account and adhere to the following recommendations.

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Directive 4: Publicly funded microcredit schemes need to be interpreted as assistance provided out of social solidarity, which, in return, has positive social impact on society.

In case of publicly funded microcredit schemes, the concept of investing public money as invested capital, which has to be returned with interest, serves the individual interests of the specific private people involved in the management, supervision and control of the funds and fails to support the interests of the desired target group or society as a whole.

This approach may significantly hinder access to the available sources by those who need this support the most.

As a result, it is highly recommended that the following should be considered when the rules of the schemes are developed:

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Directive 4.1: In case of publicly funded microcredit schemes positive social impact should have priority over the "preservation" or increase of the funds at nominal value in the course of the implementation,

Directive 4.2: The requirement of sustainability should be interpreted and expected primarily on the basis of the humane approach to a sustainable society and not on the basis of absolute financial sustainability.

According to the Declaration issued by the World Academy of Sciences: 'Sustainability is the satisfaction of current human needs through preserving the environment and natural resources for future generations'. The most important criteria and the essential requirements of a sustainable society are:

- **social justice, the basis of which is ensuring equality regarding access to opportunities,** and sharing social burdens;
- **continuous efforts to improve quality of life; the sustainable use of natural resources,** the implementation of which requires the environmentally conscious and environmentally ethical attitude of the society;
- **preservation of the environmental quality.**

The quality of life includes health – the complete physical, mental and social well-being – and in connection therewith material well-being, healthy environmental conditions, democratic rights, safety and education accessible to all.

The objective for ensuring decent living conditions, suitable quality of life and well-being applies to everybody, to the future generations as well.

A *systemic approach* and governance are inevitable for the implementation.

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Directive 4.3: Time interval (short-term, medium-term or long-term sustainability) should be assigned to the expected financial sustainability, during which period the scheme must achieve or maintain the planned positive social impacts.

The requirement of absolute financial sustainability would mean that the revenues of the specific microcredit scheme should cover at all times and under any circumstances

- all the costs required to operate the scheme (including the costs of collection as well)
- all the costs related to central fund management and financial audit,
- the written-off losses, and
- inflation if there is a need to preserve the fund in real terms.

The achievement of these joint objectives would also mean that the members of the disadvantaged target group intended to be supported who are able to pay back the loans and the interests

- must finance all the costs required to operate the scheme,
- must pay back the uncollectible loans instead of the non-paying members (the losses must be covered). This is socially unacceptable and unfair, and it reduces the development opportunity of the 'successful' undertakings.
- have to pay all the operating costs related to the maintenance of central auditors and the fund managers (who, in this case, make sure that the microfinance organizations do not lend high risk money to a target group that can only be financed with extremely high risk, thereby jeopardizing the preservation of the public funds used for this purpose).
- Obviously, community funds are not intended to keep a small group of people whose task is to 'safeguard' that such money is not lost. Its purpose should be to cover the necessary expenditures of the community, including *assistance provided as the manifestation of social*

solidarity (which investment results in a positive social impact) as well as programmes, such as microcredit schemes, securing the objectives of sustainable society.

- Therefore, in case of microcredit schemes it is expedient that the expectations related to financial sustainability are not defined in absolute terms, but are tied to a time interval (schemes that can be maintained in the short term, medium term or long term).

This means that the programme must be operated in a way that the income received from the funds should be able to cover the costs for a certain period of time, e.g. for 5, 10 or 15 years – even if their nominal value falls - while achieving or maintaining the expected social impact.

6.2.4. Ensuring the achievement of positive social goals with various funding conditions

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Directive 5: The involvement of non-profit funders in the arrangement of publicly funded microcredit schemes should enjoy priority over profit-oriented creditors.

The primary objective and function of profit-oriented businesses created from private capital is to make profit for the owners. In case of undertakings dealing with lending activities this also means that the enterprise continuously attempts to maximize profits and minimize risks. In case of microcredit schemes this otherwise absolutely natural attempt may significantly hinder the sources to reach the targeted clientele. This may seriously jeopardize the achievement of the actual social goals. The risk is considerably lower for non-profit creditors, e.g. foundations.

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Directive 6: In order to reach the clients targeted by the publicly funded microcredit scheme efficiently and to achieve the set social objectives, the credit risk should not be transferred to the intermediaries or, in exceptional circumstances, should only be transferred thereto to a lesser extent.

By transferring the credit risk to the intermediaries, social solidarity is not manifested in any form in the specific microcredit scheme. The obligation to assume risks leads to a risk-averse attitude in lending. In case of high-risk microcredit this also means that the sources do not reach the targeted clients that can be financed with very high risk (typically start-ups and young undertakings not older than three years of age), which significantly hinders the achievement of the social objectives.

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Directive 6.1: The losses on loans should be able to be written off from the funds.

By taking into consideration the length of the time interval determined to ensure financial sustainability, various risk-sharing proportions may be established between the 'Credit Fund' and the intermediary. This risk-sharing proportion could also be given as ranges. (E.g. in case of financing start-ups, more losses should be able to be written off to the debit of the fund than in case of undertakings operating for several years, since the financing of start-ups presents a significantly higher risk.)

However, it must be clear that the higher the risk an intermediary should assume, the greater extent it will avoid it. Thus, the microcredit scheme, the purpose of which is to finance high-risk clients, cannot fulfil its original function, so the expected social impact may not be felt.

6.2.5. Funding principle of client protection – microcredit should not destroy, it should provide assistance

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Directive 7: The scheme should not put the people intended to be supported, having payment problems through no fault of their own, in a more difficult situation than what they were in prior to receiving the support.

If, for example, we expect the intermediaries to apply 'hard' collection procedures due to an erroneous approach to 'protecting public funds', some of the people intended to be supported may find themselves in a worse situation after the assistance than in the past. (Some or all of their assets may be lost whereas their debt continues to exist.) In this case social solidarity is not manifested in any form in the programme, and the expected positive social impact cannot be realized properly.

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Directive 8: The social success of the scheme should be facilitated with advice and assistance provided to the target group intended to be supported.

The approach to providing complex assistance promotes the social success of the scheme. This should be manifested in the necessary advisory services and assistance closely linked to the microcredit scheme when the loans are followed up, especially when it comes to helping start-ups and young – not older than three years of age – undertakings.

6.2.6. Principle of financial efficiency

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Directive 9: The costs of central fund management and financial control should not exceed 5% of the actual programme implementation costs, and if the micro enterprise is a start-up business or younger than 3 years of age, the operating costs should be able to be accounted for partly or fully to the debit of the 'Credit Fund'.

The pressure to earn the operating costs motivates the intermediaries to avoid risks. However, one of the most important aspects of publicly funded microcredit schemes is that, in compliance with the principle of social solidarity, it is the society providing the public funds that assumes the financial risk of the programme in the interest of the expected positive social impact. At the same time proportionality should be taken into account when the costs are accounted for. The overwhelming majority of eligible costs should be spent on the actual operation of the programme and not on the financing of a central 'watch organization'.



7. Regulatory and funding practice of the European Union applied in the field of microfinance

7.1. Identifying social needs and the methodology of managing such needs

Where public money and community resources are used to satisfy a social need or to tackle a social problem, it is always advisable to follow the logical steps below:

- identifying the social problem or need,
- determining whether the problem or need requires central government intervention due to its scale, and whether the situation can be improved through such an intervention,
- where the intervention of the government is justified, examining what tools are suitable to tackle the problem,
- selecting the tools with which the identified social need or problem can be tackled efficiently or with the help of which social impact can be maximized,
- when reviewing the applicable tools, determining the resource need of the set of tools to be applied (expected costs and when they are incurred),
- determining the mechanism by which the social need – social problem is tackled with the help of the resources and the selected set of tools,
- starting the intervention in addition to informing the stakeholders,
- the impact of the intervention must be monitored (measured), and based on the experience, the process of intervention must be corrected in order to have better social impact.

In our case the social problem is that certain social groups do not have or have only limited access to loans granted by commercial banks, from which they could finance the launch or development of an independent economic activity supporting their and their family's subsistence.

This reduced creditworthiness could be attributed to:



- the small borrowing requirement of the clients (due to the high costs it is not worth dealing with such small amounts);
- the inadequate collaterals offered by the clients (owing to the lack of collaterals there is no adequate cover for the loan if the client becomes unable to repay the loan from his activity or becomes insolvent),
- the fact that they are start-ups and as a result they have no entrepreneurial past that could be evaluated, therefore the risk involved in lending money to them cannot be accepted by the banks.

i

It must be noted that in addition to the economic constraints such high-risk lending may also have legal constraints, since the banking laws of certain states may severely limit how much risk banks may take in order to protect the depositors (and shareholders) since the banks mainly grant the depositors' sources in the form of loans.

Although the scale of this social problem (social need) varies from country to country, it can also be detected in the developed industrialized countries continuously. Earlier – *when describing the theory of market failures* – we already demonstrated that central government intervention is justified in this case.

In our opinion, this criteria should be used to examine to what extent the measures of the European Union concerning microfinance can solve the identified social need (social problem) and whether such measures can tackle them adequately.

7.2. European Code of Good Conduct for Microcredit Provision

In connection with the official activity of the European Union related to the provision of microfinance – at the time these notes are written – the following should be noted:

- In the European Union loans below EUR 25,000 are considered as microloans; no other definition that would specify microloans more precisely has been published to date;
- It has published the European Code of Good Conduct for Microcredit Provision (hereinafter referred to as CoGC), which may be signed or endorsed by microfinance institutions voluntarily,
- The signing or endorsement of the CoGC by a specific creditor (as well as its assessment by a designated auditor) is a **pre-condition** for accessing the microfinance **sources** – *made available from public money* – of the EU within the scope of the EaSI programme.
- The structural funds of the EU enable the member states to fund microfinance schemes. However, instead of selecting the intermediaries through open calls applied earlier, the EU has made the application of public procurement mandatory, which resulted in the selection of one or two consortiums.

The European Code of Good Conduct for Microcredit Provision (CoGC) was published in November 2007, after the adoption of the publication on microloans. According to the official declaration, the CoGC is an integral part of the EU Programme for Employment and Social Innovation („EaSI") (Microfinance and Social Entrepreneurship Axis).

The following declaration can be found in the Foreword of the CoGC:

*„The European **microfinance market is a young and growing sector which has considerable potential.** However, this **market** is still quite heterogeneous, due to the disparity of the legal and institutional frameworks in the Member States and the diversity of the microcredit providers. In the EU, microloans are provided by financial institutions, such as commercial banks, savings banks, cooperative banks and public banks, as well as by a number of non-bank entities, such as microfinance institutions, foundations, credit unions, charities, NGOs and others.*

As a result, microcredit lending practice vary considerably depending on the type of institution providing microloans, its legal setup, the environment in which it operates and its own ability to apply sound and efficient management procedures.

*Under these circumstances, the design of a widely accepted voluntary European Code of Good Conduct for microcredit provision was identified by the Commission as an important part of its initiative to promote best practices in the field of microfinance. By setting out good practice guidelines and identifying expectations and common standards, the Commission is seeking to support the sector in facing the challenges of accessing long-term finance, maintaining and raising the quality of services and **moving towards sustainability.***

The principles regarding governance and management presented in this document are generally not new, but they reflect best practices across the sector. The purpose of this document is to detail a set of approved standards recognized in the European Union as essential in terms of the operation and reporting of microcredit providers." [5]

The set objectives are absolutely positive, however, the document has not lived up to the expectations. Below we will explain the reasons why.

It must be pointed out that the signing or endorsement of the CoGC by a specific creditor (as well as its assessment by a designated auditor) is a **pre-condition** for accessing the microfinance **sources** – *made available from public money* – of the EU within the scope of the EaSI programme.

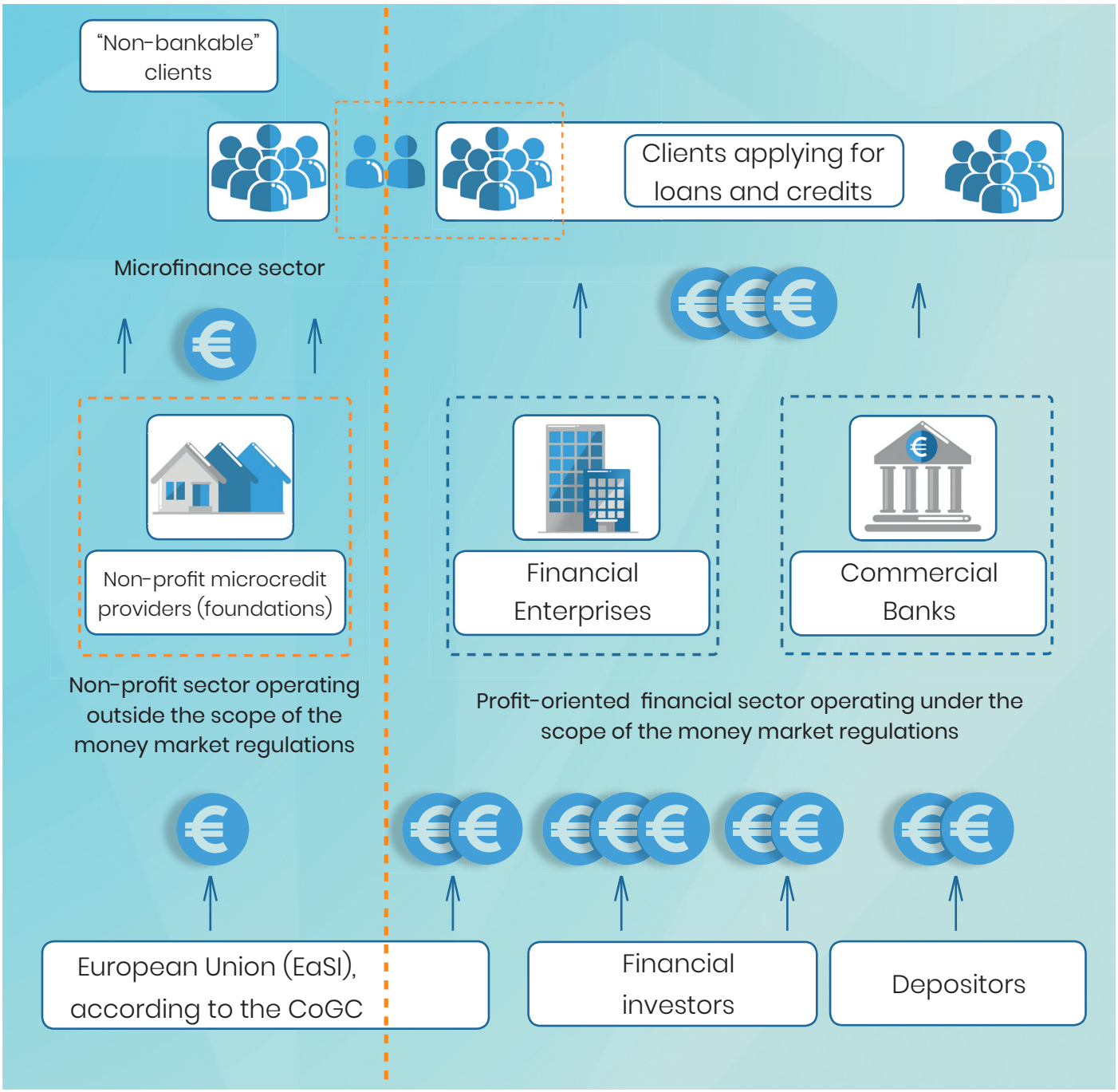
10 September 2012, Brussels. CoGC consultation in the 'pilot' phase of the programme organized by the Commission



On the right: Tibor Szekfü representing Hungarian microfinance practitioners

The diagram below illustrates the position of the CoGC, the "microfinance sector", and EaSI microfinance in relation to the funders, intermediaries and the financed entities.

We would like to emphasize that the diagram only serves the purpose of illustrating the most important relationships. Certain countries may have differing practices, but the main tendencies are the same as described here.



It can be seen that the money market basically consists of the commercial banks and the profit-oriented financial enterprises. Banks primarily finance the loans granted by them from the savings of the depositors, whereas financial enterprises grant loans from the sources of financial investors. These organizations perform their activities according to the money market regulations under the supervision of the Central Bank. Money market regulations are basically provided for by the "banking laws" of a specific country (in Hungary it is the Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises), which contain provisions that protect depositors and investors as well. Therefore, the level of acceptable risk is also legally restricted for each type of organization, and, for example, it requires the existence of regulations regarding collaterals and the existence of the collateral, too. Non-profit microfinance institutions – where it is enabled by the regulations of a specific country (for example the local enterprise agencies of the counties and the capital in Hungary) – may pursue microlending activity outside the scope of the money market regulations.

! **The non-profit and profit-oriented financial sectors operate under very different principles, have completely different objectives and fulfil different social roles, therefore, no uniform standards may be applied for their operation.**

Making profit – as a primary goal – and ensuring the primacy of positive social impact require a totally different approach and operational aspects. It can also be seen that due to the money market regulations and the profit-oriented approach the boundaries between "microloan clients" financed by financial enterprises and the "bottom level of clients" still served by the banks have become blurred.

It must be noted – as mentioned before – that there can be cases other than those described above depending on the regulations of the specific countries.

i There can be some possible deviations. For example, it can happen that where the regulations of a country do not allow non-profit organizations to provide microloans, non-profit organizations establish profit-oriented financial enterprises. Although this solution might help them bypass the obstacle caused by the legal constraints concerning the operation, they cannot bypass the directives laid down in the regulations concerning profit-oriented operation (e.g. the requirement regarding the existence of collaterals). As a result, a significant part of the clients excluded from the services of the money market cannot receive loans from these organizations either, unless another non-profit organization undertakes guarantee (surety) with regard to the granted microloans (if it is allowed by the regulations of the specific country).

Another exception is the setting up of social enterprises entitled to provide microloans, where the regulations of a specific country allow it.

It must also be mentioned that commercial banks may also set up divisions dealing with microloans. These units usually operate independently of the other organizational units of the bank and they are not expected to make profit. The loans granted by such units are not financed from depositors' money; the loans are accounted for among the "normal" operating costs of the bank. These practices can have different purposes. On the one hand (e.g. for the purpose of "marketing") they demonstrate the social responsibility of the bank, on the other hand, due to the fierce competition among banks, they tie customers to the bank before they become "bankable", since part of the clients receiving microloans may become "normal" clients of the bank after their business has become stronger. These loan schemes of the banks are usually not of such magnitude as to be able to solve the social problem described earlier in general.

! **From the above it can be seen that what is generally referred to as "microfinance sector" (the CoGC mentions the same) consists of two sectors operating under completely different laws and professional principles.**

It is made up of the profit-oriented enterprises falling under the scope of money market regulations, and the non-profit organizations operating under very different rules. Based on its structure, approach and procedures, the CoGC requires microfinance providers to *operate like profit-oriented financial enterprises.* Its criteria *meet the requirements of the investors,* in other words, the organization operating under the CoGC should be able to ensure the expected return with adequate security according to the expectations of the investor. (It is important that when judging this, we should not rely on the official declaration of the CoGC, but the specific standards and the professional interpretations thereof.)

The position of the European Union concerning the solution of the above-described social need (problem) with these instruments can be concluded from this. On the one hand:

- with the CoGC it has given a tool to the **profit-oriented financial enterprises** (profit-oriented MFIs) seeking financial investors, since their rating (compliance with the CoGC) increases the investors' confidence in them,
- it provides greater security for the financial investors if a rated financial enterprise complies with the standards of the CoGC.

These criteria may encourage private capital to participate in the profit-oriented microlending activity. On the other hand:

- since compliance with the CoGC and the rating are pre-conditions of the EaSI funding, and since the CoGC means the rating of funders from the investors' point of view, the **EU appears as a profit-oriented investor** using public money.

Based on all this, the following conclusions may be drawn:

- **currently, the European Union has no schemes to provide non-profit microfinance** through non-profit organizations for people wishing to succeed from an independent activity, who are not creditworthy or have reduced creditworthiness (they have no entrepreneurial history and/or adequate collateral) for the profit-oriented money market actors (financial enterprises and banks),
- the CoGC and EaSi funding do not provide a comprehensive solution to the social problem to be tackled;
- the **efficiency** of the method of funding (the EU acting as a profit-oriented financial investor) **is highly questionable in terms of positive social impact,**
- the non-profit organizations focusing on achieving positive social impact should transform their operating procedures significantly if they are to meet the requirements of the CoGC tailored to profit-oriented organizations, and if they manage to do so, the socially desirable non-profit aspect cannot be satisfied by them anymore.

Summary

Based on the above it can be concluded that the introduction of the CoGC cannot be considered successful (the standards stimulated intense debate when they were first published, and upon the closure of the pilot phase completed between 2013 and 2017 we can state that they did not live up to the expectations) due to the fact that the *developers of the programme did not focus on the social problem to be addressed, and thus, identified the social goals and the applicable set of tools incorrectly.*

The programme has been declared to support the microfinance sector, which, however, *does not exist,*

since *two differenct sectors must be distinguished* (the profit-oriented sector falling under the scope of the money market regulations and the non-profit sector operating outside the scope of the money market regulations). A*lthough the development of the two microfinance sectors can be a tool for addressing the identified social problem, it cannot be the goal of the development itself. At the same time, it must be seen that the development of the two sectors cannot be done with the same tools.*

The appearance of the community as a profit-oriented investor in this market is *strongly questionable considering its social effectiveness,* even more so because currently the EU has no schemes or set of tools to finance customers who are not creditworthy for the actors of the money market through specialized non-profit microfinance providers. This fundamental conceptual error led to the fact that the standards did not come up to the expectations. With special regard to the fact that the EU has launched a public debate again on the standards and initiated a procedure aiming at the revision thereof, we will not introduce the CoGC in detail.

7.3. A társadalmi hatékonyság javításának lehetőségei

Taking into account the views expressed above, the positive social impact of the microfinance schemes of the European Union could be increased significantly with the following modifications and measures (summarized without detailed explanation):

- non-profit microfinance provision through non-profit organizations should be given priority over profit-oriented funding,
- chapters concerning the operation of the non-profit microfinance sector should be added to the standards of the CoGC,
- the appearance of the community as a profit-oriented investor and its funding activity in the field of profit-oriented microfinance provision should be revised (it should be examined whether the sources were received by microfinance institutions and clients who are not creditworthy for profit-oriented organizations),
- the local revolving microcredit funds operated by non-profit organizations dealing with the provision of microfinance should be given priority when making funds available;
- the professional directives (Rome Directives) described earlier should be taken into consideration to the extent possible when creating the various schemes, with special regard to the need for achieving a sustainable society, social solidarity and social goals,
- in case of microfinance schemes – implemented by specific member states – funded from structural funds, the intermediaries should be selected with the involvement of only non-profit organizations via open calls for proposals instead of public procurement, and the conditions of the schemes should be determined on the basis of the professional directives (Rome Directives) described earlier.

The setting up and operation of successful revolving microcredit funds are not unprecedented in the history of the European Union (Community).

For example, within the framework of the Phare programme (PHARE: Poland-Hungary Assistance for the Reconstruction of the Economy) the Phare Microcredit Scheme launched in Hungary in 1992 was one of the best business development programmes of the PHARE, and the best business development programme in *Hungary concerning the fulfilment of social goals* and it was considered an outstanding success. In May 1998, the European Economic Committee of the UN organized the Microcrediting Best Practice Specialists' Meeting together with USAID within the framework of Southeast European Co-operation Initiative (SECI), in which 12 countries - including Greece and Turkey – participated from Central and East Europe. According to the survey conducted by the British Bannock Consulting, the *then existing Hungarian practice was the best microcredit programme in the region.* This means the significant recognition of the microcrediting activity of the agencies.

A positive example for the successful operation of a revolving microcredit fund is the IBM microcredit scheme, which was developed and operated by the Hungarian Fejér Enterprise Agency for more than six years.

We should also mention the Access to Microfinance for Small and Medium-sized Enterprises (ATM for SMEs Interreg Europe) project run within the scope of the Interreg Europe programme of the European Union, which was managed by the Hungarian Fejér Enterprise Agency as a Lead Partner. The general aims of the project were:

- to promote better access to microfinance instruments in the regions participating in the project,
- to examine the constraints and opportunities of maximizing positive social impact,
- to identify good practices and their most important factors,
- to introduce the opportunities to adopt the good practices at international level and to make them "teachable".

In the course of the project, several microfinance good practices were identified, which were based on the concept of revolving microcredit funds.

www.microfinancegoodpractices.com

An example for this, in addition to the IBM Microcredit Scheme, is the local revolving microcredit fund managed by the Hungarian Zala County Foundation for Enterprise Promotion, in relation to which the local government provides interest subsidy for the entrepreneurs participating in the programme. The success of the programme is proved by the fact that based on this scheme, other foundations have also implemented similar microcredit schemes with the support of the local government. (Fejér Enterprise Agency and Veszprém County Enterprise Development Foundation.)



May 2017, Budapest. One of the best practices presented in the ATM for SMEs programme is the 'Student Entrepreneur Contest', targetting the preparation of secondary school students for entrepreneurial life by taking into consideration the interest and characteristics of the age group. In the photo: Mihály Varga Minister of Finance, patron of the contest held in 2017-2018, the topic of which was microcredit, and the members of the jury.



From the left: Péter Vonnák Hungarian Microfinance Network (HMN) Vice-President, Mihály Varga Minister of Finance, Dr. Tamás Bartal Deputy State Secretary, Prime Minister's Office, Prof. Dr. Magdolna Csath Economist, Doctor of the Hungarian Academy of Sciences, Tibor Szekfü HMN President, Dr. hab. Árpád PappVáry Metropolitan University, Professor Dean, Dr. hab. Györgyi Nyikos University of Public Service, Department Head, Professor, Deputy Rector

The key features of the operation of revolving microcredit funds (non-exhaustive list):

- the allocated funds that were lent to the clients revolve back to the fund as they are repaid and are granted as loans again, thus several fold of the original fund may be granted again,
- the international professional directives (Rome Directives, 2016) may be fulfilled fully when the new programmes are developed,
- priority may be given to the enforcement of positive social impact over financial sustainability, as a result of which the nominal value of the fund will decrease continuously, but the sustainability of its operation may be linked to a specific time interval, and if needed, it can be extended with the provision of additional sources. The scale of the additional sources is a lot smaller than the initial source need, which may be placed at the disposal of the microfinance institution continuously as the sources are granted.

Practical issues related to the development and operation of microcredit schemes

Author: ©Tibor SZEKFÜ



8. General principles concerning the internal regulation of MFIs

Concerning their legal status, microfinance institutions can take various forms. They might be financial enterprises falling under the scope of the money market regulations of a specific country, or foundations, associations, etc. falling outside the scope of such regulations. These organizations have to operate in accordance with the rules of law of a given country. Strict legislation might apply to the operation, internal regulation and mandatory reporting procedures of a specific microfinance institution in a given country. Therefore, we do not wish to cover the specific regulations in detail; we will only mention some important basic professional principles. Furthermore, we will summarize the possible policy (regulation) types a microfinance institution must have in a table (non-exhaustive list).

The various policies (regulations) may be grouped according to **who can approve and modify them,** and what **operating field they apply to.**

In terms of the operating fields, the internal policies (regulations) may be put into three main groups:

- general operating policies;
- lending policies;
- accounting policies.

Concerning the operation, we would like to highlight some important principles.

Separate division to deal with lending

In the event a specific microfinance institution also performs activities other than micro-lending (e.g. arranging other enterprise promotion programmes, providing business development services, etc.), a *separate organizational unit* must be set up for the micro-lending activity, which unit must be headed by a responsible professional manager. This manager must be a member of top management in the given institution. This person is normally *responsible for managing credit risks at the institution.* The work processes related to the lending activity, their

deadlines, the responsible persons (including their positions), and the minimum qualifications required for the specific position must be determined in the policies.

"Four-eye" principle

When creating the internal procedures, great attention must be paid to the "four-eye" principle. It means that the loan applications must be approved by at least two persons. This is a significant factor in reducing credit risks.

Preparing a decision

In case of micro-lending an on-site visit must be arranged to the loan applicant before a proposal is presented to the Credit Committee. It is important that the person who is in touch with the client during the preparation process and is involved in the preparation of the proposal, *may not have decision-making authority* with regard to the specific loan application.

The possible policies (regulations) of a microfinance institution are summarized in the table below:

	I. General Operating Policies	II. Lending Policies	III. Accounting Policies
1. It is approved by the Board of Directors	I.1.1. Organizational and Operational Rules	II.1.1. Policy on the Loss of Value and the Creation of Provisions	
	I.1.2. Internal Control Policy	II.1.2. Risk Assumption (Credit Risk Management) Policy	
	I.1.3. (General) Risk Management Policy		
	I.1.4. Policy on the Prevention and Combating of Money Laundering and Terrorist Financing		
2. It is not approved by the Board of Directors (Unless it is otherwise provided for in another internal policy, it is approved by the Managing Director)	I.2.1. Quality Assurance Policy	II.2.1. Client and Partner Rating Policy	III.2.1. Accounting Policy
	I.2.2. Policy on the Protection of Data and "Banking Secrecy"	II.2.2. Collateral Evaluation Policy	III.2.2. Chart of Accounts, System of Accounts
	I.2.3. Information Security Policy	II.2.3. Transaction Rating and Evaluation Policy	III.2.3. Policy on Taking the Inventory of Assets and Liabilities
	I.2.4. Emergency Response Plan	II.2.4. Credit Monitoring Policy	III.2.4. Money Management Policy
	I.2.5. Business Continuity Plan	II.2.5. Debt Management Policy	III.2.5. Policy on the Handling, Recording and Checking of Documents and Forms Subject to Strict Accounting Regulations
	I.2.6. Complaints Handling Policy	II.2.6. Lending Procedures	

9. Forms of micro-lending

Microfinance institutions deal with two types of lending. One of them is the so-called "group" lending (Grameen model) developed by Nobel Peace Laureate Prof Muhammad Yunus and the other one is the "traditional" lending method.

It must be noted that the applicability of the specific forms of lending greatly depends on the society and culture. It depends very much on the level of economy, the general level of development and the general financial situation of the target group concerned in the specific country.

Obviously it can happen that both forms of lending are used in a country (e.g. the traditional form is dominant, however in case of funding a sub-culture – or for instance migrant people – group lending works best), but usually only the "dominant" method has a demonstrable impact on a wider social level.

In this course material we only touch upon the characteristics and phases of the procedure of the various forms of lending.

9.1. Group lending[6]

The procedure is simple; in short, it works like this:

- A group of people with similar aspirations and backgrounds is formed, who trust each other and share the desire to participate in the experience.
- They are instructed in the basics of credit, savings and business management, to enable them to draw up a micro-business project.
- Microcredit is granted, and the operators give support and advice. If possible, a weekly meeting is organized for instalment payments.

Creating a group

The relationship between the individuals and the group is a key notion in microcredit. The first step when launching a microcredit experience involves creating a small, socially homogeneous group, *on the basis of mutual trust.* Those who are interested in the project will in turn find other people they trust, with similar interests, motivations, and social status. A supportive relationship of exchange is thus established among the members, which is in itself a positive factor. Trust and assurance develop, one is no longer left alone to struggle, and a sense of pride is felt for having attained and shared results. Oftentimes, if a member of the group cannot pay back the weekly rate, for whatever reason, others can choose to step in, maybe using a tiny fund created for such cases (or in the Grameen model, it is possible to renegotiate the debt directly with the bank), but everyone will always do their best not to disappoint others. The results obtained by the group are greater than those reached adding up single actions.

Training

As we have seen, it is not enough to obtain credit to be an entrepreneur, even for a small enterprise. Before initiating any project, a training period is needed to learn how to use money, what savings is, and how to plan. This learning process is essential and at the core of microcredit.

Microcredit

Group participants receive a loan. This loan is to be repaid periodically following pre-set deadlines.

Support-tutoring-monitoring

One element characterizing microcredit organizations is the fact that the person who obtains the loan is not left alone in managing the enterprise. Operators have a decisive role of support and mediation among the parties involved. In the Grameen microcredit model, the group meets every week or two to support the entire process and the people involved. The learning process never ends in microcredit institutions, nor do encouragement and the improvement of results.

It must be noted that these groups can be expanded by involving new people by the members or the operators. In such cases it can happen that the new member visits the group meetings and participates in the trainings for months. During this period the

members of the group get to know the new person thoroughly. When it comes to granting the loan, the members of the group vote whether they accept the new member and propose granting the loan to this new member. If they do not trust the new member, no loan will be granted. This is very important for the group because as we mentioned earlier occasionally they make the payment in case of the insolvency of a member.

The issue of legal collaterals

As we have seen, in case of this form of lending usually very poor people unable to offer legal collaterals gain access to small loan amounts, with the help of which they can generate income from self-employment providing a livelihood to them. Although the repayment of these loans is not secured with legal collaterals, the retrun rate for them is more than 95%! The question then arises: what could be the reason for this success, how is it possible? The main reason for this is a human characteristic called **shame.** Shame avoidance is a very strong psychological factor for many people. Usually in case of group lending trust is mentioned as a factor that motivates repayment, but in fact it is the fear of losing trust and being humiliated that really motivates. During the regular meetings the members of the group build a strong – often friendly – relationship, which is based on trust, and which binds them. This strong personal link further reinforces the **aspiration to comply,** as well as to prove that the person was worthy of trust. **Religious beliefs** may also lead to increased impact. There is a country where microcredit groups are organized around the Roman Catholic parishes. In this case the aspiration to comply and the fear of being humiliated in front of the fellow believers (efforts to be truthful) are even stronger motivating factors.

Nevertheless, we would like to refer back to our statement whereby clients fail to pay back the loan for two basic reasons. Either because they cannot or do not want to pay it back. From the above it can be inferred that the fact *whether they "want to pay it back" has a greater significance than the other factor.*

9.2. „Traditional" lending method

Next, we will deal with the "traditional" lending method in more detail. You will be introduced to an advanced, completely electronic, Internet-based procedure covering the entire process from loan applications, through loan assessment management to the granting of the loan. We will present the various phases and procedures of lending with the help of the internationally recognized CREDINFO system, which was developed by the Hungarian Fejér Enterprise Agency®.

Milano, June 27th, 2009.



From left to right: Nándor Benczur CREDINFO Kft. Managing Director, Tibor Szekfü FEA Managing Director, Éva Faragó, FEA, International Relations Manager

The Internet-based service providing and loan assessment management system of FEA® was included among the five best practices by the scientific committee in the ***Microfinance Best Practices "Europe" Award 2009*** *announced by the Milan-based Giordano Dell'Amore Foundation and the Paris-based European Microfinance Network (EMN) in the topic of* ***innovation and sustainability*** *in microfinance. The significant professional acknowledgement was given to the foundation* ***„in recognition of the contribution in advancing the microfinance best practices frontier and in introducing innovation and valuable elements for the economic and social development of the microfinance clients".***

MICROFINANCE BEST PRACTICES AWARD
FONDAZIONE GIORDANO DELL'AMORE

In 2011 the Foundation won the ***Investment And Innovation In Microfinance Europe Award*** *in the category of* ***Innovative Use of Technology.*** *The category winners were announced in London at an international conference.*

With the award they recognise individuals and organizations that are committed to innovation and development and have demonstrated vision in delivering financial services to those at the bottom of the pyramid.

As microfinance continues to transform, the purpose of the award is to showcase best practice to the microfinance community. At this event the microfinance community came together to recognize those who had contributed innovative and original work within the industry.

MicroFinance Recognition Awards Europe 2011

This course material does not provide a detailed description of the applied procedures; we will only mention the most basic features. We will present the lending process broken down into the following sub-activities:

- customer outreach,
- preliminary screening,
- on-line loan application,
- on-line loan assessment management and risk management,
- additional procedures (such as contracting, granting the loan, collection, credit monitoring, debt management).

The loan applications are assessed within the scope of a so-called censorship procedure. The specific steps of the procedure will be described one by one.

10. Process of the "traditional" lending[7]

10.1. Customer outreach

Reaching customers a major challenge for a lot of microfinance institutions. Its classic from is maintaining a network of offices and advertising in various media. Involving volunteers - if they are part of the campaign activities of the given microcredit provider – can be a cost-effective way to reach out to customers.

In addition to the "traditional" methods, the role of new and rapidly developing Internet-based digital techniques has increased significantly. Due to their magnitude, they will be presented in a separate chapter later on.

10.2. Submitting the loan application

In Internet-based electronic systems, the loan application is completed on a web interface capable of completing loan applications and business plans. The content requirements are set by the microcredit provider in the system. Customers may apply for a loan upon registration. At first, the eligibility criteria are checked, then a "wizard" guides the client step-by-step through the loan application process. After a check has been performed by the system, as a last step it closes the loan application. The system offers remote assistance. If the applicant has any questions during the loan application process, the system enables the operator of the microfinance institution to connect to the loan application that is being completed upon the request of the applicant. The operator can see the same thing as the loan applicant and may correct it as long as the electronic connection exists. When the client has closed the loan application process, the system sends a text message to the operator of the microfinance institution immediately about the submission of the new loan application. Then the censorship procedure begins.

In the absence of an electronic system, the whole loan application is paper-based and several personal meetings are needed to complete the process.

10.3. Pre-screening, establishing eligibility

In the course of the specific credit schemes the creditors (and funders) may require different special conditions as to who and under what conditions may receive certain loans. In addition, the creditors may specify other conditions relating to the format and content of the loan application, including a list of documents to be enclosed to the application. In the traditional process, this means paper-based forms and checklists.

When an electronic loan application process is started, advanced online loan application systems, such as the CREDINFO system, display a set of questions set by the microfinance institution aiming at establishing the eligibility criteria. The "chatbot" function embedded in the webpage, described in the chapter on "customer outreach", may also serve this purpose, but it also helps the loan applicant to select the most appropriate loan product.

The purpose of pre-screening is to ensure that only those apply for credit whose eligibility for the available credit facilities can actually be established.

In the absence of electronic support systems, this check is carried out with the help of paper-based checklists. The loan application package must include a form in which the loan applicant declares that he has become familiar with the conditions of the specific programme, and that his enterprise meets the requirements. The conditions are checked by the staff of the microfinance institution when the format and content of the business plan are checked based on the documents submitted by the enterprise.

Should it become apparent at any stage in the process that despite the declaration the enterprise fails to meet the eligibility criteria, the censorship procedure must be terminated and the loan application must be rejected by the microfinance institution.

10.4. Checking the format and content of the submitted applications

In case of paper-based loan applications, basically the following format and content features are checked:

- The structure of the business plan meets the requirements set in the policy.
- The business plan includes all the chapters specified in the policy.
- The numerical relationships in the financial plans are appropriate.
- The documents to be attached to the business plan are all available.
- The business plan has been duly signed by the loan applicant.
- The business plan has been signed by an authorized signatory.

It can be seen from the foregoing that in case of electronic loan applications only loan applications that have already gone through basic checks concerning the format are received by the microfinance institution.

At the same, the microfinance institution may require certain documents to be enclosed to the loan application, the checking of which may not always be automated. When the electronic loan application is submitted, the operator checks the loan application, including the existence of the documents to be attached. If something is missing, the operator can open the loan application for the client to add the missing information. Should this happen, the client receives an automatic warning email and a text message from the system.

The possible scope of documents to be attached to the loan application (depending on the specific country and organization):

- in case of business organizations a copy of the certificate of incorporation;
- in case of business organizations a specimen signature;
- in case of business organizations an extract from the company register not older than 30 days;
- in case of business organizations a resolution adopted by the members' meeting on the taking out of the loan;
- in case of sole traders a copy of the sole trader's licence;
- credit information provided by the account holding credit institution (on the appropriate form);
- a certificate issued by the Tax Authority not older than 30 days on the tax account balance and contributions owed;
- credit information concerning the retail loan repayments of the entrepreneur;
- annual accounts or the simplified annual accounts of the previous year;
- tax return of the enterprise on the previous year;
- lease agreement concerning the shop, workshop, plant, etc. (in case of a rented property);
- documents supporting the investment plan (the itemized budget of the entire project, quotations, Memorandum of Understanding, preliminary contract);
- documents verifying the sales opportunities (contract, preliminary contract, Memorandum of Understanding);
- documents relating to the assets offered as the legal collateral of the credit:
- in case of properties:
  - » title deed not older than 30 days;
  - » if it is inhabited: declaration on the acceptance of the mortgage;
  - » if it is not owned by the enterprise: the owner's declaration in which they grant their consent to the registration of the mortgage;
  - » in case of an encumbered property a declaration of the previous mortgagors in which they grant their consent to the additional encumbrance of the property;
  - » official valuation to establish the value of the property.
    - in case of movable assets:
  - » in case of vehicles:
    - a copy of the registration certificate;
    - official valuation to establish the value of the vehicle
  - » in case of machines and equipment:
    - documents verifying ownership;
    - official valuation to establish the value of the equipment;
- the verification of the notary public concerning the fact that the person offering the collateral is not listed in the register of charges and sureties, which verification may not be older than 30 days.

In the event the Co-ordinator of the process finds the application in good order, he initiates the censorship procedure. He selects the people who will participate in the assessment process and their roles from a pre-defined list, and changes the status of the assessment process from "recorded" to "under preparation". The people participating in the "preparation" of the loan assessment process or acting as a "Proposer" receive a text message and an email from the system to inform them that a task has been set for them in the course of the loan assessment process.

10.5. Players in and the stages of the electronic loan assessment management process

The electronic loan assessment management system within the CREDINFO System handles the following rights in the course of the censorship procedure:

- Co-ordinator of the electronic assessment process,
- Person participating in the preparation of the loan assessment process,
- Proposer (non-voting),
- Expert,
- Evaluator
- Evaluator with a right to veto.

The specific stages of the assessment process can be as follows:

- Recorded,
- Under preparation,
- Suspended,
- Being opinioned by an expert,
- Proposed,
- Closed,
- Deleted.

10.6. Preparation of a decision: collecting and processing information

The main objective of collecting and processing information is to supply the debtor rating system – analysing the risk of granting the loan - with data required to establish the creditworthiness of the client, and to prepare the decision. The person assessing the loan (the person participating in the preparation of the loan assessment process or the Proposer) may obtain the information from the following places to prepare the decision:

- the business plan of the enterprise;
- additional documents attached to the business plan;
- on-site visit and interview at the plants of the enterprise;
- business and other references;
- other sources.

As a first step, the Evaluator checks the relevant documents to see whether the application includes all the information that is necessary to assess the creditworthiness of the applicant and the risk of granting the loan. If the Evaluator believes that the application does not include all the necessary information, he may request

- the submission of additional documents subsequently;
- additions to the business plan.

If the applicant fails to supply the requested documents or information until the specified deadline, the Co-ordinator of the loan assessment procedure

- may suspend the censorship procedure for an indefinite period of time;
- may reject the application due to the fact that it is not suitable for being assessed.

Naturally, the Co-ordinator will set the status of the procedure to "Suspended" in the first case and "Deleted" in the latter case in the electronic loan assessment management system.

10.6.1. Examining the relevant documents of the submitted loan application

When checking the relevant documents of the submitted loan applications, the Evaluator may check the following depending on the characteristics of the specific loan application:

- whether the business plan contains all the necessary information;
- the legal conditions concerning the operation of the enterprise are adequate:
  - » the format and content of the sole trader's licence and the certificate of incorporation/registration are adequate;
  - » the activity of the entrepreneur is reported to the Tax Authorities;
  - » the entrepreneur has all the permits required for the operation;
  - » the lease agreements are appropriate.
- adequate information is available concerning the past activities of the enterprise:
  - » the annual accounts or the simplified annual accounts are available;
  - » analysis of the balance sheet and Profit and Loss Account (examination of the indicators);
  - » the tax return of the business for the previous year is examined;
  - » the following references are examined:
    - certificate issued by the account holding credit institution;
    - certificate issued by the Tax Authorities
    - examination of other business references;
    - certificate concerning the repayment of an existing loan.
  - » the documents verifying qualifications are examined.
- the documents related to the future plans of the enterprise are examined:
  - » the entire, itemized budget of the planned investment (project) is examined (the budget of the entire investment required for the full implementation of the project);
  - » the documents verifying sales opportunities are checked.
- the documents related to the assets offered as legal collateral to secure the loan are checked;
  - » documents verifying ownership and whether the property may be encumbered;
  - » valuation,
  - » contract of sale.

The Valuers accepted by the microfinance institution have access to the loan assessment management system. They record the valuations related to a specific loan application electronically on an interface created for them, which valuations may be viewed by anybody concerned in the particular loan assessment process. Following the examination of the submitted documents, the Evaluator (Proposer) notifies the client about the date of the on-site visit.

10.6.2. On-site visit and interview at the plants of the enterprise [8,9]

The Evaluator (Proposer) carries out the on-site visit at the location of the planned investment, but if it is deemed necessary, he may visit the other plants of the enterprise, as well as the properties and other assets offered as collaterals to secure the loan. The purpose of the on-site visit and interview is:

- to check the personal suitability of the entrepreneur;
- to check the suitability of the plant;
- to compare the content of the business plan with what is experienced at the site.

When assessing creditworthiness, it is really important to check the personal suitability of the entrepreneur/management. During the personal interview, the person carrying out the on-site visit must establish:

- the "key" figure of the enterprise;
- the qualifications and professional experience of the entrepreneur/management;
- the management skills, experience and managerial experience of the entrepreneur/management;
- the general impressions of the entrepreneur/management;
- other additional information.

During the interview the person carrying out the on-site visit must clarify all the issues arising based on the application and in the course of the interview. The suitability of the plant is established by means of an on-site visit, during which a member of staff establishes

- the suitability of the plant for exercising economic activities;
- the location and accessibility of the plant;
- the infrastructural environment of the enterprise;
- the technical condition and suitability of the production tools and equipment for the planned activity.

The person carrying out the on-site visit records everything on video. If there are great differences between the business plan and what is experienced on site, the reason for such differences must be examined.

10.6.3. Making a proposal

After the on-site visit the Evaluator (Proposer)

- performs debtor rating in the Credit Scoring System,
- establishes the mortgage lending value of the offered collateral,
- uploads the videos made and photos taken during the on-site visit and any other documents obtained subsequently, which are relevant in terms of the assessment of the loan application,
- makes a written proposal for the Censorship Committee in the electronic loan assessment management system.

The proposal must include:

- all the information revealed in connection with the enterprise and its representative (owners),
- all the observations made concerning the past activities and market position of the enterprise,
- the offered collaterals and their mortgage lending value,
- the written declaration of the Proposer as to whether
  - » he deems the enterprise and its owners suitable for receiving the specific loan product,
  - » he deems the owners of the enterprise creditworthy and reliable,
  - » he finds the assets offered as collateral to secure the loan adequate and appropriate,
  - » he finds the plant of the enterprise suitable for pursuing business activites,
  - » he deems the enterprise viable,
  - » he recommends the approval of the loan application based on the above, and if yes, he should specify
    - the amount of money that should be granted,
    - the duration of the loan,
    - the grace period,
    - the interest rate,
    - and the special conditions.

Having performed the above-mentioned tasks, the Proposer changes the status of the electronic loan assessment process to "Being opinioned by an expert". Then the system sends a text message and an email automatically to all the people who were assigned to the assessment procedure as an "Expert". We will present the **Credit Scoring System** in a separate chapter.

10.6.4. Being opinioned by an Expert

At this stage, the Experts assigned to the loan assessment process will view all the written and multimedia materials related to the specific loan application. The Experts may be risk managers, funding experts, lawyers, etc. The system enables them to ask questions from the Proposer. Having established their position,

they have to make a straightforward declaration as to whether they recommend the approval of the loan application or not, and if yes, under what special conditions. The Co-ordinator monitors the electronic loan assessment process and changes the status of the process to "Proposed" once the Experts have completed their tasks. Then the system sends a text message and an email automatically to all the people participating in the loan assessment process as an Evaluator.

10.6.5. Decision-making

Having been notified by the system, the "Evaluators" will review the documents of the assessment process. At this stage, the recommendation of the Proposer concerning the loan application, as well as the videos made during the site visit and the opinions of the Experts may also be viewed. The Evaluators may also ask questions from the Experts in the system. The electronic loan assessment procedure may be suspended at any time (e.g. until the missing information is supplied) or may be deleted (e.g. at the request of the client or because the client is unable to supply the missing information/document). When the Evaluators (members of the Censorship Committee) have established their position, they can vote on an interface created for this purpose.

10.6.6. Closing the electronic loan assessment process

Based on the previously set parameters, the system monitors when a quorum is achieved. When the voting has taken place, the Co-ordinator closes the loan assessment process. The loan application may be "approved" or "rejected". The Committee may request the satisfaction of various special conditions as a precondition to enter into the loan agreement or to disburse the loan. After the closure of the assessment process, the protocols concerning the decision-making may be generated in .pdf format in the system. The full protocol includes the parameters of the loan application and the decision (e.g. the approved amounts, the votes of the Evaluators, etc.) as well as the entire decision-making communication. An extract of the protocol, which only contains the most important parameters of the decision, may also be generated.

10.6.7. Synchronization with the Backoffice system (credit register)

Following the closure of the process, the data related to the decision-making will appear in the CREDINFO Backoffice system. Once the synchronization and verification process have been completed, the parameters of the client and the loan are transferred into the credit register. The clients are only notified about the decision after this.

10.6.8. The benefits of the electronic loan assessment process compared with the traditional method

We have presented the various stages of the assessment process through the example of the CREDINFO electronic loan assessment management system. We believe that this information is enough to see the benefits of the electronic loan assessment system compared with the traditional method.

To summarize, here are some of the main characteristics (non-exhaustive list):

- it is a faster and more resource efficient procedure; the assessment process begins the moment the loan application is received,
- continuous assessment (the institution does not have to collect several applications to arrange a meeting for the Censorship Committee),
- it is fully transparent; the entire communication and information of the individual assessment processes can be still viewed and checked after many years,
- the Evaluators and Experts do not get in touch with the loan applicant, and the Proposer has no voting right, which reduces the personal risk of the assessment process,
- the decision is reached as a result of the independent votes of several Evaluators.

10.6.9. Additional stages of the lending procedure

We will only list the additional stages of the "traditional" lending procedure. The detailed description of these stages is not part of this course material.

- entering into the loan agreement and concluding contracts for the accessory obligations,
- disbursement of the loan,
- collection of the loan,
- making possible loan modifications,
- credit monitoring (monitoring specific loan accounts, monitoring the entire portfolio, making on-site visits),
- debt management,
- possible termination of the loan agreements, initiating legal procedures.

As can be seen from the above list, credit monitoring includes the monitoring of the entire portfolio, which includes the monitoring and analysis of specific portfolio indicators provided by the Management Information System.

We will deal with credit monitoring and the most important portfolio indicators and the basic requirements set for the MIS in separate chapters.

11. A Hitel Scoring System[10]

One of the greatest challenges of creditors is to establish the creditworthiness, i.e. the future solvency of the debtor and his willingness to pay. In case of long-term loans this basically falls into the category of prediction. In order to determine creditworthiness, creditors apply various information and data gathering, data processing and data analysing procedures, some of which fall under the scope of trade secret in case of profit-oriented organizations.

The applied procedures vary in case of debtors having a different size and legal background, since the scope of information that can be accessed and analysed concerning the debtors is different.

It is often said that the role of these procedures is to mitigate the risk of the creditor. This is partly true, but this expression is rather inaccurate. The risk related to lending can be reduced to zero very easily by simply not granting any loans. However, since we would like to grant loans, obviously we will take risks.

! **The purpose of the procedures aiming at establishing the creditworthiness of the debtor is to see whether the risk connected to the loan granted to the would-be debtor is acceptable for us, to what extent and under what conditions.**



Procedures aiming at establishing the creditworthiness of the would-be debtor:

- estimating the future solvency of the debtor: analysing the data and feasibility of the business plan;
- assessing the capacity of the debtor to see whether he can implement the business plan: qualities, professional preparedness, examining past business results;
- assessing the future willingness of the debtor to pay ('honesty'): how the former loans and debts towards us or other creditors/authorities were settled by the debtor;
- assessing external circumstances and risks that may jeopardize the implementation of the plans or the repayment of the loan;
- evaluating the possible additional obligations reducing the loan risk (legal collaterals offered to secure the loan)

The specific legislation concerning the basic requirements and content of these procedures of the member states might include provisions for the different creditors having different legal status (e.g. banks, financial enterprises, foundations). Credit institutions must apply these provisions in their internal regulations. In this Chapter, we only deal with the procedure created to assess the capacities of the would-be debtor, his future willingness to pay and the external conditions posing a risk. This procedure may also be called as 'Customer or partner rating rules', 'Debtor Rating System', or 'Credit Scoring System' referring to the technical implementation of the procedure.

In this Chapter, we will introduce the basic methodology required to set up a credit scoring system capable of handling credit risk.

11.1. Purpose of the Credit Scoring System

! **The purpose of the Credit Scoring System is to rate loan applicants and loan transactions in terms of their risk, as well as to determine the credit limits and the legal collateral requirements applicable for the specific risk level.**

11.2. Basic requirements of creating a Credit Scoring System

Basic requirements of creating a Credit Scoring System:

- there must be written rules that are clear for everyone entitled to deal with debtor rating (existing and future staff),
- it should have standardized processes;
- it should be simple and user-friendly;
- it should establish a clear, quantified risk level for a specific transaction;
- it should clearly categorize the specific transaction into a predefined risk category;
- it should contain at least five risk categories (E.g.: insolvent, with reduced solvency, with limited solvency, solvent, perfectly solvent);
- it should assign the minimum value of the required legal collateral to the specific risk category clearly.

It is advisable to establish a uniform Credit Scoring System, which includes the assessment of all the risk factors known and determined by the creditor. Since it is really difficult to assess all the risk factors for each client group (e.g. no credit history may be assessed in case of a start-up company), client categories must be created on the basis of the scope of risk factors that may be assessed by the specific client groups.

(Obviously, clients that can be assessed as per the same risk factors fall into the same client category.) The risk factors assessed in the Scoring System are usually rated as "objective" and "subjective" risk factors.

Objective factors are the assessment of financial indicators, whereas subjective factors include everything else assessed based on the recommendation of the person carrying out the rating.

It might be required that the score – determining the risk level – calculated from the assessed "objective" factors should exceed 50%. This, however, in our opinion is impossible in case of microcredit clients.



11.3. Steps and methodology of creating the Credit Scoring System

When establishing a Credit Scoring System, the following steps should be taken into consideration:

- determining the client categories,
- determining the main risk groups,
- determining the risk factors belonging to the specific main risk group,
- determining the relative weight of the specific risk factor and setting the relative weight of the main risk groups,
- calculating the maximum score that can be obtained by the specific client group,
- determining the limits for the score of the risk categories as per the specific client category,
- setting the maximum credit limit and coverage multiplier for the risk category by the specific client categories.

The characteristic of the debtor rating system established with this method is that each client is rated in the same system irrespective of the accounting method applied by them or the fact whether they have a history in entrepreneurship.

This is how the risk can be measured and compared in case of loans granted to various undertaking types (clients in the client categories). Also, there is need for only one scoring system (form) and only the parts that are relevant to a specific client have to be scored.

The "client category" of the specific client in terms of the rating has to be considered when assessing the client.

The system enables the application of "absolute rating" and "relative rating", which in turn makes it possible to compare the risk of lending to undertakings based on a uniform set of values.

11.3.1. Determining client categories

Determining the groups of clients that can be assessed based on the same risk factors. E.g.:

- it is a start-up company and has no history in entrepreneurship;
- it has a history in entrepreneurship
- category specified by other credit institutions



11.3.2. Determining the main risk groups and risk factors

The next step is to determine the main risk groups we intend to assess. Then we have to assign the risk factors we intend to assess to such risk groups as well as the weights of the factors.

In practice, the rating of the debtor is done by scoring all rating items from 0 to 4, and then multiplying that score by the weight number given for each item. This is how the score is achieved.

All the items in the entire debtor rating system may not be assessed for each client category, which is taken into account in the evaluation.

Typical main risk groups and risk factors that can be assessed within them are as follows:

- Financial risks:
  - » Liquidity indicator
  - » Acid test ratio
  - » Capital adequacy ratio
  - » Equity ratio
  - » Return on equity
  - » Debt repayment period.
- Market risks:
  - » Situation of the business sector of the enterprise
  - » The standard of the product or service
  - » Demand for the product or service
  - » Product diversification
  - » Rating of the competitive environment
  - » Dependence on customers
  - » Dependence on suppliers.
- 'Entrepreneurial' (or internal) risks:
  - » Assessment of the entrepreneur/management:
    - Who is the 'key' person of the enterprise?
    - The achievements of the entrepreneur/management so far
    - Profession, qualifications and skills of the entrepreneur/management
    - Professional experience of the entrepreneur/management in the profile of the business
    - Managerial knowledge of the entrepreneur/management
    - Managerial experience of the entrepreneur/management
    - Reliability of the entrepreneur/management
    - Personal characteristics, suitability of the entrepreneur/management
    - Managerial skills of the entrepreneur/management
    - Other risks of personal nature of the entrepreneur/management.
  - » Assessment of the management factors:
    - Tendency relating to the change in equity
    - Condition of the manufacturing tools
    - Quality of the business plan
    - Operation of the Management Information System.
- Risks arising from the relationship between creditors and the budget:
  - » Readiness to pay and solvency at the credit institution concerning former loans
  - » Readiness to pay and solvency at other credit institutions
  - » Readiness to pay and solvency at the Tax Authority.

Obviously, it is possible to define other main risk groups and risk factors.

An example for determining the main risk group, risk sub-group and risk factor, as well as for the evaluation and scoring of the risk factor.

Main risk group: analysing risks related to the company
Risk sub-group: assessment of the owner/management
Risk factor: who is the "key" person of the enterprise?
Assessment: „Key" person is the person on whom the success of the enterprise depends to the greatest extent, or whose professional knowledge, contacts, etc. the enterprise is built on.

Scoring:

Characteristic	Score that may be given	Weight	Achievable schore
Employee or other	0	3	0
Distant family member, relative	1	3	3
Helping member of the family or other, but the "key" person can be replaced easily	2	3	6
Owner with limited liability	3	3	9
Owner with full liability, or the long-term strategic interest of the "key" person exists	4	3	12

11.3.3. Methodology used to evaluate risk information provided by the Credit Scoring System

The data coming from the Credit Scoring System described above may be assessed as follows. Ratings that can be prepared:

Establishing the applied credit risk category

Clients are placed into a debtor rating (credit risk) category by assessing the 'scoring datasheet' with the below described evaluation method.

- Since the obtainable score may vary according to client categories, the obtained score must be compared to the maximum score that can be obtained within the own client category;
- The rating category of the client must be established based on the obtained score.



The below table provides an example for establishing the rating categories described above:

Rating categories	Percentage limit	Score limits by client categories		
		A	B	C
First class – Perfectly solvent	90%<=	234-260	140-156	108-120
Second class – Solvent	80%<= <90%	208-233	125-139	96-107
Third class – With limited solvency	65%<= <80%	169-207	101-124	78-95
Fourth class – With reduced solvency	40%<= <65%	104-168	62-100	48-77
Fifth class – Insolvent	<40%	0-103	0-61	0-47

For example, it may be required that the scoring must be performed in the system of the specific client category for at least 85% of the items to be rated.

The rating category so established is indicated in a manner that at first the client category is shown, then the obtained rating.

(E.g.: A - First class – Perfectly solvent, or C – Fifth class - insolvent)

Rating categories	Percentage limit	Disbursement limit (EUR)/ coverage multiplier per category		
		A	B	C
First class – Perfectly solvent	90%<=	25 000/1.0	25 000/1.0	25 000/1.0
Second class – Solvent	80%<= <90%	25 000/1.1	25 000/1.1	25 000/1.1
Third class – With limited solvency	65%<= <80%	20 000/1.2	20 000/1.2	20 000/1.3
Fourth class – With reduced solvency	40%<= <65%	10 000/1.8	10 000/1.8	9 000/2.0
Fifth class – Insolvent	<40%	0	0	0

Based on the *rating as per the client category* so obtained the *recommended disbursement limit* belonging to a specific rating can be established, which limit indicates the maximum recommended amount of the loan that can be granted to the entrepreneur at one time. The 'coverage multiplier' intended to be applied may also be assigned to these ratings.

Coverage multiplier:
it means the number of times the expected collateral coverage value covers the loan amount disbursed.

Additional rating options:

'Absolute' rating

When calculating the absolute rating category, the obtained score is compared to the maximum score that can be obtained in the whole evaluation system. This is the rating category by which the risks relating to the loans granted to clients falling under the different client categories may be compared. Where an item may not be interpreted in case of a specific client category, it is because of the lack of information. Such lack of information may be considered as a risk-increasing factor every time a loan is granted. The result thus calculated shows what the rating would have been if it could have been done in the whole system and the unknown items would have scored zero.

'Relative' rating

There are special cases when not every item may be assessed in the evaluation system related to the specific client category.

This is when we calculate this rating. When calculating the rating category, the obtained score is only compared to the maximum score that can be obtained based on the evaluated items.

This rating may be interpreted as how good or bad the information at our disposal concerning a specific enterprise is.

12. Establishing the collateral coverage value of the offered collaterals[11]

We only wish to deal tangentially with this topic. A characteristic of microcredit is that it also grants loans to people who do not have any collaterals, thus this topic is irrelevant for a number of microfinance institutions.

In order to mitigate the credit risk, creditors determine what percentage of the offered collateral is taken into account when granting the loan.

In general, all assets secured by collateral, from which the claim may legally be enforced, can be considered as collateral.

When establishing the collateral coverage value of the assets offered as collaterals, the initial value is the estimated market value of the asset, which was determined at the time the loan application was submitted.

The creditor may introduce a rule according to which a lower amount, for example 80% of the estimated market value established in the valuation may be accepted as collateral coverage value.

Creditors may develop various guidelines for the asset groups typically used as collaterals in order to determine the collateral coverage value.



The following table shows an example for this:

Asset	Base value	% of the base value as value	Notes
Invested assets			
Real estate	Estimated market value (or value coming from the valuation)	70-80% or liquidity value as per the official valuation	The registered pledges must be considered, too
Machines, equipment	Application of depreciation rates specified in the accounting policy. Net value less depreciation.	66-80%	
Personal car	Application of depreciation rates specified in the accounting policy. Net value less depreciation.	66-80%	Less than 2 years old
Lorry	Application of depreciation rates specified in the accounting policy. Net value less depreciation.	66-80%	Less than 5 years old
Inf. techn. equipment		0%	It cannot be accepted.
Securities		0-100%	It depends on the type
Livestock		0%	It cannot be accepted.
Current assets			

We do not wish to go into more details concerning this topic in this course material.

13. Creditmonitoring[12, 13]

The active monitoring of the credits shows the commitment of the credit provider towards the success of the enterprise financed thereby. In addition to the protection of the sources, its task is to provide high-level services to the borrower.

The purpose of credit monitoring:

The purpose of credit monitoring is to continuously keep track of and evaluate the receivables, establish the probability of the repayment of the loan, as well as to prevent non-payment by the debtor. Credit monitoring is really important in terms of reducing the credit risk, since the continuous monitoring of the credits enables the creditor to take the steps necessary to reduce the losses as soon as possible. The credit risk changes during the life of the credit, that is why the analysis of the enterprise taking out the loan will also continue after the disbursement of the credit. In the course of credit monitoring basically the following *risk factors* must be assessed:

- **Changes in the creditworthiness of the debtor**:

In the event the creditworthiness of the debtor deteriorates, the fact that the debtor will not be able to repay the credit at maturity becomes more likely.

- **Liquidity of the debtor**:

The liquidity problems of the debtor significantly affect the contractual repayment of the loan and the payment of the interests. Eventually, liquidity problems may lead to the complete insolvency of the enterprise, which constitutes the greatest risk of the lending.

Types of credit monitoring:

- **Account specific monitoring;**
- **Portfolio monitoring**.

13.1. Account specific monitoring

The basic purpose of account specific monitoring is that the creditor can make sure that the debtor is still willing to and able to satisfy its contractual obligations. In the course of credit monitoring the creditor

must examine whether the coverage behind the specific credits adequately covers the risk of the organization.

The main stages of credit monitoring:

- **Continuous credit monitoring;**
- **Detailed credit monitoring.**

13.1.1. Continuous credit monitoring

Continuous credit monitoring, which includes the following activities, should be applied for all debtors:

- Credit account monitoring: keeping an eye on the contractual repayment of the loan and interests;
- Evaluating the financial reports of the enterprises;
- Visiting and checking clients and facilities on the spot; (routine visits)
- Coverage checking (at specified times): updating the information concerning the coverage and the legal collateral, including the revaluation of the collateral coverage value of the legal collaterals as well.

13.1.2. Detailed credit monitoring

Detailed credit monitoring must be applied in case of debtors who do not pay according to the deadlines specified in the loan agreement. Detailed credit monitoring basically consists of the activities of the detailed credit check. The actual tasks as well as the frequency of on-site visits and reporting are determined in compliance with the risk classification of the loan. The detailed credit check basically focuses on the following three areas:

- **Credit quality.** Has the financial situation of the debtor deteriorated so much that the future prospects are not positive?
- **Performance.** Does the debtor pay the credit according to the original and documented conditions?
- **Coverage.** Have the factors concerning the valuation and collectability of the coverage changed?

The steps of the detailed credit check are as follows:

- Evaluating the financial situation of the debtor:
- Do the prospects of the client still demonstrate that the enterprise is likely to continue its operation?
- Repeated debtor rating (the debtor rating has to be done in the Credit Scoring System again), and establishing the creditworthiness of the debtor:
- Is the client still reliable and willing to pay back the loan?
- Is the risk rating assigned to the credit and the monitoring procedure accurate?
- Revaluation of the collateral coverage value, in other words it must be checked whether the existing collaterals cover the risk of the creditor:
- Has the collateral coverage value changed significantly (mainly negatively)?
- Have any of the factors concerning the marketability of the collateral changed since the previous revision?
- Is the coverage still provided to a sufficient degree?
- Visits of corrective nature.
- Have all the requirements of the credit and other documents been satisfied?
- Other examination.
- Does the credit documentation adequately protect the interests of the creditor, or its correction is needed?



13.1.3. Placing the credits into risk categories

Credits are placed into risk categories based on the rating of the credit accounts. When the data provided by the Management Information System are processed, a rating must be assigned to every credit account depending on how we see the risk of non-payment or loss.

As an example, we will introduce a possible rating criteria. There are six rating levels, which are the following:

"A" - Problem-free accounts

This category includes credits that are likely to be repaid.

Also, the creditor does not expect any losses, and the delay incurred in the payment of the principal or interest does not exceed 30 days.

"B" - Accounts to be watched separately

This category includes credits that are not expected to make a loss at the time of the rating, but the creditor becomes aware of information as a result of which the debtor requires special treatment in order to prevent non-payment.

This category also includes credits where the payment delay is between 31 and 90 days. The accounts have to be monitored separately until the amount in arrears is paid, and the debtor has returned to the repayment schedule.

Only then may the credit be assigned an unproblematic rating again.

"C" - Substandard accounts

This category includes credits that are expected to make uncertain losses at the time of the rating, and in case of which the payment delay is between 91 and 180 days or non-payment can be experienced.

"D" - Doubtful accounts

This category includes credits that clearly result in losses for the creditors, however the extent of the loss is not known at the time of the rating, and there is a payment delay between 181 and 360 days or non-payment. This category also includes terminated credits that have been taken to court, in case of which the payment delay does not exceed 360 days.

"E" - Bad accounts

This category includes credits in case of which the payment delay exceeds 360 days, and the winding-up proceedings have been opened.

"F" – Bad debts

Receivables that were qualified as uncollectible by the creditor according to the accounting principles. The credit accounts are rated automatically by the Management Information System every month, when the data of the credit accounts are processed.

The automatic rating of the credit accounts may be changed by an authorized person at any time in light of the experience gained during the on-site visits. However, such rating may only be worse than the automatic rating resulting from the processing of the data of the credit accounts and the repayment performance.

13.1.4. Types of on-site visits

Credit monitoring and on-site visits have to be preventive. The purpose of on-site visits is to enable the creditor to identify possible problems that might affect the repayment of the loan. During the on-site visits the debtor should be assisted to avoid or solve the problems. If clients are visited regularly, the creditor is more likely to find out about the potential problems at an early stage, therefore the necessary steps may be taken more efficiently.

If the loan has been disbursed, preventive control is the most important activity that a creditor can do to ensure timely repayments.

Based on their basic function, on-site visits may be grouped as follows:

- First control visit;
- Routine visit;
- Remedial visit.

The visits can be arranged at a time previously fixed with the debtor or they can be surprise visits.

First control visit

Following the disbursement of the loan, the first visit must be organized at the plant of the debtor as soon as possible, but within one month. During the first visit the creditor must make sure that the sources have been used for the purpose specified in the loan agreement and the business plan of the enterprise. This visit also demonstrates that the creditor does not leave the client alone once the loan has been disbursed, and monitors his activity continuously. Being aware of this might affect the satisfaction of the contractual obligations by the debtor positively in certain cases.

During the control visits paid later, the creditor must monitor the performance of the enterprise. The frequency of visits should depend on the performance. Enterprises having a good performance need to be visited less frequently.

Routine visits

Routine visits are part of continuous credit monitoring, and – based on the credit account rating example mentioned above – it must be done in case of debtors having rating "A".

The purpose of the visit is:

- to keep in touch with the client to demonstrate that the creditor monitors the debtor's activity;
- to assess the business performance of the enterprise;
- to check the existence and condition of the tools offered as a legal collateral to cover the credit.

If possible, the plant where the business activity of the debtor is performed should be visited. The findings should be recorded in a report to show the repayment history and the progress made by the enterprise. Unless potential problems are found, only a small amount of information should be recorded during the routine visit. The visits provide an opportunity for the creditor to become familiar with the industry and the products of the debtor.

The person making the visit is trying to compare the experience gained during the visit to the actual figures of the credit account of the debtor. The obvious differences must be examined and an explanation must be requested for them. If the visit identifies problems that are likely to affect the repayment of the loan, the debtor rating must be performed and the collateral coverage value must be established again, and further measures must be taken based on this information.

Remedial visits

Debtors who were found to have serious operating or payment problems during account monitoring or a previous visit are paid remedial visits. (Debtors placed in rating categories "B", "C", "D" and "E".) The visits are scheduled according to the credit risk categories. A remedial visit lasts longer than a routine visit, and includes the exploration and discussion of the business problems of the debtor in detail. It is very important that the significant problem should be found during the visit, and the factors threatening the viability of the enterprise must be differentiated from those that affect the enterprise but only influence its productivity to a small extent. The debtor's attention must be called to the significant problems and the advice given should be focused on such significant problems. The outcome of remedial visits is a proposed package of measures, which might include, for example, the measures of the debtor to rectify the situation, the possible modification of the loan agreement, as well as a recommendation as to the revision of the conditions of the loan agreement.

It is very important that the modification of the loan agreement should only be proposed if it was established that the debtor fails to pay because he cannot pay and not because he does not want to pay.

13.1.5. Possible measures according to the credit account rating levels

"A" - Problem-free accounts

In case of this category the payment delay is less than 30 days. These debtors should be monitored continuously, and the following activities should be done:

- Routine visits, especially to maintain personal relationships.
- Proposed frequency: once a year.
- Debtor rating and inspection of coverage
- Proposed frequency: once a year.
- Analysing the financial reports of the entrepreneurs
- Proposed frequency of the requested financial reports: once a year

"B" - Accounts to be watched separately

In case of this category the payment delay is between 31 and 90 days. Since in the majority of cases such delay is due to the carelessness of the debtor and it is the result of sending or transferring the instalments late, there is no need to arrange immediate on-site visits.

Usually it is enough to call or write a letter to the debtor to warn him about keeping the payment terms.



If the payment delay means the beginning of more significant paypment difficulties, the automatic credit account rating indicates rating category "C".

In this case a remedial visit and a detailed credit check are needed.

If the debtor was assigned rating "B" following a routine visit based on the decision of the person carrying out the on-site visit – due to the fact that the creditor found signs indicating more serious problems – a *detailed credit check* should be done immediately in order to avoid greater payment problems.

Measures following the detailed credit check may be as follows:

- Placing the debtor into a lower rating cetegory;
- Requesting additional coverage;
- Requesting additional financial reports;
- Proposed frequency: quarterly;
- Increasing the frequency of on-site visits;
- Proposed frequency: every month or every two months;
- Proposing credit modification;
- Changing the conditions of the credit is undesirable, however, the creditor must react to unforeseeable circumstances that were revealed during the detailed credit check, for example:
- The debtor is unable to provide the pre-established own contributions;
- The sources to purchase the basic tools are not sufficient;
- There is a delay in starting up the enterprise or purchasing the tools;
- There is a delay in starting the operation due to technical problems;
- There is a change concerning the required tools due to the newly appeared market opportunities;
- Sales grow more slowly than expected;
- Sales grow more quickly than expected;
- The repayment of the loan is stopped deliberately.

„C" – Substandard accounts

In case of automatic rating, this category includes credit accouts where the payment delay exceeds 30 days but is not more than 90 days. Usually, this refers to a significant payment problem. It may mean that the debtor cannot or does not want to pay. In order to find the reasons it is worth performing a detailed credit check – *when the debtor is assigned rating "C"* – as soon as possible, in other words

- assessing the financial situation of the debtor;
- performing the debtor rating again;
- establishing the collateral coverage value again;
- carrying out remedial visits.

When assessing the financial situation of the debtor, the following basic problems might be found: repeated insolvency, increased debts towards suppliers, underperformance of revenues, decrease in profit due to the additional costs. The occurrence of the loss may result in reduced or terminated creditworthiness. It is worth conducting remedial visits every month or every two months. Based on the outcome of the check, a package of measures must be determined.

At such times, the creditor has to make a difficult decision. If the creditor decides to terminate the loan agreement and make the entire debt overdue, it puts the debtor into an even more difficult situation. However, if the loan is extended, it may happen that it loses the last chance to recover the money.

"D" – Doubtful accounts

In case of automatic credit account rating, this category includes credit accounts where the payment delay exceeds 181 days but is not more than 360 days. In the event the creditor hopes to recover the loan in case of debtors falling into rating category "D", a remedial programme must be started aiming at the termination of the arrears. If the repayment does not seem realistic, the loan agreement must be terminated.

The frequency of on-site visits depends on the decision of the creditor. In case of a remedial programme (continuous consultation, restructuring of the loan, etc.) it may take place every month or every 2 months, in other cases every six months or annually. In case of debtors that are subject to legal proceedings, the main goal of such visits could be to see that the legal collaterals used to cover the loan are in adequate condition. Also, personal visits might motivate the debtor to pay the defaulted amounts.

„E" – Bad accounts

This category includes credits in case of which the payment delay exceeds 360 days, and the winding-up proceedings have been opened. In case of these accounts it is up to the creditor whether it visits the debtor or not. If the creditor chooses to visit the debtor, the purpose of such visit could be to check the legal collaterals.

13.2. Portfolio monitoring

Portfolio monitoring virtually means the revision of the quality of the loan portfolio and the adherence to the credit policy and lending strategy. This check determines the risk arising from the combination of the specific credits so that the creditor can maintain a balanced loan portfolio according to its strategic goals. The loan portfolio is monitored by looking at the data coming from the Management Information System. The data are analysed according to the following criteria:

- the current status sof the loan portfolio;
- the changes of the loan portfolio;
- other portfolio trends.

A set of indicators must be established in order to monitor and analyse the loan portfolio. A few possible indicators and their evaluation criteria will be described in a separate chapter.

14. Portfolio analysis[14]

As we have described earlier, the loan portfolio is monitored by looking at the data coming from the

Management Information System. When the data are analysed, the following points should be examined and analysed:

- the current status of the loan portfolio;
- the changes of the loan portfolio;
- other portfolio trends.

Now we will introduce a few indicators that can be used for the portfolio analysis on a daily basis, then briefly describe the most important elements and methodology of portfolio analysis.

14.1. Indicators

The status of the loan portfolio is analysed through the evaluation of the portfolio data as well as the portfolio indicator described below.

Indicator of overdue portfolio:

$$\text{Overdue portfolio} = \frac{\text{Overdue loan principal}}{\text{Total outstanding loan principal}} \ (\%)$$

(Overdue loan principal= outstanding loan principal that has not been settled until the due date)

This indicator shows the ratio of outstanding loan principal not paid by the debtors until the due date to the loan portfolio. Although the indicator provides information on the situation of the loan portfolio, it fails to show the real financial portfolio risk adequately. It may fluctuate greatly from month to month.

PORTFOLIO AT RISK (PAR)

$$\text{Portfolio at risk} = \frac{\text{Doubtful outstanding portfolio}}{\text{Total outstanding portfolio}} \ (\%)$$

This refers to the value of all loans outstanding that have one or more instalments of principal past due more than a certain number of days. (Providers may calculate with PAR 30, 45, 60, 90 etc.) According to the CoGC, it is advisable that providers disclose PAR 30, as this is the internationally recognised measure.

(According to our example: Doubtful outstanding principal = credit accounts having rating "B" – "C" – "D" – "E" /credits including outstanding principal past due more than 30 days/ total outstanding principal). This indicator better expresses the real financial risk of the loan portfolio.

It shows what percentage of the total outstanding loan portfolio can be found on the credit accounts of defaulting debtors.

The indicator is also suitable for characterizing the status of the loan portfolio, but it shows greater financial risk than there actually is. This is due to the fact that, for example even in case of credit accounts having rating "B" - in other words the outstanding principal is past due less than 30 days – it considers the total outstanding principal as a possible loss.

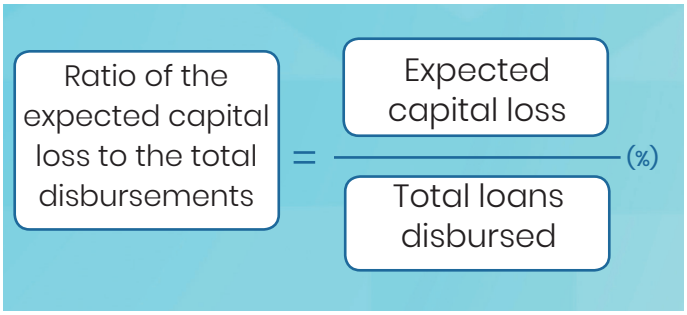
It includes an entire unpaid principal balance, both past-due and future instalments, but not accrued interest.

Ratio of the expected capital loss to the total outstanding principal

$$\text{Ratio of the expected capital loss to the total outstanding principal} = \frac{\text{Expected capital loss}}{\text{Total outstanding principal}} \ (\%)$$

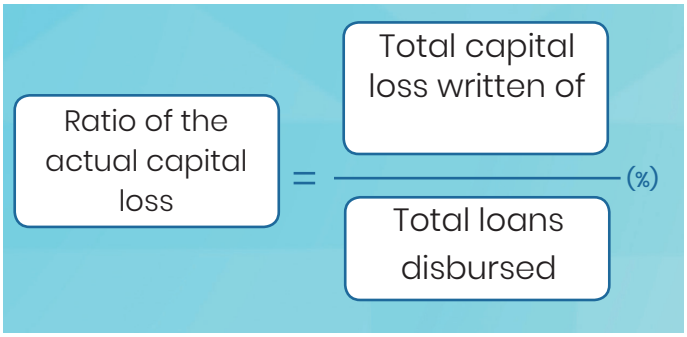
This ratio indicates the actual financial risk of the loan portfolio best, since unlike the previous ratio, it takes into account the outstanding principal of the credit accounts having different ratings with different weights.

Ratio of the expected capital loss to the total disbursements



To a certain extent, the ratio indicates the success of the specific microcredit programme (in case of social microcredit). The previous indicators compare the various values – that are typical of delinquent loans - to the specific loan portfolio (since they aim at quantifying the credit risk), and do not take into account the fact that lending is a process in which the good debtors keep changing, whereas delinquent or non-paying debtors put a burden on the loan portfolio for a longer period of time. This ratio compares the expected loss to the total loans disbursed (until the date of examination).

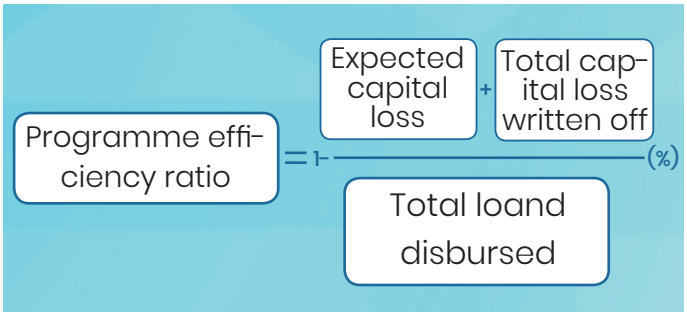
Ratio of actual capital loss



This ratio also indicates the effectiveness of the lending activity and the microcredit programme by comparing the total capital loss written off to the total loans disbursed until the date of examination. It shows what percentage of the capital loaned during the programme is written off as a loss. (The calculation of this indicator is basically important in case of social microcredit programmes.)

Programme efficiency ratio

As its name suggests, this indicator is used to monitor the efficiency of (social) microcredit programmes.



Since the purpose of microcredit programmes operated by the provider is not to maximize profit but to channel the sources to the targeted clients, the efficiency of the programme can be seen by looking at the percentage of the disbursed capital that has been used properly (in other words the number of financially successful clients generated).

In the Management Information System this indicator is the most suitable to determine the efficiency of the programme, since it shows what percentage of the sources disbursed is not written-off loss or expected loss. Indirectly though, but it refers to the extent of financial efficiency because it is presumed that the capital that has already been paid back or that does not include any losses was used efficiently, according to the goals. The calculation of this indicator is also important in case of social microcredit programmes.

Please note that the latter two indicators may be considered as efficiency ratios in case of non-profit social microcredit provision. In case of profit-oriented credit provision the primary objective is to make profit. Thus, the analysis is focused on indicators that are mostly related to the expected return, the factors adversely affecting it, as well as the credit risk.

14.2. The current status of the loan portfolio

As mentioned earlier, the primary form of portfolio analysis is the examination of the status of the portfolio.

On the one hand, it means the monitoring of the extent of certain portfolio data, on the other hand the monitoring and evaluation of the value of the established indicators.

In order to carry out the examination the Manage-

ment Information system must provide the following portfolio data in the form of synthetic (combined) statements:

- cumulative amount of the loans disbursed;
- amount of loans disbursed to current (live) credit accounts;
- amount of loans disbursed to delinquent (with a "B" - "C" - "D" - "E" credit rating) credit accounts;
- total loan portfolio (total outstanding principal portfolio);
- overdue principal portfolio (principal debt that has not been settled until the due date);
- doubtful outstanding principal (total outstanding principal resulting from credit accounts with a "B" - "C" - "D" - "E" credit rating – in other words they include overdue receivables);
- expected capital loss. It may be calculated as follows:

0% of the total outstanding principal in case of credit accounts with an "A" credit rating

10% of the total outstanding principal in case of credit accounts with a "B" credit rating

30 % of the total outstanding principal in case of credit accounts with a "C" credit rating

70% of the total outstanding principal in case of credit accounts with a "D" credit rating

100% of the total outstanding principal in case of credit accounts with an "E" credit rating

100 % of the total outstanding principal in case of credit accounts with an "F" credit rating

- written off capital loss.

An important aspect of the analysis is that *we always search for and examine the reasons.* The reasons behind an indicator are often more important than the specific value of the ratio itself. It must also be noted that the same figure may be considered as very good in certain cases, and very bad in others. For example, a 4% PAR30 ratio is considered excellent in case of a profit-oriented microcredit provider (unless it has started lending recently: see: Chapter *14.5 The most frequent errors of analysis and interpretation).* However, in case of a microcredit programme, where the goal is to assume extremely high risk even at the expense of significant credit losses, and which has been operating for quite a while with high numbers of loans it may also mean that the microcredit provider fails to channel the sources to the target clients, and tries to keep them for some reason. This situation can also be true the other way around. For example, a microcredit provider might have a very high PAR30 value because it tries to implement a high-risk credit scheme for a socially important target group. In this case the high PAR30 value results from the fact that the provider is implementing a social programme and not from the fact that the provider grants the loans in bad quality.



14.3. Loan portfolio changes

The changes in the status of the loan portfolio indicate the tendencies that occurred during the operation of the programme.

This may be presented with the help of the Management Information System. An up-to-date computer system must be able to present the portfolio data and portfolio indicators described in the previous point on graphs and in tables at different times.

The graphic description is the most suitable way to show the tendencies and changes in the portfolio quickly. The graphs and tables may also be generated for certain sub-groups of the loan portfolio, thus the changes that have occurred can also be determined accordingly.

The monitoring method is excellent to analyse the long-term effects of the lending strategy and certain operative credit management activities, and to establish the results. At the same time, it must be noted that we must examine the causes of the changes here, too.

If, for example, the PAR30 value shows continuous decline (increase), its reason must definitely be identified. A reason for the decline may be that continuous divestment is happening at the microcredit provider. In this case, the deterioration of the indicator does not indicate a deteriorating lending quality, but it is a natural mathematical phenomenon. Naturally, it can also happen that it refers to the deterioration of the lending quality. Then, the problems may only be solved after identifying the causes.

14.4. Portfolio trends

Oftentimes, monitoring the entire loan portfolio points out trends that are less obvious based on the account specific monitoring. With the right method notable, emerging trends may be revealed. The applicable method of analysis is a form of trend analysis, which we will describe below.

The essence of the method is as follows:

Trend analysis is the examination of the portfolio. It analyses to what extent the distribution of delinquent credit for a given aspect deviates from the distribution of credit accounts being in the entire loan portfolio for a given aspect.

After performing the calculations, the areas where the number of delinquent credit accounts is higher than justified by their proportion in the entire loan portfolio can be identified.

The steps of the calculation method are as follows:

- establishing the proportion (by the number of credit accounts) within the entire loan portfolio in terms of the examined aspect (e.g. industries);
- establishing the proportion among delinquent credit accounts in terms of the examined aspect (e.g. industries);
- establishing the difference between the previous two;
- given the number of delinquent loans, what would be the number of delinquent loans in terms of the examined aspect (e.g. in the examined industry) if the proportions showed the ratio within the entire portfolio;
- the difference between the actual number and the number calculated in the previous point;
- charting the data of the difference by number and percentage calculated at different times.



For the sake of clarity, we will present an example.

If, for example, the proportion of young people between the ages of 18 and 29 among delinquent clients is 31%, it would be unprofessional to state that this is the most badly paying, thus the most risky age group if their proportion within the entire portfolio is 41 %, and other age groups show just the opposite. In other words, although their proportion within the delinquent portfolio is numerically higher than that of other age groups, their proportion within the entire portfolio is lower.

These calculations can be performed based on the portfolio indicators as well. In this case the loan portfolio indicator – portfolio subgroup – as per the examination criteria is compared to the indicator calculated based on the entire loan portfolio. Thus, it can be established whether it is better or worse than the average.

It is advisable to carry out the analysis by portfolio subgroups listed later on. The examination enables the microcredit provider to spot the areas (e.g. industries) which are riskier than the others.

The calculated figures show the current status as of the given date. When examining a longer period, it can also be seen how permanent the evolved tendency is, and how it changes due to the modified lending strategy.

The method is also suitable for profiling, in other words, we can create the profile of the "best-paying client" or the profile of the "expected worst-paying client" according to the criteria examined by us.

This information may be used in the course of risk management or risk estimation, when the creditworthiness of the client is determined.

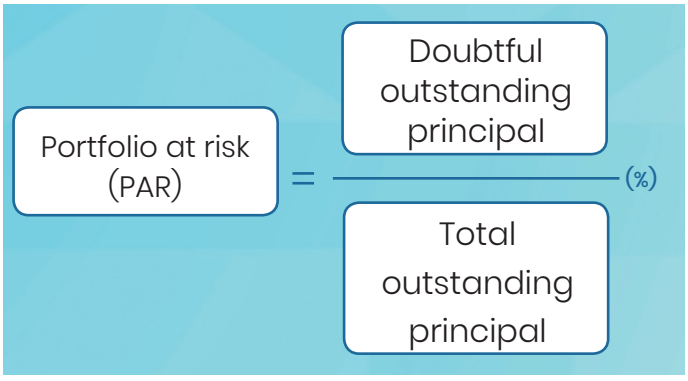
! **However, it must be noted that the GDPR forbids automated decision-making clearly based on profiling in Europe.**

14.5. The most frequent errors of analysis and interpretation

We would briefly like to introduce you to the most frequent errors committed when portfolio analysis is performed. Basically, these are the cases when incorrect conclusions may be drawn during the interpretation of certain data.

One of the most frequent errors is when certain indicators – especially PAR30 – **are used carelessly to compare the quality of the activities of the various microfinance institutions.**

As we have mentioned, this indicator is calculated as follows:



It is clear from the method of calculation that if a specific microcredit programme is not funded from a *revolving fund* but from *one-time capital*, which is *continuously withdrawn* from the microfinance institution by the funder after the clients have made their payments, the value of the indicator will deteriorate, and sooner or later will reach 100%. When the well-paying clients have completely repaid their debts, the remaining debts can only be collected slowly, or not at all. *It is a serious professional mistake* to use this ratio to compare the activity of such an organization with that of an organization that manages a revolving fund (in other words to draw the conclusion that the organization that has a lower indicator performs its lending activity "in better quality"). The lending quality cannot be compared clearly with this ratio in case of two microfinance institutions managing revolving funds either. *In case of an "older" microcredit fund,* which has been revolved several times, and has no capital replenishment, this ratio may show a worse (higher) value than that of a fund that has just started its lending activity. In case of an old fund the value of unpaid debts is getting higher and higher, thus the amount that can be granted again is becoming smaller and smaller. *In case of a younger fund* – especially in case of those where the capital replenishment is still in progress – *it is a mathematical law that this indicator is lower.* It can be clearly seen that even in this case the indicator is not suitable for comparing the lending quality of two institutions – assuming social microcredit, of course.

It must also be taken into consideration that the microfinance institutions *operate in different geographical regions, different economic environment and social climate.* As described earlier, certain social factors – in particular the general attitude – have great impact on the repayment of the granted loans. (There could be big differences even within certain countries or small regions.) That is why we cannot draw the conclusion that the institution where this indicator



is lower is the better microcredit provider, since they operate in very different environments.

This indicator may change significantly *in case of different funder expectations.* If the funder specifically provides sources as a donation for extremely high-risk loans (e.g.: as in case of the IBM microcredit described earlier), and does not expect profit and does not take away the capital, this indicator may be extremely high, which clearly justifies that *the programme is operated according to the expectations of the funder.*

Comparing the various microcredit practices with this indicator and the over-simplified assessments coming from such comparison clearly assume a profit-oriented approach to microcredit, or it could be relevant in their case.

Profit is the real *"success indicator"* for the profit-oriented investors, and everything else becomes insignificant. Thus, in these cases the assessment of financial risks – and the indicators measuring such risks – enjoys preference and often exclusivity over any other analysis in accordance with the interests of the investor.

14.6. 14.6. Other indicators (according to the CoGC)[15]

Definitions:

Current portfolio

Refers to the outstanding value of all loans that do not have any instalment of principal past due excluding accrued interest.

Gross loan portfolio

Refers to the outstanding principal balance of all outstanding loans, including current, delinquent, and restructured loans, but not loans that have been written off or interest receivable.

Net loan portfolio

Net loan portfolio is calculated by subtracting the impairment loss allowance from the gross loan portfolio.

Active borrowers

Active borrowers refers to individuals who currently have an outstanding loan balance with a microcredit provider or are primarily responsible for repaying any portion of a gross loan portfolio. Individuals with multiple loans with a microcredit provider should be counted as a single borrower.

Financial revenue

Financial revenue includes revenue from a loan portfolio and from investments. Financial revenue from a loan portfolio refers to revenue from interest earned, fees and commissions (including late fees and penalties) on the gross loan portfolio only. It includes interest paid in cash and interest accrued but not yet paid.

Financial revenue from investments refers to revenue from interest, dividends or other payments generated by financial assets other than the gross loan portfolio, such as interest-bearing deposits, certificates of deposit, and treasury obligations. It includes interest paid in cash and interest accrued but not yet paid.

Operating revenue

Includes all financial revenue and other operating revenue generated from other financial services,

such as fees and commissions for non-credit financial services not considered financial revenue. It may include revenues linked with lending, such as membership fees, ATM card fees, transfer fees, or other financial services, such as payment services or insurance. It may include net foreign currency gains/losses, but excludes any donations and revenue not generated from provision loans and financial services.

Training may be included if seen as integral to financial service provision

Personnel expense

Covers wages and salaries, other short-term employee benefits, post-employment benefit expenses, termination benefit expenses, share-based payment transactions, other long-term benefits and other employee benefits.

Administrative expense

Covers non-financial expenses excluding personnel directly related to the provision of financial services or other services that form an integral part of an MFI's financial services relationship with customers.

Financial expenses

This includes all interest, fees and commissions incurred on all liabilities, including deposit accounts of customers held by an MFI, commercial and concessional borrowings, mortgages and other liabilities. It may include facility fees for credit lines. It includes accrued and cash interest.

Write-offs

Value of loans recognised as uncollectible for accounting purposes. A write-off is an accounting procedure that removes the outstanding balance of the loan from the gross loan portfolio and impairment loss allowance, but does not affect the net loan portfolio, total assets or any equity account.

If the impairment loss allowance is insufficient to cover the amount written off, the excess amount will result in additional impairment losses on loans.

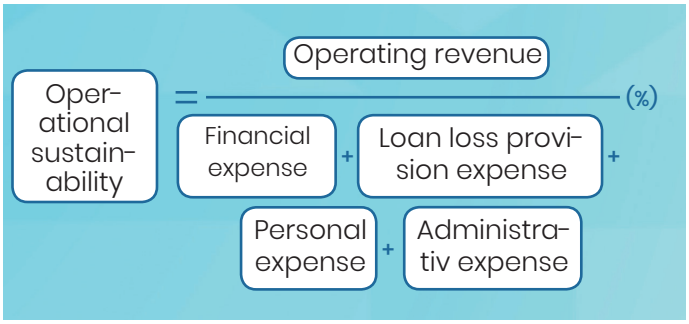
Impairment loss allowance and provision expense

Impairment loss or loan loss allowance is the portion of the gross loan portfolio that has been provided for in anticipation of losses due to default.

Indicators:

Operational sustainability ratio

It measures the extent to which a provider is covering



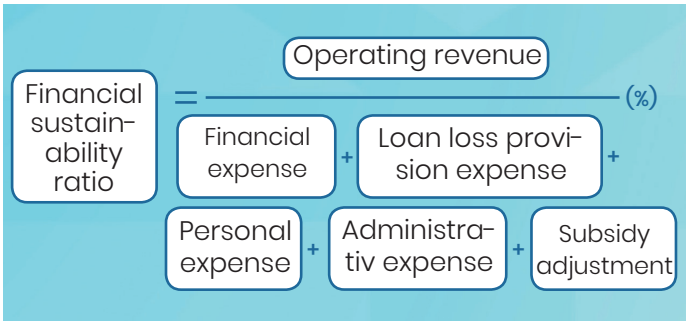
its costs through operating revenues. This is calculated using the following formula:

This ratio was identified as a priority clause in the CoGC because financial-operational sustainability enjoys preference due to its *profit-oriented approach towards operation.* (In case of profit-oriented operation this statement is correct.) That is why the documents states – *quite inadequately from a social point of view* - that it is a core indicator of performance of a microcredit provider. As explained earlier, where public money is used for funding it is a basic requirement that the results appear on the social level, and they should enjoy preference over operational and financial sustainability.

Financial sustainability ratio

The financial sustainability ratio measures how well a provider is covering its costs through operating revenues, taking into account subsidy adjustments. Subsidy adjustments are hypothetical revenues and expenses, which take into account the subsidised

cost of funds and in-kind subsidy which better allow for comparisons of performance between organisations. This is calculated using the following formula:



Adjustments to sustainability ratios taking into account subsidies

There are two types of subsidy adjustments: subsidised costs of funds and in-kind subsidy.

The subsidised cost-of-funds adjustment tries to account for the difference between an MFI's financial expense and financial expense it would pay if all funding were priced at market rates.

It is commonly done by multiplying an MFI's average funding liabilities by some shadow price – market interest rate – then subtracting actual financial expense.

The difference is the amount of adjustment and is treated as an expense.

The in-kind subsidy adjustment is the difference between what an MFI is actually paying for goods or services and what it would have to pay for the same goods or services on the open market.

These adjustments are hypothetical and are not included in the annual accounts of a provider.

14.7. Analysis that can be performed for sub-groups of the portfolio

The portfolio data coming from the electronic Management Information System as well as the portfolio indicators may be determined for certain subgroups of the loan portfolio in the interest of wider analysis, for example, by

- loan products;
- funds;
- regions;
- sub-centres;
- industries;
- the legal status of the enterprises;
- the entrepreneurial experience of the enterprises;
- the geographical location of the enterprises;
- the age of the entrepreneurs;
- the age group of the entrepreneurs;

etc.

The data generated thereby can be compared and may form the basis of wider analyses, however, this course material does not deal with such analyses.



Management information system, measuring social outreach, business development services, client (customer) outreach

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In this last chapter we will address practical issues that are closely related to microcredit. We will look at the requirements an up-to-date Management Information System must meet in the field of microfinance.

You have read about the importance of positive social impact in this field. The question is how we can measure and examine this social impact. In this chapter we will show you a possible example for this.

Microcredit itself is a great tool for entrepreneurs, but combined with business development services its impact can be multiplied. What do these services include and how can they help the entrepreneurs? We will also cover this in this chapter.

Last but not least, we will give you an overview of client outreach. We will look at some really exciting topics, like how to deliver customer experience, or how to reach and involve customers with the help of the currently available modern methods.

15. Requirements set for the Management Information System



15.1. Introduction

According to the 1998 CGAP Handbook on Management Information Systems (MIS), a "management information system is the series of processes and actions involved in capturing raw data, processing the data into usable information, and disseminating the information to users in the form needed." An effective and appropriate MIS can enable microcredit providers to serve their customers with greater efficiency and reliability. [16]

15.2. European Code of Good Conduct for Microcredit Provision

According to the definition of the European Code of Good Conduct for Microcredit Provision, the Management Information System:

- is capable of producing the data necessary for the following key management, operational and financial reports: income statement, balance sheet, daily loan and delinquency reports, ratios and trends,
- enables the provider to perform a full range of accounting activities, which will include loan-loss provisioning and tracking cash flow, revenues and expenses,
- operates in accordance with generally accepted accounting principles and recognised accounting standards,
- is able to monitor and manage loan portfolio quality and functions, which will include producing historic data and specific loan officer information, and delinquency-management facilities,
- is able to manage and maintain information about clients,
- is capable of facilitating prompt access to relevant information for management, lending staff and board members,

- is capable of handling and incorporating new products, multiple offices, services and delivery channels, which will include separating and aggregating office level data, new lending methodologies, currencies and various types of interest rate,
- is able to cope with planned growth, which will include growth in volume lent and new branches,
- restricts access to the data captured by the MIS through the use of appropriate security systems,
- operates with different levels of user access and reporting with functions reserved for specific user levels integrated into the user interface, a key aspect of which is that one person should not be able to go through the a whole process alone,
- stores completed transactions, balances and statements safely and restore information if necessary, which may include regular back-ups and built-in recovery mechanisms,
- is able to perform regular back-ups,
- prevents illicit or accidental alteration of data files,
- is able to produce an audit trail on crucial processes and data changes.

15.3. General principles

It is a basic requirement of the Management Information System that in addition to keeping basic records and providing data necessary for monitoring the specific credit accounts, it should enable

- the prompt and precise evaluation of the loan portfolio data;
- the prompt and precise monitoring of the efficiency of the intervention in the operation of the programme;
- the provider to measure the efficiency of the programme and to establish the trends that can be seen in the loan portfolio.

By providing the necessary data, the Management Information System must provide information about

- the operation and efficiency of the Credit Scheme;
- the status of the loan portfolio;
- the changes to the loan portfolio;
- the trends that can be seen in the composition of the loan portfolio

for the operators and managers of the programme.[17]



15.4. Information needs for the operation of funding programmes

The Management Information System of Funding Programmes must satisfy the following recording and information needs:

Information level 1: operative programme operation

Records must be managed separately by funds and loan products, and statements must be generated separately and in a consolidated manner.

- statements required for montioring specific credit accounts;
- statements concerning the extension and progress of the programme;
- statements concerning the monitoring of the managed loan portfolio.

Information level 2: checking and programme co-ordination

- generating statements necessary for monitoring specific credit accounts resulting from the checking function;
- statements concerning the extension and progress of the programme;
- statements concerning the monitoring of the entire loan portfolio.

At each designated checking and programme co-ordination level, the Management Information System must also provide the possibility to generate consolidated and individual statements concerning bigger sub-groups of the credit accounts and the loan portfolio (e.g. by a specific area code) by consolidating specific data groups of the operated programme.

Information level 3: strategic planning

- statements concerning the extension and progress of the programme;
- statements concerning the monitoring of the entire loan portfolio.

15.5. Statements generated by the Management Information System

As we have seen above, the information needs of funding programmes can be divided into different levels. In connection with these, the Management Information System must generate the following statements to meet the information needs necessary for the efficient operation of the programme. **The most important statements of the operative programme operation**:

- Analytic statements connected to debtor and credit account records:
» *Statement concerning credit demands (for a given period);*
» *Statement concerning the proposals of the censorship committee (for a given period);*
» *Statement concerning the approved loan applications (for a given period);*
» *Statement concerning the credit contracts (for a given period);*
» *Statement concerning the approved but not yet disbursed credits (for a given date);*
» *Statement concerning the disbursements (for a given period, on a daily basis);*
» *Statement concerning the satisfaction of the loan repayment obligation (for a given period);*
» *Statement concerning the applied interest rate (for a given date);*
» *Statement concerning the interest, default interest payments (for a given period);*
- Individual statements connected to the debtor and credit account records:
» *Individual credit sheet concerning the payments made into a given credit account and obligations;*
» *Individual credit sheet concerning the payments and obligations;*
- Statements necessary for monitoring the specific credit accounts:
» *Statement concerning the loan portfolio (for a given date);*
- Statements concerning the extension and progress of the programme:
» *Credit Scheme mapping;*
» *Data related to the clients of the Credit Scheme (broken down by sectors, sub-sectors);*
» *The plants of enterprises that have been granted loans (list of towns);*
» *The actual and expected evolution of principal repayments and interest payments;*
- Statements concerning the monitoring of the entire loan portfolio:
» *Calculation of the expected losses;*
» *Trend analysis based on the data of the Credit Scheme.*

The most important statements of checking and programme co-ordination:

- Statements concerning the extension and progress of the programme:
» *Credit Scheme mapping;*
» *Data related to the clients of the Credit Scheme (broken down by sectors, sub-sectors);*
» *The actual and expected evolution of principal repayments and interest payments;*
- Statements concerning the monitoring of the entire loan portfolio:
» *Calculation of the expected losses;*
» *Trend analysis based on the data of the Credit Scheme.*
- Statements necessary for monitoring the specific credit accounts:
» *Statement concerning the loan portfolio (for a given date);*

The most important statements of strategic planning:

- Statements of the extension and progress of the programme:
» *Data related to the clients of the Credit Scheme (broken down by sectors, sub-sectors);*
» *The actual and expected evolution of principal repayments and interest payments;*
- Statements concerning the monitoring of the entire loan portfolio:
» *Calculation of the expected losses;*
» *Trend analysis based on the data of the Credit Scheme.*

Thus, the Management Information System enables microfinance institutions to serve their clients efficiently and reliably. Efficient service is essential to maximize the social impact of microcredit schemes. In the next chapter we will examine how this effect can be measured successfully.

16. Measuring social impact

16.1. Introduction

As mentioned earlier, it is extremely important that microcredit provision should have a positive impact. That is why it is inevitable to measure social impact during the operation of our programmes.

16.2. Basic principles

It is a basic criterion that the costs of measuring social impact should be kept to the minimum and its methodology and implementation should be integrated into the working procedures of the microfinance institution. At the same time, the burdens put on the customers and the staff of the organization should be minimised.

The European Code of Good Conduct for Microcredit Provision mentioned earlier recommends the drafting of social mission and the measuring of social impact for non-profit microcredit providers. In Chapter 4 of the document, the Code suggests that common social reporting standards should be accepted by microfinance institutions for measuring social impact. Drafting and disclosing the social mission have been identified as a priority clause. Furthermore, it encourages microfinance institutions to define the target groups as well as to regularly measure and check the relevant indicators. It is just as important for non-profit microfinance as, for example, to measure customer satisfaction, protect customer data, or to prepare financial reports and statements regularly.



16.3. The 7-step methodology applied by inFocus Enterprises

As a methodology to measure social impact efficiently, I suggest going through the 7 steps developed by inFocus Enterprises [18], which are the following:

- Step 1: Decide on your overall approach to measuring social impact by developing a vision, deciding how to measure social impact (whether to use monitoring, evaluation and/or research) and who to involve.
- Step 2: Decide what to measure by exploring mapping out your programmes with programme theory and how to prioritise and use learning questions
- Step 3: Select/develop indicators that will identify what has taken place as a result of running your activities and to what extent
- Step 4: Plan your data collection by selecting the right data collection method, taking a quality approach to sampling and finalising your indicator framework
- Step 5: Develop data collection tools (we focus on questionnaires in this guide) to collect high quality data
- Step 6: Collect and manage your data through effectively deploying data collection tools, ensuring the data you collect is high quality and secure, and selecting the right software for your organisation
- Step 7: Use the data you collect: effectively analyse and learn from your data to improve the delivery of your activities, your fundraising and your accountability back to stakeholders.

16.4. Social Outreach Plan

In order to measure social outreach efficiently, a Social Outreach Plan should be drafted by the organization. I will introduce you to the structure of such a plan through the Social Outreach Plan of Fejér Enterprise Agency[19].

Chapter 1 – Introduction of the organization and defining the Social Outreach Plan

This chapter introduces the objectives of the Social Outreach Plan, the description of the historical background and activities of the organization, its mission, target groups, the needs of the target groups, and the results the organization wishes to achieve. For example: promoting gender equality and helping young people to become entrepreneurs.

Chapter 2 – Social goals and objectives of the organization

It includes strategic goals and objectives, as well as the development of the methodology, tasks and actions aiming at the achievement of these goals. The goals may be achieved by keeping in touch with the customers regularly and actively and by needs assessment. For example: participating in projects supporting women entrepreneurs, and maintaining a teaching portal for entrepreneurs.

Chapter 3 – Measuring social impact

Indicators must be assigned to the goals defined in the previous chapter, and the current initial situation must be analysed. Then, the performance of the indicators is measured and monitored, which must be done continuously, but at least once a year. One of the most important tools is the personal interview, which focuses on entrepreneurial welfare and questions concerning the relationship with the organization. This method can be completed with the application of an online questionnaire survey.

Chapter 4 – Action Plan

In order to implement the Social Outreach Plan the organization must develop an action plan, which includes the most important tasks related to the implementation, their deadlines, the methodology and the person in charge. For example: developing the course material and the framework system when developing the teaching portal for entrepreneurs, entering into teaching agreements, preparing user statistics and updating the course material continuously.

Chapter 5 - Annexes

The annexes include all the documents that are closely related to the implementation of the plan. Such a document could be, for example, the content of the developed questionnaire. Following the development of the Social Outreach Plan, the given status must be monitored continuously by measuring social impact. This is how we can ensure that our objectives are achieved. We can improve the achievement of positive social impact during the operation of our organization by setting new goals.

To increase the efficiency of the funding programmes, business development services must be provided, which will be shown in more detail in the next chapter.



17. Business Development Services

17.1. Introduction

As we have seen earlier, there is great need for microfinance because of its positive social impact. This may be achieved with the provision of microcredit. However, it is essential that this activity should be coupled with business development services. Business development services include any services other than financial services which help customers to become entrepreneurs and which support the operation of the enterprise. For example: mentoring, coaching and advisory services provided free of charge.

17.2. The purpose of business development services

Start-up entrepreneurs, who do not have adequate technical and managerial skills to improve their business activities efficiently, must be provided high-level business development services. These could be marketing activities implemented following the screening of the organization, developments carried out on the internal information technology system, organization development services. It is a key issue whether the costs of these services should be paid by customers or they could be relieved of the costs with the help of subsidies. In terms of positive social impact it is essential that customers should be relieved of the payment of the charges.

Business Development Services (BDS) are designed to help businesses overcome constraints. Micro and small entrepreneurs are frequently hampered in their business growth by non-financial factors such as inadequate business management skills, lack of information and poor market access. Due to their small size and limited sources, the administrative tasks that all firms have to address weigh particularly heavily. Research and experience indicate that access to Business Development Services (BDS) greatly enhances the performance of small businesses, in an economic as well as in a social and environmental sense.[20]

The sustainable development of these enterprises provides access to markets and the possibility to build capacity, which enable enterprises to transform their opportunities into reliable income sources. [21]

17.3. Categories of business development services

Triodos Facet is a Dutch consultancy firm specialised in the promotion and development of sustainable micro, small and medium-sized enterprises. In its joint study with InHolland University, the following types are differentiated within the category of business development services : [22]

- Client development services: raising awareness among clients of their basic business or personal (financial) situations with the general aim being to prevent harmful situations (e.g. over-indebtedness, unhealthy environments). Clients are in survival mode and may not be willing to pay for these services.

- Entrepreneurship development services: helping individuals to start their own business and raising awareness of entrepreneurship as a career choice, plus basic business skills training. Clients are aspiring to set up a business as a positive choice, not so much out of necessity.

- Business development services: supporting existing small businesses to improve their operations, with the services ranging from business advice to technical skills training

It can be seen clearly that in addition to financial services enterprises need different assistance in the various stages of their life. This ensures the sustainable development of enterprises, which in return contributes to the repayment of the sources of funding provided by the microfinance institution according to the expected schedule. So we can state that business development services and continuous assistance must be provided for start-up SMEs in addition to the sources of funding for their development. In the next chapter we will show you how we can give experiences to our customers with the help of the currently available modern methods.

18. Customer outreach methods

18.1. Introduction

These days both offline and online customer outreach techniques provide a lot of opportunities. Many say that offline outreach is being pushed into the background with the growth of online techniques. In my opinion both techniques are necessary. Why? In a world where everybody gives preference to online techniques people start yearning for personal relationships after a while. That is why it is very important to make online techniques as personal as possible. Let us be our customers' partners and help them in any way we can. Let us give them more than what they expect. This way we can make them committed to our organization and services.

18.2. Offline customer outreach

Offline customer outreach is changing more slowly, so I would like to give you only a few examples of it, such as the creation of a network of local offices, the use of flyers, placing advertisements in shop windows, newspapers, applying radio and TV commercials. They have great outreach. They are suitable for advertising products that have a diverse target group ranging from the youngest to the oldest, but it is difficult to measure their results. They are really good for increasing brand recognition, in other words we can tell other people who we are and what we represent. People can get to know us with their help.

18.3. Online customer outreach

By contrast, a huge advantage of online tools is that we can target and reach our target group efficiently, and the results can be measured and monitored simply. Why is this important in case of microfinance? It is important because we have a specific target group that can be identified and separated easily from the

other target groups. They are people wishing to set up a business and start-up SMEs, who are not creditworthy for the banks.

To be able to reach out to them, we have to imagine their life situation and need to use personalized messages. For example: “Business loans without real estate collateral? We have the solution for you! Click here for details!” or “Are you a start-up enterprise and need help to launch your business? We are your partners in developing your business!”

The most important element of the messages is that we highlight a characteristic in which we are different from the other competitors in the market. We also have to think about this if we are a non-profit organization. We must view banks as cooperation partners, since non-bankable clients are our customers.

We can create efficient cooperation if the banks send non-bankable clients to microfinance institutions to get initial funding, as well as mentoring and coaching services. Once these customers have become stronger, they may pursue their activities as clients of the bank. Several European banks, including the Portuguese BNP Paribas, have realised the potentials in this, so they set up their own microcredit division.

Let us see how we can make use of online technologies. First and foremost, as a microfinance institution we should provide assistance free of charge. This could be done most appropriately by setting up an advisory webpage, where we can educate people wishing to set up an own business by creating e-learning materials. To start with, we can upload some educational videos on YouTube, which can be embedded into our various websites in order to increase the number of views. We can also create downloadable materials in printable format and publish them by electronic means. To collect information about the people interested and to be able to help them later on, it is worth asking them for some basic data, such as their name and e-mail address, before they can access the videos and downloadable materials. Obviously, this must be done in line with the relevant rules of law in force, in particular with the General Data Protection Regulation.



Another important tool is to build a community. Just think about it how efficiently the community of start-up enterprises could cooperate with one another by helping each other to get started. They remain the partners of the microfinance institution, which assists them by providing continuous mentoring activities, but at the same time they reduce the workload of the MFI. An efficient tool of community building is social media, where we can create various groups to achieve our goals, and to manage our future customer relations more easily. We should also create a community for key account customers, who can receive additional services and more attention.

With its help we can also motivate our current customers by letting them enter this community of key account customers upon the satisfaction of certain conditions, for example if they pay back the loan without delay.



We need an efficient Customer Relationship Management system to automate all our processes and to monitor the activity and needs of our partners. This system enables us to inform and help our customers with our services directly, in the form of e-mails, once we have their consent to do so.

An efficient tool in the field of the automation of processes is Chatbot, which we can add to our website as well.

The service is based on a previously programmed conversation, which helps users solve their problems offering various options. For example, a customer contacts us at any time of the day and receives an answer from Chatbot immediately, which helps the customer as a virtual assistant to make the right decision. The preprogrammed answers are given based on the examination of logic decisions. For example: “Hi! I’m Mifi, a microfinance chatbot. How can I help you? Microfinance / Business Development Services”.

After selecting one of the options, new replies appear in the chatbox, and eventually the customer gets the information that is most suitable for him. It is important that we continuously inform our customers about the given service later on.

We should create content for them, which helps them learn its use and start up.

These are the principles with the help of which we can start our activities and help our customers efficiently as a microfinance institution, this way establishing a long-term partnership.

I must stress that these technologies change continuously, so it is important to keep up with the new trends.

Microfinance Impact Assessment by Microfinanza Srl

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19. What are impact and impact assessment? A brief overview of theory and definitions

Impact is defined as "a powerful effect that something, especially something new, has on a situation or person" (Cambridge Dictionary, 2019). [23] Since 2000s, its measurement has become a priority for both public and private organizations, independently from their vision and mission statements. The word 'impact' has come to different means and nuances: private investors talk about 'impact investing', whereas social actors refer to 'social impact' and 'social change'. Morevoer, the urgent need of finding solutions to climate change has pushed the international community to focus on the environmental dimension widely defined as environmental sustainability. So impact measurement, independently from the different signifances we do give to this word, being able to quantify and measure medium and long term im-





pact of our interventions, is a top priority. The power of impact is important as it has consequences, both positive and negatve, on a certain person, a community or situation, even environmentally. To study the impact, we do distinguish two types of evaluation:

- **Impact analysis &**
- **Impact assessment**

According to OECD (OECD Directorate for Science, Technology and Innovation, 2014), impact analysis is "part of the needs analysis and planning activity of the policy cycle", involving the perspective of what the impact of an intervention could have or be, and it is used to inform the policymakers. Therefore, this analysis is an ex-ante evaluation. On the other side, impact assessment is "part of the evaluation and management activity of the policy cicle", and is done ex post. However, we do underline that many international development organizations have given a definition of what impact is and they do apply it to their field of intervention.

To sum up, we can say that the main difference between analysis and assessment is the different time perspective: the first is prospective, meaning that it is done in the first phases of project or programme planning looking forward the interventions to be executed, whereas assessment is retrospective and ongoing as it focuses on the effect of the interventions.

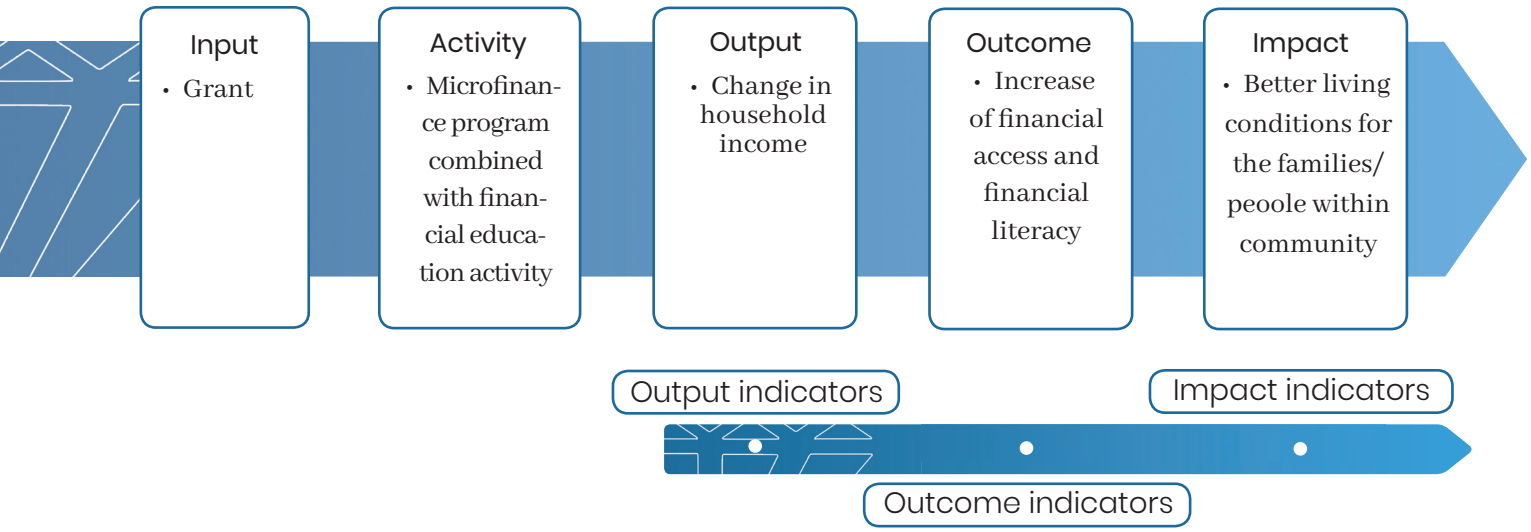
19.1 Impact assessment and the theory of change

Impact assessment can be also linked to the Theory of Change (ToC). According to the Center for the Theory of Change (Center for Theory of Change, s.d.), it is "essentially a comprehensive description and illustration of how and why a desired change is expected to happen in a particular context. [...] It does this by first identifying the desired long-term goals and then works back from these to identify all the conditions (outcomes) that must be in place (and how these related to one another casually) for the goals to occur". Following the definition, an Outcome Framework needs to be identified and it provides the basis for the finding the leading activity or intervention, so that a clear view from the start to the end of the chain is to be seen (from activity to impact). A ToC also helps to identify the underlying assumptions and risks that will be vital to understand and revisit throughout the process to ensure the approach will contribute to the desired change. Nowadays, ToC has the gained attention of international agencies, organisations and aid workers as it goes a step further than the well-established LogFrame. However, we as this chapter is not dedicated to different project evaluations in international development context, we do not go deeper into the topic, but we will give a brief glimpse of it. In brief, the theory of change starts from the desired change (impact) and looks for the activities/intervention that lead to it. Briefly, here as follow the main parts of the theory of change (or results chain):

- Input. The first element necessary to set up activities and interventions;
- Activities or interventions. They are actions undertaken to carry out a task;
- Outputs. They are the results of the activities and can be improved capacities, capabilities, skills, systems, policies; they can also be tangible elements such as something built, created or repaired;
- Outcomes. They are a further level of result and can be the effect resulting after a short/medium period. It can be hardly controlled differently from outputs.
- Impact. It is the ultimate level of result, and the effect of intervention cannot be seen in short or medium term, but we need to wait for years to see the effective improvement of a certain conditions. Both outcome and impact concern a change in behavior or in performance.



A practical example concerning microfinance intervention:



What is the relationship between theory of change and impact assessment? We can say it is mutual:

- As theory of change looks for social change, impact assessment is an useful tool toidentifty data which are necessary to be collected/gathered and for finding out indicators for output, outcome and impac in a short/medium and long term perspective.
- ToC focuses on the long-term impact, studies the "long chain of cause-effect relations" and acknowledges the complexity of development and change processes (Gerard & Saskia, 2015). All these elements can be reconducted to the impact assessment which aims at describing and measuring the changes occurred along the chain

To sum up, impact assessment is based on indicators used to monitor progresses in the ToC.

19.2 Impact assessment and microfinance

As mentioned above, impact assessment has become a crucial topic for many stakeholders who wish to study the consequences of their actions and interventions, especially in international cooperation programs implying ToC. When dealing with microfinance and microcredit, we mainly refer to developing countries, where microcredit was conceived and has found breeding ground for developing. In fact, microfinance allows 'unbankable' people to get access to finance and get them a second chance to get out of poverty trap. However, following the economic and financial crisis which has affected also Western countries, microfinance in general has gained attention and has become a trend topic even in Europe, not being confined at developing countries anymore.

19.3 Impact assessment and stakeholders at european level

European Commission states that "the impact assessment process is about gathering and analysing evidence to support policymaking. It verifies the existence of a problem, identifies its underlying causes, assesses whether EU action is needed, and analyses the advantages and disadvantages of available solutions" (Commission, European, 2019). In fact, following international trends, since 2002 European Commission has started talking and approaching the theme of 'impact assessment', and in 2006 it has established an Impact Assessment Board (IAB). It is an independent entity whose role and scope are to better the quality of impact analysis and assessment of EU interventions. Moreover, it examines all EC impact assessments, issues opinions asking for improvements, and its opinion is required for a proposal at EC level. It is composed of nine high-level officials chosen because of their personal capacities,

especially their expert knowledge on the three bottom-line, i.e. economic, social and environmental pillars. The Board is chaired by Deputy Secretary General for Smart Regulation. However, IAB has been replaced by the Regulatory Scrutiny Board (RSB), introducing wider responsibilities, such as implementing the Better Regulation Agenda. In fact, both institutions are part of a broader European programme and strategy called "Better Regulation", whose scope is to open up policy and law-making, listening to individuals. More into detail, the Agenda aims at ensuring:

- An open and transparaent decision-making process;
- A contribution throughout policy and law-making processes by citizens and stakeholders;
- Evidence and understanding of the impact of EU actions;
- A minimum regulatory burdens on businesses, citizens and public administrations.

Nowadays, RSB is composed of three high-level commission officials, and three experts recruited from outside the EC.

19.4 Why has impact assessment become so important?

According to Hearn and Buffet (Hearn & Buffard, 2016) [28], there are many economic and political factors which have led to the growing interest for the topic of impact assessment in the last twenty years. They state that a possible explanation is the reduction of financial resoruces available for international development programs, given by donors and agencies – and consequently the need for justifying the use of those financial resources; another reason might be the fact that in international development projects and programmes, 'welfarism' has clearly failed to alleviate poverty, and social and financial exclusion; therefore, there has been a growing need of being able to state and clarifiy how money was spent.

Another possible reason could be the need for overcoming the mere assessment of interventions from the economic point of view. In fact, a vaste and broad literature was produced in the last years to state that there other dimensions to take into consideration, such as the social and the environmental one.

Before continuing, it is important to underscore the link between impact assessment and microfinance. In fact, if considering other dimensions, microfinance may have a positive social impact or may generate positive externalities, but we need to learn how to measure and capture it. Moreover, in the last year, an ongoing study and research was conducted by Microfinanza Srl (Microfinanza Srl, 2019)[29], in order to stimulate debate inside and outside microfinance world. The pioneering and ambitious study was focused on the link between impact and indicators, being the latest referred to Social Development Goals (SDGs) as well. SDGs can be defined as "urgent call for action [...] in a global partnership" (United Nations, s.d.)[30] and has gained worldwide attention at different levels. The over-mentioned 17 goals aim at "eradicating poverty in all its forms and dimensions, including extreme poverty" (United Nations, 2015)[31], being committed in achieving sustainable development in three dimensions – economic, social and environmental.

The Agenda 2030 is based on principles and purposes of the Charter of the United Nations, including full respect for international laws, on Universal Declaration of Human Rights, on Millenium Declaration and on 2005 World Summit Outcome. It is important to underscore the fact that none of the three dimensions can be separated to the others in order to reach a sustainable development: we strongly believe that economic development cannot ignore anymore the scarcity of natural ressources, especially water, and the necessity of starting acting responsibly towards nature.

The underling reasons that have led to this Agenda are above others the extreme poverty of which billions of people suffer from, and the lasting inequalities, including gender ones. Therefore, Microfinanza has decided to adopt the SDGs as reference scheme for the indicators to be used for conducting an im-

pact assessment study: in fact, poverty is a multidimensional concept, referring not only to material poverty, but also to lack of health, education and dignitous living standards (Oxford Poverty & Human Development Initiative, 2019)[32].

Therefore, the link between SDGs, impact assessment and microfinance is clear: the latest is one tool through which deprived individuals can try to drop out from the poverty trap, being financially and socially included. However, the microfinance sector is strongly in need to demonstrate benefits of financial and social inclusion and whether access to finance may improve incomes, capacities, empowerment, well-being and opportunities of clients served by the different financial institutions (Microfinanza Srl, 2019)[33]. The broad nature of financial inclusion asks for adopting a holistic approach by considering several dimensions related to the social, economic and environmental capital, and that is the reason why the methodology suggested by Microfinanza focuses on these three dimensions responding to the triple bottom line. Moreover, we have been investigating the meaning and importance of financial and non-financial services through the analysis of the above-presented dimensions and capitals, and by focusing on five key categories of stakeholders such as clients, microfinance providers, investors, public institutions and donors and intervention community.



In fact, a set of indicators must be established in order to monitor and analyse the loan portfolio and credit history of the client. The proposed set of indicators should be consequently embedded in the MFI data collection procedures and become standardized for being able to produce reports, for internal and external use.

20. How to measure impact?

As stated in the previous section, impact assessment is crucial to demonstrate the effectiveness and efficacity of an intervention, both financial and non financial.

However, for the sake of the book, we will focus on microcredit/microfinance interventions at European level. In the last years, Microfinanza has developed a methodology which involves three dimensions (i.e. economic, social and environmental) and on a set of indicators retrieved from different sources and from own elaboration, based on the long international experience in different contexts.

It is important to notice that impact assessment is very precises and differs from evaluation: in fact, this latter answers to many questions and focuses on broader aspects of intervention. Being very narrowed down on specific topics, impact assessment needs a restricted framework, answering to:

- **What** impact we want to investigate;
- **Whom** the impact concerns;
- **How** the impact is;
- **When** impact materializes.

The following sections present the method used by Microfinanza in order to answer the questions.



20.1. Methodology

What?

To limit the impact, we do consider three different **dimensions**, i.e. economic, social and environmental.

Firstly, the **economic** dimension represents the capacity to satisfy essential needs for individuals and groups of individuals through the creation of economic added value. It is the easiest dimension to study and to deepen as it is composed of figures and numbers. Secondly, the **social** dimension concerns values, norms, roles and rules, and influences the human behavior. Sustainable social dimension can be related to the concept of quality of life of individuals, groups and communities which does not necessarily correspond to a high level of economic status. It is also characterized by the presence of positive, neutral and negative externalities caused by human action. At last, the **environmental** dimension represents all those elements such as activities, products and services which interact with the environment in an ecological sense. It deals with fragility of ecological and biophysical systems and their interactions. It is characterized by the presence of negative externalities which have a negative impact on the environment in the ecological sense. We do not consider environment as external context but only as natural sphere.

Who?

Once the dimensions are identified, we need to clearly define the **stakeholders,** who have a twofold dimension of 'interest', meaning that they are interested because of the results of the impact assessment, but also interested because they are affected by it. As part of impact assessment in microcredit program, we do identify five stakeholders:

- **Client**
- **Microcredit provider**
- **Investors**
- **Public institutions and donors**
- **Intervention community**

At European level, we talk about microcredit provider, and not microfinance institutions, and they are all banking and non banking institutions providing microloans up to EUR 25,000 to entrepreneurs (i.e. small enterprises), to social economy enterprises, to individuals wishing to become self-employed, or to unemployed (Kraemer-Eis & Conforti, 2009)[34].

Here as follow a summary of stakeholders and their positioning is presented:

Dimensions and capitals	*Economic* / *Social* / *Environmental*				
Stakeholders	Clients	Microfinance Providers	Intervention community	Investors	Public Institutions and Donors
Positioning	Client micro level	Market level	Meso Level	Meso – Macro Level	Meso-Macro Level

How?

As previously mentioned, to measure the impact, Microfinanza has developed a set of indicators having the following characteristics:

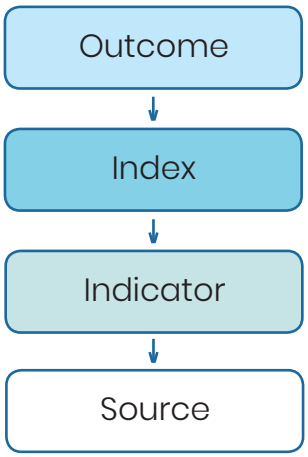
- Stable, as a good indicator should be useful and used for a long time (we should stick to the same indicator throughout the whole analysis, not changing it on the way);
- Comparable, as a good indicator should be useful to compare data of homogenous institutions, projects, programs and situations;
- Operative, specific and measurable, as a good indicator should be feasible (in terms of financial means and timing) to collect these data.

The indicators are related to the three dimensions and refer also to the SDGs.
They are both quantitative and qualitative, and refer primarily to an index (synthetic index) which is then associated to an outcome. In the European and microcredit framework, impact assessment follows this path:

- Identifying the target and goals to be achieved, analyzing vision, mission and values of the MCP;
- Selecting and developing indicators;
- Updating or adjusting Monitoring Information System (MIS);
- Organizing data collection as embedded procedure;
- Analysing data and working out the reporting.

The hierarchy of analysis is as follow:

- Outcome theme defines the macro area (What is the expected outcome?)
- Index defines the desired change (Which kind of change is the stakeholder looking for?)
- Indicator stands for the measure of the change
- Source represents where the information is retrieved



As a way of example, we do show the scheme functioning for the economic dimension:

Outcome theme	Index	Indicator	Source
Decreased Economic Poverty Fight against poverty and social exclusion is at heart of Europe 2020 Strategy for smart, sustainable and inclusive growth	Change in income People are living in situation of material deprivation, household incomes are low in several situations and due to unemployment situations many people at-risk-of poverty	• Increase of net income per client over the previous 12 months • Increased savings capacity of the client/ household (by measuring the savings) – indicator by WB	• Question to the client: What was your annual income in 2018? What is your annual income in 2019? *(Examples of key questions)* • Where are these answers recorded? (e.g. Monitoring Information System)

As to be seen, the outcome theme is Decreased Economic Poverty, to which one possible index, Change in income, is associated. In order to undergo this index, we have indicated two indicators, i.e. Increase of net income per client overt previous 12 months, and Increased savings capacity of the client.

In particular, this second indicator is retrieved from World Bank – indicators are conceived by Microfinanza or by international databases, such as United Nations (UN) Agencies or World Bank (WB). Finally, the last aspect concerns the question to be asked to the stakeholder (the client in this case) and where this information can be found/recorded, e.g. MIS.

Microfinanza strongly believes that MIS and its use should have a central role when studying and analyzing microfinance impact. In this day and age, the technology available at most financial institutions would allow to support data collection and entry into MIS which could be further analysed according to the selected set of indicators and desirable changes that stakeholders would like to follow through a systematic tracking of changes.

To summarize, the following table indicates the outcomes and indexes which have been selected by Microfinanza:

Outcome theme: Decrease Economic Poverty (DEP)	
DEP 1	Synthetic index: Change in conventional international poverty measures
DEP 2	Synthetic index: Change in income
DEP 3	Synthetic index: Change in economic (gross and net) wealth
DEP 4	Synthetic index: Housing improvement
Outcome theme: Business Development (BD)	
BD 1	Synthetic index: Change in business growth
BD 2	Synthetic index: Change in business innovation
BD 3	Synthetic index: Change in business attitude and perception
Outcome theme: Employment Progress (EP)	
EP 1	Synthetic index: Job creation
EP 2	Synthetic index: Job support (to already existing job placements)
EP 3	Synthetic index: Decent employment
Outcome theme: Build Financial Well Being, Resilience and Access (B)	
B 1	Synthetic index: Financial well-being
B 2	Synthetic index: Financial resilience
B 3	Synthetic index: Financial access
B 4	Synthetic index: Changes at institutional level
Outcome theme: Strengthen Community Cohesion (CC)	
CC 1	Synthetic index: Trust
CC 2	Synthetic index: Cooperativeness
CC 3	Synthetic index: Social Network
Outcome theme: Improve Health & Food Security (HF)	
HF 1	Synthetic index: Food security
HF 2	Synthetic index: Water and sanitation
HF 3	Synthetic index: Preventive and curative care
HF 4	Synthetic index: Psychological care
HF 5	Synthetic index: Domestic violence
Outcome theme: Environmental sustainability (ES)	
ES 1	Synthetic index: Impact of economic activity on the environment
ES 2	Synthetic index: Environmental and resource productivity of economic and productive processes
ES 3	Synthetic index: Sustainable management of natural resources in economic activities to prevent environmental degradation
ES 4	Synthetic index: Environmental quality and effects on the society and the communities
ES 5	Synthetic index: Environmental policy

To conclude, we do underline that the hereby proposed methodology can be used as complementary to other assessments.

21. Next steps

The current study presents an example of indicators that can be used to measure medium and long term impact inside MFIs, taking into account different perceptions. To sum up, we as follow present the step-by-step approach for an effective impact assessment. We do underline that it should be **an embedded procedure** in Monitoring Information System (MIS) and that indicators should be **adapted** to different stakeholders, more specifically to vision and mission.

21.1 Who is your target? Which goals would you like to achieve?

The stakeholder looking for changes, i.e. outcome and impact measurement, should clearly **identify** its

target and goals to be achieved and to required and desired kind of changes according to the three suggested dimensions: the economic, the social and the environmental ones. These latter should be further interrelated and linked in order to promote progressive and positive changes at different levels. In fact, a positive change at the economic level should be capable to produce positive effects also at social level without having a negative impact (or by expressing it in economic terms, without having a negative externality) on the environment. According to the approach suggested by Microfinanza, it is not enough to measure 'the number of jobs created, or the economic activities supported' as the other two dimensions, social and environmental, should be explored as well.

Few questions we could ask are whether these jobs and economic activities are positively contributing to changes at household level or at community level, whether the social cohesion has improved, whether the economic activities are environmentally sustainable in terms of use of natural resources and waste reduction. Once the target is clearly known and goals identified, an appropriate set of indicators should be identified and worked out according to changes to be measured in the short, medium- and long-term timeframe.

21.2. Select or develop indicators

Microcredit Providers, donors, investors and public institutions have their own set of indicators to measure changes across programmes and projects they support or to simply monitor if funds are efficiently used.

Financial institutions are more and more focused on their financial and social performances according to international best practices and procedures. However, even with a huge amount of potentially interesting data, indicators used are very few and it is difficult to grasp the signs of change; it is not always clear what to measure and whether the measurement of processes is useful and how can be used internally or externally for analysing results of ongoing activities and guiding decision making processes, as well as reporting or communication and visibility purposes.

So, the suggested methodology should be used to identify a set of stable, comparable, operable, specific and measurable indicators (about 10 to 15), covering the three dimensions; starting from the systematized ones provided by different authoritative source and by those suggested, indicators should be identified according to stakeholders' own measurement purposes. Selected indicators should be furtherly linked also to SDGs and their monitoring framework.

Finally, selected indicators should be used to constantly capture and monitor changes against the progression of time; a data collection plan should be embedded in the MFI working procedures and the MIS should be used as a data collection tool.

21.3 Update or adjust your MIS

Each Microcredit Provider has a specific MIS to manage account systems, portfolio and to track mainly financial performance through a set of financial indicators. An increasing number of financial institutions is chasing also social indicators according to internationally recognized social performance best practices and procedures endorsed by the microfinance industry[35]. At MIS level, inputs (data) and outputs (reports) are to be linked, too. To measure the selected set of outcomes, input must be the most adequate to measure expected changes. The work must be based on an adequate collection of data at the source to ensure that the same data can then feed the analysis of the outcomes according to the selected indicators.

The MIS is the 'core' of data management and is used for different reporting purposes at MCP level, for regulators, donors, partners and stakeholders. In our experience we can say that MIS and data stored are often underused and given the huge amount of data collected at field level by the staff and the technology, available outcomes measurement can be improvable. Few refining might be needed at software level.

21.4. Organize data collection as an embedded procedure

The work must be based on an adequate collection of data at the source to ensure that the good and right data can then feed the analysis of the outcomes according to the selected indicators. An internal data collection plan and related procedures should be defined and known by the staff that should follow the process. The data must be collected constantly and entered into the MIS for subsequent processing. It is key to have data looked-for obtaining the selected indicators.

21.5. Analyze data

Collected data according to a work plan and constantly imputed in the MIS will feed the outcomes analysis according to a previously selected set of indicators. Data analysis according to impact measurement objective should be an embedded practice allowing to have a clear understanding on outcomes related to the three dimensions: the economic, the social and the environmental. According to data analysis it will be possible to have a critical thinking on results achieved and analysing data more in detail. Data will feed the set of indicators and by guiding the outcomes analysis will serve to guide the operations of the institution according to its mission and vision. The constant availability of data with respect of its work objectives will facilitate the decision-making process by the BoD, the external communication - towards partner and donors – and will improve visibility with respect to community.

21.6. Work out reporting

The outcome assessment should be used to constantly guide and systematically analyse changes incurred at client and community level in the three dimensions (economic, social and environmental). Reports can be a time-consuming exercise, if data are not constantly collected and managed, but certainly reports are relevant to every stakeholder and for internal decision-making process.

Reporting can be used as way to present MFI to external stakeholders as well as to internal communication. According to this approach, in the following pages an example of a set of indicators is provided for a microcredit provider having the following mission: "Promoting employment, support and accompany micro-entrepreneurs, support financial education, promote transition to formal sector and promote social solidarity economy".

This data measurement is mainly based on data that can be accessible from the MIS or loan officers reporting documents; these last can be easily integrated in the MFI's monitoring information system and the institution should just modify the system in order to track also few new data. For some areas of analysis, information should be specifically collected such as data to monitor social and environmental outcomes are missing and a specific monitoring culture should be developed on these areas.

Given the importance of youth job creation in Europe, this set of indicators includes also a 'bang for the buck' marker focusing on cost-benefit analysis. The bang for the buck provides an estimation on the cost per unit of employment created considering the overall financial support provided to supported financial institution.

By taking into account the mission and the vision of both the institution and the donor the overall frame suggested for outcomes monitoring is therefore the following.



22. Outcomes progresses

Donor's mission: Promoting economic opportunities for youth through innovative social enterprise development and job creation initiative.	**MCP's mission**: Promoting employment, support and accompany micro-entrepreneurs, support financial education, promote transition to formal sector and promote social solidarity economy.

	DATA				
	As of June, '19	As of month/year	As of month/year		
Total financial support provided by the Donor					Contracts
Credit line provided by the Donor					Contracts
Technical Assistance funds provided by the Donor					Contracts
Guarantee Fund provided by the Donor					Contracts
Total youth clients supported by the MFI					MIS
Mean employment multiplier per enterprise					MIS

Outcome theme: Employment progress

Syntethic indexes: Job creation and job support

Indicators	As of JUNE, ,19	%	Type of indicator	Outcome on total population as of March ,19	Outcome as of month/date	Outcome as of month/date	Unit of measurement	Key question	Source
Business created		%	Outcome				# or %	When you asked for the first loan where you a start up? Startup loans in youth portfolio (# or %) – Insert, Data on new business created from MIS over total youth clients supported	MIS
Newly created businesses and already existing IGAs supported			Outcome				# or %	Do you believe that the support received was crucial for sustaining the employment of your business? How many of your family (men-women, include yourself) did work with you in this business before getting support? How many work now? How many paid workers (non-family) did collaborate with you in this business before getting support? How many work now? Data on new business created and already existing business supported from MIS over total youth clients supported	MIS + qualitative interviews
Overall employment units supported			Outcome		0	0	#	**Do you believe that the support received was crucial for enabling improvement or the startup of your business?** How many of your family (men-women, include yourself) are working in this business? How many paid workers (non-family) do collaborate with you in this business? Are you receiving some income from your business (PROBE: is the business still existing)?	MIS
Bang for the buck (Average financial support provided for 1 employment unit supported)			Output	EUR			EUR	How much is costing the support of a unit of employment? Total financial support/Overall employment units supported	Contracts/MIS

Outcome theme: Business development (BD)									
Synthetic index: change in business growth									
Indicators	As of JUNE,19	%	Type of indicator	Outcome on total population as of March ,19	Outcome as of month/ date	Outcome as of month/ date	Unit of measurement	Key question	Source
Increase (and strongly increase) of annual sales (taking account of seasonality) (productivity)			Outcome				% (strongly decreased, decreased, stable, increased, strongly increased) or #	Over the last year/s, have your business sales increased/ stayed the same/decreased?	Question in Reporting & Monitoring+ MIS
Number or % who experienced changes in their income during the high season in the past year			Outcome				% (strongly decreased, decreased, stable, increased, strongly increased) or #	During the high season/harvest (e.g. Eid, Christmas etc.) of this past year, were your sales/income greater than, about the same, or less than your sales from the same season of the prior year?	Question in Reporting & Monitoring+ MIS
Exit from informality			Outcome				Decrease in business informality - % of newly formalized	Is your business registered (according to legal requirements)? If yes, was your business registered before getting financial support?	Question in Reporting & Monitoring+ MIS

Synthetic index: Change in business innovation									
Indicators	As of JUNE,19	%	Type of indicator	Outcome on total population as of March ,19	Outcome as of month/ date	Outcome as of month/ date	Unit of measurement	Key question	Source
Number (or %) of youth clients who introduced product/service innovations			Outcome				Appreciation and % of firms that introduced a new product / service or # of clients having introduced new services and products	In the last 12 months (or since you started the business if less than 12 months), have you started producing / selling new products / services that you didn't previously produce or sell (YES/NO)?	Question in Reporting + MIS



Synthetic index: Change in business attitude and perception									
Indicators	As of JUNE,19	%	Type of indicator	Outcome on total population as of March ,19	Outcome as of month/ date	Outcome as of month/ date	Unit of measurement	Key question	Source
Increase of confidence in ability to be successful at their business (Business confidence)			Outcome				Appreciation, perception based	How confident do you feel you will be successful at your business (very, somewhat, not so much, not confident)? Do you have any specific project for the future? How far do look into the future when you plan the evolution of your business (no planning, up to 6 months, 6 months-1 year, 1-2 years, more than 2 years)?	Question in Reporting + MIS
% of women clients who make business decisions			Outcome				Appreciation, perception based	Who (in the household) decides how the money (profit) realized from the business should be used/spent? In your business activity, who makes the most important decisions (i.e. buying new assets, hiring new staff, etc.)?	Question in Reporting + MIS

Outcomes Theme: Build financial well being, resilience and access to finance									
Synthetic index: Changes in attitudes									
Indicators	As of JUNE,19	%	Type of indicator	Outcome on total population as of March ,19	Outcome as of month/ date	Outcome as of month/ date	Unit of measurement	Key question	Source
The youth is more confident about managing money and motivated to plan ahead			Outcome				% (increased, same, decreased)	Do you feel more confident in managing your resources and in taking financial decisions?	Question in Reporting + MIS
Confidence in increasing household's well-being by reducing unuseful expenditures			Outcome				% (increased, same, decreased)	Are you aware about the need to better manage households' expenses also by reducing un-useful expenditures?	Question in Reporting + MIS
Motivated to track cash flows even though income sources are little, irregular and unpredictable			Outcome				% (increased, same, decreased)	Are you motivated on tracking your cash flows even though income sources are little, irregular and unpredictable, in order to focus on your objectives and future plans?	Question in Reporting + MIS

Synthetic index: Changes in behaviors									
Indicators	As of JUNE,19	%	Type of indicator	Outcome on total population as of March ,19	Outcome as of month/ date	Outcome as of month/ date	Unit of measurement	Key question	Source
Track expenses regularly using the family budget	Baseline survey		Outcome	No			Yes/No	Do you regularly track family expenses by using family budget or other tools?	Question in Reporting - Attawafiq APP
Owns a savings account	Baseline survey		Outcome	Yes			Yes/No	Do you have a savings account, and do you save in order to plan your future?	Question in Reporting - Attawafiq APP
Borrows with full understanding of terms	Baseline survey		Outcome	Yes			Yes/No	Do you have a full understanding on lending conditions (duration, amount, interest rates, penalties, etc.)?	Question in Reporting - Attawafiq APP

Synthetic Index: Trust and social network									
Indicators	As of JUNE,19	%	Type of indicator	Outcome on total population as of March ,19	Outcome as of month/ date	Outcome as of month/ date	Unit of measurement	Key question	Source
Increase of trust			Outcome				% (increased, same, decreased)	How do you feel comfortable in your community? Does the community trust in you? Studies show that a high level of trust reduces transaction costs and negotiation costs; hence, trust makes economic transactions more efficient because it will reduce the risk of failure of the contract, litigation, law enforcement and bureaucracy (Fukuyama, 2001).	Question in Reporting + MIS
Increase of participation in community activities			Outcome				% (increased, same, decreased)	„During the last 12 months did you participate in/ benefit or use community activities?". "yes" (1) "no" (0). Other proxies: the amount of participation in community activities, attendance at community activities meetings, participation in decision making. Who do you usually spend your time or engage with (frequent relationships)? PROVIDE DIFFERENT OPTIONS. Who do you mainly rely on for support / who assists you (and with what / for which purpose) (PROVIDE DIFFERENT OPTIONS THROUGH A MATRIX	Question in Reporting + MIS

Outcomes Theme: Environmental sustainability									
Synthetic Index: Impact of economic activity on the environment									
Indicators	As of JUNE,19	%	Type of indicator	Outcome on total population as of March ,19	Outcome as of month/ date	Outcome as of month/ date	Unit of measurement	Key question	Source
Decrease of use of natural resource consumption			Outcome				% (increased, same, decreased)	In an economic and productive process several resources are used (water, land, wood, energy etc.). Nowadays water is a key resource in all productive and living process and it should be used conveniently. You should have an idea on the amount of water used in the different productive process and you should monitor water used also in running small business activities. Additionally, the right use of water has an impact on human life and environment protection. Saving water is good for protecting the environment but also an economic impact (in terms of costs reduction).	Question in Reporting. Ask for consumption of water (liter per person day/year) + MIS
Reduction in waste production			Outcome				Increase, same, decreased or % of waste reduced	Waste production might be tracked according to different type of business activities (production of organic waste in agriculture and vegetable shops, not organic, plastic, paper, glass, batteries, etc.). Waste management indicators should be used to measure the total amount of per capita waste generation. At the same within an economic activity business promoter can reduce the use of plastic bags, or other products generating waste.	Question in Reporting. Ask for waste production (Kg per person day/year) + MIS
% of businesses having enhanced material recyclability			Outcome				% (increased, same, decreased) material recyclability	During the last year - were your capacities to enhance material recyclability improved? Is material recyclability increased/ stayed the same/decreased? For which kind of material did you improve recyclability? (according to the different types of business it can be water/agriculture, compost for agriculture, raw materials for products and services, etc.)	Question in Reporting. Ask for material recycled + MIS



Reporting Dashboard – Model 1

Outcomes reporting for youth employment.

DONOR's mission - Promoting economic opportunities for youth through innovative social enterprise development and job creation initiative	**MCP's mission** - Promoting employment, support and accompany micro-entrepreneurs, support financial education, promote transition to formal sector and promote social solidarity economy

Youth males



	As of March, '19 %	As of month, /year %	As of month, /year %
18-24 years			
24-29 years			
30-35 years			

Youth females



	As of March, '19 %	As of month, /year %	As of month, /year %
18-24 years			
24-29 years			
30-35 years			

Level of education

No primary school			
No primary school but can read and write			
Primary school			
Middle school			
Secondary school/high or technical school			
Tertiary education - College or University			

Outcome theme: Employment progress					
Synthetic indexes: Job creation and job support					
	As of March ,19	Outcome as of month/date	Change %/#	Outcome as of month/date	Change %/#
Business created					
Newly created businesses and already existing economic activity supported					
Employment units created in new businesses					
Overall employment units supported					
(Bang for the buck I) Average financial support provided for 1 economic activity launched					
Bang for the buck (Average financial support provided for 1 employment unit supported)					

Synthetic index: Change in business growth					
	As of March ,19	Outcome as of month/date	Change %/#	Outcome as of month/date	Change %/#
Increase (and strongly increase) of annual sales (taking account of seasonality, productivity)					
Number or % who experienced changes in their income during the high season in the past year					
Exit from informality					

Synthetic index: Change in business innovation					
	As of March ,19	Outcome as of month/date	Change %/#	Outcome as of month/date	Change %/#
Number (or %) of youth clients who introduced product/ service innovations					

Synthetic index: Change in business attitude and perception					
	As of March ,19	Outcome as of month/date	Change %/#	Outcome as of month/date	Change %/#
Increase of confidence in ability to be successful at their business (Business confidence)					
% of women clients who make business decisions					

Outcomes Theme: Build financial well being, resilience and access to finance					
Synthetic index: Changes in attitudes					
	As of March ,19	Outcome as of month/date	Change %/#	Outcome as of month/date	Change %/#
The youth is more confident about managing money and motivated to plan ahead					
Confidence in increasing household's well-being by reducing unuseful expenditures					
Motivated to track cash flows even though income sources are little, irregular and unpredictable					

Synthetic index: changes in behaviors					
	As of March ,19	Outcome as of month/date	Change %/#	Outcome as of month/date	Change %/#
Track expenses regularly using the family budget					
Owns a savings account					
Borrows with full understanding of terms					
Has experience with multiple financial products (e.g. Short-term savings account, fixed-deposit accounts, bank loans, MFIs, employers, shops etc.)					

Synthetic Index: Trust and social network					
	As of March ,19	Outcome as of month/date	Change %/#	Outcome as of month/date	Change %/#
Increase of trust					
Increase of participation in community activities					

Outcomes Theme: Environmental sustainability					
Synthetic Index: impact of economic activity on the environment					
	As of March ,19	Outcome as of month/date	Change %/#	Outcome as of month/date	Change %/#
Decrease of use of natural resource consumption					
Reduction in waste production					
% of businesses having enhanced material recyclability					

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Reporting Dashboard – Model 2

• How many and what kind of resources have been injected?	• What was done? Which kind of activities were addressed and to whom were these activities proposed and promoted?	• What has changed as a result of input provided?	• To what extent and how much of the outcomes is attributable to this process? Which impact would have occurred that would not have happened without provided input?
• Amount of the contribution 250,000 EURO • HR level of effort • 1 Full time staff • Equipment • 1 office fully equipped	• # of beneficiaries (gender, age, nationality, etc.) • 95 persons • 45 men, 50 women. 34 years on average, 18% are youth <30 years, 3 disables, 0.5% refugees • # of economic projects supported/created • 32 economic activities supported/revamped • 2 economic activities newly created • 12 training sessions on financial education and business planning • 95 people trained • From/to • # training organized and #people trained	**Economic dimension** • +2% increase of annual sales, +1% purchase of fixed assets, +10% increase in the profitability per production unit in rural enterprises, 1% introduced services innovations, increase of confidence in the ability to be successful at their business, increased saving capacity **Social dimension** • Increase of trust, increase of cooperativeness, increase of participation in community activities, increase in women empowerment **Environmental dimension** • Decrease of use of natural resource consumption	**Economic dimension** • +1% of employment rate within the community • 90 sustainable long-term jobs created • Increased well-being of employed people **Social dimension** • Changes in attitudes (youth are more proactive) • Increased ability to explore innovation and develop new skills • Increased safety at community level, decrease in damage to public goods • Improvement of community assets **Environmental dimension** • To be assessed against local, regional, national objectives and policies

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