

Evaluation of the Hungarian Microfinance Program - Kiútprogram

Executive Summary

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This document is an independent expert review of Kiútprogram. In 2008 the founders and the board of Polgár Alapítvány az Esélyekért (in short Polgár Foundation) initiated the establishment of a microcredit program in Hungary, which would differ from previous local efforts. Officially, Kiútprogram started in January 2010 with three year tenure. Although the first client groups had graduated relatively early, - during the spring of 2010, - the first loans were only disbursed in the fall of the same year (September). In June 2010 Kiútprogram won a tender and signed the two-year-long contract with the European Commission. With this, Kiút initiative as a community development program became the pilot of the EU Regional Directorate.

Kiútprogram's strategic goals are supporting households in disadvantaged areas to avoid poverty trap, clearing up potential clients' informal enterprises and support entering the regulated enterprise sector, and fostering the social integration of people in endemic poverty, primarily the Roma. The program targets peoples in the disadvantaged areas, mostly but not exclusively the Roma population by offering a small business loans in groups. Apart from deploying a financial tool (i.e. the group-loan), the clients receive a wide variety of business development and administration services from Kiútprogram. The operation and execution of the program is the responsibility of the legal entity called Kiútprogram Közhasznú Nonprofit Zrt.

Due to the perceived slow-down in the progress of the efforts, during the spring of 2011 the management introduced some changes in some of the main elements of the microcredit activity. While they didn't drift from the initial mission and strategic direction, they have modified for instance the targeting criteria of clients and they introduced or reinforced some other elements. As a result, potential clients who had business acumen and prior experience in entrepreneurship more likely became successful candidates. It also meant slightly higher economic strata as a new target group. Several organizational changes took place such as the establishment of a crises committee to assist defaulting clients individually, or the nomination of regional coordinators to improve communication and work efficiency among the field staff.

Currently, 27 active loan groups participate in the program. By November 2011 the number of clients reached 70 out of which 64 had already received loans. There is an equal share of clients who regularly pay their installments and those who are late or already

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expelled from the program. 11 clients had received their second or third loan. The initial goal of the program, similarly to the Grameen Bank clientele, to target mostly women, is not sufficiently achieved at this stage. At the moment 45% of the borrowers are women and among the waiting clients the majority is also men.

The size of the loan portfolio is close to 50M HUF. The outstanding arrears totals to 16.2M HUF. The average loan size for the period ending November 2011 was 651.151 HUF, which is in the range of 200.000 HUF to 1.000.000 HUF.

Considering that our assessment was requested in June 2011 it entailed the evaluation of Kiútprogram using a double filter. On the one hand we have studied the relevance of the program activities in light of the initial goals of the founders and we aimed also at the evaluation of the so called 'model change' (introduced in 2011) and examined the internal consistency of the program (*quasi ex ante* evaluation). We have not focused however on the program efficiency or the comprehensive assessment of the program management. Instead, we examined the consistency of the implementation (*cf* focus of classical ongoing evaluations).

We have applied both qualitative and quantitative methods, in the case of the latter with severe methodological caveats (see, limits to statistically significant interpretations due to low number of observations). The assessment period covered July-December 2010.

The experiences of the last three decades show correlation between the international/regional and domestic microcredit programs. The impact assessments of these programs list several success and failure factors, which we summarize below.

Relevance and consistency of the program

- Kiútprogram's strategic goals are justified however its targeted results are overly ambitious. The three long-term strategic goals' simultaneous realization has trade-offs, and at the same time, the three-year pilot tenure makes it unrealistic to achieve.
- This program's strategic goals are extremely challenging to achieve even if there existed synergic relationships with other development initiatives locally, or if it was a well-tested and carefully planned intervention – though none of them is the case.
- Previous experiences of microcredit in Hungary showed that fostering registered enterprises is hampered by difficulties especially among the most underprivileged population. In an otherwise highly regulated, developed market environment the market entry costs, the seasonality of relevant business activities, the information asymmetry, presence of strongly competitive informal businesses etc. explain the failure of micro enterprises rather than the motivations of the individual entrepreneurs. The early phase of the Kiutprogram (October 2010 and beginning 2011) has also confirmed this experience.
- Formalizing the „black” or „grey” enterprises coupled with the goal of minimizing the social prejudice have a lot of embedded challenges if one tries to do it for the poorest of the poor. This holds true even more for a program, which works in isolation and not as part of a geographically focused, long-term and comprehensive development scheme. Having said that the economic sustainability of the enterprises established under such a program is strongly questionable.

- The operative management of Kiutprogram quickly realized that the targeted number of clients (100 in the first year and 300 in the following year) is unrealistic to achieve. This is mainly a result of the initial phase where the implementation has already been started before finishing the operative planning of the program. This also explains the substantial delay in the first loan disbursement compared to the group formation date. Despite knowing all this, no changes have been made in the target numbers by June 2011.
- It will be part of the *ex post* impact assessment upon the completion of the pilot to decide whether there is any income increase among the people who availed business loans from Kiut. According to currently available monitoring data it is questionable that during the first year the current borrowers experienced any increase in their household income especially considering the low (or zero) saving rates of these households and the upfront investment needs of their enterprises. (These often include the settlement of previous debt as well thus not solely the procurement expense of the business equipment and/or inventory.)
- The repayment targets (75% of the first cycle clients and 80% of all subsequent cycles) are justified and well in accordance with international standards. However, it is important to note that these performance measures usually refer to scaled up and long-term programs and not pilots, which in addition operate in the midst of an economic crisis.
- The group lending activity has a key focus on the group itself. On the one hand the group ensures efficiency in lending but most importantly it provides a platform for mutual learning, an opportunity for shared responsibility and ensures moral obligation. (I.e. the members try to avoid losing face in front of others.) These factors are fundamental in circumstances where the commercial lending conditions cannot be met by traditional collateral.
In the international context the success of strong group dynamics in microlending were achieved best in communities where other binding forces like religion, or traditional social structures and customs supported the community or when mutual financial guarantee were introduced to the members. Prior to this pilot in Hungary we have no example for the former solution (moral or religious ties), but the latter (mutual financial guarantee) has proved to deliver negative acceptance. Kiutprogram experienced that groups function well until the loan disbursement but after that point in some cases the support function diminishes and peer pressure becomes weak or nonexistent.
- The „model change“ brought the crisis committee into action to individually nurture defaulting clients and extend customized support to group members. Although this new program element seemed obvious from a cost consolidation and implementation perspective (and as a response to multiple defaults in the beginning of 2011), it proved to be only symptomatic treatment and had a rather negative impact on the effectiveness of the program.
- Regarding the loan tenure we have found the one year without grace period repayment condition hardly feasible despite the carefully assessed business plans. Internationally, only those businesses were able to deliver on this where the yield after one year was exceptionally high, which is of course an activity dependent factor. Kiútprogram could alleviate this by initiating savings activity in the first 6 months when special state support schemes is available for most of the clients (see welfare bridge subsidy). While attempts to implement this are clearly documented in the internal policies of Kiút, during the execution we found little evidence for the same.
- The life rules, which serve usually as a code of conduct for credit groups, were elaborated by the program management and accepted but regarded unnecessary

by the group members. (They have shared this view during interviews.) They had no or limited active role in forming these rules. It is more an exception where the members could contribute to form these rules or they could complement and discuss the existing ones. We conclude thus that these life rules played no effective role in the operation of Kiútprogram, despite having a proven track record of the benefits of it in other microcredit initiatives.

- The program designers recognized well the necessity of additional business development services such as financial literacy training, entrepreneurial skills training, group formation and mentoring services even after the loan disbursement.

Targeting

- The early programs run in Bangladesh implied various elements such as landless women as potential clients, Grameen rules regarding living circumstances (referred to 16 decisions), short-tenured small loans mostly as a working capital, and dissemination of basic market information. On the contrary the North American microcredit programs were targeting mid- and long-term investments and/or working capital coupled with business planning and cash flow management mostly explained by the complexity of the business environment and the society. The same holds true for those Eastern-Central European programs where the refundable contributions were targeting the extension of existing enterprises other than start-ups.
- On the one hand, it is an important empirical lesson that those programs that provide consumption loans, which in most cases cover the existing debt of clients, are doomed to fail. (See more the lessons learnt from the Hungarian microcredit experiences in Hungary.) On the other hand, international program experiences suggest that the *a priori* assessment of potential clients' financial needs (and saving potentials) despite being time-consuming is fundamental and most beneficial to mitigate default risk. This allows the loan product and the support services to be customized exactly to the beneficiaries' needs.
- Kiútprogram's efforts are commendable in identifying the above needs both during the feasibility study and the planning phase. The challenge instead proved to be how the implementation will adjust to needs of real clients as opposed to the those of an „ideal client” envisioned by the program architects (and sponsors) initially. Our review shows that despite the efforts to correct targeting mistakes after the model change, the new clients happen to be minimally different from those who were recruited earlier. We expect improvement in this with more experienced field staff joining the program, but the high fluctuation of staff (especially among the field agents), the internal communication difficulties, and the lack of organizational learning may hinder the same.
- By tailoring the model to local and individual needs special factors such as the close proximity of markets, information and procurement opportunities and the differences of the same in urban *versus* rural areas should be considered. Such differentiation is visible in the program, but strongly dependent upon the personal commitment and loyalty of the field agent and his flexibility towards clients. Upon the completion of the pilot, institutionalizing these efforts would be worthwhile by comprehensively assessing which business development service is preferred by clients at what location.
- Even in Budapest the ethnic discrimination strongly narrows the possibilities of having a relevant customer base for Kiut enterprises; hence the change in targeting towards more integrated markets gives a better chance for the Kiut businesses to survive. Our observations, without being representative, show that

there are only few enterprises in the isolated villages, which could be sustainable even after the pilot is over, and the current services (such as procurement with the field staff vehicle or complimentary accountant, etc.) are discontinued. Our experience reinforced thus that the model change turned the targeting for the better, but we would like to draw the attention to the necessity of „exit strategy“ to ensure the survival of supported businesses post the pilot.

External coherence of the program

- It is an important international and national experience that a country's business environment and the quality of the regulatory framework strongly influence the success ratio of startups. Therefore, in an over-regulated and instable business environment the survival and the success of the established enterprises may depend on factors over which are beyond the control of program management. For instance the constantly changing taxation and social security system, or the relatively high administrative burdens of setting up business might challenge the potential target group due to informational asymmetries and limited financial resources. The lack of information or uncertainties in framework conditions can easily absorb the savings of the targeted households or even provide disincentives to necessary savings. Such factors weigh equal if not more than the potential demand or the input expenses of the startups.
- In developed economies the market competition is more vibrant. Dominant market players (large conglomerates), import prices, or the informal business practices of local competitors often determine the local prices. This may put microfirms easily out of business in some sectors as far as profitability is concerned. During our review such disadvantages became clear through the group interviews. The comprehensive analysis of the above factors, however, should be part of the *ex-post* impact assessment.
- Being a financial intermediary is heavily regulated in Hungary and burdened with strong financial sector entry barriers. This and the pilot nature of Kiut inevitably resulted in a partnership with a bank and established the need for a new product with all its procedures suitable for their low-income clientele from scratch. This resulted a substantial delay in the first loan disbursements (September 2010), which impacted the fragile trust between the first group members and the program staff. The overly extensive banking administration hampered the efficient execution of the program also later and contributed and still contributes to the decreasing confidence of the field workers.
- When discussing external factors it is crucial to mention the impact of the Hungarian Government policy changes in the underprivileged segment of the society. Most of the relevant state subsidies (social transfers, business development support schemes) relevant to the target groups and their potential local clientele were modified to the disadvantage of those groups. Our experience showed that the purchasing power of the Kiut target communities decreased by and large by 2011 and shows string seasonality depending on the availability of the social schemes. (E.g. community work program are provided mostly in the summer period by local governments). We have not covered under this study the thorough research of consumption behavior pattern changes in the aforementioned period, but we strongly recommend running an extensive assessment on this issue (see, seasonality of local demand, changes in complimentary household incomes and consumption behaviors).

In summary, Kiutprogram is an initiative that fills the gap for an experimental program in Hungary, and its lessons and experiences should be capitalized when designing future similar interventions.

Kiutprogram is a constantly changing, experimental program financed by committed and devoted sponsor and founders. While this could also be an advantage, for instance when the product/service is flexibly tailored to the needs of the clients, we discovered more disadvantages of the same (unpredictable operating framework, occasional, *ad hoc* decisions in given credit cases as opposed to a standardized decision-making process, etc.). The designers of the program have successfully identified many of the risks, which prompted quick response during the model change, however the initially identified program goals were left untouched and several implementation risks were *a priori* ignored.

The overly ambitious targets in client acquisition and the short program period is counteractive to careful and time-consuming client selection, to rolling re-design of the program based on feedbacks from the field and on the internally managed learning mechanism. Similarly, the performance monitoring also becomes less regular and systematic.

Another important lesson for all future experiments is that the Hungarian regulatory framework and the business environment for micro startups requires investment in time and capital far beyond a credit scheme designed basically for one year tenure (with weekly repayment pattern!). The regulated enterprises in Hungary have substantial upfront capital-, and time investment needs and they are also cost-intensive to administer (e.g. each enterprise needs a chartered accountant). This could be a serious challenge for the Kiut target population, in which accumulated savings are virtually non-existent; hence it should be part of the financial literacy training. The model change promptly and appropriately responded to the planning flaws, but it failed to address critical issues such as longer tenure or enterprise specific repayment pattern.

Our assessment ends with a short summary on our main recommendations. In order to address implementation deficits in a systemic way we recommend the following for the rest of the program period:

- Focus on fostering the mutual learning within groups even after the loan disbursement.
- Reinforce group cohesion and peer pressure to build up more effective moral guarantees.
- Support the field staff and reduce fluctuation, monitor their work more closely.
- Fine-tuning client targeting/screening.
- Diversify business development and operations services for clients and provide exchange of information among and corresponding training for field staff.
- Ensure a more organized documentation and experience/knowledge sharing platform for the implementation team.