

Cost-effective Client Assessment in a Small Microfinance Institution (MFI): the Experience of DEMOS in Croatia.



January 2004
Caroline Tsilikounas and Biserka Kljaic¹

This case study highlights the approach taken by DEMOS in Croatia in order to institutionalize its knowledge of clients and to provide clients with more tailored and appropriate products and services. The decision by Demos to invest in client assessment can be explained in part by the weakness of the market for microfinance² and the need to actively promote demand for its services. Through engaging in client assessment, DEMOS has increased **cost-effectiveness** of its lending activities and has built better and longer-term relationships by enhancing **client loyalty**. The example followed by DEMOS shows that such approaches can work even in small institutions with limited resources.

This paper provides a justification of Demos's commitment to routine client assessment and describes system components and the process of system development, including a discussion of problems encountered. It also analyses the cost-effectiveness of the system used and summarizes lessons learnt. Background information about microfinance in Croatia and more detailed information about Demos's client assessment activities can be found in the annexes.

THE OPERATING CONTEXT FOR DEMOS

DEMOS³ is a Savings and Loan Co-operative (SLC) based in Karlovac, Croatia, 50 km SW of Zagreb. It was founded by the Swiss-based refugee organization, the International Catholic Migration Commission (ICMC), in July 1999. DEMOS's mission is to provide financial and non-financial products and services throughout Croatia to those with limited access to formal financial services. DEMOS serves predominantly small entrepreneurs in rural areas and/or low-income businesses in urban areas. Its activities cover a wide area of the country and it is currently active in Sector North, South and Western Slavonia and in Karlovac and surrounding municipalities. Two-thirds of DEMOS's active clients are returnees to their pre-war homes, the other third domiciled. Cumulatively, loans have been disbursed to 45% of domiciled and 53% of returnees. DEMOS aims to build its comparative advantage in Croatia based on its long-term scope of work and its integrated and mobile approach to clients' needs (be it geographically or in terms of products).

When DEMOS's lending operations started, many international organizations that had been providing grants were lowering their level of activity. Most war-affected areas suffered from damaged infrastructure (roads, electricity) and people were surviving mostly on milk production. Animal husbandry was one of the few viable economic activities that could be identified at the time, which led DEMOS to provide support in this sector. However, the situation in urban areas in and around Karlovac was oftentimes harder because businesses could not find appropriate suppliers while at the same time they were being overburdened by high tax and legal requirements.

Having in mind this challenging environment with a combination of subsidized credit and regulatory rigidity, DEMOS set about understanding what its clients really wanted and began to create the systems to facilitate this approach.

From the start, DEMOS was faced with the issue of low demand and has been actively involved in looking into different ways of addressing this. In this context, DEMOS pioneered the market research tool as only the second institution in the region to test these tools. DEMOS considered merging with other institutions, and experimented with various marketing strategies (as described later in this paper). It also searched for strategic partnerships with other economic institutions, which resulted in strong co-operation. In this way, DEMOS has remained constantly ready to innovate and stay competitive on the market.

¹ Caroline Tsilikounas is an independent consultant with 10 years of experience running and advising microfinance institutions, of which 5-years in the Balkans. She founded DEMOS in 1999 and managed it. She is now on DEMOS's supervisory board. Biserka Kljaic works as Operations Manager of Demos. The authors are very grateful to James Copestake for his comments on the first draft.

² Microfinance in Croatia, where Demos operates, is less mature than in neighboring countries. Annex 1 explains why this is the case and provides background information about the country.

³ For more information about DEMOS see: www.DEMOS-skz.hr.

SYSTEM DESIGN

1) Rationale For Client Assessment on a Routine Basis

As mentioned, it became clear early on in the institution’s life that the challenges of working in Croatia would require creative and timely responses, both for survival purposes and to achieve greater social impact. The fact that DEMOS is a relatively small institution did not come into consideration because it was the environmental conditions that generated the need for a client assessment system, rather than the size of the institution.

DEMOS faced relatively low demand for its services (as compared to other MFIs in neighboring countries) and delinquency in urban areas. While trying to address these obstacles, DEMOS became familiar with several market research tools which, when combined with other information systems, enabled a better reading of signals from clients about satisfaction and/or delinquency. They could also be used for product and service development and/or refinement. Ultimately this would ensure a better match between products offered and clients’ needs.

The proven results are **higher penetration** in rural as well as urban and suburban areas, and a **higher range of available products**.

2) System Components and Use

- **Client Assessment Process**

The process followed by DEMOS consists of the following steps:



Client baseline data is analyzed to examine trends. Data is gathered from forms and from the loan tracking system. If any trend seems unusual, promising or worrisome, DEMOS’s operations manager discusses the issues with loan officers in various meetings. Based on these meetings, management

determines how significant the issue is and whether to investigate further to address it. In some cases, loan officer feedback may come first (such as the arrival in a municipality of a grant project), and signals are reviewed later (for instance, drop-out from the program by people running the businesses for which the grant project is now available). Therefore, the sequence of steps 1 and 2 may be reverted.

Once issues have been identified, management and advisor prepare research objectives to be pursued in order to address these issues, along with the tools to be used and any training needed or logistical arrangements. Logistics are then delegated to the administrative staff or the corresponding satellite office. The entire research process leads to conclusions and management then determines the importance of implementing any recommendations, bearing in mind the financial implications to the program. At this stage, product development/refinement may take place, as well as potentially changes in delivery.

▪ **An Essential Strategic Tool**

Client assessment has been used by DEMOS in pursuit of various strategies, mainly as a tool to inform **strategic planning** as well as to generate **timely reactions** to the changing market situation.

Currently the client information system available within DEMOS is used to constantly gauge clients' demand and to better adjust products and services to the area and/or the economic sub-sector. It is also used to address the issue of drop-out through incentives for follow-on loans and introduction of new loan products.

Strategic planning is linked to client assessment both as an input and an outcome. Strategic planning as an outcome of client assessment is illustrated by competition analysis carried out using market research tools and interviewing. This provided DEMOS with all the necessary information so as to better position itself on the market, as well as providing informed decisions to the board for its strategic planning.

Conversely, one of the strategic objectives of the planning process consisted in the development of several new products under the general goal of reaching 2,500 clients by year 2005. In this respect, client assessment was used to identify the products and services that the market wanted and to develop them.

Table 1 . Summary of Implemented Strategies		
	EXISTING PRODUCTS	NEW PRODUCTS
EXISTING MARKETS	<p>Market Penetration Strategy</p> <ul style="list-style-type: none"> ▪ introduction of incentives for follow-on loans (July 2001) ▪ secession of the business training for all loans except individual loans (July 2001) ▪ introduction of all group loans and of individual micro-loans in Western Slavonia (Spring 2003) <p>Timely reaction to sudden introduction of new agricultural law requiring of farmers greater quality milk to be eligible for subsidies (November 2002) - revision of existing product - increase in loan size for milk production</p>	<p>Expansion Strategy</p> <ul style="list-style-type: none"> ▪ introduction of specific loan product for milk production (July 2001) ▪ design and pilot test of loan product for pig production with market linkage via BDS organization (January 2003) ▪ design and pilot test of consumer loan product in Karlovac (July 2003) <p>Timely reaction to increased delinquency in urban areas (July 2001) - introduction of individual lending methodology in urban areas</p>
NEW MARKETS	<p>Market Development Strategy</p> <ul style="list-style-type: none"> ▪ Introduction of SME loans in Former Sector North (December 2002) 	<p>Product Diversification Strategy</p> <ul style="list-style-type: none"> ▪ Opening of satellite office in Western Slavonia - design, pilot test and roll out of SME loans (December 2001; January-February 2002) ▪ Opening of satellite office in former Sector South - design, pilot test and roll out of loan product for raising sheep and goats (August 2003)

INSTITUTIONALIZATION OF CLIENT ASSESSMENT: PROCESS AND CHALLENGES

When DEMOS started its operations in 1999, client information was gathered for loan evaluation purposes. Business plans, loan applications and simple Management Information System (MIS) were not enough to capture detailed information about clients, segmenting them into groups of similar characteristics and needs. This created difficulties in adjusting DEMOS's products and services to specific market segments'

needs, and in responding to changes in the market in a timely manner. This is why DEMOS became very interested in the MFC⁴ MicroSave tools⁵ testing project undertaken in 2001 and volunteered to take part in the study.

Table 2. Development Process		
Date	System developed	Gaps in information
June 1999-July 2001	Business plans, loan application, simple MIS	Hard to capture detailed information about clients by segments of the market, resulting in difficulty understanding reasons for low demand and high delinquency.
July 2001 and on going after October 2001	Market research	Understanding low demand and high delinquency in urban areas but lack of information on an ongoing basis and hard to capture quick trends on the market.
October 2001-Feb 2002	Monitoring forms	Possibility to detect signals from clients in a timely manner and complement the MIS. But MIS not providing enough client data.
September 2002	Introduction of new MIS	Possibility to obtain more accurate and in- depth client data. Lack of information about exit clients.
January 2003	Exit forms	Reasons for exiting programs used as a baseline for further market research.

In the project, DEMOS staff were trained in using the tools and conducted market research that led to product changes. Since the methodology proved very useful, **DEMOS made market research one of its core initiatives** and after receiving additional training on data analysis, the DEMOS team was able **to use it on an ongoing basis**, which it has been doing ever since.

Although equipped with market research tools, DEMOS still lacked ongoing information on **how to capture trends in the market** as well as information on its structure and the dynamics of the client base due to MIS limitations. To deal with this problem, DEMOS decided to revise its site visit forms to be able to use them to detect signals from both clients and the market in a quick manner. Finally, the new MIS, along with the information gathered from the exit forms on existing clients, complemented the missing information. It provided the DEMOS team with a more accurate picture of its clients and the market.

Throughout the development process, DEMOS faced several challenges:

- **Staff time and buy-in**

On an ongoing basis, the system has been requiring that staff be involved in setting research objectives, interviewing clients, facilitating focus groups and reviewing data gathered. This in turn involves additional workload that a small organization such as DEMOS would find difficult to bear. Also, as the client assessment system started bearing fruit in terms of significant increases in the volume of lending, the staff time spent on these activities continued to steadily increase. One way to mitigate this was to simplify the process (and documents) while still striving for a depth of information about clients, and including staff feedback at all stages of the process, especially when creating forms. This method was particularly effective when designing the monitoring forms, which were reviewed and simplified several times by staff themselves. This significantly helped staff buy-in into the process.

While staff were always made aware of why DEMOS was embarking on such activities, when caught up in their ongoing work and being eager to perform well, they did not always see why this process was so important as to entail so much more work for them. It is to be noted that focus groups, when first introduced into an organization, require considerable training as well as time spent on the actual facilitation, so they are very time consuming and intensive. Additionally, the first focus groups do not usually yield very accurate results because staff are still learning and the facilitation is mostly aimed at training purposes. This tends to decrease motivation. DEMOS's management has tried to focus more heavily on **communication of the process to staff** and on using their suggestions about trends in the market (a separate and important item of staff meetings) when deciding to explore a new issue.

- **Staff turnover**

For the first three years staff turnover at DEMOS was perceived to be high. Turnover affected all levels of the organization, including management, administrative staff and loan officers. In fact, while it represented only about 30- 40% of total staff over a period of three years, every departure was critical and led to severe shortages of skills and the need for rapid adjustment due to the small size of the

⁴ MFC – Microfinance Centre for Central and Eastern Europe and the New Independent States is a membership based resource centre based in Warsaw, Poland. For more information about the MFC see www.mfc.org.pl.

⁵ More information on the tools test can be found at www.mfc.org.pl/research; for more information on MicroSave tools see www.MicroSave-Africa.com.

organization. Microfinance being a new industry in Croatia, the skills and type of personalities best suited for it were not yet well understood, and staff who were enthusiastic about working with DEMOS sometimes realized that the work required of them did not match their own personal talents and motivation. Finally, while DEMOS always focused heavily on training of all kinds, people often outgrew their job descriptions. However, there was little space for promotion beyond senior loan officer or trainer, given the small size of the organization at the time, and this led some staff to leave. Turnover was an added challenge to the process of client assessment because staff trained in the use of some tools and/or data analysis would suddenly leave the organization. This usually meant that management had to carry out the process themselves for a while and that in the meantime training had to be conducted all over again, leading to inefficiency in the process.

In order to deal with this situation, the focus has been placed on systematic staff training in relation to the client assessment process, including the design and feedback stages, so as **to ensure that staff feel part of this approach** and to decrease staff burn-out. As much as possible, the market research/client assessment team is composed of administrative staff who tend to be more interested in such processes and less attached to clients. A bonus for the performance of the market research team (based on quality of data gathered, facilitation and data analysis), has ensured higher reliability of the results and created more team work (the bonus is shared amongst all members of the team equally – see the chart). Cross-training is also being promoted now, not necessarily with management involvement. Staff turnover has been decreasing in the past nine months, potentially because greater knowledge of microfinance amongst management and staff leads to better staff selection and understanding of the skills required from the start. Finally, the process has gradually become institutionalized in that **it is an inherent part of the ongoing lending activities** and can no longer be dissociated from them. The components/actions that facilitate the institutionalization of the system are as follows:

- The management information system is analyzed either on an ongoing basis (loan tracking system) or quarterly (monitoring and exit forms, except for the first monitoring visit to take place one month after loan disbursement). It is documented in reports highlighting key issues.
- All steps related to client monitoring and exit analysis per type of loan are included in the credit policies and procedures manual.
- Staff training on market research and facilitation is conducted as needed.
- There is a performance related bonus for the market research team.
- The loan officer bonus is linked to the quality of their monitoring.

Frequency of monitoring is meant to ensure buy-in into the system and greater motivation for what may be perceived as added work. At this stage, such research is no longer viewed as “extraordinary” and exceptional, rather it is part of maintaining high performance and takes place on a routine basis. **Everyone in DEMOS is involved in client assessment**, from field staff providing input on client satisfaction and conducting monitoring visits, to administrative staff involved in market research and data

Team Bonus for Market Research			
Project:	Total No. Of focus groups:		
Name :	Team members:		
Date Completed:			
Please circle the option that corresponds to this quarter's performance.			
	No of groups	Bonus per team member:	Total
1 Attendance (No. of participants)			
a) Group of 4-5 people	_____	x 10 Kn	_____
b) Group of 6-7 people	_____	x 15 Kn	_____
c) Group of 8-10 people	_____	x 30 Kn	_____
2 Quality of facilitating			
a) Poor	_____	x 0 Kn	_____
b) Average	_____	x 15 Kn	_____
c) Good	_____	x 30 Kn	_____
3 Quality of recording			
a) Poor	_____	x 0 Kn	_____
b) Average	_____	x 10 Kn	_____
c) Good	_____	x 20 Kn	_____
4 Quality of data analysis			
a) Poor	_____	x 30 Kn	_____
b) Average	_____	x 70 Kn	_____
c) Good	_____	x 100 Kn	_____
			TOTAL: _____
Approval: _____			
Manager/TA _____			

analysis, to management providing reports and feedback to staff for future product modification. **Client assessment is used for every aspect of DEMOS's operations**, including not only lending activities, but also non- financial services, strategic planning (especially through the environmental analysis), human resources management and fund-raising, to name only a few.

However, for greater institutionalization, certain aspects of the process need improvement. Firstly, because the environment changes so fast and DEMOS is a small organization, feedback to staff on using the results of the process tends to be lacking, mostly because of workload. While staff are inherently part of the research and the implementation of the changes, they often miss the link between both. The approach should be reviewed to allow staff to better analyze their own client results, rather than rely on management conducting the analysis (especially for analysis of program exit). In this way, further staff training on facilitation and probing would enhance the use of simple monitoring forms, which can then be revised to save time.

Likewise, institutionalizing the documentation is still insufficient, i.e. all approaches, tools and systems used are documented with specific rules, policies and methods; however this is still documented separately from the key manuals such as the credit policy or human resources manual. In other words, although monitoring and exit forms are included in these manuals, the client assessment process in itself is still separate, as is the market research bonus system.

While staff understand the point of the process for monitoring delinquency or retaining clients, they are still not quite clear on the benefits of such a process in measuring impact. This is also due to the fact that at the time, measuring impact was not a priority for DEMOS. But after over three years of lending activities, it is time to develop some simple impact indicators and include staff in this effort so as to ensure that DEMOS will reach its **social goals**. In this process, DEMOS will pursue its recent initiative of including some **new impact indicators** in its loan tracking system with the software provider, and start a broader process of impact analysis with the staff.

COSTS AND BENEFITS

1) Financial and opportunity costs

Many institutions interested in setting up such a system will wonder about the costs of both developing and maintaining it. The costs below do not include the development of an MIS, given that this is considered necessary for any type of MFI, even ones not engaged in client assessment. As of July 2002, DEMOS started tracking the costs of this process through a separate budget for the development and maintenance of such a system, specifically for Business Development Services (BDS) introduction and market research (read further information in the Annex), therefore the direct costs were relatively easy to calculate for this second year.

	Development Phase⁶	Maintenance Phase⁷
Direct costs <i>Market research and other costs (internship, part of office supplies, one computer, travel and accommodation for focus groups and assessments, 20% of coordinator and manager's time, a few days of technical advisor time, indirect costs related to designing monitoring forms, preparing a competition analysis, training, data collection, data analysis, product design and reporting)</i>	\$270/month (average)	\$390/month (average)
Opportunity costs <i>Free training and pilot-testing, staff time</i>	\$700/month (average)	\$490/month (average)
TOTAL	\$22,860 (13,5% of total revenue)	\$10,560 (4,3% of total revenue; \$12,32 monthly/client)

More challenging is the estimation of the opportunity costs related to this process. In DEMOS's case, opportunity costs consist of staff having less time available for program outreach and administrative work. This has been estimated to represent about one day per month for six people, i.e. a total of about \$210 a month. However, given that one of the direct benefits of this process has been reduced delinquency and less time spent by DEMOS on delinquency management, it is unclear whether \$210 represents the true

⁶ 18 months (the period of July 2001 to December 2002). The average number of clients for this period accounts for 303, total revenue is \$169,695.

⁷ 12 months (the period of January 2003 – December 2003). The average number of clients for this period accounts for 857, total revenue is \$247,841.

value of the opportunity costs or an overestimation of them. Opportunity costs for administrative staff are mostly reflected in extra hours worked, having implications on motivation (partly compensated by the bonus system). This amounts to about \$60 per month and an additional \$60 in bonus, i.e. \$120 per month. Free training and assistance within the Imp-Act Project⁸ and pilot testing of tools are another clear opportunity cost to the program and can be estimated at \$9,180⁹.

Management opportunity costs - designing the tools, informing/training staff and designing new products - are viewed by DEMOS as an inherent part of management functions because innovation is a critical aspect of the management role. Therefore it is not perceived as an opportunity cost, but for the sake of providing the complete picture on opportunity costs it is included in the calculation and amounts to \$160 per month.

One should note that the highest costs were incurred at the beginning and as the new activities became part of the operations, their costs decreased (even though the system evolves over time).

2) Benefits and Results

This process has brought about many benefits for DEMOS, as shown in the following tables (table 4, 5, 6 and 7):

- Increase in demand and subsequent volume of activity due to product development/refinement thanks to the fact that the DEMOS team can now make informed decisions regarding client needs.
- Portfolio quality improved in 2002 due to the introduction of individual (collateralized) loans in urban areas and the adjustment of loan parameters to the specific target group in Western Slavonia. In 2003, portfolio at risk increased due to an increased delinquency with SME loans (higher loan sizes have a larger effect on portfolio quality), which is currently being solved.
- Broader outreach: in 2001, the number of active clients went up by 446% compared to the first year of lending, and this rising trend was sustained in 2002 with the number of active clients being 87% more than in the previous year.
- Enhanced institutional capacity (skills) and efficiency. (While costs of running such a system exist, the direct decrease in outreach efforts as a consequence of a systematic client approach should not be underestimated)
- Greater ability to respond to market changes (faster response) and better ability to survive (all the more so in a very competitive environment such as Croatia).
- Risk reduction thanks to diversification of the portfolio and the basis for more informed decision-making through market research.

Year	Active clients (number)	Growth (%)	Portfolio at risk (>30 days)	# of products	Product types
2000	54		0%	1	group loans
2001	295	446	4%	2	group and individual loans
2002	551	87	1%	4	group loans for milk production, group loans for other agricultural activities, SME loans
2003	1162	111	2%	5	all of the above as well as group loans for sheep and goat raising, consumer loans

- General improvement in performance: financial indicators improved overtime. As an example, thanks to higher demand, portfolio increased and general efficiency improved.
- Recognition in the industry as a dynamic innovative institution.
- Strengthened market position. Thanks to this approach, DEMOS has become the strongest MFI in Croatia. DEMOS offers more loan products than any other MFI there and has the largest number of clients with the best portfolio quality.
- Increased client loyalty. Clients are more aware of the interest of DEMOS to support them in their businesses and improvement of their lives (table 7).

Year	Administrative Efficiency (%) ¹⁰	Operational Efficiency (%) ¹¹
2000	122,65	173,23
2001	84,29	132,19
2002	41,36	77,12
2003	19,91	46,59

⁸ More information on Imp-Act - the Ford Foundation sponsored global action-research program designed to improve the quality of microfinance services and their impact on poverty by developing impact assessment systems can be found at <http://www.imp-act.org/>. More information on the regional work conducted within the project is available at www.mfc.org.pl/research.

⁹ 20 days technical assistance in qualitative research (14 days - training in conducting FGDs and PRAs, 5 days - data analysis training, 1 - discussion on initial system concept) including travel costs; participation of two Demos staff in three-day Client Assessment for Microfinance Training Course.

¹⁰ Administrative efficiency = (administrative expenses + in-kind donations in personnel)/average net portfolio outstanding

¹¹ Operational efficiency = (operating expenses + in-kind donations personnel)/average net portfolio outstanding

- Increased competitive advantage on the funding market. The market research conducted in the summer of 2003 and presentation of the results in ECRA (Economic and Community Revitalization Activity) proposal increased DEMOS's chances to secure ECRA funds.
- Strengthened staff capacity. Staff have better skills and improved knowledge of clients.

It is very difficult to evaluate the financial benefits derived from this process. Indeed, if DEMOS had not embarked on client assessment, a part of the funds would still have been outstanding with clients and would have yielded some operational income, and the difference between this level of income and the current one would represent the added benefit of the system. As one can imagine, this is hard to calculate. However, as a point of illustration, the revision of the loan product for milk production in itself generated an interest income of \$260,000 cumulatively since July 2001 with a portfolio disbursed of US\$1.3 million. Much in the same way, the new consumer loan product already represents 10% of active loans after four months and the sheep and goat loan product represents 5% of the outstanding portfolio in three months. Additionally, introducing new products has convinced "rester" clients to join the program again. The institution's books show that the organization has gone from having idle funds to a desperate need for funds in order to match the high level of demand. This is a powerful statement of how successful client assessment has been for DEMOS.

Therefore, while the costs may appear high and the process cumbersome for staff at times, they appear quite small if compared to the benefits derived.

Strategy	Initiative	Indicator	Measure	Period considered
Market penetration	Introduction of incentives for follow-on loans (2001)	Retention	Increase from 50% to 86%	Since July 2001
	Succession of business training for group loans (2001)			
New product development strategy	Introduction of loan product for milk production	# active clients	Increase by 54%	2001-2002
		Portfolio size	Increase by 50%	2001-2002
	Design and pilot test of pig production loan with BDS component	# loans disbursed	50	Jan-March 2003
	Design and pilot test of consumer loan	# loans disbursed	110	Aug-Dec 2003
Product diversification strategy	Introduction of SME loans in new location	# loans disbursed	50	2001-2002
	Design, pilot test and roll out of loan product for raising sheep and goats		47	Aug-Sep 2003

Delinquency Problem Solving (July 2001)	Introduction of individual lending methodology in urban areas (instead of group lending)	On time repayment rate	Increase from 94% to 99,5%	2001-2002
		PAR (>30 days)	Decrease from 4% to 1%	2001-2002
Introduction of the new agricultural law (eligibility criteria for subsidies) – November 2002	Revision of milk production product – increase in loan size	Loans disbursed	113	May – Nov 2003

CONCLUSIONS

The DEMOS team started its process of client assessment in July 2001 and has developed it gradually. This approach has helped DEMOS become more aware of client needs and thereby improve its performance and situation in the market. The experience of DEMOS shows that such an approach is feasible even within a small institution, in fact it is often the only way for a small institution to survive in a competitive environment.

A factor crucial to the DEMOS initiative was an impetus drive from outside parties (in this case the support brought by the MFC and the technical advisor to DEMOS). As more MFIs move in this direction, additional support is available in this field of work.

Some of the lessons learned from DEMOS's experience are that **staff motivation is crucial** to the success of the process and obtaining their buy-in early on will ensure that the process is not only accepted but understood and indeed welcomed. In terms of costs, **the process can be viewed as an investment at the start, because its costs are reduced when it becomes systematic and institutionalized.** Institutionalization implies incorporating the approach into daily activities, and this also improves staff buy-in as it is no longer perceived as an additional or separate project. DEMOS has become a stronger institution thanks to the institutionalization of the client assessment process, and is planning to further improve it and make it more efficient in the years to come.

ANNEX 1: Croatia and Microfinance

Croatia¹² has a population of 4.4 million, of whom 59% live below the national poverty line. The macroeconomic situation is relatively stable with a low annual inflation rate of approximately 2%. The unemployment rate has been steadily decreasing to its current level of 23.8% and is expected to remain low over the next period, albeit with many regional disparities.

▪ Croatia after the war

In the war-affected areas, most of the infrastructure was destroyed, and the structure of the local economy was in shambles. More importantly, recurring ethnic tensions meant that social cohesion itself was at stake. Many settlers from Bosnia were occupying houses of Serbs who had left the country during the war. Additionally, the many grant programs during the period cultivated a sense of dependency among the population affected by the conflict. However, these programs had almost entirely stopped by 2001, and donors were turning towards economic development, such as microfinance, that had the potential to help populations return to their areas of origin. Political tensions eased significantly, and by 2000 the banking sector emerged from the 1998 crisis consolidated and stronger.

Indicator	Croatia	Bosnia & Herzegovina	Serbia & Montenegro	Kosovo
GDP per capita in US \$	5,057	1,463	2,370	3,807*
Inflation %	2.3	3.5	19	n/a
Unemployment rate %	23.8	40	28.1	Estimated 40%

*2001 data

▪ Needs and challenges for Microfinance

The need for microfinance in Croatia is acute. Because services exist and banks are stronger than they have been in the past, there is a misconception that the Croatian population is well served with financial products. Five years of USAID-funded MFI experience in the field prove the contrary. The gaps in the supply of small credit are to be found both geographically and functionally (in terms of access to credit and in underwriting criteria). Regionally, most MFIs work in the war-affected areas of Croatia where banks have a presence only in the larger towns. Banks do not promote their operations in villages that are sparsely populated and often over an hour away from the main towns, and they expect prospective applicants to come to their offices. Although some banks recently introduced the concept of personal bankers, they do so only in urban areas. The villages gather the most economically vulnerable population. Alternatively, all government programs are developed for people who have guarantees and property, and are usually disbursed through banks. In contrast, MFIs attempt to serve a whole gamut of individuals, from the very poor to small and medium-sized entrepreneurs who need more flexible conditions and personalized services.

Specific to the Balkan region is the fact that while banks could theoretically use land and property as guarantees, property ownership must be registered in court and all owners need to agree with this settlement. However, such records were often stolen during the war and it is difficult to ascertain ownership of the property. Litigations can take years, thus banks tend to refuse property as a loan collateral in war-affected areas. Banks resort to expensive notarized services for property valuation, which adds to the costs of the loan, and they tend to refuse movable property unless it is very well secured. This specific issue, combined with a longer approval process and other more stringent requirements for guarantors, implies that while bank interest rates may appear quite competitive, access to these loans is difficult and inherently selective. MFIs in Croatia typically offer a personalized service and more flexible guarantees as well as clear and transparent justifications of the rationale for approval or rejection of an application.

Functionally, microfinance first and foremost offers access, and this rule applies to Croatia as well.

Microfinance in Croatia remains small in terms of breadth of outreach (number of active clients) and number of institutions, compared to neighboring countries with similar or lower population levels, while the average loan size is typically higher, as shown in the table below. Only three MFIs in Croatia serve the population, primarily in war-affected areas, compared to many more in equally depressed areas in neighboring countries.

	Croatia	Bosnia & Herzegovina	Serbia & Montenegro	Kosovo	Albania
No of MFIs	3	18	7	7	5
Gross loan portfolio	3,9 mil \$	62 mil \$	12 mil \$	11 mil \$	17 mil \$
No. of active clients	2,400	57,440	13,532	9,428	10,235

Source: Forster S., Greene S., Pytkowska J. (June 2003), "The State of Microfinance in Central and Eastern Europe and the New Independent States", CGAP Regional Reviews. Only MFIs that reported to the MFC (Microfinance Centre for Central and Eastern Europe and the New Independent States) in December 2002. There are effectively over 35 MFIs operating in Bosnia and Herzegovina and over 10 in Kosovo, therefore the above figures are not complete.

The smaller scale of MFIs in Croatia stems from several factors, both positive and negative:

1. Heavy taxation burdens both MFIs (in the form of taxes and contribution on salaries) as well as microfinance clients (fear of starting or registering a business) and increases costs of operations. In Bosnia and Herzegovina, Serbia and Kosovo, the laws that regulate businesses are more flexible and enable clients to run a business in a friendlier environment;

¹² for more information on Croatia, please see www.hnb.hr.

2. In other countries, particularly in Bosnia and Herzegovina, lobbying has successfully resulted in the creation of a microfinance law that enables MFIs to work as non-profit organizations. The lack of such a law in Croatia forces MFIs to adapt the clumsy and expensive legal form of an SLC (Savings and Loan Co-operative), which is NOT the optimal legal form for an MFI due to high transaction costs;
3. Most importantly, limited donor activity in the past makes it challenging for MFIs to grow their portfolios while keeping their current clients (for greater social and economic impact). Donors invested relatively small amounts into Croatian MFIs so far, especially compared to Bosnia Herzegovina.
4. The advanced economic situation (compared to neighboring countries) implies more permanent employment opportunities, making self-employment less attractive than in other Balkan countries;
5. Linked to this point, the tradition of entrepreneurship is less developed in Croatia than in Kosovo or Serbia.

Additionally, the regulatory landscape is not conducive to microfinance. Indeed, while the need for pursuing microfinance services is recognized, the current Croatian legal framework hinders effective delivery and prohibits long-term expansion and sustainability of MFIs. A microfinance law in Croatia was rejected after years of lobbying. The current savings and loan co-operative law prevents equity investment, sets interest rate ceilings, taxes and requires frequent and heavy reporting to the Croatian Ministry of Finance (MOF).

ANNEX 2: Strategies selected by DEMOS through a client-driven approach

▪ Example 1: Market Research of July 2001 as Part of the MFC’s Pilot Testing of Microsave Tools

DEMOS was selected by the Microfinance Centre to pilot test a new market research methodology designed by the Institution “MicroSave”. The 13 market research tools are administered in the form of Participatory Rapid Appraisal (PRA). The Microfinance Centre research expert visited DEMOS for two weeks. For this research, nine of the existing 13 market research tools were used.

Throughout the process, DEMOS staff gained new skills in administering the tools and in group facilitation and recording. Results were recorded and translated into English on a daily basis. Analysis started during on-site research and was intensified after the MFC expert left.

The study was divided into two phases. During the first phase the rural area of DEMOS’s operations was investigated. Then the research was carried out in Karlovac. The choice of areas was determined by the high concentration of DEMOS clients there. A total of 19 focus groups of approximately six participants each were conducted in six different locations. 14 focus groups in the rural area were conducted with people engaged in milk production or animal husbandry. The other focus groups were administered with clients and non-clients engaged in trade and services and operating in towns. Such stratification was determined by high concentration of such business types in rural and urban areas accordingly. This was supposed to enable comparison of the needs of different target population strata.

In rural areas and while ranking the relative importance of the loan parameters both with clients and non-clients, loan term and guarantees were ranked as very important, especially for poorer people. Interestingly, another attribute highly ranked by all the groups was grace period. Most of the respondents interviewed were people engaged in milk production and their concern revolved around purchasing cows from the loan money. When people buy a cow that is supposed not to be pregnant they can never verify this information. Even though a cow is not pregnant it may become pregnant during the first two months after the purchase. The best solution to manage this risk is to buy a cow in the state of “high pregnancy” (the last month of the pregnancy) and have the possibility to sell the calf then. The problem with such a cow is that it does not produce any milk for the first three months and no income can be generated during this period to repay the loan. Current coping mechanisms people apply are to use pensions, borrow money from friends and relatives or use the income generated by other cows/other income-generating activities to repay the loan. But not everybody has additional cows to be able to cover monthly repayments when the investment is not generating return, and not everybody has access to additional sources of money. That is why the lack of the grace period seemed to exclude some groups of people from DEMOS’s products. These would be relatively poorer people – the ones that do not have enough cows or do not have any additional source of income or financing. Some non-clients said that without a grace period and with no access to additional sources of financing, the only solution for people would be using the loan money at the beginning to repay the loan (this may be a possible explanation why some people tended to overestimate the loan amount needed for their investments in business plans).

Participants also mentioned loan sizes could be better adjusted to the loan purpose, type of business, household income level, business advancement, and to have fixed amounts in order to plan ahead exactly what can be purchased with the loan. The lack of communication over the exact loan size and subsequent disappointment when the amount requested was cut was a great source of client dissatisfaction.

In urban areas, people were aware of regulatory issues and solidarity groups were not taken seriously as a guarantee mechanism, also due to the lack of social cohesion.

Based on market research findings, the following modifications were introduced:

- Introduction of a

Loans for cows	Loans for agriculture
<ul style="list-style-type: none"> ▪ Loan size: 1020 EURO for cow without papers 1280 EURO for cow from selection ▪ Loan term: 12 months with grace period of 3 months ▪ Interest rate: 1,33 % per month (flat rate) ▪ Upfront fee: 5% for the loan processing and review 	<ul style="list-style-type: none"> ▪ Loan size: 620 EURO ▪ Loan term: 6 months ▪ Interest rate: 1,33% per month (flat rate) ▪ Upfront fee: 4% for the loan processing and review

specific loan product for cows ,with a higher loan size depending on whether or not the cow has got selection paper. Subsequent loans for clients interested in additional cows with the same amount and a term without a grace period. This only applies to a group where all members already have cows. Village level clients to be offered an individual loan product if they have been clients with the program for three cycles and have a demonstrated need to expand their

- projects (for example, they may need a tractor).
- Introduction of a loan specifically for the purchase of cows and refinement of the existing group loan for other agricultural activities as per the table below.
- In urban areas, refinement of the current micro-loan by modifying the guarantee requirement through a shift from group loan to individual lending in urban areas to prevent delinquency.
- For all loans except individual loans, secession of the business training that was viewed as either a burden or as intimidating for most clients. It was decided that for the time being this business training would remain in urban areas for the purpose of added monitoring. Business plans tailored to milk production clients were designed in rural areas.

Table 11. Individual Loans for Small Businesses
<ul style="list-style-type: none"> ▪ Loan size: max. for the 1st loan 1,020 EURO ▪ Average amount: 765 EURO ▪ Loan term: 6 - 10 months ▪ Interest rate: 1,33% per month (flat rate) ▪ Upfront fee: 4% for the loan processing and review

2) Example 2: Linkages with Business Development Services organizations and farmers.

While DEMOS had done well in establishing systems, controlling delinquency, and becoming relatively efficient, it became clear after two years of operations that DEMOS needed to seek alternative market channels. The key to sustainability for DEMOS lies in differentiating its services in rural and urban areas. Initially DEMOS provided business training to clients who applied for the first time to help them generate business ideas and gauge viability. Animal health seminars were conducted in parallel, with the help of a veterinarian. However, these services were provided free of charge, and on an ad-hoc basis. Further BDS project ideas stemmed from clients’ needs and loan officer input regarding market gaps.

Given that BDS services are expensive and require expertise, DEMOS decided early on that its comparative advantage lies in the provision of credit, and that the organization would outsource most BDS services and stay away from direct provision as much as possible in view of the available supply. In doing so, DEMOS would develop critical partnerships with other BDS organizations and the private sector. DEMOS’s goal in entering BDS was not only to satisfy clients’ needs, but also to increase demand for loans and improve retention. Services are currently either offered for free, or factored into the loan size. This form of pricing structure may be modified at a later stage depending on the market and on the success of the current pilots. However, an added challenge for DEMOS is that in Croatia, while there is strong demand for market linkages, there has also been a tradition of donor-driven BDS provision with no cost-recovery goal. DEMOS started working on three BDS projects, one of which is presented below.

In the design of products tailored to the pig market and its linkages with buyers, DEMOS obtained information from staff (loan officers), clients (current and potential), and BDS organizations. DEMOS did not organize focus groups but compiled all the feedback received to-date and worked with the BDS organization in determining the most appropriate product parameters and delivery process.

DEMOS partnered with FLAG International to disburse loans for piglets to farmers. FLAG is helping farmers raise a certain breed to a specific weight and meet feeding requirements to obtain high quality pigs. The pigs were sold to pršut processors in the South of Croatia via co-operatives, therefore not only sustaining farmers and processors, but also revitalizing the market linkages. The project was designed in November 2002 and implementation began in February 2003. Pig producers will gain significant benefits from the program, and will have firm market linkages with Drniš pršut producers who will provide forward contracts and guarantees on purchasing their entire pig production for the next year. The increased quality of production will help pršut producers create a brand name for their product.

The role of the organizations participating in the project is to facilitate the supply of the pigs to clients, to monitor the quality of the pig -raising process and to monitor the loan repayment. DEMOS loan officers have worked alongside FLAG staff to select loan recipients, and tailor their business plans to this specific business activity. Loans were approved in joint loan committees and the DEMOS loan officer is visiting clients with the FLAG expert. Pigs are being delivered to clients, and monitoring will also take place in pairs to verify the state of the business and to give advice to the farmer in raising the piglets, thereby preventing loan delinquency. This project is innovative in that it intends to create market linkages among the rural, less developed areas in the North-West and in the South, and to improve brand name for Croatian processors. If the pilot project is successful, a new cycle will be initiated in the coming year with a larger number of clients.

Overall, achievements of this pilot test to-date have been:

- connection of the producers to the market at a fair sales price;
- strengthening of the co-operatives (all the supply of pigs) being carried out through them;
- development of a Croatian pršut brand with high quality raw material.
- DEMOS has increased knowledge of clients’ businesses so as to better tailor lending activities to their needs and is seeing demand for loans emerging from the pršut processors as well.