

Summary Report: Second Annual Responsible Finance Peer Exchange for DFIs FMO Headquarters, The Hague, Netherlands, January 28 2011

The second annual DFI responsible finance consultation was hosted by FMO, with KfW and CGAP as co-organizers. The peer exchange on implementing the client protection principles (CPPs) attracted nine DFIs: FMO, KfW, ASDB, CDC, EIF, EIB, IADB, IFC, and OPIC . In addition, two MIVs -- Incofin and Finance in Motion (manager of EFSE) – were invited to share their responsible finance experience.

The agenda (attached, along with the presentations referred to in summary below with *) was designed to promote candid exchange on progress and challenges in moving from principles to implementation. The opening discussion provided an opportunity for participants to share observations from the January 27 Responsible Finance Forum, including reflections on the specific implications for DFIs. This was followed by a “deep dive” on measures to prevent and mitigate the effects of **client over-indebtedness**. Finance in Motion presented contrasting data and analysis from Bosnia and Kosovo, and shared the “systems approach” and concrete actions being taken by EFSE and the EFSE Development Facility to address over-indebtedness in Bosnia.

The next session focused on **current practice in due diligence**. After CGAP briefly introduced the updated [Investor Guide](#) and [due diligence checklist](#), FMO and KfW described how they are beginning to mainstream client protection into their screening and assessment processes. FMO shared early lessons from applying the CPPs to consumer finance investees and working with them to identify weaknesses and provide incentives to implement an action plan. The KfW presentation included due diligence tools that are being developed to assess responsible finance issues at the micro, meso and macro levels. INCOFIN then shared its experience with a tool that scores potential investees based on their client protection and social performance.

Following lunch, FMO presented findings from recent analysis of its **consumer finance** portfolio and key points from the proposed policy on financing this sector that the FMO Board will be considering this month. The next session focused on the role of **DFIs as equity investors** – how they are approaching their governance roles, key “hot button” issues in the Board room, and avenues for strengthening responsible finance through active governance. The closing session provided an opportunity to reflect on **next steps for DFIs** in client protection and the broader concept of “responsibility” suggested by the Principles for Investors in Inclusive Finance.

Highlights of presentations and discussion:

- **Challenges in implementation of CPPs.** DFIs face challenges in implementing the CPPs, including: lack of good practice standards/benchmarks; uncertainty about what to do if financial service providers (FSPs) behave irresponsibly or have deficiencies; and disincentives due to factors such as disbursement pressures or short time horizons for exit. Among the solutions suggested were that DFIs can exercise their governance roles to raise awareness of CP among investees, provide TA funding for improving FSP practices, reward responsible behaviour with improved financing terms, and ensure that their own behavior is responsible (for example, in estimating demand, practicing fair competition and collaboration with other investors, funding in local currency or managing forex risk).

- **Due diligence and screening.** KfW* uses a “traffic light” system to warn its investment officers to probe deeper when there are potential responsible finance problems. The check list, which applies to the entire financial sector portfolio, has red/yellow lines – that is, “no-go” or “proceed cautiously” clusters of indicators at the levels of the retail institution and the market. INCOFIN shared information on its social score card that includes assessment of investees’ client protection practices, ethical business behaviour and social performance; a next step is to adjust the weights so as to set minimums for some indicators and enable clearer “no-go” decisions. Partners are re-assessed once a year and 80 have been scored so far.
- **Over-indebtedness and credit bureaus:** Finance in Motion* shared interesting lessons learned from its over-indebtedness studies in Bosnia and Kosovo (new data from Kosovo shows much lower levels of over-indebtedness than in Bosnia – they posited that one likely factor is the existence of a functioning credit bureau to which all MFIs have reported for the past 5 years). KfW is putting more emphasis on credit bureaus in its due diligence and has developed a checklist for staff to analyse the effectiveness of the credit information sharing at the country level.
- **Consumer finance:** DFIs have different opinions about how to address consumer finance. Some such as KfW limit the amount of consumer finance activity in the overall portfolio and in the loan books of individual investees. Others, like FMO*, regard consumer finance as one legitimate dimension of offering financial services, including to low income (although usually salaried) clients. FMO has developed a new policy around financing of this sector to address potential consumer protection related issues. It takes a risk-based approach that focuses in-depth client protection diagnostics and improvements on higher-risk investees. FMO commissioned a Smart-certified assessor to review client protection policies/practices (paid for by the investees) of 2 Uruguayan consumer finance companies. The assessments resulted in a negotiated action plan; if the investee implements the plan to the agreed-upon standards (as certified by an independent audit), it will get a 25 basis point discount on its financing. The Board will review the proposed new policy this month. Staff is generally very supportive of this – see CP risk as very intertwined with the business risk. Next FMO will do analysis of MFI business models re how to draw risk lines and allocate due diligence and monitoring resources. FMO considers high ROE/NPL/APR as danger cluster for consumer lenders (and probably for MFIs). KfW has a similar list of “alarms” in its traffic light system.
- **Role of DFIs as equity investors.** DFIs have quite varied and evolving approaches to their role as equity investors (i.e., whether to insist on a Board seat, who serves in that role, which committees to serve on, whether to promote independent Board members, etc.). A number expressed growing concerns about their liability as Board Directors or even representatives on Advisory Boards or Investment Committees.¹ Others view active governance as an essential element of being responsible investors and actively promote client protection in their Board roles (and sometimes in their shareholder agreements). One key point that came out was that while many screen for responsible practices and double bottom line performance at entry through their due diligence processes, ongoing oversight through regular reporting and monitoring is less common. Several DFIs reported tensions within the Board around social performance reporting, etc. Several DFIs such as the IFC have some sort of annual training or induction for board members and would find a well-structured module on client protection and responsible finance to be useful.

¹ EIB and IADB take observer status only for liability reasons, FMO only takes a full seat or none for liability reasons, IFC no longer automatically accepts a board seat – need to justify for liability and cost reasons. FMO mostly uses external board members while KfW has a legal requirement that board seats are only taken by senior KfW staff. Incofin has its senior staff taking board seats. Like FMO, IFC and EIB they support independent board members. Most have a maximum number of mandates (4-5).

- **Shareholders.** Existing owners need to be clear about implications of different financing strategies and who will be joining them in the Board room. It makes a big difference if the next ones in are PE firms with very high return expectations and a very short time horizon (point made at the Responsible Finance Forum the previous day by Emile Groot, FMO: “we need to not demonize but also not encourage entry of these guys who walk in and the only question they have is ‘how quickly can I walk out with a 3-4-5 times pay-out?’”) vs. investors with a longer time frame and very different risk-return preferences (Matthias Adler at DFI consultation: impressed with the Dutch pension funds -- this is who we should be wanting to provide our exit as DFIs). The INCOFIN representative described their tool for Board self-assessment – its composition, operations and processes. He stressed the importance of active governance: “Our entry to MFIs is the Board – let’s take advantage of this to improve the MFI. Where there were problems/work-outs, there was usually a correlation with weaker governance.”
- **Hot-button issues in board rooms:** A new generation of controversial issues related to responsible finance is beginning to emerge in some board rooms. These include parameters for retail provider growth rates, profit targets, executive compensation, and financing strategies. They can also emerge as DFIs and other social investors plan their exit and consider which new debt and equity partners to invite into the ownership structure. The CDC representative and other DFIs notes that they negotiate most of these conditions up front and integrate CPPs into their investment policy. EIB and others require social performance monitoring to keep an eye on the double bottom line and responsible practices over time.
- **Funders of funds.** Indirect investors have additional challenges in implementing responsible finance. Rather than handing off accountability for responsible finance to the next player in the value chain, there is a need to include references to responsible finance up-front in shareholder agreements.
- **Costs of responsible finance improvements for FSPs and fund managers:** Several DFIs voiced concerns about the potential burden on their partners, both on retail MFIs and on the MIVs, which are operating on rather thin margins these days. While it is still rare for a DFI to screen a potential partner on the basis of poor client protection practices and policies, it is not yet clear what are the best ways to support thorough diagnostics (which are relatively costly) and improvements through action plans. In the FMO presentation entitled “It Ain’t Easy” on conducting client protection due diligence of the Uruguayan consumer lenders, the analyst stressed the staff time and knowledge that was required, as well as the challenges of finding the right experts, making a proper action plan for improved practices, and staying the course in a top-to-bottom culture change that might take several years before clients actually start noticing the difference. Interestingly, both Finance in Motion and INCOFIN got their investors to agree to assign 2% of the profits to a development facility/TA for investees. The IADB/MIF representative noted that this DFI has a TA component to help partners, but also commented that it may be a challenge to balance client protection improvements with seeking out second- and third-tier partners. The AsDB representative pointed out that it is important that this not be just another compliance exercise – adequate commitment and resources are needed to bring about more fundamental changes.
- **Strong interest in collective action in potentially overheating markets:** DFIs have been engaging with other investors and stakeholders in several countries (e.g., Peru, Bosnia, Morocco) to explore collective action that might be appropriate in markets at risk of overheating, over-lending and client over-indebtedness.
- **DFIs raised concerns about bad press and impact questions.** Several DFIs have been dealing with the press (though most severe in Germany). INCOFIN commented that for the first time a potential investor (a large bank) had withdrawn from a deal (after significant due diligence) due to bad press for MF. It was joining with several other organizations to support some longer-term independent research on client impact and social performance. Participants expressed interest in receiving

materials from CGAP and others that addressed issues of impact, reputation risk for the sector, and developments in hot spots such as Andhra Pradesh.

In sum, the consultation revealed that many of the leading DFIs are making serious efforts to move beyond endorsement of the CPPs to implementation, with a focus so far on integrating emerging minimum standards and good practices into their screening and due diligence processes. Some are also beginning to work with investee partners to improve client protection practices. This work to bring about improvements in retail providers' policies, products and practices requires strong assessment skills, time, resources and experimentation to identify specific measures that are practical and cost-effective. Rewarding more responsible practices through DFI financing on more and better terms is a new development that merits attention.

Another new focus is on active governance by DFIs and fund managers; further discussion is needed on how equity investors can best translate their commitment to client protection and responsible finance into action throughout the governance process. One more new frontier is collective action by investment organizations to tackle market-level concerns such as fast growth, multiple lending and the potential for over-indebtedness. The industry will benefit from continued exchange and candid dialogue on responsible finance across the investor community and between investors, their partners and other stakeholders. There is no blueprint yet, but the ongoing learning process is achieving discernible progress towards industry consensus on acceptable behavior.