

Responsible Finance: Putting Principles to Work

Early microfinance pioneers created the sector with the aspiration to improve poor people's lives. There were huge swathes of "white space" where low-income households had little or no access to formal finance. This challenge, in turn, demanded sustainable and scalable models for delivering adequate financial services to poor people.

This is the essence of the double bottom line in microfinance: a social commitment to benefiting clients married with a financial commitment to operating profitably. In the long run, these two objectives do not contradict each other: doing right by all stakeholders is the only long-term sustainable business solution. Over time, the market should reward retail providers that adequately protect clients' interests, affirmatively treat them well, offer a product line responsive to their needs, and deliver good value for money. In the short run, however, tensions can arise.

Tensions are evident in the microfinance sector—in the recent repayment crises, local microcredit markets suffered from overly rapid growth, resulting in loss of credit discipline, multiple lending, and instances of over-indebtedness. There were powerful social and financial reasons to scale up quickly, and investors were eager to back this rapid expansion. In retrospect, however, we see that lenders in these markets—and indeed in the microfinance field as a whole—may have overestimated the demand for credit. Saturation occurred more quickly than expected, particularly since microcredit institutions often competed for market share in the same client segments and areas rather than reaching out to less served areas. Internal systems, including controls and staff development, failed to keep pace with growth. Regulation did not permit these nonbank providers to offer other services, such as deposits, that would have improved both the customer value

proposition and provider risk management. Other mechanisms that could have helped manage the growing risks, such as effective credit information sharing systems, were not in place.¹

The credit crises brought into focus the short-term trade-offs that may exist among the quantity, quality, diversity, and reach of financial services delivery. We need to better manage the trade-offs to ensure that products and practices are sound and client welfare and institutional viability are not put at risk. Scale and sustainability goals remain legitimate and, indeed, critical goals, but they must be supported with the necessary infrastructure, such as credit bureaus, and public goods, such as transparency regulation.² In sum, we need to rebalance the double bottom line as our collective goal shifts from simply filling in the white space to developing a healthy and responsible market.

Against this backdrop of high aspiration and new challenges, the microfinance field has embraced the need for a proactive responsible finance agenda and accelerated its efforts to implement meaningful improvements in products and practices. There is a growing consensus that providers of financial services to the poor must adhere to a standard of care that minimizes risks for their customers, who typically have low and variable incomes, little margin for error in financial decision making, and limited formal education and exposure to formal finance.³

In this paper, we define what we mean by responsible finance, both as an end-state vision and in terms of a pragmatic focus on client protection and social performance management to help achieve our goal. This paper explores the state of responsible finance knowledge and practice, with a focus on three mutually reinforcing client protection strategies:

1 See Chen, Rasmussen, and Reille (2010) and CGAP (2010).

2 Transparency is a general problem for all financial services, since their features and quality are difficult for consumers to assess fully before purchase. This information asymmetry between providers and consumers is exacerbated when consumers are unfamiliar with formal finance and have little choice among providers and products. Transparency regulations, such as disclosure requirements, seek to address information asymmetries and can also take into account behavioral biases.

3 See, e.g., findings from financial diaries research such as that analyzed in *Portfolios of the Poor* (Collins, Morduch, Rutherford, and Ruthven 2009).

- Industry self-regulation.
- Government regulation and supervision.
- Improved consumer capability.

It also examines emerging practice to support the basic premise of social performance management—that business processes must be aligned with mission and, ultimately, deliver on the promise of client benefit. It then describes funder roles in promoting responsible finance and closes with observations about future implementation challenges.

What Is Responsible Finance?

In a financial world characterized by responsible finance, clients' benefits would be balanced carefully with providers' long-term viability, and client protection is built into the design and business at every level. Products are thoughtfully designed, offer reasonable value-for-money, and minimize potential harm, such as over-indebtedness. Delivery practices are respectful, and do not rely on aggressive sales, coercive collections, or other inappropriate behavior. Clients receive clear, comprehensible information so they can make informed and careful choices about financial products and providers. When problems or misunderstandings arise, customers have accessible and effective mechanisms for resolving them.

Within a few years, this vision of responsible finance could bring discernible improvements in the appropriateness and quality of services. Responsible providers would benefit from enhanced customer loyalty and trust, opening the door to cross-sale of additional services, new deposits, increased market share, and brand enhancement. Many measures that protect clients also help providers manage key operational risks and reduce the likelihood of heavy-handed regulation or political interference. The institution might attract more and better financing from investors that seek strong social returns.

Those providers with a double bottom line⁴ would also hold themselves accountable for achieving

their mission. Collateral benefits from good social performance include a positive corporate culture and good employee morale. Recent studies have shown encouraging evidence of a “virtuous circle” of positive links between financial performance, responsible practices, and commitment to social returns in the microfinance sector.⁵ This resonates with a premise gaining ground in the mainstream corporate world—that the best way for corporations to do well is by creating shared value for customers and communities as well as shareholders (Porter and Kramer 2011).

To bring this about, our practical focus in responsible delivery of financial services to the poor is on client protection and social performance.

From the perspective of client protection, providers need to have appropriate products, policies, and practices, and clients need to have the basis for making informed choices, understanding their rights, and meeting their obligations. And effective recourse mechanisms need to be in place. These basic conditions need to hold for any provider of financial services to lower income and less experienced consumers, regardless of the provider's specific mission, profit goals, or ownership structure.

Other actors come into play to reinforce responsible retail service delivery. Governments can regulate with clear, enforceable, and “access friendly” market conduct rules. They can also help catalyze consumer awareness and financial capability initiatives. Donors and investors can create appropriate incentives by supporting standards development and rewarding improved products and practices. The media and civil society can help by shining a spotlight on irresponsible practices and supporting consumer awareness and rights.

In respect to social performance, many industry players need to go beyond the “do no harm” standard of client protection to measure and manage progress against a specific social mission,

⁴ “Double bottom line” refers to socially responsible enterprises and investments that measure their performance in terms of positive social impact, as well as the more traditional financial bottom line of financial profit or loss. “Triple bottom line”—also sometimes referred to as “people, planet, profit”—goes further by adding environmental accountability into business—or investor-level performance metrics.

⁵ See Gonzalez (2010) and Dewez and Neisa (2009).

ensuring the mission is translated into client benefit and appropriate behavior toward staff, the community, and the environment. Microfinance was created as a client-centric enterprise, and almost all retail providers in the sector commit to specific client benefits and strive for a business culture that reflects those core values. The most common objectives are outreach to the underserved, poverty reduction, and empowerment of women. Two sets of metrics—one focused on financial performance and the other on social performance—hold retail providers accountable at the process and outcome levels for their double bottom line. Social performance metrics assess progress in reaching their intended clients, providing financial (and sometimes nonfinancial) services that meet clients’ life-cycle needs, and bringing about positive change in their lives. They also help hold providers accountable for soft money received in the form of grants, financing on attractive terms, or subsidized technical assistance.

Over the past decade, leading practitioners around the world began exploring responsible finance by developing codes of conduct and tools to better measure, manage, and improve their social performance. This first-generation work focused on putting client interests and outcomes (such as improved money management, incomes, assets, security, and empowerment) at the center, while improving institutional efficiency, scale, and profitability. Progress on the social performance front was closely followed by a wave of innovation and tools around client protection.⁶

Three Strategies to Advance Client Protection

Client protection is at the heart of responsible finance. The three key ways to promote client protection are (i) industry-led initiatives, such as client protection-focused codes of conduct and

standards development, (ii) consumer protection regulation and supervision, and (iii) efforts to improve consumer awareness and financial capability.⁷ These elements of the strategy to promote client protection, though articulated in terms of three different actors, are not mutually exclusive and, in fact, overlap and reinforce one another.

Industry self-regulation needs to be at the core. By definition, microfinance services tend to work with poor households in the informal economy and to happen in countries with limited regulatory and supervisory capacity. The onus on bringing about responsible finance and protecting clients is first and foremost on providers themselves. Financial services delivery entails risks, credit markets are prone to boom-and-bust cycles, and there are inherent imbalances of information and power between providers and their clients. There is growing consensus among providers and their supporters, such as social investors, that it is both right and good business to adhere to a standard of care that provides value and minimizes risk for clients while at the same time helping the provider manage its own risks.

That said, self-regulation may not have sufficient coverage and enforcement power to ensure adequate client protection. Regulators and policy makers in developing countries are beginning to put in place basic consumer protection rules to complement and reinforce industry initiatives by strengthening transparency, fair treatment, and effective recourse. And there is growing recognition that lower income households at the base of the pyramid need to do their part for responsible finance by developing the skills, knowledge, and attitudes that help them “self-protect” and better navigate financial decision making. Governments, consumer organizations, development agencies, and researchers are working together to address this particular challenge.

6 The pioneering “Beyond Codes” action research project laid the groundwork for industry-wide initiatives by analyzing current practices of diverse microfinance providers against the new client protection principles. It documented specific areas for improvement and helped raised awareness about the need for increased efforts to promote responsible finance. Synthesis report available at www.smartcampaign.org. Recent research directly with low-income consumers in developing countries supports these findings.

7 The term “client protection” refers to the obligation of retail providers to behave appropriately in regard to their own clients. The term “consumer protection” is broader and refers to the responsibility that other stakeholders, such as policy makers and regulators, have to ensure transparency and fair treatment across the entire market.

Industry initiatives

Over the past decade, many international microfinance networks, national associations, and individual retail providers have committed to improved transparency, fairness, client protection, and social performance by putting in place codes of conduct, financial education for customers, and other measures. Some of the codes also incorporate emerging good practices in customer service relationships, business ethics (e.g., not pursuing unfair practices, such as poaching staff from competitors), and social performance. Overall, however, incentives for code compliance have not always been strong enough to overcome short-run temptations to cut corners, and sanctions for noncompliance were weak. Recent experience has strengthened resolve to improve responsible finance practices, with progress evident at the level of individual microfinance providers, national networks, and global initiatives.

To some extent, addressing responsible finance challenges at the industry level requires better understanding and overcoming some limitations of the first generation of microfinance products and practices, including limited product flexibility and diversification. This also means ensuring that incentives are well-aligned for all parties in financial transactions, such as adjusting loan officer compensation arrangements to reward portfolio quality and customer service as well as volume. The recent crises and the growing commitment to responsible finance have accelerated innovation to lay the base for this next generation of microfinance products and practice. There is also greater awareness of trade-offs that might arise in balancing the double bottom line and how these trade-offs can be addressed. Boxes 1, 2, and 3 illustrate some of these challenges and solutions.

One particular area for improvement identified by practitioners is working with clients at risk of delinquency and default. Several of the crises served to highlight the limitations of the “zero tolerance” approach that tended to characterize the first generation of microcredit risk management models. Many lenders are now revising their delinquency handling and collections processes.

Box 1. Partner Microcredit Foundation’s Approach to Over-Indebtedness in Bosnia

The Bosnian microcredit sector has experienced high competition and fast growth, which contributed to a serious crisis in the sector in 2008–2009. Some providers may not survive. Others are overhauling their credit processes based on analysis of what went wrong. In 2007, Partner Microcredit Foundation began crafting a comprehensive approach to prevent, detect, and correct client over-indebtedness. Partner recognizes that a risk for the client means a risk for the institution. It has integrated this philosophy into its organizational culture, and built systems and procedures to support it:

- Loan officers conduct thorough borrower analysis, including field visits, business diagnostics, and checks with credit bureaus.
- Internal auditors detect violations of policy through random spot checks and branch visits.
- Both staff and clients receive financial education training and information, to enhance customer service and clients’ decision making.
- Partner conducts regular surveys, focus groups, client exit monitoring, and mystery shopping to ensure that products are appropriate and institutional behavior is client-centric.

Source: Smart Campaign (2010a).

National microfinance associations can reinforce and complement action by individual providers, such as Partner and FinComún, at a sector level, for example, by organizing their members around improved credit information sharing, coordination of branching and expansion strategies, and client education.

Preventing over-indebtedness and ensuring transparency and fair treatment are receiving increasing attention in other countries as well. Providers and their associations are taking steps to improve how prices, terms and key conditions, and risks are disclosed and communicated to clients. For example, at a recent retreat on client protection, leading Indian practitioners, the two main microfinance associations, and other stakeholders identified the need for specific improvements in product design and pricing, marketing, group formation, disclosure, lending and collections processes, and use of third-party

Box 2. Collections with Dignity at FinComún, Mexico

When FinComún faced rising default rates in 2008, it revamped its collections process to focus more on client outcomes in loan recovery. The “Collections with Dignity” approach enabled FinComún to strengthen client relationships while increasing on-time payments and mitigating some of the effects of the global financial crisis on its loan portfolio.

The approach is client-centered and promotes listening to clients and building relationships so as to understand each situation, maintain mutual trust, and lay the basis for exploring repayment options and agreeing on solutions. Negative labels, such as “delinquent clients” are avoided. Human resource management is essential to the success of this new process. FinComún stopped using outside collection agents and redesigned its hiring, training, and performance evaluation to support the new philosophy.

Source: Smart Campaign (2010b).

agents. One senior executive reported that his MFI had internalized the code through staff training, limits on certain collections practices, targeted communications to clients orally and with local-language signs in branches, and a toll-free phone number for grievances. Actions are underway to reinforce the associations’ codes, including a new Lenders Forum and independent appraisals commissioned by the State Industrial Development Bank of India to assess its investees’ compliance with the code (Microfinance India Summit 2011).

Microfinance Transparency (MFT) is a global initiative focused specifically on improving credit price transparency across the industry. It collects and disseminates national-level price data by type of credit product and facilitates in-country discussion among providers, policy makers, funders, and others about how to improve price transparency.⁸ It is active in 28 countries and has collected price data for more than 1,000 different loan products sold to over 50 million clients.

Clear progress is also evident in many countries on informing clients more fully about their rights

Box 3. Pakistan Microfinance Network Consumer Protection Initiative

Pakistan’s microcredit sector experienced a crisis in late 2008 and early 2009.^a Analysis revealed that credit underwriting and client protection practices had deteriorated as competition increased. In response, Pakistan Microfinance Network (PMN) launched a consumer protection initiative that aims to improve practices through a voluntary code of conduct and related measures. The code of conduct offers PMN’s members—which include regulated microfinance banks as well as unregulated MFIs—a common client protection vision and guidance to improve practices. Four components support implementation:

1. **Dissemination.** PMN trains staff of PMN’s members, clients, and policy makers on the code.
2. **Standardization of pricing and disclosure policies.** Using the existing regulation as a starting point,^b PMN is working with members and the central bank to develop a common method for calculating product prices and disclosing prices for both regulated and unregulated providers. PMN also advocates for its members to adopt standardized pricing tools developed by MFT and the SEEP Network.
3. **Code monitoring and compliance.** Members are required to monitor compliance. PMN developed a tool for internal and external auditors to score members’ compliance with the different values in the code. After the pilot, PMN expects all stakeholders (e.g., central bank, rating agencies, funders, local apex) to use the tool to appraise provider practices.
4. **Implementation of a client grievance redress system.** PMN is establishing an independent redress platform. When a client registers a grievance, a trained PMN staff member works with the provider to investigate and resolve the issue. PMN will also report recourse data to the central bank’s consumer protection department (for regulated MFIs) and the Pakistan Poverty Alleviation Fund (for unregulated MFIs).

Source: Smart Campaign (2010c) and interview with PMN staff.

^aSee Chen, Rasmussen, and Reille (2010) and Burki (2009).

^bIn Pakistan, the central bank regulates the pricing and disclosure policies of microfinance banks. Unregulated MFIs (nongovernment organizations, cooperatives, etc.) determine their own policies.

and responsibilities, ensuring appropriate sales and collections practices, improving complaints handling, and training and rewarding staff to exhibit the highest level of personal integrity.

Building off this work by providers and associations, the industry-wide Smart Campaign was launched late in 2009. Seven core client protection principles (CPPs), developed and recently revised through widespread industry consultation, form the cornerstone of the Campaign (see Box 4), which provides practical support to turn these principles into action. By mid-2011, Campaign endorsers numbered more than 640 retail providers, from 130 countries (serving an estimated 50 million clients), 225 associations and support organizations, and 125 funders (including most of the largest).⁹

The Campaign's main focus now is on moving from principles to action. It has collected examples of good practice from diverse providers and has developed training and Web-based tools that offer detailed guidance (organized by principle and by type of financial service) to help retail institutions assess the adequacy of their current product features, processes, and policies. Additional tools serve third-party assessors (such as raters), networks, and associations. To date, Smart-certified consultants have conducted in-depth assessments of 23 MFIs. Memoranda of understanding with 30 national and regional microfinance associations help organizations, such as PMN, to strengthen their member MFIs' client protection efforts.

Client protection practice is evolving rapidly, particularly in the areas of credit policies and procedures and transparency. Of the MFIs reporting to MIX on how they are integrating client protection into their operations, roughly two-thirds cited measures in these areas, and just over 40 percent reported improvements in collections, redress of grievances, privacy of client data, and ethical behavior by staff. Only 15 percent reported applying all the principles at this point. It is also important to note that these data are self-reported, and the gap between reported and actual practice might be large. In fact, Planet Rating found that 70 percent of the MFIs it rated are in the process of implementing the principles. However, the rater found room for improvement in 50 percent

Box 4. Smart Campaign's Client Protection Principles

1. Appropriate product design and delivery
2. Prevention of over-indebtedness
3. Transparency
4. Responsible pricing
5. Fair and respectful treatment of clients
6. Privacy of client data
7. Mechanisms for complaint resolution

of the cases and satisfactory performance in only 20 percent of the cases. This is consistent with the divergence Smart has found between MFI perceptions and results for those same MFIs that have gone through its thorough assessment process.¹⁰

Finding credible ways to validate performance is a critical part of moving from principles to standards and benchmarks. The Campaign convened specialized microfinance ratings agencies and social auditors to share experiences in integrating client protection within existing tools and to develop a single tool for validating MFI compliance with CPPs. Launch of the certification tool is slated for early 2012.

Consumer protection regulation

In Peru, the lead financial sector regulator (the Superintendent for Banking and Insurance) has pursued a deliberate strategy to improve transparency and fairness in the market. It established a simple disclosure regime for credit products and gradually extended its coverage beyond banks to additional lenders. This appears to have improved comparison shopping by consumers and price competition among regulated providers, contributing to meaningful drops in prices.¹¹ Now, the Superintendent is turning to deposits and recently put in place new disclosure requirements for these products (which led some banks to reduce fees and commissions in advance of the data becoming public). Insurance is the next candidate

⁹ See www.smartcampaign.org for detailed guidance, tools, and emerging good practices.

¹⁰ The Smart Campaign (2011) commissioned a study to evaluate how CPPs are being adopted in the industry.

¹¹ Peru's Superintendent for Banking and Insurance (www.sbs.gob.pe), MFT data (<http://mftransparency.org/data/countries/>) and unpublished CGAP research.

for a stronger disclosure regime. The regulator engages very actively with the public through the media and has taken steps to improve consumers' access to dispute resolution mechanisms, promote responsible lending practices, and monitor consumer protection in branchless banking services.

Other countries are moving forward as well. Some years ago, the National Bank of Cambodia put in place a simple requirement that MFIs state their interest on a declining rather than flat rate basis. The Central Bank of Ghana requires regulated providers to give consumers a "Key Facts" document that states all key prices, terms, and conditions of the product. Regulators in other countries have provided guidance on ensuring that collections practices are effective but nonabusive. The South Africa National Credit Act established a flexible, but firm, requirement that all lenders analyze borrower repayment capacity and determine that their loans will not over-indebt customers. The Central Bank of Kenya's recent banking agent regulations extend certain protections to branchless banking customers.

Consumer protection regulation aims for transparency, fair treatment, and effective recourse. The tools to achieve this include rules that require providers to disclose product prices, terms, and conditions with reasonable accuracy and comprehensibility; have responsible lending safeguards and checks against aggressive sales or collections; and offer accessible and even-handed channels for clients to resolve disputes. Regulators also sometimes work together with industry leaders and associations or funders to build needed market infrastructure, such as more inclusive and accurate credit bureaus.

As the only actor with the power to establish legal standards, governments have considerable power to improve practices. Consumer protection regulation can advance responsible finance, if it is designed and implemented with sensitivity to financial inclusion goals. Policy needs to carefully

consider the characteristics of lower income and less experienced consumers, provider compliance costs, and the regulator's own capacity for market monitoring and enforcement. Consumer research can be an essential tool in pinpointing priority problems and how they might be addressed.¹² A proportional approach can leave space for innovation, by monitoring the actual risks in the market and phasing in new rules to address them rather than placing upfront restrictions on new approaches and business models.

This step-by-step approach would start with transparency problems or practices in the market that affect many consumers. For example, in some countries, regulators first have required that providers use the declining balance method to state loan interest rates or place the most critical product information in a preclosing "Key Facts" document. This can create a foundation for improved transparency without imposing undue costs on providers or overstressing regulatory capacity. Later on, more ambitious and comprehensive approaches, such as standardized price formulas or cooling-off periods,¹³ might be justified if there is evidence that the simpler measures are not achieving the desired results. These safeguards are likely to strike a better balance than more intrusive measures, such as interest rate caps. To improve recourse, regulators can work with financial service providers and their associations to agree on standards for receiving and resolving complaints, including measures to make sure that recourse options work for consumers with lower levels of education, income, and financial sophistication. This option is feasible for regulators whose capacity is too limited to provide recourse themselves. Once the market is more developed, initiatives to create third-party recourse options for consumers may be appropriate, whether through financial sector regulators, industry associations, or specialized ombuds.

Setting basic standards and "rules of the game" protects clients; it can also protect responsible

¹² E.g., a comprehensive consumer protection diagnostic process in Kenya benefited from extensive consumer research through focus group discussions and a representative national survey. See FSD Kenya (2011).

¹³ A cooling-off period permits a consumer to cancel a contract within a specified period of time from the sale. It aims to guard against pressure sales and provide the consumer the chance to review product terms and conditions fully.

providers against unfair competition. This could become more necessary as purely commercial players—that might be less likely to participate in industry standards development and feel less pressure to conform to codes—enter these markets. The credit crises showed that short-term incentives to cut corners can arise as markets begin to get saturated and competition heats up. Carefully designed regulation could help ensure that increased access is healthy for consumers and providers alike.

Many governments in emerging and developing countries are putting in place new financial consumer protection laws and regulations and the institutions to implement them (CGAP and World Bank 2010). The imposition of these “rules of the game” does not appear to have had a chilling effect on innovation and expanded access for poorer and underserved consumers. For example, MIX data suggest that Peru, Cambodia, and Ghana have experienced strong gains in the quantity and diversity of financial services on offer. However, consumer protection regulatory experience is still quite limited in developing countries, and much remains to be learned. For example, the challenge of making disclosure and recourse work for consumers with limited literacy, formal education, or knowledge of formal finance is not trivial. Policy making would benefit from further documentation, analysis, and exchange among regulators, industry players, researchers, and other important microfinance stakeholders.

Regulation by government versus self-regulation by industry is not an either/or proposition, of course. Some problems, such as price transparency, may be too difficult for providers and their associations to resolve on their own. Individual providers can profit from deliberately understating their prices, and the ability of industry to self-police may be too limited.¹⁴ The only realistic solution to this information asymmetry may be regulation with clear rules about price formulas and disclosure across as much of the market as feasible. And indeed, there

is encouraging evidence that, in markets where some providers are covered by transparency rules and others are not, unregulated providers tend to adopt the same standards as their regulated peers over time (Pistelli, Simanowitz, and Thiel 2011).

Successful self-regulation might have more potential for an issue such as complaints handling, where compliance costs are lower and short-run business advantages (customer satisfaction and retention, feedback on service quality improvements) are more obvious. Targeted consumer awareness efforts could strengthen client use of new mechanisms, and associations might be able to monitor and sanction inadequate practices. Experience from other sectors also suggests that self-regulation might itself be more effective when the regulator engages actively in observing it and appears willing to step in should it not succeed. A formal role for regulators in overseeing industry self-regulation, such as codes of conduct, is becoming more common.

Consumer awareness and financial capability

Neither industry initiatives nor regulations are likely to succeed fully if consumers are not aware of their rights and responsibilities. To benefit fully from access to formal financial services, clients need improved information, skills, and attitudes. More “financially capable” consumers can select appropriate products, take steps to protect themselves from products and practices that are not in their best interest, and comply with the terms of the financial products they use. This behavior, in turn, rewards responsible providers and products and mobilizes consumers’ “power of their feet” to favor those that adhere to acceptable practices. This also helps to reinforce the business case for responsible finance. Improved consumer awareness and financial capability could help regulators monitor the market, as consumers and their advocates report abuses through hotlines or other recourse channels.

¹⁴ Indeed, in the report from a recent retreat on client protection strategy in India, providers and their associations called for regulators’ support to improve enforcement of the associations’ codes of conduct. See Microfinance India Summit (2011).

Government, financial institutions, and funders have roles to play in supporting gains in client knowledge, skills, and ability to assert their rights. Unequal information and power mean that consumers start out at a disadvantage compared to their providers. Furthermore, recent behavioral research shows how certain systematic cognitive biases, “rules of thumb,” and other behaviors undermine the ability of low-income clients (and others) to protect themselves. The following are some of the most important observations from recent behavioral studies that affect responsible finance at the base of the pyramid:¹⁵

- Consumers tend to discount greatly the future for the present, known as hyperbolic discounting. This can be seen in credit products where consumers focus more on the allure of up-front cash than the interest and other costs they have to pay over the life of the loan.
- Consumers tend to underestimate costs of financial products and overestimate their potential for success (and in turn their capacity to repay). In the case of low-income microentrepreneurs, this could lead them to borrow at a higher cost than expected, while also anticipating greater future revenues than are likely. As a result, they could be at greater risk of becoming over-indebted.
- When facing decisions on complex or confusing products, such as financial services, consumers often use overly simple calculations and base their decisions on erroneous conclusions or assumptions. For example, one respondent in a focus group of Mexican consumers described how he compares the total cost of a consumer loan with the amount of cash he will receive up front. His rule of thumb is that the loan is a good deal if the total cost is no more than twice the proceeds.
- Consumers often tend to choose products where approval is fast, reliable, or easy, even if the product in question is more expensive or less favorable than alternatives where the client perceives that approval is less certain.

These findings are relevant to consumer awareness and financial capability efforts in developing countries that could benefit poorer and less experienced consumers. The insights should also inform regulatory and industry efforts to protect consumers against avoidable risks and design products that consider their needs and financial behaviors. For example, the Central Bank of the Philippines recently applied these emerging lessons and used focus groups to test the clarity and effectiveness of a new draft credit disclosure form with low-income financial consumers. The form was redesigned to make it easier for consumers to understand costs and key terms, compare similar offers, and make informed financial decisions.

Developing country governments are demonstrating a keen interest in taking action on this front. Often, financial sector authorities play the roles of convener, champion, and overseer of consumer awareness and financial capability efforts, while mobilizing support from industry and other public- and private-sector players to experiment with how best to improve consumers’ financial knowledge, skills, and decision making.¹⁶ Interestingly, of the more than 400 MFIs that completed the MIX social performance report, 38 percent stated that they offer some type of financial education to clients (although this group is likely to comprise more socially oriented providers and not be representative of MFIs as a whole) (Pistelli, Simanowitz, and Thiel 2011). Early lessons from this work include the need to tailor strategies to different segments (e.g., in-school youth, formal sector employees, older people, etc.) and complement classroom education with awareness-raising campaigns and nontraditional approaches, such as “edu-tainment” through soap operas and popular media. Funder interest is growing at the national, regional, and global levels, including support for research on financial behavior and capabilities of low-income consumers, partnerships with financial institutions, and policy advisory work.

¹⁵ See, e.g., Barr, Mullainathan, and Shafir (2008); Dawnay and Shah (2005); and Krishnan (2008).

¹⁶ See, e.g., government-promoted initiatives in Brazil, Kenya, and Indonesia. The International Network on Financial Education, facilitated by the Organization for Economic Co-operation and Development, convenes governments working in this area to share emerging good practices and articulate principles of effectiveness.

Of the three lead strategies, the state of knowledge and practice are most limited in the areas of consumer awareness and financial capability. It is unclear what will work, how, and for whom, especially in low-income markets. The conversation has just begun about the respective roles of government, industry, civil society, and consumers themselves. Little is known about consumer perceptions and behavior (especially for consumers in developing countries) and how product design, regulation, or consumers' own knowledge and skills might overcome behavioral biases that put consumers at greater risk. Research on these issues could go far to inform industry and policy initiatives. It will also shed light on how to design and implement specific interventions to improve consumer awareness and capability.

Strategies to improve social performance

For most service providers who have a social mission, responsible finance extends beyond client protection to the commitment to actively measure and manage their double bottom line. The vision here is that the many players in the microfinance market with social missions first apply improved metrics for assessing client outcomes, and then act on the findings by adapting their products and methods to better address clients' vulnerabilities and life-cycle needs. This objective is advanced by social performance awareness and training initiatives for staff and integrating both bottom lines into staff performance appraisals. The governance dimension is also coming into sharper focus, including the Board's role in ensuring the provider stays on course in balancing financial and social performance.

The industry has made solid progress in developing social performance metrics, tools for client targeting, and independent audit and ratings methodologies that assess a provider's entire business process against its intended client outcomes. In just two years, more than 400 MFIs (representing 40 percent of MIX reporters) have submitted public (self-reported) data on their social performance, using indicators and a common

framework developed through consultation among practitioners, funders, networks, technical assistance providers, rating agencies, and researchers. Four specialized microfinance ratings agencies conduct social ratings, more than 120 of which the Rating Initiative funded in 2008–2009.

Social performance data reported thus far show that an MFI's ability to collect and report social performance data correlates strongly with the level of market maturity and competition, social performance training provided to its staff, and investors' demand for such data. MFIs have made the most progress in measuring client retention and integrating social performance into staff performance appraisals and incentives. Weak areas include monitoring of client poverty levels and ongoing market research to improve products and processes (Pistelli, Simanowitz, and Thiel 2011). Half of the MFIs reporting to MIX offer nonfinancial services specifically designed for needs of female clients. Reporting on client outcomes is still at a very early stage, with few MFIs able to assess with precision whether they are meeting their stated goals. For example, while 84 percent of MFIs reporting to MIX indicated they had a goal of poverty reduction, only 10 percent had systems in place to track client progress out of poverty.

The global Social Performance Task Force (SPTF) includes practitioners, funders, networks, technical assistance providers, rating agencies, and researchers. It serves as the information hub, drives standards development, and coordinates industry-wide consultation to ensure that standards are practical and adapted to the realities of delivering financial services to the poor. SPTF is in the process of developing a set of universal standards for providers that establish clear expectations on social performance management and reporting. These cover client protection and other areas, such as social goals and target clients, governance and staff commitment to social goals, client-responsive products and services, client monitoring, responsibility to staff, and responsible financial performance. Providers are applying lessons emerging from the rich social performance management experience, as they seek to better

segment demand, diversify product offerings, ensure quality, and increase client benefit.

Role of Funders in Promoting Responsible Finance

Donors and investors play an important role in accelerating uptake of client protection and social performance management by supporting all the strategies. They can create the right incentives by funding providers that have missions aligned with their own and that adhere to emerging good practices. As standards and benchmarks develop, funders that finance retail providers directly have begun to screen for acceptable practices and to support partners to address responsible finance weaknesses.¹⁷

Funders also can provide stronger performers with more financing, financing on better terms, or visibility. Several social investors now offer such financial incentives (see Box 6). To encourage use of social performance tools and MIX reporting, several funders collaborated to offer a global social transparency award. Others backed a regional social performance award that offers a monetary incentive and recognition process for Latin American MFIs that meet higher standards of accountability for their missions. Beyond providing technical assistance and grants at the retail level, donors (and some investors) also are funding the Smart Campaign, MFT, SPTF, and other initiatives that provide industry-level “market infrastructure” for responsible finance, through standards development, tools, and validation processes.¹⁸ Another constructive development is collective action by investors to identify markets at risk of overheating and to take preventive action.¹⁹

Funder roles are not limited to working directly with providers and industry initiatives. Development

Box 5. Integrating Social Performance Management into Operations at AMK, Cambodia

AMK is a fast growing MFI that serves the largest number of clients in Cambodia. It has cultivated a strong social performance culture and integrated management for its double bottom line throughout its strategy and operations. The Board-level Social Performance Committee oversees reporting from management that integrates social and financial metrics.

The Research Department serves management with information, including an annual client survey.^a The findings feed into a holistic index of household well-being for AMK to assess client poverty status and track impact over time. AMK’s leadership views the benefits of the strong internal research function it has created to be well worth the investment. The research has contributed to new product design and delivery methods, examples of which follow:

- Scoping studies helped estimate demand for new products (individual loans, remittances, deposits).
- Client profiles helped AMK design its credit line product, including loan ceilings.
- Client cash-flow information helped AMK better plan its own cash flows and demand patterns.
- Exit surveys highlighted problems, such as the need to communicate better on or eliminate the practice of charging daily interest.
- Satisfaction surveys highlighted what clients particularly valued (such as credit officers’ respectful behavior), gave feedback on product and process suitability, and fed into training for new staff.
- The internal audit function kept a check on client protection practices.

^aClient-level information includes household profiling (members, livelihoods); household cash flows and seasonality; financial transactions, including use of other financial services (informal, other MFI), extent of indebtedness, and savings; loan use; poverty assessment; and client satisfaction (likes and dislikes about AMK, compared with alternative providers).

Note: Drawn from Imp-Act Case study in Social Performance Resource Centre, <http://spmresourcecentre.net/index.cfm/linkservid/89852517-DD4D-4144-827D9E42C793805D/showMeta/0/>.

¹⁷ CGAP worked with the investor community to develop detailed guidance on integrating client protection concerns at every stage of the investment process. The latest guidance document includes a “due diligence” checklist with 12 core areas of investigation that investors can adapt to their own due diligence process. See Forster et al. (2010).

¹⁸ The MicroCredit Summit Campaign is spearheading creation of a Seal of Excellence for Poverty Outreach and Transformation in Microfinance. The Seal would recognize superior performance by sustainable MFIs with this social mission that achieve significant scale of service to poor clients and demonstrate strong commitment and a strategic approach to transformation of clients’ lives and poverty reduction.

¹⁹ See Kappel, Krauss, and Lontzek (2010).

Box 6. Donors and Investors Stepping Up on Client Protection and Social Performance

- **Incofin** developed a dashboard (called ECHOS) to score potential investees on 43 environmental and social performance indicators during due diligence. A score below the cut-off set by policy results in automatic rejection of the investment proposal.
- **Oikocredit** provides a premium to investees that show good social performance, using a scorecard on the institution's environment, social, governance (ESG) profile. The "extraordinary social relevance discount" is a reduction of 0.25 percent to 1 percent off the negotiated rate, depending on how an organization scores on eight questions.
- Since 2010, the **United Nations Capital Development Fund** performance-based agreements reference CPPs, and the agency has identified quantitative indicators to track retail providers' progress on the two dimensions of responsible finance.

agencies and donors often support consumer protection policy processes with diagnostics, technical assistance, and capacity building. They are also contributing to progress in market infrastructure, such as credit information sharing, and are playing an important role in advancing knowledge and practice on practical approaches to improve consumer awareness and financial capability.

The Way Forward

We see clear progress on each of these strategies to advance client protection and social performance. This progress is building awareness across the microfinance sector about the role of responsible finance in delivering stronger value for clients and ensuring the long-run viability of providers. Industry leaders understand the operational, reputational, regulatory, and political risks from failure and agree that action on responsible finance is the right thing to do and reflects the core business values of the great majority of market players in our sector. Balanced management of financial and social performance and accountability for client benefit are important for market development, the sector's credibility, and its ability to finance growth.

Despite progress over the past few years, however, much remains to be done. There are significant gaps in knowledge and practice surrounding each of the three lead responsible finance strategies. Discussion is just getting underway on important new dimensions of responsible finance in our sector, such as growth management strategies, profit levels and allocation, and proactive governance for the double bottom line. Pioneering first-generation products and methodologies in microfinance are evolving to enhance client outcomes and sustainability. As new products and channels come on line, responsible finance considerations can be built in from the beginning. When the three strategies come together, they will create stronger incentives across the board for microfinance as a long-term relationship business that delivers shared value for client and provider.

In the longer term, evidence about the business case for responsible finance will be critical to widespread adoption of improved practices. Further research is needed to document potential trade-offs and test specific premises about how doing right by one's clients is good for business.

Client protection and social performance are at different stages in the journey from initial development of guiding principles, to application of commonly accepted standards, to transparent, universal reporting, and ultimately, to benchmarks for improved practices. Global efforts, such as the Smart Campaign and SPTF, amplify action by retail providers and play a key role in advancing responsible finance and facilitating the frank industry-wide discussion that is needed to maintain momentum and deepen implementation. Good practice examples and new tools are needed, including for noncredit products, such as microinsurance. The sector's reputation will also hinge on success in verifying actual practice against emerging standards, particularly through third-party certification by raters and auditors that is being developed by the Smart Campaign and SPTF.

Donors and social investors will continue to play important roles for some years to come in many markets and for many providers. To the extent they align their financing to create the right incentives, advances in responsible finance will be faster and

more widespread. This requires further integration of responsible finance into due diligence and reporting processes, as well as clear policies to reward strong performers and turn down providers with inadequate practices.

In January 2011, more than 40 microfinance investment organizations came together in a responsible investment initiative, launching the Principles for Investors in Inclusive Finance (PIIF) under the umbrella of the United Nations Principles for Responsible Investment (UNPRI). PIIF commits endorsers to fund responsible retail providers and try to create the right incentives for their investees to treat clients appropriately. They specifically incorporate the Smart CPPs and the SPTF social performance management principles. PIIF underscores the need for more active engagement throughout the investment process, including in governance. Mirroring a trend in the broader investment world, endorsers also commit to fuller integration of ESG criteria into investment decisions and reporting. PIIF addresses fair treatment among investors and between investors and their investees. This includes acceptable risk-sharing on foreign exchange, right-sizing investment levels to MFI demand (so as not to over-indebt MFIs or exceed their absorption capacity), balancing expectations for financial and social return, and working out troubled deals even-handedly and transparently.

PIIF acknowledges the important role investors play in shaping the direction of the microfinance industry. If these principles are translated into practical guidance and implemented vigorously, they could help spur widespread innovation and improved practices. It must be acknowledged, however, that investors themselves sometimes face incentive issues, such as pressure to disburse large sums quickly, to report only positive news on partners' performance, or to earn higher returns. The success of the UNPRI process will hinge on managing these realities.

Coordinating the various responsible finance initiatives and taking care not to overburden providers are challenges. Yet the progress made so far is encouraging. For example, hundreds of providers, national associations, the Smart

Campaign, SPTF, and funders agreed on and began implementing CPPs in the space of just a few years. Transparency efforts exhibit close collaboration among providers, regulators, and international organizations, such as MFT. Particular care must be taken to communicate clearly with retail providers about these initiatives, set realistic expectations about the pace of implementation, and work to keep compliance costs manageable for those at the front line of responsible finance. Funder support for the change management process at the level of the retail provider is helpful, as is streamlining of tools and processes (e.g., the planned rating tool reduces costs and time demands for providers by combining financial and social performance metrics in a single standardized tool).

The vision of responsible finance is compelling. Working together, hundreds of microfinance providers, networks, funders, and policy makers are charting the path toward models of financial services delivery that can provide a powerful demonstration—including, perhaps, to the broader financial sector—of how the interests of consumers and financial institutions can be balanced to the long-term benefit of all.

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Annex: Selected Responsible Finance Tools and Resources

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