Implementing the Client Protection Principles

A Technical Guide for Investors

Second Edition

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Since 2008, CGAP has been working with the investor community to address how client protection can be integrated into the process of investing in microfinance. This updated Technical Guide has been developed based on the generous contributions and knowledge sharing of many diverse investment organizations. In particular, CGAP wishes to thank Aavishkaar Goodwell, BlueOrchard, Calvert, Credit Suisse, Deutsche Bank, Developing World Markets, FMO, Grassroots Capital, Incofin, KfW, Kiva, MicroVest, Oikocredit, Oxfam Novib, responsAbility, Symbiotics, Triodos, Triple Jump, UNCDF, and Unitus Capital for their contributions.

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I. About the Guide

As the microfinance sector has come under more intense scrutiny than ever before, responsible finance initiatives have picked up steam. Hundreds of organizations from across the industry (providers, associations, funders, etc.) have come together in the Smart Campaign, endorsing six core Client Protection Principles for microfinance and committing to implement specific improvements in products, practices, and policies. As of November 2010, more than 100 investment organizations have endorsed the Principles and are taking concrete actions to encourage providers to adopt appropriate client protection policies and practices.

In September 2009 CGAP published the first edition of this Technical Guide for investors to support the integration of the six principles into investors' policies and processes. This second edition reflects the developments in implementation and practices over the past year.

Experience in putting client protection into practice is accelerating quickly. Many investors are now moving from endorsing the Principles to mainstreaming concrete action. This Guide provides an updated set of action steps for investors, including a new due diligence tool that provides practical guidance and tips on how to assess implementation of client protection practices by retail providers. This Guide also reflects on the main operational questions investors are facing, such as how to assess over-indebtedness and transparent and responsible pricing, and emerging responses.

We are still at the nascent stages of developing standards for client protection assessment. However, to this end we are benefiting from investors sharing knowledge and experience. We hope this Guide will facilitate continued knowledge sharing and the joint development of good practices and standards.

The target audience for this Guide is investment organizations ranging from development finance institutions to specialist microfinance funds and fund managers. However, much of the content is adaptable for use by funders more broadly, including those that provide grants.

This Guide continues to be a "living" document that will be updated as practice evolves. **Investors are strongly encouraged to provide feedback on how to improve this Guide and to share additional material that could be included.** Comments and material should be sent to Kate McKee (kmckee@cgap.org) and Estelle Lahaye (elahaye@cgap.org).

The Guide is organized as follows:

- Section 2 describes the Principles and their importance to ensuring sustainable microfinance development that serves the best interests of clients.
- Section 3 provides an update on the Smart Campaign.
- Section 4 offers practical advice on approaches and tools to incorporate the Principles into investment processes.
- Section 5 highlights questions that investment organizations are facing and emerging responses.
- Section 6 provides a list of resources and tools.

II. What Are the Client Protection Principles and Why Do They Matter?

The Client Protection Principles promote ways for microfinance providers to take practical steps to treat clients fairly and respectfully while avoiding practices that might harm them. These Principles are distilled from the path-breaking work of providers, international networks, and national microfinance associations to develop proconsumer codes of conduct and practices. While the Principles are universal, meaningful, and effective, implementation requires careful attention to the diversity within the provider community and conditions in different markets and country contexts.

The six Client Protection Principles are listed below. During the past year, two of these Principles—on responsible pricing and data privacy—have been modified to reflect recommendations from the field. The modifications are shown in *italics*. Further modifications are likely as more lessons are learned from implementation experience.

- **Avoidance of Over-indebtedness.** Providers will take reasonable steps to ensure that credit will be extended only if borrowers have demonstrated an adequate ability to repay and loans will not put borrowers at significant risk of over-indebtedness. Similarly, providers will take adequate care that noncredit financial products, such as insurance, extended to low-income clients are appropriate.
- **Transparent *and Responsible* Pricing.** The pricing, terms, and conditions of financial products (including interest charges, insurance premiums, all fees, etc.) will be transparent and will be adequately disclosed in a form understandable to clients. *Responsible pricing means that pricing, terms, and conditions are set in a way that is both affordable to clients and sustainable for financial institutions.*
- **Appropriate Collections Practices.** Debt collection practices of providers will not be abusive or coercive.
- **Ethical Staff Behavior.** Staff of financial service providers will comply with high ethical standards in their interaction with microfinance clients, and such providers will ensure that adequate safeguards are in place to detect and correct corruption or mistreatment of clients.
- **Mechanisms for Redress of Grievances.** Providers will have in place timely and responsive mechanisms for complaints and problem resolution for their clients.

- **Privacy of Client Data.** The privacy of individual client data will be respected *in accordance with the laws and regulations of individual jurisdictions*, and such data cannot be used for other purposes without the express permission of the client (while recognizing that providers of financial services can play an important role in helping clients achieve the benefits of establishing credit histories).

Client protection is part of responsible finance

These client protection concerns form part of the focus on "responsible finance," which has come to the fore as the overarching framework for supporting inclusive financial services that are delivered in a transparent and equitable fashion. Responsible finance implies that products, processes, and policies avoid harmful or unfair treatment and appropriately balance customers' interests with those of providers. At the retail level, responsible finance translates into minimum standards concerning client protection (do no harm) and ethical behavior of providers. Retail providers that are concerned with their social performance do not only aim to deliver financial services responsibly but are also committed to a positive change in clients' lives and have double or even triple bottom line goals of balancing concern for people, profit, and planet.

This integration of client protection in broader responsible finance and social performance management thinking is reflected by the incorporation of the Principles in management, audit, and reporting frameworks for social performance. The Smart Campaign has been working closely with the Social Performance Task Force, MIX, and related investor initiatives to facilitate this.

Why is client protection a priority now?

A number of recent trends have focused investor attention on client protection. Microfinance has come under more critical scrutiny in the press and recent publications. Especially worrying is evidence of over-indebtedness of microfinance borrowers in some countries where microfinance has grown very rapidly. These markets, including Bosnia-Herzegovina, Morocco, Nicaragua, and Pakistan, have experienced intense competition in some markets, multiple borrowing by clients, and erosion of credit discipline. This has led to repayment crises and the rapid deterioration of portfolio quality.[1] Globally, the mainstream banking industry is also paying greater attention to responsible finance following the subprime meltdown and financial crisis.

[1]See CGAP Focus Note 61, *Growth and Vulnerabilities in Microfinance*, February 2010. http://www.cgap.org/gm/document-1.9.42393/FN61.pdf

As a result, investors are more attuned to making sure that microfinance does no harm and realizes its potential to achieve its social mission of contributing to poverty reduction. Investors should also seek to ensure that client protection issues are built into new products and new models for microfinance delivery, such as branchless banking and use of mobile technology in financial services provision, from the start.

What is also clear is that responsible finance and client protection issues apply across the entire landscape of financial services, not just specialized microfinance providers. Minimum good practice client protection standards should apply to all retail financial institutions and in relation to all products, including microenterprise loans, personal loans, savings, microinsurance, and payment products. In the United States and many European countries, there are banking industry codes of conduct and lending codes focused on consumer protection across the banking industry.

Investors themselves are also beginning to recognize that the Client Protection Principles apply as much to themselves as to MFIs. They need to apply rigorous standards in their own microfinance investment policies on matters such as avoiding over-indebtedness at the MFI level and transparency in their own pricing.

III. The Smart Campaign Status and Strategy

The industry-wide campaign for client protection was officially launched as the Smart Campaign (see www.smartcampaign.org) in September 2009. The Campaign is a global effort to unite microfinance leaders around a common goal: to keep clients as the driving force of the industry. At the heart of the Campaign is encouraging the endorsement and implementation of the six Client Protection Principles.

The Center for Financial Inclusion at ACCION International serves as the secretariat for the Campaign. CGAP is a co-founder of the Campaign and serves on its Steering Committee. CGAP leads on work with funders and regulators and coordinates this work through the Campaign.

The Smart Campaign aims to bring improvements in microfinance practice. To this end, it is developing tools (see Tools & Resources Library) to share with retail providers, international networks, microfinance associations, and funders. Core tools include the following:

- **Getting Started Questionnaire: Client Protection Self-Assessment for Microfinance Institutions**[2] helps microfinance institutions (MFIs) begin to investigate their client protection practices within their organization. The questionnaire provides a framework for evaluating an MFI's practices principle by principle, focusing on the 5–10 practices that are most important for determining how effective the organization's systems are for embodying the principles.
- **Conducting Client Protection Assessments: A Guide** is designed to provide guidance to an assessor on how to conduct a consumer protection assessment for an MFI and thoroughly evaluate the MFI's implementation of the Principles. The guide leads the assessor through a step-by-step process of collecting the information and documents necessary to evaluate a microfinance provider's client protection practices and offers advice on how to evaluate this information against indicators for each principle, which are also discussed.
- **Smart Lending: Client Protection in the Credit Process** is a roadmap for MFI staff to incorporate client protection practices across the entire loan cycle. This tool was

[2]This tool was developed by the Beyond Codes project, which is now part of Smart Campaign. This was an action research project that examined the practices of MFIs, rural banks, and credit unions in Bosnia, India, Kenya, Mexico, and the Philippines.

developed jointly by a technical team from the Smart Campaign and ACCION Global Programs. It focuses specifically on the lending process, providing MFIs with guidelines and recommendations of good practices for each step of the lending cycle so they can provide clients with transparent, respectful, and prudent financial services.

- **Tools and guidance from microfinance practitioners** such as the following:
  - Responses to facing over-indebtedness by Partner in Bosnia-Herzegovina, including credit analysis and financial literacy initiatives
  - Fincomun's guidance on appropriate collection practices in Mexico
  - Serbia's Procredit Bank leaflet on how to talk to consumers
  - Debt management guide by the National Credit Regulator of South Africa

These tools can be useful to investors as they indicate how MFIs are evaluating their own implementation of the Client Protection Principles and hence to which issues and actions investors need to pay attention. The Conducting Client Protection Assessment Guide is particularly useful for investors, especially those that conduct field-based due diligence, as it provides practical guidance on how to verify client protection practices. In addition, there are several social performance assessment, management, and reporting tools that include the client protection dimension, for instance the MIX/SPTF Social Performance report. For an overview of social performance tools, see the Social Performance section on the Microfinance Gateway.

IV. Seven Steps to Implementing the Principles

The 2009 edition of this Guide recommended actions for investors interested in incorporating client protection assessment into their investment processes. These recommended action steps, outlined below, have been validated by experience over the past year:

1. Incorporate the Client Protection Principles into investment policies.
2. Endorse the Client Protection Principles.
3. Encourage current and prospective investees to discuss and endorse the Principles and take material action to implement the Principles.
4. Develop, test, and refine criteria and procedures to assess investee implementation of the Principles during screening and due diligence processes.
5. Integrate the Principles into financing or shareholder agreements, as appropriate.
6. Monitor implementation of the Principles by investees through mandatory reporting and regular monitoring and evaluation.
7. Report on progress to investors and other stakeholders.

This section provides an update of how investors are incorporating the Principles into their investment processes and the issues that are arising in the move from endorsement to implementation. It also presents a standardized due diligence checklist. This is in response to investors' requests for a streamlined approach for assessing client protection practices that could fit into their existing due diligence processes.

1. Incorporate the Client Protection Principles into investment policies.

Awareness and recognition of the importance of client protection and of the Smart Campaign is by now widespread. Many investors see client protection as the cornerstone of responsible finance and are increasing their focus on these issues as the industry-wide discussion about responsible finance deepens.

Often, ensuring client protection becomes part of core business processes requires a champion within the organization who drives work in this area. Several investors have such champions who develop internal policy papers and guidelines to inform and focus the attention of senior management and staff on client protection issues.

Typically, they highlight three factors as the drivers behind the need to integrate client protection concerns into investment policies:

- **Reputational risk.** Investors recognize that their own reputation as well as that of the microfinance provider could be severely damaged if the provider is linked to unethical financing practices, over-indebtedness of clients, lack of transparent pricing, inappropriate loan collections, etc. This reputational risk can be associated with regulatory and political risk as well in some settings, for example, if a microfinance provider is violating local regulations or seen to be charging excessive interest rates.
- **Credit risk.** Clearly, the consequences for clients of over-indebtedness are severe and can lead to a worsening financial situation. Both the microfinance provider and the investor also face significant financial risk if clients take on debt beyond their capacity (or willingness) to repay. This will lead to increasing numbers of nonperforming loans and deteriorating portfolio quality, and ultimately could put the institution into a loss-making position.
- **Accountability for social performance.** Many investors see assessing client protection practices as a core part of their objective of ensuring good social performance by investees and a minimum standard of doing no harm to clients. Microfinance investment vehicles (MIVs) are increasingly being held responsible for reporting on MFIs' adherence to the Principles and their records as responsible lenders by their own investors.

Investors report that the reaction of management and staff to incorporating client protection issues is generally positive. However, in some cases, there are concerns about their implementation, compliance, and a certain amount of push-back to actually signing up for the Client Protection Principles publicly as discussed in the next section.

Once management has committed to working on client protection, there is typically a period of raising the awareness of internal staff, e.g., through internal workshops on client protection and training. Training may be in-house or external, such as the training offered by the Smart Campaign to train champions in investment organizations. The Smart Campaign also has a webinar training tool that can be found in the toolkits downloads.

2. Endorse the Client Protection Principles.

A key step in demonstrating an organization's commitment to the Principles is to endorse the Principles. Endorsement demonstrates to MFIs, investors, and other stakeholders that client protection issues are part of an organization's doing good business. It can also

provide an entry point to start a dialogue with partner MFIs. In addition, endorsing the Principles helps build momentum in developing shared norms and practices.

Joining the Smart Campaign is a simple and effective way of demonstrating your institution's public support for the Client Protection Principles. Investors can join the Campaign by going to the Smart Campaign Web site and signing up. As of November 2010, more than 100 investors and donors and over 330 MFIs had endorsed the Principles. Results of the CGAP 2010 MIV Survey highlighted that more than 80 percent of the MIVs have endorsed the Principles compared to 61 percent in 2009.

Some investors have had reservations about endorsing the Principles. This is typically not reflective of their commitment to the substantive issues, but rather compliance and competitiveness concerns raised either internally or by their partner microfinance providers in the field. These concerns are summarized below with the responses that counter them.

Are we entering into a legal commitment to enforce the Principles if we sign up to the Smart Campaign? There is a concern among some investors about the extent of their legal responsibility for enforcing the Principles if they sign-up to the Smart Campaign. There is no legal responsibility to enforce the Principles. These are principles rather than prescriptive rules. By signing up, investors demonstrate their commitment to the Principles and ambition to encourage their implementation. As KfW puts it, "Signing-up to the Principles will not give you sleepless nights, but it will show that you take these issues seriously."

A related concern for investors is that there is no simple means of verifying implementation of the Principles nor is there a certification process. This may develop over time. However, for now it is the case that investors or their fund managers need to take responsibility for reviewing implementation of the Principles by their partner MFIs.

Some microfinance providers are concerned that it is not in their business interests to commit to implementing the Principles if their competitors are not implementing these practices, too, particularly the principle on transparent and responsible pricing. Investors are responding to this concern by arguing that an MFI may be able to build a competitive advantage by committing to client protection practices. Acting in a transparent, straightforward, and responsible manner can build client loyalty and attract new clients. Many MFIs recognize this and believe that client protection concerns are fundamental to doing good business, and they will have first-mover advantage by introducing good practices.

Investors are generally aware that the pace of implementation of the Principles will be different for different MFIs. None wants to further increase the funding/resources gap between Tier 1 MFIs and less developed MFIs. Hence, the focus currently is on reaching agreement on the Principles and working out implementation plans that prioritize areas

for attention and fit with an organization's stage of development. Hence, an investor might focus on ensuring clients are fully aware of the costs of borrowing but not expect an MFI to have a fully thought through ethics policy in place yet.

In some countries, there are specific concerns, for example, about potential conflicts between implementing practices to avoid over-indebtedness (Principle 1) and data privacy (Principle 6). Some MFIs are sharing credit information informally with other microfinance providers to check if there is multiple lending and guard against over-indebtedness. They are concerned that the information they are sharing on clients could potentially contravene the principle on data privacy.

There does not have to be a conflict between these two principles. The emphasis behind the data privacy principle is ensuring that individual clients have *consented* to any sharing of personal information and that data sharing is compliant with any local data protection legislation. To share personal information, MFIs should insert consent clauses within loan agreements stating that they will share client data with third parties, including credit bureaus and other lenders, as long as certain protections are followed. However, in some countries there are bank secrecy laws that prohibit sharing of client data. In these countries, MFIs are not allowed to ask for client consent and hence are reluctant to sign up to the Principles. If this is the case, investors can help by speaking to policy makers and financial regulators about the role of data sharing in ensuring responsible lending and advocate for regulations that allow such data sharing.

Overall, a vast majority of investors and donors view joining the Smart Campaign as the right and constructive thing to do to build improved practice and, eventually, performance standards across the industry. Public endorsement signals to the microfinance community that your organization takes client protection issues seriously and that you are joining the industry-wide initiative to identify workable improvements in products, practices, and policies to improve client protection.

For investor endorsement of the Principles to be meaningful, investers must move on to encouraging current and prospective investees to endorse and implement the Principles.

3. Encourage current and prospective investees to discuss and endorse the Principles.

The next step is to inform your investee MFIs of your commitment to the Principles. CGAP has drafted a template letter that can be modified and used by investors to communicate with MFIs (Annex 1). Investors are also educating MFIs about the Principles by including them in presentations and discussing them in-depth with current or prospective investees.

Investors are typically not making it mandatory for current or prospective investees to join the Campaign and endorse the Principles. Rather, at this stage most see the

Principles as important topics for dialogue and building a shared understanding and approach to implementing client protection practices over time.

Over the past year, many investors have communicated their endorsement of the Principles to investees. Here is what they are finding:

- Awareness and knowledge of the Principles is mixed. Grassroots Capital found that about 30 percent of investees are already familiar with the Principles; thus, for 70 percent of their partners, Grassroots Capital is the one doing the education and awareness raising.
- Some MFIs, including those that are doing a lot about client protection in practice, are wary about formally joining the Campaign for the reasons outlined earlier. However, typically when MFIs question endorsement it is because they want to make sure that they understand what the implementation of the principles will require and that they will be able to implement any needed measures. They want their endorsement to be meaningful (which is a good thing!).

Equity investors are finding that board meetings provide a very productive opportunity to discuss the Principles and the status of implementation. Board-level buy-in also helps ensure that there is follow-up, for example, by conducting a self-assessment using the Smart Campaign tool.

4. Develop, test, and refine criteria and procedures to assess investee implementation of the Principles during screening and due diligence processes.

Most investors are focusing now on how best to assess adequate implementation of client protection practices by current and prospective investees. **One key strategic choice is whether it is better to have assessment of the Principles as a separate part of due diligence carried out by specialist staff, or to integrate it into standard due diligence.** Our inclination is that client protection be integrated into your organization's core due diligence so that it gets done consistently, and performance on client protection issues is clearly seen as one dimension of operational and credit risk assessment. A downside of such an approach, however, is that the quality and depth of the assessment might be lower. One way to guard against this is to have a standardized due diligence tool that identifies considerations to be assessed on a systematic basis.

CGAP has developed a due diligence checklist to provide input into the due diligence tools that investors themselves are adopting.[3] The checklist was developed to respond to

[3]This due diligence tool has drawn on the work of Deutsche Bank, FMO, Grassroots Capital, Incofin, KfW, Oikocredit, and Triodos.

investors' requests for a streamlined and more standardized approach for assessing client protection practices. The checklist draws on the tools and indicators being developed by investors and others involved in the Smart Campaign, and it helps to share emerging practice. A summary of the checklist is provided in Box 1, with the full set of questions in Annex 2. The full version of the checklist will be available on the Smart Campaign Web site.

The due diligence checklist is primarily for investors and funders that invest directly in retail financial institutions providing microfinance products. Those that outsource their due diligence function can include these topics in the due diligence team's terms of reference. But the tool could also be used in other ways. For example, limited partners considering investment in an MIV or fund or grant funders of apex organizations could use this tool to ensure that the fund/apex managers review client protection practices as part of their own screening procedures. Investors may consider requiring use of the checklist as a condition for their participation in a fund.

While developed for microfinance, the checklist is designed to be appropriate for those who invest in any retail financial institution, including consumer lenders. Ultimately these client protection practices need to become standard practice across all retail financial institutions to provide clients with appropriate levels of protection and ensure responsible banking practices become the norm worldwide.

Investors can decide how to make use of the checklist. Several social investors have integrated their client protection assessment criteria into their social performance scorecards and questionnaires, which complement their financial due diligence.

Box 1: Client Protection Due Diligence Checklist

This checklist includes 12 client protection questions to ask when conducting due diligence on client protection practices in the field. The questions are organized under common due diligence topics and designed to be integrated into investor's own tools and processes. The checklist provides practical tips for investors on how to assess practice and what to watch for. Annex 2 presents a more detailed version of the tool with more guidance. This tool is also available as a stand alone document on http://www.microfinancegateway.org/p/site/m/template.rc/1.9.49071/.

1. Is there evidence of intense competition leading to overheated lending? For example, is it widely known that borrowers have more than one loan with more than one institution? This question is discussed further in the next section.

2. Is there a Board-approved code of ethics that management and staff are expected to follow? Is there a committee dedicated to oversight? The Smart Campaign provides a useful tool—How to Develop an Institutional Code of Ethics—and a list of ethics codes from a range of institutions.
3. How well does the financial institution manage risk and return? What do the financial indicators show?
4. Are prices, terms, conditions, and risks of all financial products fully disclosed to the customer prior to sale?
5. Are staff trained to communicate effectively with all customers, ensuring that they understand the product, the true costs and risks, the terms of the contract, their rights, and obligations?
6. Are prices reasonable, fees and penalties not excessive, and bundling of products optional?
7. Does the loan underwriting process require an assessment of repayment capacity?
8. Is there a sound loan restructuring policy requiring the number and amounts of rescheduled loans to be clearly reported and designated a higher reserve rate?
9. Are acceptable and unacceptable debt collection practices clearly spelled out in a book of staff rules or debt collection manual?
10. Do productivity targets and incentive systems value portfolio quality at least as highly as growth?
11. Is there a mechanism to handle customer complaints that is actively used and has a dedicated staff?
12. Does the financial institution have a written privacy policy that requires staff to explain how clients' data will be used and seek their permission for use?

Some basic minimum standards are emerging for several of the Client Protection Principles, such as the principles of collections practices, complaints mechanisms and resolution, and privacy of client data. However, other questions, such as preventing over-indebtedness measures, are more complex, and what is emerging is guidance based on investor experience, rather than hard-and-fast standards. This guidance is presented in the full version of the tool and highlighted in Section V.

5. Integrate the Principles into financing or shareholder agreements as appropriate.

Whether to integrate explicit Principles-related provisions into the financing (debt and equity) documentation used by lenders and investors in microfinance remains a subject of debate. Some question whether it is too soon to start including such provisions in financing documentation, given the early stage of client protection implementation and standards. Others have voiced concerns about the scope, enforceability, and capacity to monitor compliance of such provisions.

Investors who decide, in principle, to include client protection provisions in their financing agreements, might want to make certain decisions: do certain types of investments require more explicit provisions than others, and are certain types of financial institutions better prepared to handle explicit Principles-related provisions in their financing documents than others? For example, if a financial institution conducts a portfolio sale or securitization of its microloans, one could argue that such an institution *must* be able to demonstrate its adherence to a fairly sophisticated consumer protection policy or program (to ensure that it is not pushing credit inappropriately on to customers, knowing it can then sell those loans to others). An equity investor may include a provision requiring that shareholders and directors be informed quickly of any significant allegations of unethical lending practices. On the other hand, lenders that do not have a governance role in the MFI may want to rely more on due diligence before they decide to disburse a loan.

Some investors, such as Aavishkaar Goodwell, Incofin, and KfW, have drafted and inserted standard clauses, such as requiring financial institutions to assess the repayment capacity of clients, in both their loan and equity documentation related to client protection. Their view is that this signals the seriousness with which they take these issues, and the covenants also provide them with possible redress in the case of a serious abuse of client protection principles. They recognize that compliance may be an incremental process, but they may want to ensure an up-front commitment on behalf of the investee to client protection. Other investors, such as Oikocredit, feel that legal clauses are not necessary at this point, and they focus their efforts on working with their partners to improve practices.

One factor that may shape the scope and reach of embedding the Principles into financing documentation is the requirements of local law and regulation. It makes sense for investors to have local counsel assess the extent to which local laws and regulations impose any consumer protection, data privacy, or ethical lending practice requirements on the MFI. If such laws exist, investors may consider including a requirement in financing agreements that the MFI comply with all applicable laws and regulations. The opening statement of KfW's clause is provided in Box 2.

Box 2: KfW's responsible finance clause

The Borrower shall fully comply with all existing and future national laws and regulations on consumer protection especially in the area of financial services. The Borrower shall in particular provide its customers with clear and comprehensive information on the main characteristics of the financial services the customers seek. The Borrower shall, for example, have thoroughly informed its customers in good time before the signing of a loan agreement on the terms and conditions of the loan in a way easily understandable for the customer.

These loan agreements shall further contain such information and shall be drafted in a manner the customers are able to understand. Furthermore, the Borrower shall critically review the customer's repayment capacities before signing a loan agreement and shall refrain from any form of unfair or even harmful debt collection practices.

Legal covenants may be particularly important when investors are considering how to ensure that their intermediaries, such as MIVs or apex organizations, are accountable for ensuring good client protection practices at the retail level. KfW aims to get its responsible finance clause into shareholder agreements with fund managers. This requires raising the topic with all other shareholders. It will be interesting to observe how these discussions unfold and whether there is push-back from funds. Leading specialist microfinance fund managers, such as Blue Orchard and responsAbility, are already engaged in promoting client protection and will share the concerns of their investors with the Smart Campaign.

Another example is Symbiotics, which has had an internal debate with investors about how to integrate environmental, social, and corporate governance (ESG) issues into Symbiotics' fund management mandate and advisory services. Investors that invested in the recently launched REGMIFA Fund have agreed on a proposal made by Symbiotics regarding ESG policies and procedures, to include among other things a responsible finance clause incorporated into loan agreements, committing the MFIs to adopt ethical practices.

6. Monitor implementation of the Principles by investees through mandatory reporting and regular monitoring and evaluation.

Designing a system to monitor MFIs' progress in implementing the Principles is an important part of investor oversight. Monitoring processes will differ depending on the nature of the investor. Investors that invest directly and carry out field-based due

diligence are typically incorporating a review of Principles implementation into their annual performance reviews. These investors, which include Incofin and Triodos, believe that self-reporting on client protection indicators is more difficult than for other social performance indicators, and they rely on their own field assessments to assess progress. Other investors may also request social ratings that include a verification of adherence to the Principles.

Others are designing surveys to gather MFI feedback on implementing the Principles. Adherence to the Client Protection Principles is included in the Social Performance Report of MIX to which MFIs self-report. The social performance reporting framework is widely promoted by the Social Performance Task Force and used by many MFIs and investors. Some social investors are including client protection questions into their own annual reporting or requiring investees to complete the MIX social performance report. Symbiotics is currently developing an online interface that will include 23 questions on client protection, all based on the MIX social performance reporting format. Its investees will have to answer those questions every year. In turn, this information will be verified by its analysts through field visits. Deutsche Bank has a similar approach.

7. Report on progress to investors and other stakeholders.

The final step is for investors to report their commitment and actions taken for implementing the Principles to their shareholders and other stakeholders. Some investors are already reporting on the Principles. With the financial crisis, many shareholders have increased their focus on the social impacts and returns of microfinance and are asking partners to report more information. Since 2009, Calvert Foundation has made significant progress to incorporate social performance into its annual reporting with questions on client protection, such as over-indebtedness, transparent pricing, and client satisfaction. Equity funds, such as Aavishkaar Goodwell, have included the Principles in their social and environmental reporting, laying out the action steps taken to incorporate the Principles into their processes.

To hold investors accountable for progress in integrating the Principles into their processes, CGAP has integrated questions on client protection implementation into its annual MIV survey. According to the CGAP 2010 MIV Survey, more than 80 percent of the MIVs have endorsed the Principles compared to 61 percent in 2009.

V. Implementation Challenges and Emerging Responses

This section discusses critical questions and issues that are arising as investors implement the Principles and their responses to date.

Understanding the current market environment

How do you assess the level of market saturation and potential for over-indebtedness before the bubble bursts? Investors have become more aware of the problem of over-lending over the past year. And most are developing strategies to help them better understand the current market environment as an integral aspect of making investment decisions in an individual MFI. The advice emerging from investors is as follows:

- When assessing a microfinance investment opportunity, look explicitly at the issue of market saturation and growth rates at the market level. Review the gross measures of market penetration, such as the number of MFIs operating, total number of clients compared to conservative estimates of demand, total portfolio per capita, and rates of growth. These may provide an initial approximation of whether the market is saturated. High growth rates, in particular, can be an early indicator of potentially harmful lending.
- Conduct interviews across the industry to determine whether there is evidence of multiple borrowing by clients, including both from microfinance providers and commercial banks. EFSE carried out a study of over-indebtedness in Bosnia–Herzegovina and found that there were substantial levels of multiple lending and actual levels of over-indebtedness and that it was not limited only to MFIs. The study also found a high level of cross-guarantees, including to clients who had repayment problems. The terms of reference of this study are available.
- Review whether there are local standards among MFIs that provide reassurance that management is aware of and taking action to avoid multiple borrowing and over-indebtedness, e.g., MFIN in India (association of NBFCs) has adopted a pledge that members will not make a loan to anyone who has more than three loans already or an agreed total amount outstanding.
- Beware of any of the following red flags:
    - There is no credit bureau, most MFIs do not belong or do not have ways to check if a client has multiple loans.

- Rapid annual portfolio growth rates in highly competitive markets.
- Abundant debt funding accessed by MFIs to support more growth, leading to a buoyant cycle.
- High portfolio at risk and aggressive write-offs.
- Multiple clients borrowing from multiple institutions. Even in the absence of official statistics, financial institutions can generally provide an estimate of the number of borrowers who have multiple loans.
- Over-stressed risk management systems (high growth in new staff, outdated management information systems, growth outpacing internal control systems, and erosion of credit discipline).[4]
- Inadequate credit analysis, rigid products, high-volume targets, incentives that reward growth over quality, and high competition in a saturated market can drive borrower over-indebtedness systemically.[5]

Investors can work with MFIs to put in place practices to help guard against over-lending and over-indebtedness. For example, they can require the Board or a subcommittee to have specific responsibilities in this area and make sure it has the appropriate monitoring tools.

Some investors may also have the capacity to help strengthen institutions at the macro level, particularly to set-up or improve the effectiveness of **credit bureaus**. Credit bureaus play a crucial role in enhancing transparency in the bank–client relationship that is needed to ensure sound credit decisions and help avoid client over-indebtedness. Where credit bureaus do not yet exist, investors can discuss the need for and possibility of setting up credit bureaus and may potentially be able to invest in credit bureaus. Investors can also help ensure that "alternative data," including lending data from nonbank MFIs, are shared with credit bureaus so as to help "thicken" the credit reference files of low-income clients.

However, it should be recognized that credit bureaus are not the solution to the problem of over-indebtedness. First, credit bureau information is sometimes used by commercial lenders to identify possible customers and to sell them loan products without due care as to their capacity to pay. In more developed financial markets, such as Peru and Poland, microfinance providers are already running into competition with finance companies and banks selling high-cost credit to low-income people. Second, credit bureau

[4]CGAP, "Growth and Vulnerabilities in Microfinance," Focus Note 61, February 2010.
[5]Smart Campaign, Center for Financial Inclusion, Conducting Client Protection Assessments: A Guide (February 2010).

data are typically used by credit providers to carry out credit scoring, which tests a person's "propensity to pay" rather than their "ability to pay." Credit scoring typically has no income dimension, so consumers with negative affordability can still be approved credit based on their credit score alone. Hence, MFIs need to make sure that they are checking affordability in the ways described below.

Assessing over-indebtedness levels

What is an acceptable level of indebtedness? Investors are now very aware of the need to ensure that Principle 1—avoidance of over-indebtedness—is being implemented by MFIs. However, questions about how to assess a client's ability to pay and what would be considered an unacceptable level of debt remain. Investor feedback suggests that there can be no one standard: debt repayment capability depends on the product, the business, and whether it is a group or individual loan. However, it is clear that the MFI should have a methodology to assess the borrower's ability to repay that can be judged and is systematically applied and monitored, and is always conservative.

Most investors underline the importance of going back to basics and ensuring the MFI has in place a solid lending methodology that includes an assessment of a client's estimated disposable income (EDI) and ability to afford loan repayments.

EDI = Net Monthly (or weekly) Income − Net Monthly (or weekly) Outgoings (including household expenditure and existing credit commitments)

This is usually assessed through information provided on the client's credit application form or from an interview. Estimates can also be made from national household expenditure survey data. However, these are less reliable. Investors then expect the MFI to have a guideline for the percentage debt service (the amount they will have to repay in that period, including capital and interest) compared to EDI. FMO sets guidance that acceptable affordability levels range from installments of 30–50 percent of disposable income. Triodos advises setting guidelines by type of credit product. Hence the installment/EDI typically would be lower for consumer credit (20–30%) but higher for microenterprise lending (50–70%).

Also critical is that the financial institution makes lending decisions based on cash flow analysis and does not rely on assets that may inflate the balance sheet and allow for more debt than prudent cash analysis would allow.

One challenge is assessing MFIs that use the Grameen or other group lending methodologies, which do not focus on assessing individual borrower's repayment capacity

but rather rely on the character assessment and trust of solidarity group members in each other's ability to repay. The Client Protection Due Diligence Tool provides some guidance on this. Advice includes reviewing group membership policies to verify that groups are generally self-selected based on character, not collateral, and to check whether the MFI trains group members in how to assess cash flows for common types of businesses.

Be aware that investor return expectations and financing conditions can create pressure for unsustainable growth.

Do investors need to be considering how their own return expectations might fuel irresponsible lending? This is a fundamental question. The evidence from overheated, high-growth microfinance markets, such as Bosnia and Morocco, is that some of the pressure to achieve very high growth rates (20–30% portfolio growth year-on-year or even more) that led to overlending and over-indebtedness was driven by investors' portfolio growth and return expectations. Investors' expectations of scale and market share and their short time frames for growth and profitability may create incentives for unsustainable and even irresponsible practices. High-growth MFIs are finding that some investment funds providing equity are more focused on achieving a high-return exit for themselves than promoting responsible practices and well-planned growth.

Red flags that investor expectations could drive unsustainable growth include the following:

- If portfolio growth and return on equity expectations at either the financial institution or investment fund level remain the same despite economic downturns or other adverse developments, the board should be requested to justify these expectations.
- The investee is highly leveraged and has not developed appropriate assets and liabilities management systems. Capital adequacy standards might be applied that are relevant to the organizational form and size.
- Substantial investments in systems development, maintenance, or staffing are not being made.

MFIs themselves may hesitate to raise with investors the need to reduce growth rates and discuss longer term, lower return prospects, as they do not want to deter investors. In times of high growth, access to external finance can be essential, particularly for credit-only institutions. When being realistic, some MFIs in mature markets are reducing their internal annual portfolio growth projections from 30 percent to 5 percent, and in less developed markets from 60 percent to 30 percent. While they may still accede to investor

return expectations of 15 percent, for example, they are aware that a more responsible, realistic return level would be 5 percent.

Return expectations and the underlying assumptions must be discussed, and both investors and financial institutions need to provide clearer market signals. Are investor return expectations excessive in some instances? Will commercial investment slow if return expectations cool down in mature markets? What are the risks for the sector as a whole as well as for the parties on either side of the conversation?

Transparency and responsible pricing

Is it realistic to expect MFIs to disclose accurately their full cost of credit if competitors do not—and for investors to insist they do so? What is considered "responsible" pricing? At a minimum responsible pricing relies on full disclosure by the seller to enable a customer to make informed decisions. Most investors feel it is appropriate to expect that providers disclose their prices completely and in a fashion comprehensible to clients, but that it is unrealistic to expect industry players voluntarily to disclose using a standard that would permit full comparability—such as the annual percentage rate or effective interest rate—when competitors are not doing so. Investors have more leverage when disclosure is required by regulation for all providers, rather than when it is subject to negotiation with individual providers, e.g., in South Africa. CGAP and some development finance institutions are making efforts to spread good practice in disclosure regulation, e.g., Focus Note 64 "Protecting Branchless Banking Consumers: Policy Objectives and Regulatory Options." Hence, hopefully, there will be improvements in this area.

However, even without disclosure regulation, investors can be pro-disclosure and encourage a step-by-step approach. Investors can send a message that there could be a first-mover advantage to disclosing interest rates and that this action will likely encourage greater disclosure among other MFIs. Clients may show greater loyalty and switch to an MFI that is transparent and seen to be trustworthy.

For most investors a "responsible" price (including interest, fees, commissions, mandatory savings or cash collateral, etc.) needs to be viewed in the context of local markets, the stage of the development of the MFI, and the costs of outreach to specific client segments. Smaller loans and rural outreach are simply more expensive, and this needs to be figured into analysis of responsible pricing, so as not to unintentionally disadvantage these activities. Rates should be sustainable so as to cover all operating costs. Analysis of the MFI's business model, its efficiency and return ratios, and prices of competitors offering similar products in similar segments may help an investor assess whether the financial institution's prices seem out of line.

The **MicroFinance Transparency** initiative (MFTransparency) can also help investors assess what is a reasonable interest rate by providing country-level interest rate data for certain countries. MFTransparency collects and standardizes microfinance price data for individual country markets. It publishes these data as a series of interactive tables and graphs. As of November 2010, there are live data for Azerbaijan, Bosnia-Herzegovina, Cambodia, and Kenya, with data being collected for Peru, Bolivia, Ecuador, India, and other countries. The Web site also has a useful tool to calculate and understand interest rates, annual percentage rates, and the correlation of operating costs and loan size.

Using MFTransparency data, the Smart Campaign has drafted a discussion paper on responsible pricing and its state of practice, which examines the full range of approaches to responsible pricing of loans, from promoting competition, to return on equity limitations, to interest rate caps, to comparative transparency.

Provision of pricing incentives by investors for client protection

Some investors are providing positive incentives for MFIs to perform strongly on social issues, including client protection, through the pricing and terms of their own financing. For example, Incofin provides better financing conditions for MFIs that have achieved a minimum level of both social and financial performance. Oikocredit has a similar pricing policy.

Use of grant funding

Investor organizations with grant funding can play an important role in helping MFIs build the capacity to implement the Client Protection Principles in the following ways:

- **Strengthen internal capacity of MFIs.** Provide MFIs with technical assistance resources to undertake a client protection assessment/social rating and develop the systems, training, incentives, etc., to apply the Client Protection Principles in their organization. This can be done as part of larger social performance management efforts. *SDC offers training to partners on social performance measurement and reporting, including the Principles. UNCDF will fund client protection assessments for some of its MFI partners.*
- **Reward good practice.** Several investors reward microfinance providers that can demonstrate particularly strong performance on client transparency and fair treatment—with more financing, financing on better terms, and visibility. Donors can consider something similar when using performance-based payments. *UNCDF includes client protection targets in it's performance-based agreements.*
- **Support industry-wide initiatives.** Provide grant funding for sector-wide initiatives to further the client protection agenda, invest in tools development, conduct monitoring,

etc. (e.g., funding for the Smart Campaign or support for national microfinance associations to promote this agenda). Ensure coordination with these efforts and those related to broader social performance management issues. *The Michael & Susan Dell Foundation and Ford Foundation support the Social Performance Transparency Award. The Netherlands Ministry and MasterCard Foundation provide grant support to MFTransparency and the Smart Campaign.*

- **Educate clients.** Support consumer awareness initiatives and financial education that assists clients improve their financial literacy and ensure responsible borrowing. *DFID created a Financial Education Fund to catalyze experimentation and learn about different approaches to financial education. GTZ supported Ghana to develop and implement a national financial education strategy.*

Implementing the Client Protection Principles is essential to ensuring that the future growth of microfinance is driven by its social mission and is beneficial for its clients. A committed focus to client protection is particularly needed now as some microfinance markets tackle problems of multiple lending and client over-indebtedness. This report has demonstrated how investors are already engaging with this agenda. As they continue to implement the Client Protection Principles, norms and standards will continue to develop. CGAP aims to help facilitate knowledge sharing in this area to help build financial systems that deliver responsible finance for all.

VI. Resources and Tools

Investment policy and screening

FMO—Guidelines for Consumer Finance
KfW—Responsible Finance Paper

Due diligence

Deutsche Bank—Due Diligence Questionnaire for Head Office
Deutsche Bank—Due Diligence Questionnaire for Branch Office
Deutsche Bank—Loan Application
Deutsche Bank—Effective Cost of Borrowing in Microfinance
Deutsche Bank—Microfinance Effective Interest Rate Calculator
FMO—Guidelines for Consumer Finance
Incofin—Assessing MFIs Social Performance
KfW—Responsible Finance Checklist at Institutional and Macro Levels
Oxfam Novib—Social Performance Questionnaire
Triple Jump—Due Diligence Questionnaire on Client Protection
Smart Campaign—Conducting Client Protection Assessments: A Guide
Microfinance Transparency—APR Calculator
MIX—Social Performance Standards reporting for MFIs
responsAbility—Exclusion List for Microfinance Institutions
CGAP—Client Protection Due Diligence Checklist

Investment decision making

Deutsche Bank—Investment Decision Memo
KfW—Clause for Financing Contract
KfW—Responsible Finance Clause for Funds/Apex Institutions

Monitoring

Deutsche Bank—MFI Annual Review
Deutsche Bank—Effective Cost of Borrowing in Microfinance
Deutsche Bank—Microfinance Effective Interest Rate Calculator
Incofin—Assessing MFIs Social Performance

Reporting

Grassroots Capital—Social Performance Indicators
Calvert Foundation—Core Social Performance Indicators for Annual Reporting
Symbiotics—Annual Reporting Form on Client Protection
CERISE—Auditing the Social Performance of Microfinance Institutions: SPI Questionnaire
CERISE—Auditing the Social Performance of Microfinance Institutions: Operational Guide to the SPI Questionnaire
Incofin—Assessing MFIs Social Performance

Annex 1 Draft Sample Letters from Endorsing Investor to Investee MFI

FOR INVESTORS WITH DIRECT RELATIONS WITH MFIs

Dear xxxxx,

We wanted to let you know that [NAME OF INSTITUTION] has recently signed up to support the **Client Protection Principles for Microfinance**. The purpose of these Principles is to ensure that all providers of financial services to low-income populations take concrete steps to protect their clients from potentially harmful financial products and ensure that they are treated fairly.

There are six client protection principles:

- Avoidance of over-indebtedness
- Transparent and responsible pricing
- Appropriate collections practices
- Ethical staff behavior
- Mechanisms for redress of grievances
- Privacy of client data

Attached is a description of what each of these principles means in practice.

Additional text used by Developing World Markets

A commitment to avoid over-indebting clients is part of these core client protection principles, as well as carefully establishing the clients' ability to repay before granting the loan. Transparent pricing requires that the effective interest rate for the microcredit is prominently published in the loan contract and marketing materials. Ensuring that the microfinance client clearly understands the terms of the contract is a mutually beneficial practice to create a long-term relationship built on trust. A debt collection process should be established and clearly disclosed that does not deprive customers of basic survival capacity. Finally, incentives will also ideally be in place in your institutions to reward robust risk management.

You may have already heard of the accompanying Smart Campaign, a collaborative initiative led by a broad coalition of microfinance institutions, networks, and funders that reflects the consensus within the microfinance industry that now is the time to join together and proactively safeguard the interests of microfinance clients through appropriate policies, practices, and products related to these principles.

[NAME OF INSTITUTION] is committed to building the Client Protection Principles into our own investment policies, including our due diligence and monitoring and reporting processes. We would like to do this as a collaborative process with our partner microfinance institutions. Together we aim to identify how best to implement the principles and incorporate them into your policies, procedures, staff training, and compensation incentives.

During our next visit, we look forward to discussing the Principles with you in more depth. If you haven't already done so, we would also encourage you to review and consider endorsing the Client Protection Principles yourself (see ***www.smartcampaign.org***). This Web site has tools and good practice notes based on practitioners' experience that can also help you in implementing the Client Protection Principles.

FOR INVESTORS WORKING THROUGH INTERMEDIARIES

Dear xxxxx,

We wanted to let you know that [NAME OF INSTITUTION] has recently signed up to support the **Client Protection Principles for Microfinance**. The purpose of these Principles is to ensure that all providers of financial services to low-income populations take concrete steps to protect their clients from potentially harmful financial products and ensure that they are treated fairly.

There are six client protection principles:

- Avoidance of over-indebtedness
- Transparent and responsible pricing
- Appropriate collections practices
- Ethical staff behavior
- Mechanisms for redress of grievances
- Privacy of client data

Attached is a description of what each of these principles means in practice.

You may have already heard of the accompanying Smart Campaign, a collaborative initiative led by a broad coalition of microfinance institutions, networks, and funders that reflects the consensus within the microfinance industry that now is the time to join

together and proactively safeguard the interests of microfinance clients through appropriate policies, practices, and products related to these principles.

[NAME OF INSTITUTION] is committed to building the Client Protection Principles into our investment policies, and will be doing this in partnership with [[our fund managers]]. If you haven't already done so, we would also encourage you to review and consider endorsing the Client Protection Principles yourself (see ***www.smartcampaign.org***).

Annex 2 CGAP Client Protection Due Diligence Checklist

12 Key Questions

These 12 questions on client protection are organized according to topics used in investors' screening and due diligence, although formats and organization may differ. The questions are designed to "add in" to interviews and document review. Interpreting the answers to the questions requires engagement; further probing and investigation are often required.

Guidance on good practice and indicators for caution are presented. Some of the Client Protection Principles lend themselves to quantitative indicators; others will always be process indicators. Concerns are identified for monitoring and developing a follow-up action plan. Expect financial institutions to show strong performance in some areas, and weaknesses (or nothing) in other areas. The annex provides additional considerations referenced by question.

When reviewing a financial institutions'. . .	*Ensure these questions are addressed. . .*	⚠ *Use caution when. . .* ★ *Note good practices when. . .*
Current market environment	1. Is there evidence of intense competition leading to overheated lending? For example, is it widely known that borrowers have more than one loan with more than one institution?	★ Regular industry updates are provided on the number and size of financial institutions in the market and on aggregate volume of lending matched to realistic estimates of overall demand levels. For example, Grassroots Capital uses aggregate measures of penetration (total clients with no adjustment for double counting/population), numbers of MFIs operating, and total portfolio per capita) as a first approximation. ★ Financial institution management is aware of the potential for over-indebtedness and taking action to avoid it. For example, the MFIN Initiative in India (an association of NBFCs) has adopted a pledge that members will not lend to anyone who already has more than three loans or total amount outstanding of Rs. 50,000. ⚠ There is no credit bureau, checking is not required, information is not reliable or current, or most microfinance providers do not belong. ⚠ Informal information sharing among financial institutions is deemed unreliable. ⚠ Even when official statistics are not available, financial institutions note one of the serious issues they confront is multiple borrowing. ⚠ Portfolio at risk (PAR), write-off, customer and staff complaints, and loan officer turnover are increasing from historical trends, especially in several branches. ⚠ The financial institution uses credit bureau information to aggressively market to competitors' customers. ⚠ Industry-wide performance statistics show high annual portfolio growth rates in mature, saturated, and competitive markets.

(continued)

When reviewing a financial institutions'. . .	*Ensure these questions are addressed. . .*	⚠ *Use caution when. . .* ★ *Note good practices when. . .*
Corporate Governance	2. Is there a board-approved code of ethics that management and staff are expected to follow and a committee dedicated to oversight?[6]	★ Board and staff committees address ethics.[7] ★ Ethics are regularly monitored by internal audit; whistle blower protection is addressed.[8] ⚠ The board or a board committee does not consider ethics as part of reputation risk. ⚠ Staff are not aware of ethical codes of conduct and are not rewarded or sanctioned for compliance or violations, respectively.
Corporate Governance: Managing Risk and Return	3. How well does the financial institution manage risk and return? What do the financial indicators show?	⚠ "A constellation with ROE > 25%, a PAR 30 days of 10%, effective interest rates > 40% and insignificant levels of loan loss reserves would give a first hint to irresponsible lending practices."[9] ⚠ If MFIs charging medium–high rates are earning ROAs higher than 5% use caution—the MFI may be focused more on generating financial return than on passing on high earnings to reduce interest rates for clients.[10]
Product Offerings	4. Are prices, terms, conditions, and risks of all financial products fully disclosed to the customer prior to sale? 5. Are staff trained to communicate effectively with all customers, ensuring that they understand the product, the true costs and risks, the terms of the contract, their rights and obligations?	★ Simple, standard disclosure in marketing material for all products. ★ Loan contracts include a complete amortization table, including all fees. ★ Staff make an extra effort to ensure customers with low levels of financial literacy clearly understand the costs and terms of the product, e.g., using a checklist or reading provisions of the contract aloud, and other communications techniques that work in the context and with the customers. ★ Customers "opt-in" to linked products, such as credit life insurance. ★ Penalties and late fees are disclosed before sale; they are not excessive and do not compound debt to unsustainable levels. (E.g., use of the *in duplum* rule.)[11] ★ Internal audit is tasked with monitoring to ensure standard practices are systematically implemented. ⚠ Loan contracts apply a flat rate or do not show installment payment amounts, separated by principal, interest, and other fees, or do not include the costs of mandatory linked products. A flat rate in itself is not necessarily

	6. Are prices reasonable, fees and penalties not excessive, and bundling of products optional?	a sign of nontransparent pricing. However, if interest rates are presented in this way, extra care should be taken to ensure that an amortization schedule is shared with clients clearly setting out repayments and the full cost of the loan, including the effect of compulsory savings, if any. ⚠ Fees and penalties are not explained prior to sale (e.g., minimum balances for savings or current account, arrears penalties, debt collections practices—including unauthorized automatic deductions from savings accounts, savings accounts blocked or seized, remittance fees and exchange rates.) ⚠ Credit life insurance is mandatory or benefits and costs are not well explained to the borrower.
Loan Underwriting—Credit Approval Process	7. Does the loan under-writing process require an assessment of repayment capacity?	★ Credit manuals include specific guidelines and ratios for the percent of net disposable income for borrower debt service according to installment interval or debt thresholds. For example, FMO sets guidance that the installment should preferably be below 30% but should not be above 50% of disposable income.[12] Triodos uses guidelines that differentiate ratios by credit product, e.g., for consumer lending an installment/disposable income ratio of 20–30%, for microenterprise lending, 50–70%.[13] ★ Cash flow formulas include adjustments for errors, or overly optimistic estimates, and low or high season estimates when relevant. ★ Local business norms include pledges regarding refraining from lending to clients who already have borrowed from others.[14] ★ MIS is used to track borrower late payments to determine credit risk and any increases in the loan amount. ⚠ Collateral, guarantees (peer, co-signer, or physical collateral) are the sole criterion for loan approval. ⚠ Loan evaluation relies on assets that may inflate the balance sheet, allowing for more debt than prudent cash analysis would permit. ⚠ MIVs are advised to conduct a review of a random sample of credit files to ensure that the files back up the credit assessment policies. Good policies may not translate into good practice.

(continued)

When reviewing a financial institutions'. . .	*Ensure these questions are addressed. . .*	⚠ *Use caution when. . .* ★ *Note good practices when. . .*
Bad-Debt Management Practices	8. Is there a sound loan restructuring policy requiring the number and amounts of rescheduled loans to be clearly reported and designated a higher reserve rate? 9. Are acceptable and unacceptable debt collection practices clearly spelled out in a book of staff rules or debt collection manual?	★ Credit manuals clearly identify steps in the collection practice; internal audit monitors practices. ★ Debt collection is a standard process, follows the code of ethics, and involves the legal department. ★ Collections agents are trained in ethical dilemmas of the job and ethical practices they are expected to follow. ⚠ Credit products feature liberal rollover of debt that is not captured as loan restructuring. ⚠ Rescheduled loans are not reported separately; provisions are not adjusted for increased risk. ⚠ Debt collection is ad hoc, deceptive, or abusive. ⚠ A "zero delinquency" policy can have negative repercussions on debt collections practices.
Human Resources	10. Do productivity targets and incentive systems value portfolio quality at least as highly as growth?	★ Loan officers and decision makers are held responsible for the quality of the loan. ★ PAR is used as an "entry pass" to receive a bonus. ⚠ No one can clearly describe how the incentive system values portfolio quality over growth. ⚠ Incentives reward growth (customers or portfolio). ⚠ The incentive bonus substitutes for a living wage.
Customer Service	11. Is there a mechanism to handle customer complaints that is actively used and has a dedicated staff?	★ Customers are informed of their right to complain and are actively encouraged to do so. ★ Various channels exist for customer feedback and complaints receipt. ★ Internal audit checks customer receipt of information about the complaints procedure. ★ Complaints are tracked, monitored for timely and unbiased resolution, and used to improve products and services.

		⚠ Suggestion boxes are the only means to solicit complaints. Unless there is abundant evidence that suggestion boxes are actively used, they are not considered effective mechanisms. ⚠ Resolution of complaints is not regularly tracked or monitored by internal audit or another monitoring unit.
IT Security and Data Privacy	12. Does the financial institution have a written privacy policy that requires staff to explain how clients' data will be used and seek their permission for use?	★ Clients know how their information will be used (e.g., credit bureaus, marketing campaigns, reports to funders, insurance providers, and other third parties.) ★ Written permission is sought before sharing client data with any outside party. ★ Data privacy is compliant with the law. ⚠ Client data are shared with third parties without verbal explanations or written permission. For example, complete data are shared with insurance companies rather than the minimum required for obtaining a policy; no permission is sought for photographs used in marketing campaigns or funder reports. ⚠ Clients are not informed that the financial institution consults with other lenders on an informal basis.

[6] See, Smart Campaign Web site for good examples of financial institution Codes of Ethics and "How to Develop an Institutional Code of Ethics," available at www.smartcampaign.org.

[7] Deutsche Bank's loan application asks "Does your Board monitor the institution's performance relative to the Client Protection Principles?" in CGAP (2010) Implementing the Client Protection Principles: A Technical Guide for Investors, p. 25. Several MFIs that have well-established complaints systems have established "whistle blower" protection, as ethics violations have serious consequences, such as employment termination or legal prosecution.

[8] Several MFIs that have well-established complaints systems have established "whistle blower" protection, as ethics violations have serious consequences, such as employment termination or legal prosecution.

[9] KfW Checklist for Promoting Responsible Finance, cited in CGAP, Implementing the Client Protection Principles: A Technical Guide for Investors, p. 25.

[10] This guideline is used by Deutsche Bank in its assessment scorecard.

[11] FMO Guidelines for Consumer Finance as cited in CGAP, Implementing the Client Protection Principles: A Technical Guide for Investors, p. 25.

[12] FMO Guidelines for Consumer Finance as cited in CGAP, Implementing the Client Protection Principles: A Technical Guide for Investors, p. 25.

[13] Interview with Triodos investment officer

[14] E.g., see the MFIN Initiative in India. Example provided by Grassroots Capital.