

# The Role of Funders in Responsible Finance

Most donors and investors supporting financial inclusion do so with an aspiration to improve poor people's lives. In recent years, the movement toward responsible finance has shaped the industry's belief that financial service providers have a responsibility to deliver financial services in a way that is transparent, fair, safe, and likely to generate benefits for poor clients.<sup>1</sup> There are two key dimensions to implementing the responsible finance agenda: client protection and social performance.

**Client protection** is essential to ensure that providers do not inadvertently harm their clients. It means that providers take reasonable care that their products, policies, and practices avoid harmful or unfair treatment and appropriately balance clients' and their own interests as they conduct business. This minimum standard of "do no harm" is part of the good conduct of business, regardless of the provider's specific mission, profit goals, or ownership structure.

**Social performance** is achieved if retail providers go beyond the "do no harm" standard of client protection to measure and manage progress against a specific social mission, ensuring effective translation of the mission into client benefit and appropriate behavior toward staff, the community, and the environment. While providers' social missions may vary, the most common social goals pursued by double and triple bottom line retail providers are outreach to underserved people, poverty reduction, and empowerment of women.

Retail providers are clearly the central actors in responsible delivery of financial services. Three complementary strategies can help providers put into practice a responsible finance agenda: (i) industry initiatives that focus on standards, knowledge, and information sharing; (ii) consumer protection policies, regulation, and supervision; and (iii) efforts to improve consumer awareness and financial capability.

## What Roles Can Funders Play?

There are two main roles donors and investors can play to reinforce these three strategies. First, they can integrate client protection and social performance management

considerations into their own investment and grant making due diligence processes, policy documents, agreements, and annual reports. In line with their social mission, funders can differentiate those retail providers that are responsible in their practices and treat clients well, from those that do not, and provide funding to those with responsible profiles. Several tools are available to help funders assess providers.<sup>2</sup> Second, funders can use grants and technical assistance to reinforce the three strategies and help improve practices and products, policies, and consumer capability (see Box 1).

## Industry standards, knowledge, and information sharing

Ultimately, responsible finance aims for all retail providers to incorporate client protection and social performance management measures in line with their social mission. In the long run, providers will be well-served by adopting responsible policies, products, and practices. These will help them better manage risks (such as over-indebtedness), adequately protect clients' interests, and deliver good value for money and quality. Several recent studies have indicated that balancing social and financial performance can be good for business.<sup>3</sup> However, in the short run, providers can face strong countervailing incentives to pursue gains in market share, efficiency, and profits that may come at the expense of clients' interests. Recent experiences in some competitive markets have demonstrated some of the risks associated with certain patterns of competition in overheating markets.<sup>4</sup>

Funders can help address these tensions at the retail level in three ways. First, they can offset, with grants or in-kind technical assistance, some of the upfront costs

1 The terms "microfinance providers", "retail providers", and "financial service providers" are used interchangeably in this Brief to refer to the range of institutions (banks, nonbank financial institutions, cooperatives, microfinance institutions, etc.) that extend financial services to low-income people.

2 See, e.g., CGAP (2010), which includes a due diligence check list that can be used by both donors and investors. Other tools are available at the Smart Campaign ([www.smartcampaign.org](http://www.smartcampaign.org)) and Social Performance Task Force Web sites ([www.sptf.info](http://www.sptf.info)).

3 See Gonzalez (2010) and Dewez and Neisa (2009)

4 See Chen, Rasmussen, and Reille (2010).

### Box 1. Technical Assistance for Providers

The Swiss Development Cooperation offers training to microfinance institution (MFI) partners on social performance measurement and reporting. The International Finance Corporation's Performance-Based Grants Initiative provides technical assistance (advisory services) to its partners to set clear social objectives and strategies, develop procedures and systems to achieve objectives, monitor indicators and assess progress, and use social performance management to improve organizational performance.

involved in assessment, market research, systems upgrades, staff training, and internal oversight to improve practices. For example, more funders are directly commissioning or giving grants for institutional assessments that identify weaknesses in internal systems and products, such as credit policies, product features, targeting tools, or management and reporting of social performance. Second, a new trend is that investors are offering favorable financing terms to those providers with more responsible profiles that can demonstrate particularly strong client protection and social performance. The third action that donors can take is to require transparent reporting according to emerging industry standards. Ideally, grantees should report to the global MIX platform. To date, more than 400 MFIs have submitted data on client protection and other social performance management measures to MIX.<sup>5</sup> Third-party verification of self-reported data through ratings can help flag areas for improvement and should be encouraged by funders. Building on this reporting and transparency work, donors can fund recognition programs, such as awards for those MFIs with good practices (see Box 2).

Beyond the retail level, funders can also support industry-wide initiatives and public goods that serve the broader sector. At the national level, grant funding can support sector-wide initiatives to raise awareness, develop tools and training, and support testing and consultation processes required to develop industry standards. Grants can also help build and strengthen the reporting infrastructure for transparency on retail provider performance. The leading industry initiatives, such as the Smart Campaign, the Social Performance Task Force (SPTF), and Microfinance Transparency,<sup>6</sup> work closely

### Box 2. Incentives for Retail Providers

Oikocredit provides a premium to investees that show good social performance, using a scorecard on their environment, social, governance (ESG) profile. The "extraordinary social relevance discount" reduces the negotiated interest rate by 0.25–1.0 percent, depending on the organization's score. The Inter American Development Bank (IADB) created a social performance award sponsored by Citi Foundation. The \$17,500 award recognizes MFIs that achieve their missions against stated client- and institution-level development goals, while maintaining efficient operations. With support from the Ford Foundation and the Michael and Susan Dell Foundation, MIX also gives a Social Performance Reporting Award that rewards MFIs' transparency on their social performance.

with microfinance associations and networks to field-test tools and train their members in improved client protection practices and social performance management. Among the supporters of the Smart Campaign to date are Credit Suisse, KfW, and ECLOF. The Ford Foundation, Swiss Development Agency, and Oikocredit are among the agencies that have supported social performance standards and tools development. Grant funding and in-kind technical assistance can also help build crucial infrastructure, such as credit information systems, for which IFC and others have provided extensive support. See Box 3.

Funders can also support research to better understand clients and the impact of various provider practices and product features. Several investment funds, such as the European Fund for South Europe (ESFE) and the Deutsche Bank Microfinance Fund,

### Box 3. Support for Industry Initiatives and Public Goods

The Ford Foundation is a co-founder of SPTF and has been a pioneer in social performance. It has supported the development of the MIX social performance indicators and a poverty measurement tool (the Progress out of Poverty Index). The Ford Foundation helped drive creation of social ratings and regularly requires them from its MFI partners. USAID financed the development of the Poverty Assessment Tool. The MasterCard Foundation stepped up support for the Smart Campaign and social performance management initiatives in sub-Saharan Africa.

<sup>5</sup> See Pistelli, Simanowitz, and Thiel (2011).

<sup>6</sup> MFTransparency gathers data about microfinance interest rates, calculates annual percentage rates and effective interest rates, and publishes educational material about microfinance pricing. The Smart Campaign unites microfinance leaders around implementation of seven core Client Protection Principles. SPTF is the microfinance industry standard setter and information hub for social performance reporting and management.

have contributed to research to better understand client over-indebtedness. Triodos and responsAbility co-financed a study by Zurich University to establish an early warning index to help prevent over-indebtedness crises in microfinance markets.

### Consumer protection policies, regulation, and supervision

In 2010, consumer protection regulation and financial literacy were the two most frequently cited policy reforms in a global financial inclusion survey of 142 economies (CGAP and World Bank 2010). The G-20, at its June 2010 Toronto Summit, also included consumer protection as one of its nine Principles for Innovative Financial Inclusion.<sup>7</sup>

Funders can support improvements in the enabling environment for financial consumer protection that complement and reinforce industry initiatives. For example, financial sector regulators can mandate measures that improve the effectiveness of well-calibrated disclosure and complaints handling to provide poor and more vulnerable consumers with improved transparency, choice, redress, and privacy.<sup>8</sup> Funders such as GIZ, KfW, Luxembourg, Switzerland, USAID, and the World Bank have supported country-level diagnostics that shed light on priority consumer protection issues in specific markets and follow-on assistance to implement recommendations and build regulatory capacity (see Box 4). Grants and technical assistance can be used to draft or amend legislation and rules, strengthen enforcement, or create an ombuds function for dispute settlement.

#### Box 4. Support Consumer Protection Diagnostics

GIZ, the German technical cooperation agency, undertook country diagnostics in four African countries on the three responsible finance strategies: industry self-regulation, consumer protection regulation and supervision, and financial capability. It is now working with stakeholders to implement recommendations on the ground.

The Bill & Melinda Gates Foundation has funded the Alliance for Financial Inclusion, a peer network of central banks and other financial regulatory bodies in developing countries, which has consumer protection as one of its priorities.

### Consumer awareness and financial capability

Measures at the retail and policy level are unlikely to succeed if consumers are not aware of their rights and responsibilities. Funders can play a useful role in supporting the nascent field of financial capability, which aims to develop the combination of knowledge, skills, attitudes, and especially behaviors that consumers need to make sound personal finance decisions. Many socially oriented financial service providers offer financial literacy training to improve clients' understanding and effective use of products. Broader financial education campaigns and programs are usually undertaken by public entities, including regulators, the education system, or consumer organizations. For instance, in the Pacific islands, central banks are leading efforts to integrate financial education in school curricula under the 2020 Money Pacific Goals initiative. Grants can support financial education for clients and other consumer awareness initiatives such as edu-tainment, including technical assistance for governments seeking to guide such interventions. Since knowledge and practice is at such an early stage, funder support for experimentation, research, and evaluation is especially useful. See Box 5.

### From Principles to Action

Awareness and action on responsible finance has increased significantly in the past few years. And

#### Box 5. Financial Capability Initiatives

Citi Foundation joined forces with Microfinance Opportunities and Freedom for Hunger in the Global Financial Education Program (GFEP) to help poor people build, protect, and better manage their assets. GFEP has collaborated with MFIs and others to develop a comprehensive financial education curriculum and train trainers in 59 countries to use them. Impact evaluations conducted by MFIs and NGOs that have implemented the GFEP curriculum indicate that program participants increased their savings and reduced their expenses as a result of knowledge gained from the program's modules.

In 2009, the Russian Federation funded the Financial Literacy and Education Trust Fund at the World Bank. The fund is providing \$15 million over four years for experimentation and development of toolkits for measuring levels of financial capability and evaluating the impact of financial capability programs.

<sup>7</sup> This public declaration was followed up with specific requests to the Financial Stability Board, OECD, and other international organizations to draft high-level financial consumer protection principles. See also CGAP (2011).

<sup>8</sup> See Brix and McKee (2010).

funders have played an important role in supporting work on improved industry practice, consumer protection policy measures, and financial capability. A Smart Campaign state of the practice report analyzes implementation of client protection by around 300 retail providers (Rozas forthcoming). It uses data from third-party assessments, including 12 in-depth Smart assessments, 110 ratings reports, and 357 due diligence assessments by four MIVs. The report concludes that, on balance, providers are working to improve their client protection practices. However, third-party evaluations consistently give MFIs lower scores than they self-report in the MIX client protection module of the Smart self-assessment tool. The gaps are largest on the most important Client Protection Principles: transparency, over-indebtedness, and responsible pricing. This shows the importance of independent assessments and highlights areas that require further work. See Box 6.

The end goal is widespread adoption of financial products and practices that reliably protect clients from harm, ensure them fair treatment, and improve their lives. Not surprisingly, there is still much work to be done. The first priority is to develop standards, metrics, tools, and an enabling environment for further progress on responsible finance, including on the next generation of thorny issues surfacing around noncredit products, responsible pricing, and balanced returns. The second is to assess on an ongoing basis whether these efforts are translating

### Box 6. From Principles to Action

The United Nations Capital Development Fund (UNCDF) endorsed the Client Protection Principles and encouraged all its partners to do the same. Since 2010, UNCDF performance-based agreements have referenced the Client Protection Principles, and the agency uses key quantitative indicators to track retail providers' progress on responsible finance.

More than 50 investors have signed on to the Principles for Investors in Inclusive Finance (PIIF), which commit endorsers to build client protection and social performance into their investment processes and act responsibly themselves. The United Nations Principles for Responsible Investment supports PIIF implementation, and signatories will report annually on specific actions they have taken.

into better outcomes for both clients and the institutions that serve them.

Improving performance is an incremental process. Donors and investors are well positioned to be strong partners to retail providers, policy makers, and industry players working to ensure that poor people around the world have access to quality financial services. By sending the right signals and aligning their investment and grant decisions with responsible finance goals and practices, they themselves can be responsible funders.

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