FINDINGS FROM SOCIAL RATINGS

Authors: Micol Guarneri and Lucia Spaggiari, Social Rating Department
Acknowledgements: we owe special thanks to Silvia Lucherini for the statistical analysis and to Eugenie Constancias and Michael Fabbroni

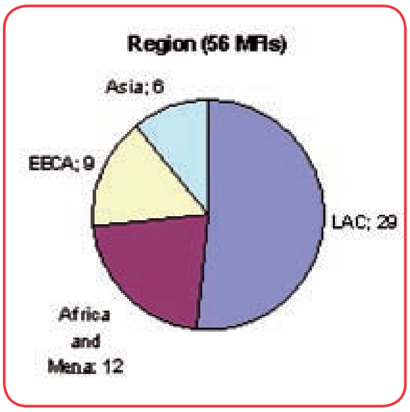
Consumer Protection and Social Responsibility

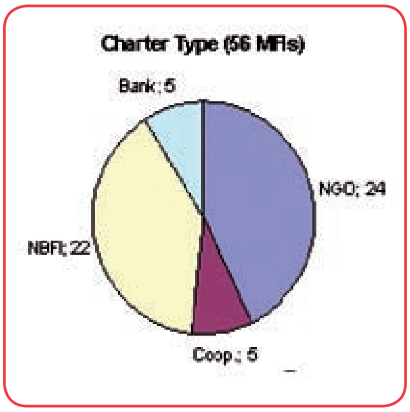
INTRODUCTION

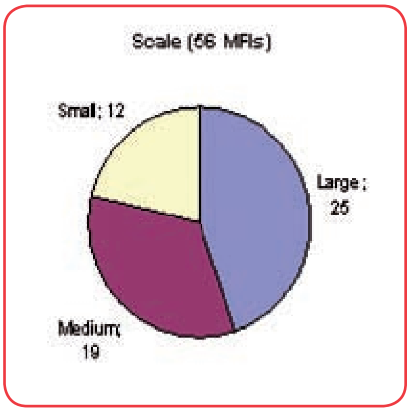
Social Responsibility and consumer protection have become critical issues in microfinance and there is evidence of a continuing effort within the sector to apply corporate social responsibility standards (staff, clients, community and environment) to microfinance as well.
Moreover, the need to put clients first and to protect them from possible negative effects of the services provided is even more important for the microfinance industry whose declared target is to reach out to poor and vulnerable people.
The Smart Campaign was launched as a global effort to unite microfinance leaders around a common goal: to keep clients as the driving force of the industry and to widespread the implementation of **6 consumer protection principles** (CPP) as indicated in the table.

- Preventing Overindebtedness
- Transparent and Responsible Pricing
- Appropriate Collection Practices
- Ethical Staff Behaviours
- Mechanisms for Redress of Grievances
- Privacy of Clients Data

Social Ratings are not only about consumer protection but also about the overall social performance of an MFI. It assesses the capacity of an MFI to put its mission and values into practice and achieve its social goals. The microfinance industry is currently facing a transparency gap between the stated social missions of MFIs and their actual social performance. Social ratings are intended to help fill this gap.
A social rating consists in evaluating four dimensions one of this being Social responsibility and Consumer protection. The area of social responsibility focuses on those policies and procedures implemented by the MFI contributing to an overall positive impact on society, including clients and staff, community and environment. The analysis of the customer protection dimension is aligned with the six principles promoted by the Smart Campaign. Indeed, a social rating examines how an MFI monitors and promotes compliance with the 6 principles. A social rating helps in revealing gaps in compliance with the above principles, so that MFIs can take action toward improvements.
So far, MicroFinanza Rating has undertaken almost 70 social ratings. 70% of them are social ratings which include a survey on a representative sample of clients. This document aims at presenting some findings from the database of social rating information of MicroFinanza Rating. So far the dataset contains data of 58 MFIs from all over the world. An overview of the main characteristics of these MFIs is reported below.







[1] The other three are: Social Performance Management System, Outreach and Quality of the services

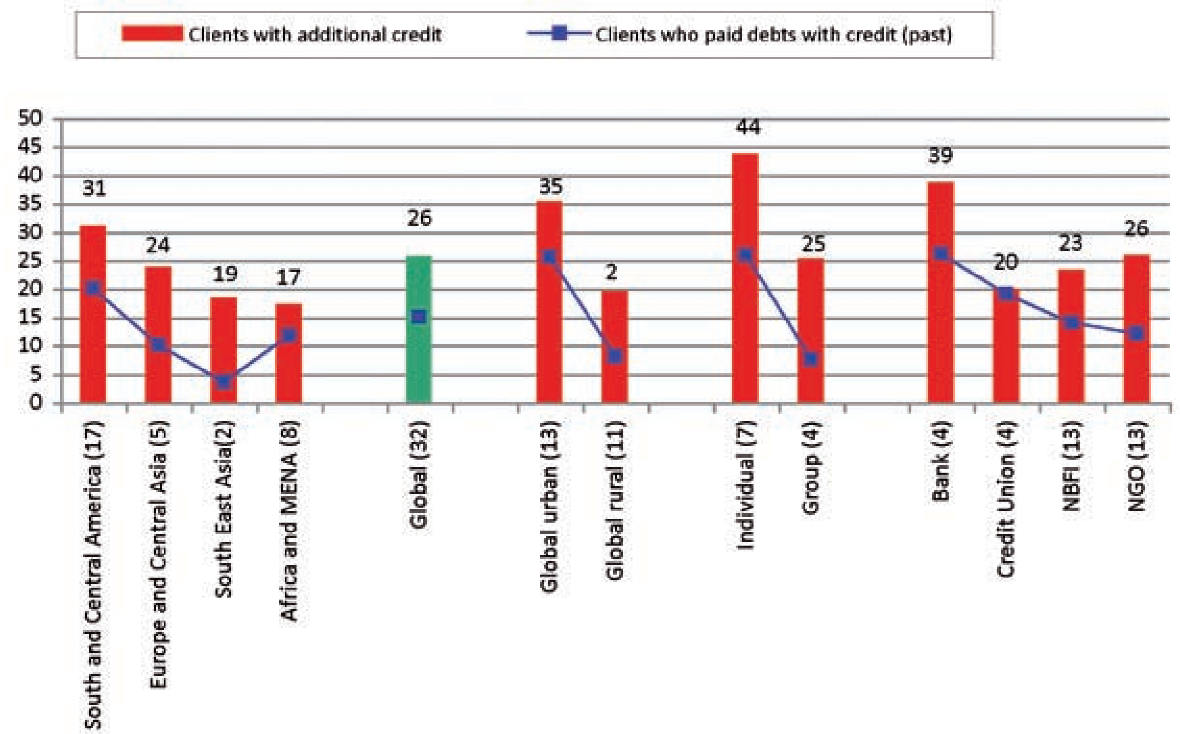
Additionally, it is important to note that the sample used to carry out this study is drawn from MicroFinanza Rating's clients portfolio and not representative of the world-wide microfinance industry as a population. However, we consider that it provides a good coverage of institutions with different characteristics in terms of geographical location, assets size and charter type.

FINDINGS FROM SR: OVERINDEBTEDNESS

CPP 1:
PREVENTING OVERINDEBTEDNESS

Overindebtedness is a growing concern in the industry. It is not something new to microfinance but it has definitely been exacerbated and become more visible with the outburst of the financial crisis. In some countries this problem has reached the level of a systemic risk. However, it is very difficult to measure and quantify, in particular since effective Credit Bureaus are often lacking.
Overindebtedness is not only a problem relating to credit risk and financial management of the MFI but also a matter of responsibility vis-à-vis with the clients. MFIs run the risk of lending amounts that clients are not able to repay therefore contributing to a harmful access to credit. A joint effort of all the relevant stakeholders (donors, investors, regulators, MFIs, etc.) is required so that the risk is properly addressed. If the risk of Overindebtedness is not well managed by the microfinance industry as a whole, it could seriously damage its image and reputation of being a good tool towards responsible banking and sustainable development.
Cross-indebtedness of microfinance clients and multiple borrowing has proved to be one of the major causes of over-indebtedness. This section shows some quantitative and qualitative findings from our social rating experience.

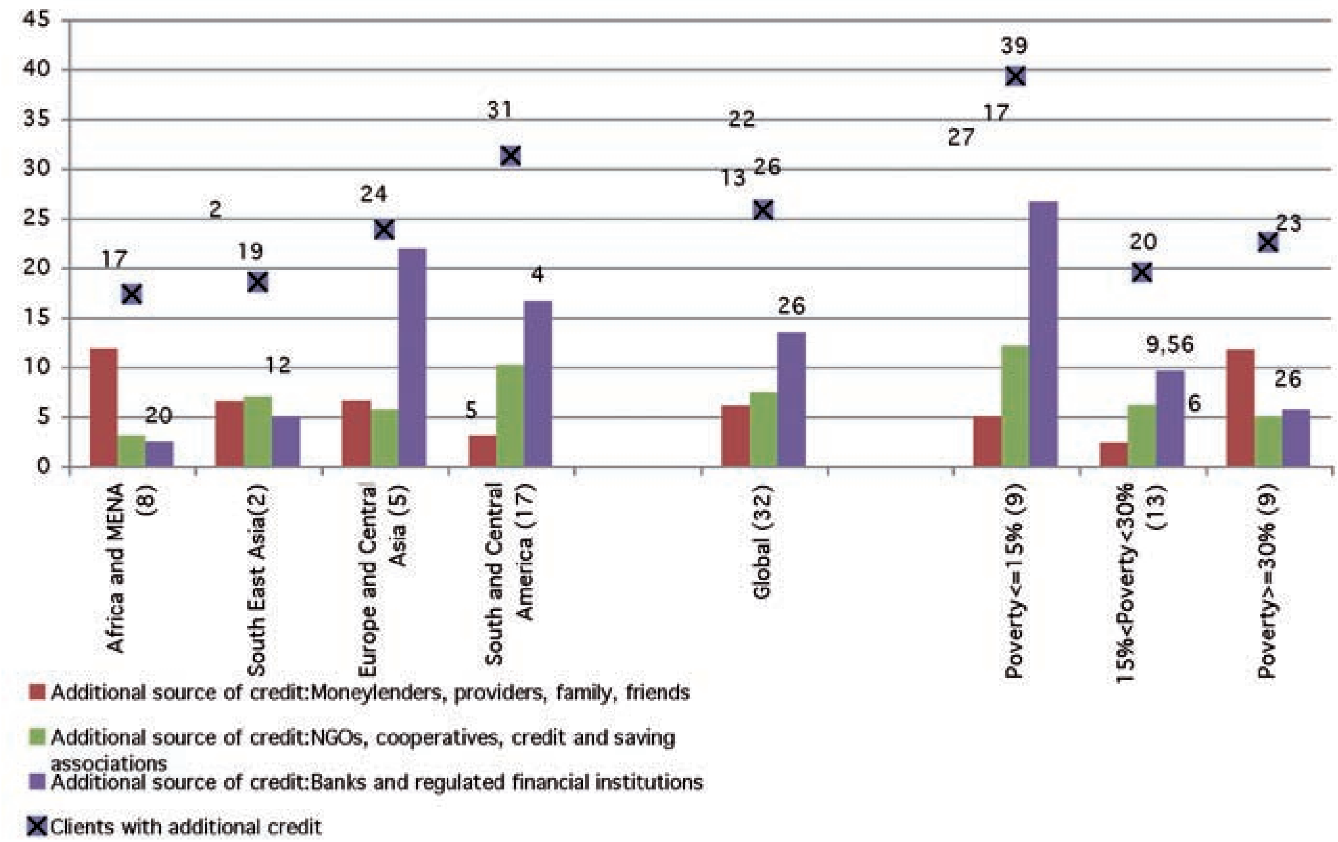
SOCIAL RATING FINDINGS ON CROSS-INDEBTEDNESS



- **Cross-indebtedness is quite high with 26%** of recent clients showing additional loans to those provided by the rated MFIs; Moreover it is worth mentioning that this ratio could be underestimating the reality on the ground since it is very likely that a number of interviewed clients chose to report untruthfully. Clients usually prefer not to disclose this kind of information as MFIs usually set policies forbidding clients to borrow from other sources. The relevance of the overindebtedness risk is further witnessed by the practice of **reimbursing a past debt with a new loan** (**15%** of clients of the MFIs in the dataset).

- Results seem to suggest that the proportion of clients with multiple loans is higher in more competitive markets, in particular:
- In Latin America the percentage is higher (31%) than at global level, while it is significantly lower (17%) in the Africa and MENA Region;
- MFIs operating mainly in urban areas and with the individual methodology, as well as MF banks (serving the microfinance sector) are more affected by cross-indebtedness with 35% and 44% of clients with additional loans respectively; Yet, the practice of repaying a debt with a credit is more common among clients from MF Banks (26%), MFIs operating in urban areas (26%) and under individual methodology (26%).

WHICH ARE THE OTHER SOURCES OF CREDIT? POVERTY AND CROSS-INDEBTEDNESS



- When looking to other source of credit, in addition to the loan already availed by the MFI, 13% of clients resorted to borrow also from banks and regulated financial institution;
- In Europe, Central Asia and Latin America clients tend to have an easier access to parallel loans from the most formal loan providers, respectively 22% and 17% of clients engage with banks and regulated financial institutions;
- The poorer the clientele, the less likely they are to be cross-indebted
- **Poorer clients** tend to resort more to **informal credit providers**, and the latter account for half of the cases of multiple borrowing;
- Also the results on outreach to the financial excluded (at global level: 37% of clients with previous access to credit) seem to suggest that an **unmet demand for credit still exists** and that turning to populations currently excluded from access to credit could reduce the issue of over-indebtedness (e.g.: financial excluded people in rural area)

QUALITATIVE FINDINGS ON OVER-INDEBTEDNESS

Besides the quantitative findings coming from the surveys conducted on a representative sample of clients within the comprehensive social rating exercise, the table below summarizes the main findings of our social rating experience and the common weaknesses.

TOPIC	FINDINGS
Contextual Factors	• **Aggressive growth strategies** (with excessive productivity targets and incentive systems mainly rewarding growth) entail higher risk; • Effective **Credit Bureaus** are rarely available: - The majority of countries have a credit bureau only for banks - Often the information available at Credit Bureaus is not complete and up-to -date (Individual credit history is not always accurately reported, low frequency, etc) - When available, MFIs do not use it effectively • In the absence of a Credit Bureau: - Informal information sharing among credit providers is not always in place due to the lack of trust/high competition; - The social investigations conducted in the community provide a partial picture of the [2]credit history • The **Regulatory Environment** is not sufficiently developed to effectively prevent this risk (with some exceptions); • In some context (Latin America), the large supply of consumer loans and the excessive involvement of MFIs in the provision of this kind of loans increase the risk
Repayment Capacity	• The **assessment of the client's repayment capacity** is generally **weak**: - it does not always include the analysis of household income and expenses, cash inflows and outflows, business assets and complete liabilities analysis - weaknesses are more serious in group lending and village banking methodology (assessment is often delegated to the clients without sufficient guidance and/or training) - too much emphasis is often given to guarantee availability instead of actual repayment capacity (in particular in salary and consumption loans and loans backed by compulsory savings) - higher accuracy in the repayment assessment should be ensured in case of loans generally associated with a higher risk: start-up, large loan size, consumption and housing loans. • The agricultural and other seasonal activities are not always financed with products presenting **repayment schedules tailored to the business's cash flow**; • **Training on the assessment of repayment capacity** is not always properly and regularly provided to loan officers. In this view higher efforts should be required when rapid staff growth and staff turnover are permanent features of the MFI
Mitigating Policies and Procedures	• Overall MFIs are **not well equipped** to face this risk • Some MFIs set policies to limit the maximum number of loans from other financial providers (**multiple borrowing**) • A limited number of MFIs set **thresholds to clients indebtedness and repayment capacity**, even in a high-risk environment (competitive environments, higher loans size, start-up, consumer loans, etc). • **Debt consolidation** and **refinancing practices** are not always accompanied by adequate prudential policies • Staff is **not sufficiently trained** about this risk and how to deal with it (increase awareness!); • **Weak MIS** can contribute to the non-respect of policies • **Internal control and audit** is often weak ⇨ even where policies are in place, compliance remains an issue • **Incentive schemes** are often pushing to much growth (to the detriment of quality and customer care) negatively affecting the compliance with credit policies

TRANSPARENCY AND RESPONSIBLE PRICING

CPP 2:
TRANSPARENCY and RESPONSIBLE PRICING

This principle mainly refers to **fair pricing** and transparent **pricing communication**. MFIs should disclose a complete set of written and oral information to clients about terms and conditions of services, in a language that is not misleading and that the customer can easily understand.
A social rating analyses those internal policies used to set interest rates and the cost and revenue structure of an MFI. It assesses fair pricing with reference to the key elements that affect MFI costs (e.g., loan size, loan methodology, type of services offered, etc.) and compares an MFI's prices with those of alternative national financial service providers and regional benchmarks. The **comprehensive social rating** questionnaire also captures direct data on clients' **awareness** on each financial product's terms and conditions.
The main findings from the social ratings experience on the actual implementation of this principle are summarised in the table below. The findings clearly show that **transparency is an area for improvement**.

FINDINGS ON FAIR PRICING AND TRASPARENCY

- Even if very few MFIs are showing excessive profit margin, MFIs still have **room** to mainstream operations and **improve efficiency** in order to **reduce offered interest rates**;

- **Real portfolio yield** range from 5% (high inflationary environment) to 81% with an average value of **28%**;

- MFIs generally provide written materials for communication and receipts, however additional efforts are requested: **Written information** is **not always complete** (contract not always provided to all clients of the group) and not coupled with **extensive oral explanations** (about all the different components of the cost1);

- **Actual interest rates** are **rarely calculated** and **disclosed** (exception with some regulated institutions)

- Many MFIs keep charging **flat interest rates**, despite this being poorly transparent and hard to compare with other interest rates offered by the markets (especially with respect to the declining method):
  - the declining balance calculation method **is more difficult to explain to clients**;
  - MFIs using a declining method that clearly communicate their interest rates are seen as being less competitive compared to MFIs that state their interest in 'flat' terms.

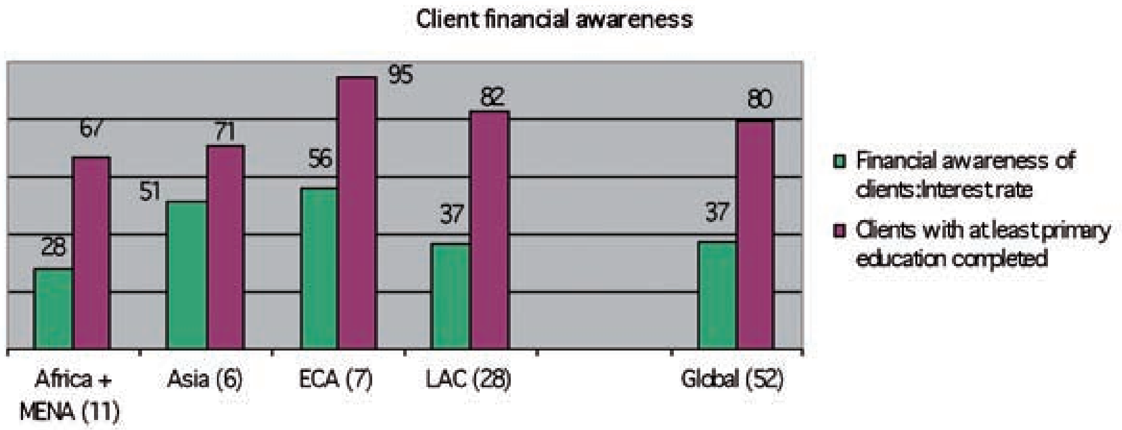
- In particular, under group lending and village banks methodologies interests are calculated on the nominal value of loan even if upon disbursement it has been discounted by the **compulsory savings amount**.

- Regulation imposing **interest rates ceiling** (e.g. in Nicaragua) is likely to affect transparency and to **lead to less transparent pricing practices**, as MFIs charge additional commissions and fees to clients;

- However, transparency and price disclosure is generally higher in **regulated MFIs**

(1) Services fee, government charges, compulsory savings, additional transaction costs

FINDINGS ON FINANCIAL AWARENESS



- The results in terms of **financial awareness** of clients are quite **disappointing** (only **37%** of clients know the interest rate which is applied by the MFIs)

- Similarly, not encouraging results arising from several other questions (saving interest, amount of savings, fees %, etc) show that for some MFIs there are certain aspects of operations that need to be better clarified and communicated by field staff to perspective and current clients.

- Many different factors can have an influence on clients' **financial awareness**. Indeed, it has many determinants:
  - transparency effort: effectiveness of efforts by MFIs to explain their procedures and conditions of services provided to clients
  - market maturity and structural market failures (being transparent in an opaque market frequently leads to a comparative disadvantage),
  - exogenous factors, like clients education level and culture and the importance they attribute to transparency
  - Regulation, which can set transparency standards

- The **correlation** between financial awareness and **clients' education** at MFI level is not clear; clients with higher levels of schooling are not necessarily more aware than clients with lower levels of schooling.

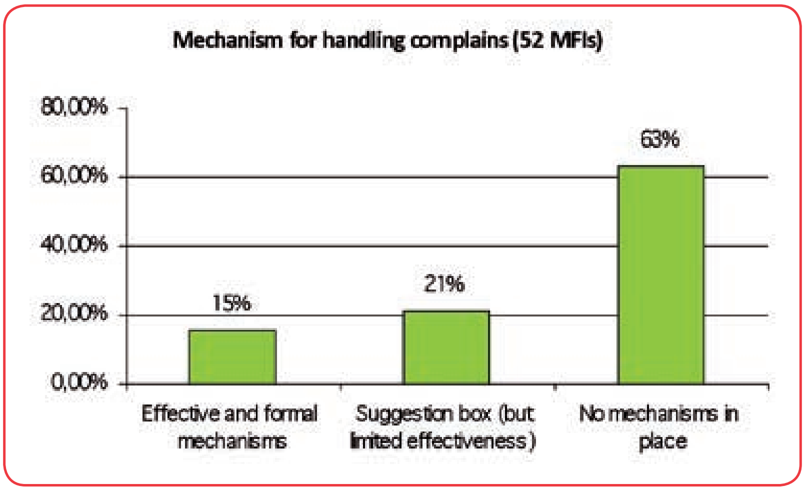
- There is a need to enhance the financial education of clients. Financial education activities are carried out by some MFIs (mainly under group lending and village banking methodology), but overall this is limited.

REDRESS OF GRIVIENCES

CPP 5:
MECHANISMS FOR REDRESS OF GRIVIANCES

MFIs should (and start to) recognize the importance of responding fairly and efficiently to consumer disappointment. Complaints offer businesses an opportunity to correct immediate problems and can provide constructive ideas for improving products, adapting marketing practices, upgrading services, or modifying promotional material and product information. Moreover, a wise and effective complaint management can save any business from incurring in additional costs.
An MFI adhering to this principle should have in place formalized, timely and responsive mechanisms for complaints handling - and complaints-related problem-solving management for its clients.
The existence of written policies and the status and effectiveness of the mechanism in place to address clients' complaints is assessed during the social rating exercise. SR also check if there is dedicated staff actively dealing with this issue and if the complaint management system is well-disclosed (clients know how to submit a complaints)

FINDINGS ON COMPLAINTS HANDLING and RESOLUTION



- Few institutions have written policies in place to address clients complaints;
- A minority of MFIs (15%) have in place completely formalised and effective mechanisms to handle consumer's complaints. The majority of them (%) are regulated institutions.
- The majority (63%) do not have any system in place. Some have however established informal communication channels through loan officers, branch managers and sample checking by internal auditors;
- Complaint and/or suggestion boxes are provided by a small percentage of the observed MFIs (21%), however they seem to be ineffective. For those suggestion boxes to become effective, the MFI should adopt a systematic approach by inviting clients to use them, by carrying out a regular and open process of review and by responding to client suggestions.
- Indeed, an increasing number of MFIs is adopting suggestion boxes, but they seem to be not effectively used by clients because of:
  - Lack of effective communication of the mechanism in place
  - Complaints collected are not effectively treated

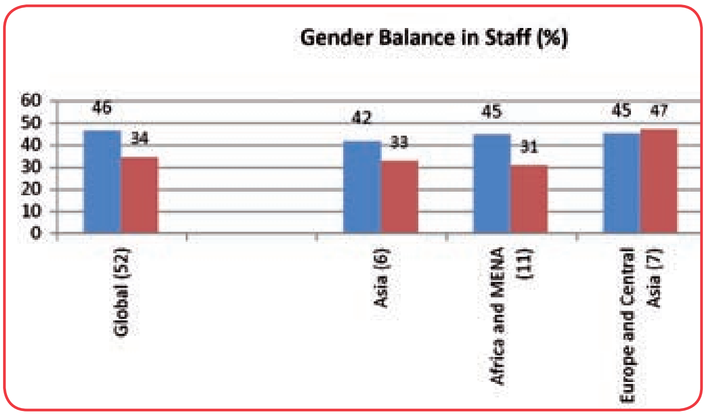
(1) Services fee, government charges, compulsory savings, additional transaction costs

SOCIAL RESPONSIBILITY TOWARDS STAFF

Social Responsibility towards staff mainly refers to the development, integration and motivation of employees within the institution. Key topics are a stable and quality employment, access to equal opportunities, adequate training and professional development, transparent communication and care for employees' health and safety issues, fair and transparent economic package and contractual conditions.

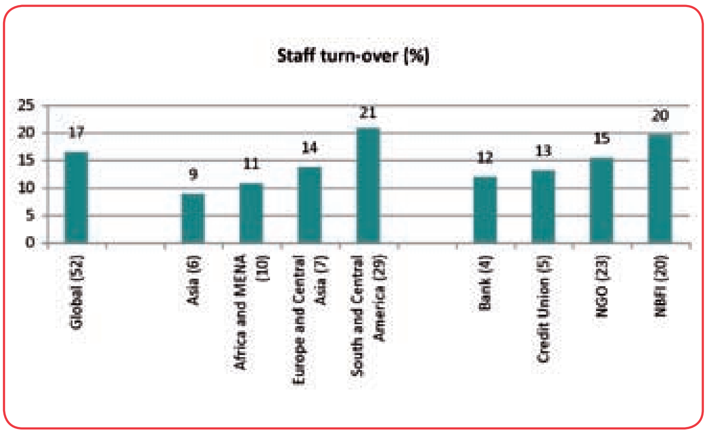
Through an analysis of the HR policies in place and several interviews with MFIs employees, the social rating assesses the quality of HR Management, the working environment and the staff satisfaction and motivation.

FINDINGS ON SOCIAL RESPONSIBILITY TOWARDS STAFF



- The formalisation of social responsibility policies is very limited and few MFIs have dedicated staff to this function;
- MFIs show a **good gender balance** in staff composition, with female averaging 46% on total staff;
- % of **female in management**, shows a lower level standing at 34%, with positive peaks in Europe and Central Asia (47%);
- The implementation of specific activities to promote staff sensitivity on gender issues and gender equality within staff is however lacking;
- The labour climate in the majority of cases is positive and internal growth opportunity are often provided;

- On the other hand, communication is not always adequate and participation into decision making shows room for improvements;
- **Staff turnover** is generally **quite high (17%)**, in particular in competitive and more mature market (Latin America: 21%) and reasons for staff loss are not systematically tracked;
- Staff satisfaction surveys are not a common practice, even if MFIs are getting increasingly aware of the importance of it:
  - 66% of MFIs have never conducted a staff satisfaction survey;
  - 34% have conducted at least one
  - 20% seem to implement staff satisfaction surveys more systematically, i.e., on a regular and frequent basis.



It also worth to highlight that HR Management and social responsibility towards clients are crucial for consumer protection. Our social rating experience shows that disregarding important aspects of SR towards staff can be of negative incentive and foster unethical behaviours toward clients, therefore affecting the level of clients' protection.

CONCLUSIONS

The overall analysis of the information collected through our social rating experience shows that while many MFIs are committed to Social Responsibility and do recognize its importance and have started to blend in their operations consumer protection principles, the actual implementation of a comprehensive social responsibility strategy is still a challenge.
There is the need for technical assistance to support the MFIs in capacity building to allow MFIs to concretely put social responsibility issues and CPP into practice.
Indeed, summarizing the main conclusions:

- The formalization of social responsibility policies is very limited and few MFIs have dedicated staff to this function;
- Formalized code of contact are not very common;
- Transparency is definitely an area of improvement ;
- Overindebtedness is a crucial problem and MFIs are not well equipped to face it;
- More effort should be done to ensure a proper working environment to staff, although this is the area where most of the progress in social responsibility have been achieved.

However, from our analysis we can also draw encouraging conclusions. Consumer protection is crucial and can be very beneficial for MFIs. Indeed a correlation analysis conducted on our social rating database reveals that there exists a negative and significant correlation (correlation: -0,44)between the overall consumer protection score and the drop-out ratio, therefore indicating that Implementing CPPs, can improve clients retention in turn improving the overall business.

Corporate responsibility toward staff is widely recognized as an ethical aspect of social management, however, it also seems to yield positive spillovers on the financial sustainability of MFIs. This is confirmed by another correlation exercise carried out on our database, investigating the relationship between the OSS ratio and the score that MFI have achieved in their responsibility towards staff sub-indicator. Indeed, the correlation is positive and significant - standing at 0,39 – possibly suggesting that a higher staff motivation translates into higher employees' productivity and loyalty, which in turn contributes to an improved financial performance of the institution.

MF Rating HQ
Corso Sempione, 65
20149 Milan - Italy
Tel. +39 02 3656 5019
Fax +39 02 3656 5018

MF Rating South America
Calle Pasaje El Jardín #152 y Avenida 6 de Diciembre
Quito * Ecuador
Tel. +593 2 2248 114

MF Rating Central America
Altamira D´este, de la Vicky 4 cuadras al norte 75 vrs arriba. No. 62.
Managua - Nicaragua
Tel. +505 2774 676

MF Rating Mexico
Av. Patriotismo 229 Piso 8
Mexico City
Tel. +52 55 2881 0394
Tel. +52 222 284 52 01

MF Rating Central Asia
231 Tynystanova Str., apt. 14.
720011, Bishkek, Kyrgyz Republic
Tel. +996 312 624441

MF Rating Africa
Prima Apts., Gichugu Road,
Kileleshwa Nairobi, Kenya
Tel. +254 20 300 6423
Mob. +254 73743 9297

MF Rating South East Asia
Unit 34 Cattleya Gardens, 111 C.
Palanca St., Makati City
Metro Manila, Philippines
Tel. +63 2 8173767

www.microfinanzarating.com
info@microfinanzarating.com