

The Consultative Group to Assist the Poorest (CGAP) gathers bilateral, multilateral and private donors and has a mission to contribute to the development of the financial sector that targets the poorest populations. In this article, Elisabeth Littlefield, its Chief Executive Officer, and Luc Rigouzzo, Chief Executive Officer of Proparco, together address the issue of overindebtedness. In addition to a review and analysis of the situation, they go through the reforms that need to be implemented and possible solutions for fighting against abusive practices.

Microfinance: on the road to responsible finance?

Although serious abuses may be in the minority, the microfinance sector is not without flaws – or temptations. Some highly competitive markets put considerable pressure on costs to the detriment of service quality, while others that are less competitive tend to overbill their clients. It is essential for the sector to come back to the fundamentals of the profession based on a sound knowledge of counterparts and “long-term” relationships with clients. It must also be a priority to protect the latter. The action of CGAP and Proparco provides an example of how donors can support existing initiatives in this field and promote their dissemination – this will create the conditions for the development of responsible finance.

By Elisabeth Littlefield, CEO of CGAP, and Luc Rigouzzo, CEO of Proparco

There is much talk about “responsible finance” these days. Within the microfinance industry, there’s been a tendency to believe that “irresponsible finance” was confined to mainstream financial markets. But in 2009, the microfinance sector has come under more intense scrutiny than ever before, and some are asking whether providers of microfinance—a vast majority of which were created specifically to serve the poor and provide them with better options than money lenders do—might have been lured away from their original missions by the temptation to become larger and more profitable.

Some outside observers and the media are openly wondering if some areas of microfinance aren’t guilty of the same excesses of unrestrained mainstream financial markets — reckless and predatory lending practices that over-indebt the poor, products that lack transparency on pricing and lending conditions, pressures on loan officers and other staff to cut corners and put short-term gains before their client’s interests, and too much investment money pressuring providers of microfinance to pursue unrealistic goals in terms of growth and return¹.

What’s the reality? Does microfinance exemplify “responsible finance” or does the sector need to take action now to ensure transparency, fairness, and services to low-income clients that improve their welfare rather than undermine it? We would argue that the problems that received most of attention and that raised the biggest concerns —

namely over-indebtedness and the subordinating of client interests to growth and greed—are not widespread in the microfinance industry worldwide. Most microfinance providers offer financial services that deliver substantial benefits to their users and are highly valued by clients. Lack of access to basic financial services, rather than excessive access, remains the larger problem. This is certainly the case for credit services and even more so for financial services, such as deposits and payments services that do not raise the same risks for poor people as taking on debt.

On balance, access to microfinance is a good thing, but this does not mean it should be endorsed unreservedly. In some markets, escalating competition and very rapid growth have created pressures to cut corners. This deserves careful analysis, and action. While there is little evidence that microfinance is causing widespread insolvencies, there are many reasons to shift the focus, once again, on sound underwriting. Microlending should be built on the premise of knowing the customers, carefully analyzing their ability to reimburse loans and to satisfy other obligations. It should also be measured against its capacity to provide well-structured loans, and lay the foundations for a mutually beneficial long-term relationship².

At this particular juncture, there is a strong case to strengthen that foundation and adopt the same ‘back to the basics’ policy that produced decades of strong loan recovery rates. Clients in many markets are under higher pressure as a result of the global crisis. Remittances are down in many coun-

¹ *The Wall Street Journal*, for example, recently warned of a brewing credit crisis in microfinance as a result of poor neighborhoods in India being «carpet bombed» with loans [13 August 2009], and France 24 accused microfinance providers in India of causing over-indebtedness for borrowers through multiple loans that failed to take account of borrowers’ capacity to repay.

² It is also important to note that multiple lending—where a client has loans outstanding from multiple providers—is not the same as over-indebtedness.

Often, in fact, the client can afford more debt than any single provider is willing to offer. Here the problem might be rigid products rather than debt-stressed clients.

Microfinance: on the road to responsible finance?

By Elizabeth Littlefield, CEO of CGAP, and Luc Rigouzzo, CEO of Proparco

tries, and costs of living are up. Performance of microfinance portfolios is slipping in some markets, particularly those experiencing fierce competition or economic stagnation. In most markets, there is a dearth of new capital to finance growth in the microfinance sector, but this can also be welcomed as an opportunity to strengthen basic operations. The subprime credit crisis is a grim reminder of the dangers of irresponsible finance—for consumers, providers, and entire financial markets.

To avoid over-indebtedness, providers need to take the lead in strengthening their credit operations, by carrying out a top-to-bottom review of their credit policies, staff training and compensation policies, loan monitoring and collections, as well as client communications. Not only should microfinance providers take these actions within their own structures, they should also enter into partnerships at sectorial level in order to improve credit information sharing, educate their clients, and coordinate expansion strategies and the establishment of branches. National microfinance associations in countries ranging from Mexico to Uganda to Pakistan are developing strong codes of conduct and pushing their members to implement these codes of conduct in an effort to improve policies, products, and practices.

Ensuring that clients can handle the loans they are provided with is not the only dimension of responsible finance. Around the world, providers of microfinance are beginning to enhance client protection, transparency, and fair treatment, on an individual basis as well as a sectorial basis. They are taking steps to make their pricing more transparent, fully inform clients about their rights and responsibilities, ensure that collection practices are appropriate, improve clients' access to redress when things go wrong, and train and reward staff to display the highest level of personal integrity.

CGAP joined with ACCION International and others to translate these commitments and initiatives into six core client protection principles and create the Campaign for Client Protection in Microfinance. To date over 450 institutions—retail microfinance providers, national associations, international networks, donors and investors—have endorsed the principles and committed themselves to practical steps in order to translate them into real improvements in policies, products, and practices. For example, in Nicaragua, Banex has made significant changes in its internal processes, including implementing a code of ethics for col-

lectors and attorneys, training them on customer rights, avoiding forced loan recoveries whenever possible, adding an ombudsman to protect the customer, and informing customers about their rights in writing.

Microfinance providers and their backers must be held accountable for translating these lofty principles into actual practice. We need robust, field-tested tools (such as the Beyond Codes Self-assessment Guide³ that enables microfinance providers to make a clear and honest assessment of how they measure up to each of the principles) that lay out very clearly what improved policies and practices should look like for retail providers. Thorough and straightforward reporting (e.g., the new MIX Social Performance Standards Report⁴) is part of the solution as well.

Considering that some of these responsible finance measures are difficult to take, especially in competitive environments, providers will also need incentives. This is why CGAP has taken the lead in reaching out to the microfinance investor community and mobilizing an initiative to integrate the Client Protection Principles into every step of the investment process, from due diligence to financing agreements to monitoring. To date, more than 85 investors and donors of all types—small and large, public and private, debt and equity providers, funds and fund managers—have endorsed the principles and committed themselves to action. We want investors to ask tough questions. We want them to work with their partners to identify areas for improvement; we want them to support vigorous efforts to address them. And we want them to reward those microfinance providers that can demonstrate particularly strong performance on client transparency and fair treatment—with more financing, financing on better terms, and visibility.

Proparco and AFD have benefited of the CGAP experience when redefining their strategy in microfinance in 2006. AFD Group accepted genuinely to be part of a peer review led by CGAP. This gave the Group a clearer view of its comparative advantages and areas of progress. Being part of this “global team” helps Proparco to select MFIs with a proven track record and which have developed a recognized responsible model for financial service provision to the poor. First of all, this means that the institution will need to be able to provide clear evidence of its strategy in terms of its profitability targets and how these targets are moni-

 **Elizabeth Littlefield**
CGAP

Elizabeth Littlefield is a director of the World Bank and the chief executive officer of CGAP. Previously she was the managing director of JP Morgan's Emerging Markets Capital Markets in London. As such, she was responsible for all bond offerings, structured financing, and credit ratings for emerging Europe, Middle East, Africa, and Central Asia. She has served on many corporate and nonprofit boards and founded several not-for-profit organizations. A U.S. and U.K. citizen, she is a graduate of Brown University in Rhode Island and also studied at the École Nationale de Sciences Politiques in Paris.

 **Luc Rigouzzo**
Proparco

Luc Rigouzzo holds degrees in both agronomy and finance and began his career as an agronomy engineer in Mexico. In 1995, he joined the cabinet of the French Minister for Cooperation and then the IFC in 1997 where he was in charge of structured finance in Brazil, Argentina and Central America. He has been Chief Executive Officer of Proparco since 2006 and has redefined the company's strategy to focus on infrastructure and the financial sector in Africa, equity investment for SME financing in the Mediterranean, and combating climate change in major emerging countries.

Microfinance: on the road to responsible finance?

By Elizabeth Littlefield, CEO of CGAP, and Luc Rigouzzo, CEO of Proparco

tored. Proparco doesn't want to provide finance to institutions which are over profitable as a result of charging their clients with unreasonable interest rates. Secondly, in these turbulent times of "irresponsible finance", it is more crucial than ever before to expect rigorous, transparent and sound financial management of MFIs. Moreover, Proparco will insist on "best practices" in terms of environmental, social and anti-money laundering issues. The assessment of each of the above focus points is made all along the appraisal process, before the investment actually takes place. If critical issues are identified, Proparco will weigh the opportunity to invest against the positioning of the MFI management team and its shareholders, and their willingness to undertake effective measures to fix such issues. Being most of the time minority shareholders, another crucial element for Proparco is then *affection societatis* and the choice of partners made by the MFI under consideration. Then, it will be ensured that partners share the same approach on microfinance investments.

Donors have important roles to play at the institutional level as well. They can support responsible finance initiatives of providers and their associations, identify trouble spots and determine practical actions to fix them. They can support appropriate consumer protection policy initiatives and invest in helpful market infrastructure (such as credit information reporting, a powerful tool to

help borrowers and lenders guard against over-indebtedness). Donors could also make critical contributions to an essential element of responsible finance—ensuring that the clients themselves are equipped with the knowledge, skills, and attitudes to protect themselves, make informed choices, and hold up their end of the responsible finance bargain. "Financial capability" initiatives are in their infancy for low-income consumers in low-income countries. Well-designed external support could play an important role in assessing priority issues, building knowledge about what does and doesn't work, and scaling up cost-effective programs.

Consumer protection regulation is also part of the solution, if it is designed and implemented with financial inclusion goals in mind. CGAP is identifying and analyzing regulatory approaches from around the world that appear to be striking the right balance. Setting basic standards and market conduct "rules of the game" protects clients. These rules can also protect responsible finance providers against unfair competition.

The time is right for the microfinance sector to re-dedicate itself to its original mission of providing diverse, high-quality financial services—not just credit—to the poor. This needs to be done in ways that protect clients' interests, offer good value for money, and mitigate risks appropriately. This is, ultimately, the essence of responsible finance. ●

³ *The Self-Assessment Guide is a manual designed to make a thorough assessment of MFIs' client protection performance. It can be used by MFIs to assess their own performance and may also be used to develop third-party assessment tools. The guide takes users through a process whereby they collect the information required to evaluate a MFI's consumer protection practices.*

⁴ *This report collects information on 22 core indicators and focuses on the MFI's mission, products and services, social performance and outreach, client and employment outreach, social and environmental responsibility, child education and poverty levels.*