From Social Rating to Seal of Excellence: Utility or Futility?

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The microfinance sector stated with a promise of being good for poverty reduction. Thus, there was a social bottom line. Instead of giving charity, we were giving loans which help make the poor responsible and entrepreneurial. Thus microfinance developed with a strong social bottom line brand image. Donors rushed in.

However, it was soon clear that if the MFI is not durable over time, then the social impact is minimal. Since donors are subject to fads, we need to wean away the sector from free funds and grants. Thus, we brought in the double bottom line: profits and social impact. The brand image of microfinance got modified: diluted as well as reinforced: diluted, because in addition to making poor people responsible and entrepreneurial, we were insisting that the MFIs themselves be responsible and economically sustainable; reinforced, because it now indicated that both the poor and the IMF associated with the movement would eventually not require donor finance.

It seems that the double bottom line mission has generally become reduced to a focus on profits as MFIs realized that there is money to be made and that the amount of profits depends on scale. The rush to scale and taylorism made one forget the social impact.

Can social rating or social labeling reinforce the social mission?

SOCIAL RATING

Many investors would like to invest in this sector because it is a socially responsible sector. But they want to know if the MFI is profit seeking only or whether it actually has a social mission. While many MFIs can fill up the volunteer information suggested by the Social Performance Task Force (SPTF) on the Microfinance Information Exchange (MIX) website, it is not the same thing as a third party audit certifying that the institution has a social mission. In the former case, one is saying "I'm good", in the second case, someone (reliable), is saying "he's good". What would investors trust?

In a nutshell, if the economic model of microfinance is supposed to meet the “double bottom line” objective of financial and social returns, then traditional credit ratings will assess the quality of the financial sate of the MFI and the more recent social ratings will assess the quality of the social impact. Donors and socially oriented investors are willing to provide subsidized or free capital, or grants in exchange of social return, so these stakeholders should be the main users of social rating reports. MFIs can also order own social rating to get an outsider’s opinion on their efforts either to get ideas for improvement or to get a confirmation that their image is

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perceived correctly by the experts. If so, this can help open or broaden the door for cheaper "social" capital.

Ratings remain however "relative" compared to peers. So, social rating measures what one MFI is able to do compared to other MFIs. At the same time, it has been found that impact is difficult and expensive to be measured or proved. Therefore, social rating is limited to seeing the mission and the drive to place that task into practice. Rating agencies compare, evaluate and communicate. MF rating agencies study what is the level of excellence of that institution in the sector. They use judgmental methods to come to their conclusions.

As the rating is an independent opinion, the best rating should be the one delivered by the best experts or by the methods developed by the best experts. The rating is also based on benchmarks, so the quality of the rating will depend also on the knowledge of the industry at regional and national levels as well as the performance of the peer groups. The same MFI operating in a country with dismal competitors would be better rated than if it is operating in a country with excellent competitors.

There are several notorious rating agencies: M-CRIL, Microfinanza Rating, Planet Rating and MicroRate. Some are better than others in different regions where one can have bigger field experience.

Different rating agencies have different grading procedures and different weights to the factors they choose. For example, in credit ratings, PlaNet rating's GIRAFE could have a different system than Accion's CAMEL methodology. However, although methodologies are important, we observe that with time these converge to a generally agreed framework. Niche players may decide to measure different things.

Not every MFI needs a social rating. First of all, if the institution doesn't need "social" funding, it may not need such rating. It also may not need it if funding partners trust the information presented by the MFI and know how to analyze it. The rating procedure is an audit, if the funders can asses directly the quality of data a rating is not necessary. Some social funders may be shareholders and by consequence assist or participate in the production of "social impact" reports, for them the rating may have low added value.

The necessity for rating depends on whether one needs to communicate and why? Usually, ratings are required by donors and investors, as explained above, as they are external to the firm. If the MFI is a cooperative where funding is coming from internal deposits, and there is no need for donors or investors, there should be no need for rating. Although social funding may be cheaper, it has to be weighed against the costs of a social rating and the costs of following social performance reports which will be required regularly by the social investor.

The rating itself is expensive. The procedure is affordable for big and medium MFIs. These are the MFIs which are usually looking at scale and profits. Thus, in fact, a rating would be used to show that, despite gaining in size, the MFI did not lose the social objective.

For smaller but mature MFIs, which have been staying near break-even levels in non-saturated markets, perhaps their lack of growth is owing to a commitment to staying small enough to retain

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social objectives. And, if they don't require additional funding, since they don't want to grow further, they don't need to be rated.

Commercial investors do not need social ratings prior to investing. However, socially responsible investors, social investors and donors could require this. At this point, it may be worth mentioning the cases of Compartamos and SKS, who have become notorious for their economic bottom line. Did they take care to showcase their social performance?

Compartamos has been financially rated by S&P as well as Fitch for its bond issues. However, when it went for its IPO, which was oversubscribed 13 times, observers began to raise ethical questions on interest rates approaching 100% per annum. At that time, Compartamos had not conducted any social performance rating. But it was quick to learn. It has now provided voluntary social performance indicators to MIX. It also got MicroRate to perform a Social Rating in December 2008, giving to Compartamos four out of five stars, meaning very high social return through good social results and excellent social commitment. Analyzing Compartamos's data at that period, most will agree with the rating. The interest rate remained relatively high, but other indicators showed serious commitment to serve the poor and financially excluded female borrowers throughout urban and rural Mexico. Perhaps the high interest rates explain why Compartamos got only four stars and not five.

SKS had the benefit of the prior Compartamos experience. It had had financial ratings from CRISIL and CARE. It has provided voluntary information for SPTF to MIX for 2008, before the IPO. SKS was ranked the No. 1 MFI in the Country and No. 2 in the World in the annual composite rankings conducted by MIX based on the parameters of outreach, efficiency and transparency in 2009. Similarly, SKS was awarded the Silver Certificate in October 2009 by CGAP with Michael & Susan Dell Foundation, the Ford Foundation, and the SPTF, powered by MIX for implementing standards in microfinance operations providing services to the poor. All this was before the IPO in 2010, which was also oversubscribed 13 times. And, although SKS interest rates were more in the region of 26%, the critiques were as vocal as for Compartamos. Moreover, the political fallout was greater.

All this to say, the ethics of high interest rates to poor people seem to be far more complex and welfare critiques are not satisfied with the argument that sustainability is important, or that fast growth permits doing more good or that if people can pay back at 99% of the time, they must be earning even more.

This may explain why social performance is becoming the buzzword, and social ratings and social performance indicators are coming in to hush the outcries. Social rating is available to MFIs since 2005 but the bulk of the work started in 2008-2009. MIX itself had more than 400 social performance reports (not certified by third party) from MFIs in 2009 and 2010.

Will the social rating industry grow? Yes, if only MFIs want to attract social investors. If, as is commonly believed, the industry is already over-funded, then MFIs may not take this extra trouble to conduct social ratings. Instead, they would rely on internal profits, leverage and commercial investors to fund growth. This then leads to the question whether labeling would not be more appropriate. This is especially in view of the Seal of Excellence being proposed by Microcredit Summit.

SOCIAL LABELING

Labeling or certification is like a trademark with brand equity. The certificate indicates quality and reduces the asymmetric information problem since, the minute you see the mark, you no longer need to read a detailed social performance audit report. The label is a flag that signals to the others that the MFI is different and should be selected in order to reduce adverse selection. The question is who these "others" are and do they need the flag to make an informed decision?

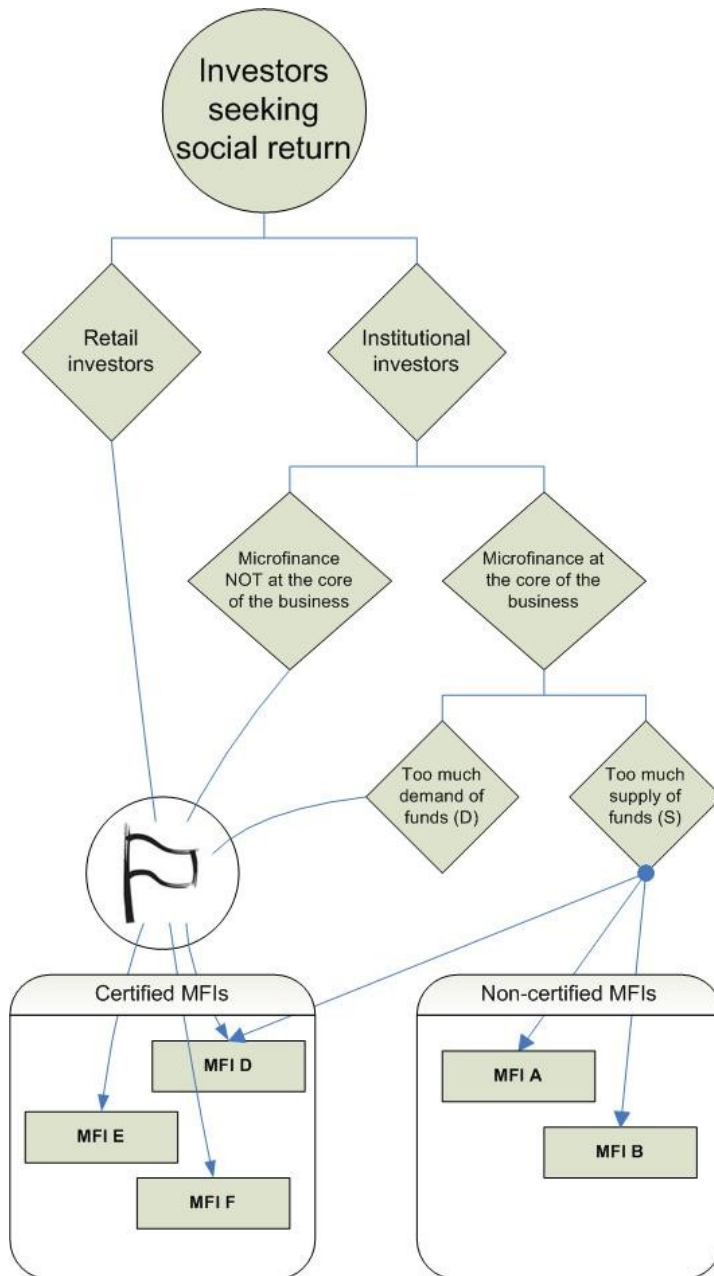

Figure 1: Who needs a flag?

For the labeled institution, there may be additional advantages. First, it is used to improve standards, motivating service providers to improve, or demonstrating the direction of future development. Second, it helps stakeholder engagement in setting standards: to build buy-in. Third, often, certification is for a fixed period and re-certification requires improving because the standards evolve with time.

The question is whether it is worth it. In our opinion, the additional advantage of certification, as opposed to rating, is that it is easy to see. But this visibility matters only to those who do not have the time and skills to investigate or to read a detailed report. Usually, this advantage is directed to consumers or businesses behaving like consumers, because a specialized business would take the time to read detailed reports.

This Seal of Excellence, proposed by Microcredit Summit, would be for MFIs, investors and other funders whose mission is for financial inclusion that focuses on the poor, and the delivery of financial and supporting services that effectively contribute to poverty reduction and transformation. The

project is trying to incorporate all the different social performance criteria into one criterion. And add back the objective of reaching the bottom of the pyramid.

As with ratings, such certification may help, especially if the MFI is seeking retail investors. Or a Microfinance Investing Vehicle (MIV) that is investing in MFIs and itself wants to attract retail investors. Once again, the problem is that the sector is probably suffering from over-funding. If the short time period taken by Kiva or Babyloan to fund new projects listed on their website is any indicator, the problem is not finding funders but to find projects to fund.

Perhaps, it may also be of some use to bureaucrats or governments who want to direct subsidized funds or priority sector lending to MFIs which have the appropriate seal of excellence. Therefore, Microcredit Summit may need to do some marketing towards central banks.

The question is who will pay for the third party certification? If MFIs will pay, obviously, the big ones will get it. Alternatively, if donors will pay, again they would finance certification where they are interested in placing a lot of money: perhaps not the small MFI!

A question remains on the methodology used by the Seal of Excellence to bring out the social impact. Impact assessment is far more complicated and expensive that a social rating. It is not an opinion but based on empirical research. It also requires some notion of poverty.

There are different definitions and perceptions of poverty. The most used definition links poverty with income per family member. There are international and national poverty lines and if the household has an income per capita below that line, it will fall in the category of poor or very poor. The problem is in calculating the daily income knowing that income generation activities are irregular and often informal. So the state of poverty of a household may be assessed directly through surveys and numerous visits or indirectly, analyzing usual living conditions.

Grameen's Progress out of Poverty Index (PPI) uses statistics in predicting the income level of the household. The technique was developed by Mark Schreiner – one of the pioneers of adapting the credit scoring technique to micro lending. A similar technique is used in PPI. A sample of true poor and not poor households is analyzed and their profiles are statistically linked to their state of poverty. A scorecard is generated and when applying it to new subjects, it gives the chances (with a certain error margin) that the subject belongs to the category of poor. For bigger numbers of subjects, we have the estimated share of poor amongst the subjects. Tracking the PPI of a certain population over time, an MFI can observe if this population progresses out of poverty or not. Any reduction of the share of poor subjects in the same population over time indicates that there are subjects that graduated and are no longer poor. Linking this progression with the benefits of providing financial services is a more complicated task, but so far it is commonly considered implicit.

Randomized control trials and similar on-ground experiments are better scientific tools, but implementing and conducting such experiments is very costly in terms of time and money, so in the vast majority of cases, an indirect measure of the progress out of poverty is acceptable. Moreover these trials are not only difficult, they require control samples who are not benefitting from microfinance. In saturated markets, where people have more than one loan, finding the control sample of "no loan" people who need loans becomes difficult.

Concluding remarks

In an over-funded world, MFIs don't need to attract capital and don't need to invest in ratings or certification for this reason alone. However, these may still be required to mollify the government and the media, as well as those MFIs who are not yet profitable. Micro borrowers would probably take loans as long as they are cheaper than going to the money-lender. Time and effort spent for formalities and group meetings will count in choosing the provider. Thus, in such a world, social performance ratings are of academic interest only.

Nevertheless, if ratings are being undertaken, the curious researcher should first study the methodology of the rating agency to see what is being rated. Is it the internal processes (mission, governance, internal controls) or the external relationship of the field agent with the borrower (interest rates, collection practices) or more? Obviously, a higher weight given to the internal processes without looking at interest rates can lead to wonderful ratings, as we have already seen. The same is true for collection practices.

Finally, before undertaking an exercise in labeling MFIs, research is required to see whether the poor, and within them literate and illiterate, really discriminate between labeled and non-labeled products and firms supplying them. In the case of intangible products, the firm may replace the product, but the advantage of labeling may be limited. However, MFIs exposed to such international pressure may benefit by improving their internal processes in response to labels incorporating and updating best practices in their evaluation criteria. The success of labeling may also depend on the herd mentality of MFI CEOs.