Making microfinance work for the poor and excluded

Internal controls and audit: *Integrating SPM into microfinance capacity building*

Guidance Note

Introduction

Microfinance capacity building on internal controls and audit has mostly focused on financial concerns, especially protecting against fraud in the areas of cash management, savings and loan operations, write-offs and procurement. As social businesses, microfinance institutions (MFIs) also need checks and balances to ensure that they perform against their social objectives, as stated in their mission. Internal auditors can and should verify the MFI's compliance with its policies and procedures related to social performance, as highlighted in **Box one**. Internal controls and audit should also ensure that quality standards are maintained in service provision, as quality is often compromised by shortcuts and cost-cutting measures.

Box one: Quality and compliance at the Small Enterprise Foundation (SEF)

The **Small Enterprise Foundation (SEF)**, a South African MFI, has a strong internal audit department, which focuses primarily on ensuring compliance. Management recently identified weaknesses in how consistently SEF's methodology was being applied in areas such as evaluation of client repayment capacity, group training and support, and client–staff interface. As a result, SEF established a set of quality checklists for 'key operational activities' that will be used by management and internal audit to ensure quality. These quality checks are integrated into the standard internal audit, which also verifies compliance with SEF's operational policies.

This briefing emphasises the importance of integrating social performance into internal controls and audit. It offers guidance on how MFIs can systematically check compliance with their social mission in the following areas: social responsibility towards key stakeholders, client protection, quality of service provided to clients, and monitoring impact on clients' lives. It aims to inspire MFIs to improve their operational social performance. We begin by raising key questions to consider, then discuss some emerging practices being used by some MFIs to address these issues. We end with some guidance on best practice.

Key questions

- Do MFIs systematically incorporate social responsibility and client protection principles into their policies?
- Are the internal auditors trained and experienced in measuring social performance management?
- Do internal auditors use tools designed to assess the organisation's social performance?
- Are MFIs equipped to monitor and assess the quality of the services they provide to clients, including changes in clients' lives?

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Emerging good practice

The following emerging practices are helping MFIs to integrate SPM into internal controls and audits:

Raising awareness about the importance of monitoring social performance

MFI management and staff need to be convinced that extending internal controls and audit to social performance is a good management practice so that they can equip their internal auditors with the knowledge and tools needed to incorporate this task into their responsibilities. As part of that process, MFIs should make a business case for integrating social performance into internal controls, and should ensure that all staff are involved in discussions about how to achieve this (for example, providing good customer service as a strategy to improve client retention).

Verifying progress in achieving social responsibilities

MFIs need to put policies and procedures in place to protect their social mission and to mitigate reputation risk.[1] Depending on their social mission, they need to integrate policies and procedures related to social responsibility to clients, staff, communities and the environment (see **Table one**).

By clearly defining their target client characteristics (location, gender, poverty level, type of economic activity, etc), the MFI can set SMART objectives (specific, measurable, achievable, relevant and time-bound). An MFI with a social mission to reduce poverty could, for example, set the following SMART objective: 50 per cent of new clients will have an income below US$1.5 a day.

To check progress against that objective, loan applications could track income levels. At the branch level, the number of new clients earning less than US$1.5 a day could be computed on a weekly basis (using the Progress out of Poverty Index (**PPI**) tool, for example). That data could then be compiled by branch managers and sent to headquarters for comprehensive monitoring. This enables management to analyse the data, identify which branches are more successful at poverty targeting and why, and use the information to make, and regularly review, decisions to ensure that the MFI fulfils its mission.

Preventing client over-indebtedness

In the individual loan approval process, the loan officer generally uses a standard format to collect information that is used to determine the borrower's repayment capacity. This information often includes a full assessment of the client's business and personal revenues and expenses, as well as other outstanding debts. MFIs should have a formula to protect against over-indebting clients, such as limiting loan payments to a maximum of 50 per cent of current monthly income. They could also collaborate with other MFIs in their area (either directly or through a credit bureau) to track clients who are borrowing from several MFIs.

Monitoring how clients use loans

To ensure transparency, before loan disbursal, the MFI should have a system for ensuring that the client understands all the terms of the loan, including the repayment schedule and amounts owed, procedures in case of default, etc. Once the loan is disbursed, the loan officer should check whether the client is using the loan as stated in the application,

[1] See the guidance note on Risk management

Table one: Sample policies and controls to ensure social responsibility

Policy[2]	Controls to ensure implementation
Clients	
Our MFI is committed to quality service, which includes easy application processes, timely disbursements, provision of information about service terms and conditions, accurate assessment of repayment capabilities, and friendly staff	• Monitor average loan processing time • Spot-check loan officers' repayment capacity calculations • Spot-check loan collection approaches • Interview clients to assess their knowledge of service terms and conditions, and soliciting feedback on client–staff relationships
Staff	
Our MFI is an equal opportunities employer. Qualified applicants are considered for employment without regard to age, race, colour, religion, sex, national origin or sexual orientation	• Monitor diversity of selected candidates against applicants • Assess salaries to check for gender and other biases • Conduct exit interviews with staff • Check compliance with local law and transparency of salary scale
Gender awareness	
Our MFI ensures that our staff, both women and men, are able to interact with women with respect and a sense of equality, and promote a vision of women's empowerment	• Train staff on gender awareness • Client and staff interviews
Strengthening communities	
Our MFI works to strengthen community bonds and we do everything in our power not to disturb or break any previous ties within communities	• Conduct community assessments • Check how community complaints are resolved
Environmental protection	
Our MFI does support enterprises that have negative environmental impacts, e.g. logging	• Review loan applications by business type • Conduct visits to clients' businesses

by visiting the client for follow-up interviews.

Ensuring collection practices follow code of ethics

Loan officers need to be able to distinguish between clients who are experiencing real hardships, making it difficult for them to repay on time, and those who have the capacity to repay but not the goodwill to do so. When managing the collection of repayments, MFIs must walk a fine line between putting pressure on clients to repay, and putting vulnerable clients into a worse financial situation.

To manage this and other difficult situations, MFIs should have a code of conduct to guide staff. The human resources (HR) department should ensure that all staff

[2] Adapted from Campion, A., (2009) *Social Performance Management Policy Templates and Best Practices for Microfinance Institutions*

understand and comply with the code of conduct. Field staff in particular should know that it is unacceptable to use abusive language or threats, harass borrowers, or forcibly enter a client's house and seize property without a court order or in violation of the law. The code of conduct should be included in orientation for new staff, and existing staff should have periodic refresher sessions. Managers and supervisors should monitor compliance with the code of conduct as part of their regular staff supervision.

During loan disbursal, clients should be made aware that they have a right to make a complaint, and should know the MFI's procedures for doing so (for instance, a client suggestion box, or taking a complaint to a third party ombudsperson). The internal audit process should include a check to see that client complaints are addressed in a timely and appropriate manner.

Mitigating client vulnerabilities and ensuring client protection

MFIs should recognise that clients are vulnerable to shocks such as natural disasters, sickness and death of family members. To mitigate the effects of these shocks, MFIs can offer products such as emergency loans and insurance, as well as non-financial products and services (health education, for example). In case of debt restructuring, this should be done in a fair, standardised manner, and the loan should not be re-financed for a higher amount. The internal auditors should also make sure that restructured loans are not treated in the same way as regular loans in the management information system (MIS), but instead reflect the appropriate risk profile. The MFI should make sure that this practice is reflected in its operational procedures.

As most MFIs have social missions linked to serving the poor, internal auditors should check clients' poverty level by analysing changes in income or assets over time. They should also check that the MFI's field staff have the necessary skills and knowledge to effectively assess how their clients are progressing out of poverty. They should carry out spot-checks to identify household debt exposure, lending practices that violate procedures (such as unauthorised re-financing), multiple borrowers or co-signers per household, and other practices that could increase client indebtedness and vulnerability.

Ensuring quality service and transparency

Good customer service is an important aspect of all MFI operations. Procedures and policies should emphasise good customer service, such that it becomes a part of the institutional culture. To ensure good customer service, all field staff should receive training, ideally using participatory methods so that they can role-play and practice handling client complaints and other sensitive situations. While the customer may not always be right, he or she always deserves to be treated with respect.

MFIs can reinforce good customer service and let clients know what they can expect from staff by, for example, placing posters (e.g. 'Customer First!') on the branch walls. As well as carrying out customer satisfaction surveys and exit interviews, internal auditors can ask questions about the quality of customer service during client visits, and include the findings in their audit reports. They can ask clients to describe their perceptions of the MFI, how they feel they are treated by staff, the extent to which they value its products and services, and the difference the MFI has made to their lives. As good-quality customer service also implies protecting clients' rights to information and privacy, internal audits should also check clients' understanding of product terms and pricing, as well as verifying how sensitive data is handled within the MIS.

Checking availability and reliability of social data in the MIS

What gets measured is what gets done and managed. You cannot influence change in social indicators if you don't measure them. Depending on the MFI's mission, institutions can include indicators related to clients' poverty levels, percentage of women or rural clients, or number of jobs created, etc.

The internal audit process should spot-check both the data and the processes used to collect it, to ensure accuracy and consistency. MFIs should make sure that these indicators are fully integrated into data capturing, analysis and reporting. Management should review and analyse the data on a regular basis, and make adjustments to staff and procedures as necessary to fulfil the mission.

Protecting staff against biases

MFIs should have clear HR policies to guide them in hiring, firing and promoting staff to ensure fair and consistent treatment. As with clients, staff should have a channel through which they can express grievances and seek redress in a timely manner, other than through their direct supervisor.

Training is especially important to ensure that management understand HR policies, especially related to gender awareness, and how they should conduct performance appraisals to avoid biases.

Ensuring quality of implementation

Field staff are often under considerable pressure to increase their efficiency, and as a result, may take shortcuts that can have a negative impact on quality of services. Financial service delivery (loan disbursements and collections) is easy to monitor through portfolio quality, and therefore tends to receive priority attention by staff.

Staff are more likely to take shortcuts in activities that support the quality of financial services, such as thorough assessment of repayment capacity, provision of information about the products and services and terms and conditions, formation of cohesive client groups, and provision of training, advice or other support.

To ensure that shortcuts are not being taken in these 'softer' areas, it is important to monitor the way they are being implemented – for instance, regularly collecting feedback from clients by someone other than their loan officer (the internal auditor, for example). Ensuring that field staff receive strong supervision and support is one of the best ways to ensure the delivery of good-quality services.

Adopting best practice

As MFIs integrate SPM into their internal controls and audit, three key lessons will ensure success:

Stay focused on your social goals

Internal controls represent a strategy to improve an MFI's social performance just as it can improve financial performance; there should, therefore, be a clear link between the MFI's stated social goals and the tools made available to the internal auditors. Your internal audit questions (or considerations) cannot be separated from your social and financial goals. If your goal is to have an outstanding client service, that's what the internal auditors should be checking (using appropriate tools to do so).

Prioritise the process, not the result

The process of integrating social performance into internal controls and audit requires a strong commitment, as it involves several areas of the MFI's operations. In order to avoid staff feeling overwhelmed, MFIs should plan the process carefully, prioritising activities based on their needs and capacities.

Ensure consistency

MFIs should ensure that field staff (particularly loan officers) have sufficient training and support to carry out the activities that internal auditors will be checking on. For example, if internal auditors are asked to check whether the MFI is targeting very poor clients, loan officers should be effectively trained how to identify clients in this segment in their daily work.

Conclusion

Extending internal audit and internal controls to the area of social performance appears to be an effective incentive for MFIs to develop their capacity and strengthen their SPM systems. It also enables them to achieve a better balance in their performance management and to become more responsive and responsible as an organisation, not only towards their clients but towards all stakeholders.

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About this series

This series of Guidance Notes emerges from a collaboration between the *Imp-Act* Consortium and key industry technical experts. Recognising that the ongoing support to MFIs from funders and support organisations is critical to ensuring a balanced approach to performance management, series aims to help them integrate the missing "social lens" into existing MFI training materials. The notes provide targeted guidance on critical issues, as well as details on further resources available.

Development process

The *Integrating social performance management into mainstream capacity building* initiative, led by the *Imp-Act* Consortium, involves a three-part strategy:

Linking SPM experts with experts in key technical areas: Consortium members and associates join forces with industry experts to apply a social lens to key technical areas.

Reviewing existing mainstream training materials: Through online workshops between project partners, gaps in training currently provided to MFIs are identified and prioritised.

Facilitating online knowledge sharing discussions: Each technical area is addressed in a facilitated discussion on the **SPM Network** in order to add to the rich experience base of these Guidance Notes.

Imp-Act Consortium: *Learn, connect, share*

A range of online resources are available to help you improve your SPM practice:

The **SPM Resource Centre** offers step-by-step guidance on integrating a social lens into MFI performance management systems, including an interactive SPM self-assessment tool. Head to: **www.spmresourcecentre.net**

The **SPM Network** connects individuals and organisations who are committed to managing and achieving social performance in microfinance. The Network is a virtual space for practitioners to share experiences and information, and debate new ideas in SPM. Join in today! **www.spmnetwork.net**

The ***SPM Practice Guide*** offers step-by-step guidance on integrating SPM into your MFI alongside real MFI case studies. Download in English, French, Spanish or Arabic.

Fulfilling the Promise is a new film by the *Imp-Act* Consortium that captures the SPM experience of two mission-driven MFIs, **SEF** (South Africa) and **AMK** (Cambodia). Short and long versions are available in English, French, Spanish and Arabic.

Learn more about the *Imp-Act* Consortium and its work by visiting **www.Imp-Act.org**.

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