

## Responsible Finance a Leitmotif for KfW financial sector promotion

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In a globalised world with a high degree of transparency and information flows, socially and morally appropriate behaviour is becoming increasingly important for all market participants. *Responsible Finance* has become a catchword in development finance and, in particular, in financial system development. Along with financial sustainability goals, the “social return” is a factor of growing importance for the decision-making of many finance institutions (double bottom line).

Over the past years the financial and micro-finance sectors in developing and transition countries have experienced enormous growth rates. Enterprises and the population in many developing countries now have significantly better access to financial services. This has contributed to economic growth and greater prosperity, including among poorer groups of the population. Yet despite these positive impacts, the upward trend has also shown its downside - intransparent and, ultimately, prohibitive lending practices have put many customers at the risk of overindebtedness, particularly through uncontrolled and sometimes aggressive marketing of consumer lending.

Even if there are no internationally acknowledged definitions or standards of *Responsible Finance*, it can be summarized as practices that are designed to create a fair balance of interests between a finance institution and its customers, employees and business partners on the one hand and with their shareholders and refinanciers on the other hand. *Responsible Finance* is ultimately a precondition for increasing the well-being of all stakeholders involved.

### What does Responsible Finance mean for the stakeholders in the financial sector?

*Responsible Finance* is a topic that affects all market players and cannot be reduced merely to the relationship between a finance institution and its customers. The following four dimensions of *Responsible Finance* can be outlined:

- **Customers.** Customers are in a weaker position particularly when their level of education is insufficient for them to overlook the consequences of their borrowing (“financial literacy”). Customers therefore should be capable of understanding the fundamental aspects of financial services, particularly a debt relationship. Giving them certain basic knowledge (“financial education”) is therefore indispensable. Likewise, strengthening clients’ confidence into the whole financial sector is vital, e.g. by promoting deposit insurance schemes.
- **Financial institutions.** Amid growing competition, finance institutions today face the challenge of matching necessary growth with a sound lending practice and, most of



all, avoiding intransparent lending practices. Transparency in a customer relationship includes comprehensible information about the products and conditions, particularly the disclosure of all costs associated with the lending operation ("truth-in-lending"), restructuring instalments and periods in line with the customer's repayment capacities and cash flow, credible management of complaints, a clearly defined and communicated corporate philosophy, the setting and monitoring of developmentally relevant objectives such as promoting employment creation, and compliance with adequate environmental and social standards ("social performance").



- **Regulatory authorities.** The protection of consumer interests should include not only responsible banking practices (through voluntary undertakings) but should be based on a legal and regulatory framework that creates proper incentives for banks and their clients. Ultimately, regulatory requirements (proscribing certain collection practices, requiring disclosure of effective annual interest rates, and others) have proven to be more efficient than interest ceilings still being applied in some countries which often impact negatively on the poor (credit rationing).
- **Donors and investors.** Donors and investors can behave responsibly, for example, by engaging in long-term commitments, by

helping to develop new products, by promoting good corporate governance, and by using their instruments (funding, guarantees, participations, subordinate debt capital) in line with the needs of the finance institutions they support. This would help to achieve a significant impact to strengthen local financial markets so as to respond to the needs of enterprises and private households. In the area of micro-finance this also means, for example, refraining from undermining the potential to mobilise savings.

### What role does KfW Entwicklungsbank play in the area of *Responsible Finance*?

*Responsible Finance* is not a new issue for KfW but has been consistent with its own vision before it became a topic of international debate. With its financial sector operations in developing and transitional countries, KfW contributes to disseminating responsible practices in all of the four dimensions described above; and this is not limited to its microfinance operations. KfW thus contributes to the principles established by the German Federal Ministry for Economic Cooperation and Development for a social and ecological market economy, and it contributes above all to achieving broad-based growth for poverty alleviation, promoting gender equality, strengthening the private sector, improving the conditions for a market economy, strengthening social partnerships, making the economy ecologically sustainable and creating equal opportunities for disadvantaged groups of the population.

Various facets show the role of KfW in the area of *Responsible Finance*:

- **Systemic approach.** KfW's activities focus on different levels of intervention (micro, meso and macro level) and pursue a comprehensive and systemic approach to financial system development in transition in developing countries ("building inclusive financial systems"). In this approach we make

use of long-standing, close contacts with ministries, central banks, commercial banks and micro-finance institutions in our partner countries which are characterised by a partnership based on mutual trust. The development and application of best practice minimum standards and individual projects helps to develop the financial sector framework conditions. KfW regards itself as a partner who contributes to development at the various levels of intervention with a long-term perspective.

- **Selecting the "right" partners.** KfW Entwicklungsbank provides funding and equity to financial institutions which, for their part, regard responsible banking as an integral element of their business model and have appropriate strategies to achieve this. Banks that make their lending terms transparent and customer-friendly are among the preferred partners of KfW Entwicklungsbank.
- **Focusing on suitable products.** Financial sector projects have a focus on successful intermediaries whose business activity is not primarily geared to short-term financial returns (for example by focusing on consumer credit), but to responding to the needs of relevant target groups for development, such as by focusing on MSME loans in the area of micro-finance, housing finance and savings products for small and micro-savers. Through the creation of deposit guarantee funds, for example, micro-savers can be encouraged to place more trust in the financial sector.
- **Long-term commitment as an investor in microfinance funds and MFIs.** KfW plays an important role in setting up and promoting funds which it accompanies over many years as an investor with a seat and vote in the supervisory board, thus contributing to disseminating standards applicable to *Responsible Finance*.
- **"Additionality" for socially motivated investors.** Socially motivated investors (such as private foundations) are developing an increasing interest in investing, for instance in microfinance, and they rely on KfW's country, sector and target-group expertise to ensure that their funds are employed in institutions acting responsibly and that their investment is consistent with their risk preferences. Examples include structured finance operations in the micro-finance sector.
- **Contributing to international discussions.** KfW is acknowledged as one of the leading development finance institutions in the area of financial sector development, particularly microfinance. By hosting and participating in international conferences and in an intensive and continuous dialogue with relevant stakeholders, KfW helps to set the standards for the development and trends in financial sector development. Its main focus is on the promotional and developmental aspect.

Overall, *Responsible Finance* is an important overarching topic for financial systems development at KfW Entwicklungsbank. The bank can draw on many years of cooperation with financial intermediaries in developing and transition countries in which it has gathered vast experience with regard to *Responsible Finance*. It feeds this experience into the international debate. By KfW's way of working, its operations contribute to disseminating good – responsible – practice.

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