MicroSave Briefing Note # 128

Responsible Finance: Concepts and Challenges

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July 2012

Responsible Finance – What Is It?

Responsible finance (RF) is simply *offering financial services in an accountable, transparent and ethical manner*. By definition, responsible finance must focus on ***financial service providers***, (their practices, what they do or do not do) **and** on ***clients***, (mainly aimed at improving their capacities to access and use high quality financial services). The consultation draft of the Responsible Finance Forum[1] refers to RF as "coordinated public and private sector interventions that encourage and assist financial service providers and their clients in improving their understanding and approaches, practices, and behaviours that can eventually contribute to creating more transparent, inclusive, and equitable financial markets".

RF involves and applies to not just financial service providers, but also to investors, lenders and funders – not only of microfinance, but the financial sector as whole. This Note, however, will focus on the applicability of the concept to the microfinance sector.

> **SPM, CPP and RF**
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> **Social Performance Management**[6] as advocated by the Social Performance Task Force (SPTF) focuses on the translation of social missions into practice, and has mission as its starting point. It offers organisations a framework that can help them align all aspects of the institution – strategy, operations, human resources, products and services – with its mission to achieve favourable outcomes / results for clients.
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> **Client Protection Principles**, as advocated by the SMART Campaign, are standards that focus solely on the practices, processes and paper (documentation, physical evidence) of the institution geared towards the protection of clients.
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> **Responsible Finance** (RF) draws from both these concepts. It builds on the broader framework of SPM while putting extra emphasis on measures designed to optimise the supply side for clients (thus improving the demand-side function), and encompasses client protection as one of its main aims.

RF Is Now More Relevant Than Ever

RF has gained importance in recent years due to the series of crises that hit the industry microfinance.[2] There are a number of reasons for the emergence of the importance of RF:

- The race for growth and profits resulted in high growth rates and less focus on customer service and product innovation;[3]
- Allegations against microfinance institutions (MFIs) of profiteering at the cost of clients;
- Client protection issues (especially multiple lending leading to over-indebtedness and coercive collection practices) leading to repayment issues;
- Focus on a rapid rollout and a mono-product culture (excessive focus on only credit led to inadequate efforts to address the diverse needs of the clients, which are again linked to client protection).[4]

The problems outlined above have led to: political interventions (in Andhra Pradesh (India), Nigeria and Morocco to name a few) where governments have taken action against the sector; clients' apathy towards MFIs (more importantly the clients, who once supported the sector – at least in India - have not raised their voice or come to its rescue); stricter regulation/self regulation; and repayment crises.[5]

All this has forced many financial service providers to return to their drawing boards to develop strategies and practices to win back the lost confidence of their clients, other stakeholders and the public in general.

The irony is that RF is clearly essential for the longer-term success of any financial service business serving the poor. *MicroSave*'s research across the globe has demonstrated the importance of loyal customers for portfolio quality and profitability, and how transparency, respect, customer service and appropriate products build trust and loyalty. RF makes basic business sense: it reduces customer churn, protects against reputation and political risk, and ultimately enhances both the financial and social bottom-lines.[7]

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[1] For more details see the consultation draft titled "Advancing Responsible Finance for Greater Development Impact".
[2] Including repayment crises that hit Morocco (2008), the 'Movimiento No Pago' (No pay movement) in Nicaragua (2008), and Pakistan (late 2008), as well as over-indebtedness in microfinance sector in Bosnia and Herzegovina (2009) and the crisis in the state of Andhra Pradesh that changed the face of microfinance forever in India (2010).
[3] See the MicroBanking Bulletin's Defining responsible financial performance: how to think about growth and Defining responsible financial performance: the role of profits
[4] See *MicroSave* India Focus Note 41: Microfinance – Time to Get to Back to Basics?
[5] See article "6 Microfinance Crises that the Sector Does Not Want to Remember"
[6] See *MicroSave* India Focus Note 35: Social Performance Management in India

What Does This All Mean In Practice?

In practice, RF is about putting clients at the centre and offering them high quality products and services. For financial service providers embracing responsible finance means improving their long term relationship with their clients; having an ability to attract and retain a customer base; and improving reputation and risk management systems, thereby increasing efficiencies, and accessing diversified sources of funds.

The core components of RF are:

- ***Client protection*** including offering appropriate financial services to meet the financial needs of the clients;
- ***Financial capability*** that enables clients to better understand the products and services offered and to take informed decisions;
- ***Social performance management*** that can help organisations optimise both financial and social results (and is not just focused exclusively on depth of poverty outreach); and
- ***Offering high quality*** and appropriate services to excluded and vulnerable market segments such as youth.

The underlying themes, of course, are ethical behaviour and codes of conduct, disclosure, product and service quality, transparency and fairness of pricing, and respectful treatment of clients.

It Is A Coordinated Effort!

RF is being propagated by a wide range of bodies including investors, lenders, financial institutions (individually or in partnerships with others), commercial banks, microfinance institutions, support organisations, industry associations, advocacy organisations and in some countries governments / regulators. Some examples include the client protection principles and the SMART Campaign, the Equator Principles and Global Alliance for Banking on Values.

Challenges

The implementation of RF is challenging for all involved. The biggest challenge of all remains the financial service providers that are often too resource-constrained, or lack the incentive, to invest in RF. In addition, some financial service providers have limited management capacity to implement RF. This is compounded by the need to customise RF to the needs of each institution and its clients. There is no cookie-cutter RF solution for all.

What Needs To Be Done?

- Creation of more awareness about the importance of RF practices as "business common-sense" and not some "external imposition". *MicroSave* is currently doing this under the SPM Implementation Project and other projects working with various partners in India, Sri Lanka, Bangladesh and the Philippines. All these projects seek to help MFIs, cooperatives and banks understand and realise the huge business potential of a client-responsive, RF-based approach.
- Facilitating sharing of best practices among service providers. Platforms like SPTF and various RF forums are helping to disseminate this through their websites and publications. *MicroSave* is currently hosting the RF month (July 2012), and its aim is to propagate the latest thinking and lessons learned on RF.
- Investors, funding agencies and lenders should also follow the principles of RF in their lending activities. This way they can follow a "practice and preach" policy more effectively with their lending partners.
- Support by the advocacy organisations / support organisations for client education. It is important to create awareness amongst the clients about their rights, responsibilities and redress as well as how they can make informed choices when confronted with certain situations (for example multiple lending). Of course, considering the client profile, this is easier said than done – for two reasons: one, the number of such clients is huge; and two, their literacy levels and the existent power structures often put them in disadvantageous position. Alternative approaches to financial education are required.[8]
- Industry associations should work with each other towards aligning their self regulation principles.

Doing all this requires a concerted effort from service providers, regulators, industry associations / self regulatory organisations, lenders, funding agencies, investors, support organisations, advocacy organisations and last but the least clients.

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[7] See for example Wright, Graham A.N. "Drop-Outs, Graduates, Defaulters and the Excluded" or Hulme, David, "Client Drop-outs From East African Microfinance Institutions"

[8] See *MicroSave* Briefing Note # 112, "Financial Education – Time For A Re-Think?"