Segments from the Universal Standards for Social Performance Management Implementation Guide – resource for Board of Directors

December 2014

NOTE: This document is a summary of the Universal Standards for SPM Implementation Guide that refers to the role and activities that the board of directors of a financial institution should have in regards to the management of social performance. The information is organized according to the six dimensions of the Universal Standards. Please note that this document does not include all the information that can be found in the Implementation Guide but just the standards and essential practices that relate to the role of boards.

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Dimension 1: Define and Monitor Social Goals

Standard 1a. The institution has a strategy to achieve its social goals

1a.1 Articulate a social mission. Your institution's mission is your cornerstone, and it defines your identity as a social institution. Your board and senior management should be involved in creating your mission. You should also consider involving field staff and clients in the creation of the mission in order to get full buy-in.

Your mission is also the foundation for monitoring performance. A good mission statement will be short and clear. It will summarize your social goals and answer three key questions:

1. Whom you want to reach (target population),
2. How you intend to serve them
3. What changes you hope to influence.

It should describe concrete, measurable, and plausible impacts, rather than vague aspirations that are hard to assess and achieve.

Example mission statement

The following mission statement is succinct, and it clearly answers the three questions above.

To provide competitive credit and savings products that empower smallholder farmers and rural enterprises to create sustainable agri-businesses and improve their livelihoods.

Dimension 2: Ensure Board, Management, and Employee Commitment to Social Goals

Standard 2a. Members of the Board of Directors hold the institution accountable to its mission and social goals.

Essential Practice 2a.1 The institution provides board members with an orientation on the social mission and goals and the board's responsibilities related to the social performance management of the institution.
Essential Practice 2a.2 The board reviews social performance data, including: mission compliance, performance results, human resource policy, social performance related risks, client protection practices, growth, and profit allocation.
Essential Practice 2a.3 The board uses social performance data to provide strategic direction, taking into account both social and financial goals.
Essential Practice 2a.4 The board incorporates social performance management criteria into its performance evaluation of the CEO/Managing Director.
Essential Practice 2a.5 The board has a documented strategy to prevent institutional mission drift during changes in ownership structure and/or legal form.

2a.1 Orient the board to your social mission. In order for your board to manage the institution's social performance, each board member must understand the institution's social goals, and how s/he can contribute to meeting them. A board orientation to SPM should include a comprehensive look at the institution's social strategy,[1] as well as updates on local initiatives (e.g., regulation; national Codes of Conduct), and international initiatives such as the Smart Campaign[2] and SPTF).

As a part of this orientation, discuss with your board members their specific responsibilities related to the social performance management of the institution. Such responsibilities include:
- Ensuring that client focus is integrated into the institution's strategic and business plans
- Reviewing and discussing social performance reports provided by the institution to ensure:
    - The institution reaches target clients.[3]
    - The institution's products and services are appropriate to client's needs.[4]

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[1] Guidance on standard 1a discusses the social strategy.

[2] For more information, visit the Smart Campaign website: www.smartcampaign.org.

[3] Guidance on standard 1a discusses the importance of defining target clients.

[4] Guidance on standards 3a and 3b discusses how to understand client needs and preferences and design appropriate products and services.

- Suggesting modifications to the institution's products and operations based on review of social performance information
- Reviewing Human Resources policies to evaluate social responsibility to employees
- Reviewing and updating the institution's social mission, goals, and targets, as necessary

Confirm that [5]each board member agrees to uphold the responsibilities that your institution specifies. Standard 6b provides further guidance on ensuring that investor board members are aligned with the institution's social goals.
In addition to providing board orientation, consider pairing newer board members with existing ones ("mentors"). Ask the pair to meet one or more times to discuss the institution's history, mission, social goals, and related topics. Board members should visit clients and understand the institution's field operations, so that the institution's social goals "come alive" to the board.
If you find that your board resists their social performance responsibilities, consider using the terms "client focus," "responsible finance" and "balanced performance management" instead of "social performance." Choose terms that appeal to the financial orientation of board members and describe the financial benefits of pursuing social goals.

NWFT, Philippines orients the board on SPM

In 2012, Negros Women For Tomorrow Foundation (NWTF) hired an external consultant to orient the board on SPM. The consultant used two overhead projectors for the orientation meeting. One projector showed NWFT's social performance goals and indicators, and the other projector showed NWTF's plans and activities to achieve each goal.
Viewing the goals and the plans for achieving them side-by-side allowed the board to easily understand what NWFT wanted to accomplish and what activities it would undertake to address social performance goals. The board was very responsive to this presentation, and it was motivated to participate in setting SPM goals and activities. Specifically, the board helped to formulate NWFT's "80-50-30" social performance target: the institution targets 80% of new clients living below poverty line upon entry, 50% of clients making progress out of poverty after three years in the program, and 30% of clients moving about the poverty line after five years in the program.

Chamroeun Microfinance, Cambodia creates a board SPM Committee

In 2012, Chamroeun created a board committee for SPM. The primary function of the SPM Committee is to assist the board in protecting the institution's social mission while the institution pursues financial sustainability. The committee formalizes the board's responsibility for overseeing the achievement of Chamroen's social goals.
The SPM Committee Terms of Reference lists the following responsibilities for its members:

1. Create an SPM strategy: The Committee is tasked with reviewing the mission when necessary, and ensuring that the institution enables clear understanding and consensus on the mission at all levels. The committee also ensures that Chamroeun translates the mission into a strategy that has clear targets and indicators.
2. Monitor social performance: The Committee monitors the achievement of the institution's social goals and compliance with stated values, by reviewing, analyzing, and discussing social performance data.
3. Promote good practices: The Committee advises the institution on good practices to further enhance Chamroeun's social performance. It provides Chamroeun with updated information on global SPM initiatives.

See the Terms of Reference for Chamroeun's SPM Committee here: http://www.entrepreneursdumonde.org/pratiques/index.php?option=com_docman&task=cat_view&gid=375&lang=en

2a.2. Review social performance data at the board level. Many boards view their role as primarily financial, and as such, they focus on corporate oversight and fiduciary responsibilities. However, this creates a gap between the institution's purpose (benefiting clients), and the board's management priorities. Your board should adopt a balanced approach to performance management, drawing on both social and financial information. To achieve this balance, the board must:

- Have on-going access to social performance information, and
- Use this information to make decisions

Provide your board with regular social performance reports, which contain data on the institution's social goals. Ensure that these reports present information that is needed by the board, to fulfil their SPM responsibilities.[6]
Report contents. Report social data that is important to your board.[7] Decide on the content of the report together with your board. This will promote buy-in and facilitate improved decision-making. The report contents should include:

[6] Guidance for standard 2a discusses board SPM responsibilities.

[7] Chapter 3 of this guide, *How to use social performance data for decision-making*, describes how your institution's decision makers (the board and senior management) can use social performance data to inform operational and product decisions.

- Outreach to target clients[8]
- Social indicators that measure progress toward social targets[9]
- Client retention[10]/feedback data or satisfaction surveys/exit survey data
- Client protection risks and practices[11]
- Employee retention and satisfaction/effectiveness of HR policies[12]
- Growth targets vs. actual growth and data/discussion on “responsible growth”[13]
- Profit allocation and data/discussion on “responsible prices and profits”[14]
- The report can integrate or have as an annex any independent information on the above (e.g., from internal audit or independent external assessments, such as audit/rating).

Consider a dashboard report that includes thresholds that trigger decision points around key indicators. In the report, provide a mix of short-term indicators (e.g., client retention by month; progress toward client outreach goals by quarter) and long-term indicators (e.g., change in client poverty levels over two years; results of annual employee satisfaction survey). Together with the board, decide which short-term indicators are relevant to their decision-making timeline and are sensitive enough to provide early warnings.

Think beyond quantitative information. Qualitative information adds richness to data by giving an insight into the reason behind trends (e.g., provide client exit rate numbers, bolstered by data—narrative answers—from focus groups with exiting clients). Segmented information is also a powerful tool for comparative analysis, allowing your board to understand performance variations between different groups/products/branches in relation to key issues (e.g., client exit or level of satisfaction segmented by region, main products, or business type).

If these indicators are new to your board, work with them to learn how to understand and interpret social performance data. Start with a simple report that provides concrete information about the institution (e.g., client satisfaction data, employee retention rates, % female/male clients). Discuss the report, and allow the board to discover how the information is useful for decision-making. Use the same report format for several meetings in a row, so that members become accustomed to reading the report. Then, discuss with board members how the institution might improve the SPM report to make it more useful for the board.

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[8] Guidance for standard 1a discusses defining your target clients. Guidance for standard 1b discusses disaggregating client data based on target client characteristics.

[9] Guidance for standard 1b discusses social indicators that measure progress toward social targets and measuring progress toward poverty reduction goals.

[10] Guidance for standard 3a discusses measuring client satisfaction and client retention.

[11] Guidance for standards 4a to 4d discusses client protection risks and practices.

[12] Guidance for standard 5c discusses employee satisfaction and employee retention. Guidance for standard 5a discusses Human Resources policies.

[13] Guidance for standard 6a discusses responsible growth.

[14] Guidance for standard 6b and standard 6c discusses responsible prices and profits.

Report frequency. Provide a SPM board report at least annually, and as frequently as is necessary to ensure the board has relevant and timely information needed for decision-making. Eventually, provide an integrated report, with social performance alongside financial performance, for each board meeting.

2a.3 Put SPM on the board agenda. To ensure that boards use social performance information to provide oversight for the institution's strategy, each board meeting agenda should include time for review of the SPM report. Additionally, the board should establish a set time (e.g., annually), to review the institution's strategy—particularly the social goals and products/services—and make any changes based on the institution's changing priorities, if necessary.

Give members specific responsibilities. Review the activities and mandate of the existing board committees to analyze whether social performance is adequately covered. If not, consider adding a designated SPM committee. Whether you do so will depend on the extent to which this will marginalize or strengthen the SPM agenda within your particular institution.[15] Potential SPM committee responsibilities include the following: ensuring the credibility of SPM information; engaging employees at all levels in SPM; prioritizing SPM issues to be addressed by the board and management; drawing in relevant expertise for SP research and analysis; and proposing corrective actions for social performance risks identified by the board.

Highlight the risk management implications of SPM. Many aspects of SPM need to be integrated into the risk management strategy: a failure to deliver positive outcomes for clients will lead to poor performance as clients struggle to repay their loans and leave the organization; failure to protect clients will have similar negative impacts and will lead to reputational damage. Ensure that board discussions about risk include this client perspective. To make this practical for board use, segment client data according to characteristics that highlight clients who are most at risk. For example, segmenting exit clients by loan cycle may show that the majority of exit cases happen in the first and second cycles, which is highly costly for the institution, as the recruitment investment is not recovered.

Consider effects on clients. The board should review every decision in light of how it will affect clients. This check may be as simple as asking: "how does this decision affect clients?" before choosing a course of action. The board should decide on the best way to introduce this check. For example, one board member might be in charge of raising the issue, or each board agenda might include time dedicated to

[15] Some institutions have found it best to spread SPM-related issues among various board committees, so that SPM is integrated into all types of board decisions and activities. Other institutions have found that having a designated SPM committee helps social performance issues to achieve equal status to financial performance issues.

the "client check." With time, the board should naturally begin to raise and discuss the positive and negative effects of decisions on clients.

2a.4 Evaluate the CEO on social performance. Board evaluations of the CEO/Director should be based on the financial performance *and* the social performance of the institution. The board should take the evaluation criteria directly from the social targets established in the social strategy.[16] Example evaluation criteria include:

- Institution meets client outreach targets (client characteristics, not just numbers)
- Institution meets client retention targets
- Institution makes progress toward achieving its social targets, as measured by the social indicators that the institution tracks
- Institution meets employee retention targets
- Institution implements an SPM action plan within a given time period
- Institution responds to issues highlighted in market research report by modifying a product or service

The board's evaluation of the CEO/Director should determine how s/he is compensated (salary and bonuses). The board should take corrective action if the CEO/Director achieves positive financial performance (e.g., meeting profitability targets) but demonstrates poor social performance (e.g., failure to meet many of the institution's established social targets).

2a.5 Prevent institutional mission drift. Your board should safeguard the institution's social mission at all times, but particularly during periods of major change that make the institution vulnerable to "mission drift" (e.g., serving relatively wealthier clients over time).

New investors. Before accepting a new investor or donor, the board and management should consider:[17]

- whether the investor has already made a commitment to, or is likely to commit to the institution's social goals
- whether the investor brings experience and/or resources for social performance
- whether the investor demonstrates an understanding of and commitment to the institution's areas of emphasis, such as women's issues

Non-profit institutions generally have more freedom to choose board members that represent the institution's values. For-profit institutions have to balance the need for capital with the desire to bring in investors that reflect the institution's values. Nonetheless, all institutions should be careful when considering a new investor or donor, to avoid bringing in a stakeholder that could steer them away from their

[16] Guidance for standard 1a discusses how to set social targets.

[17] The guidance for standard 6b discusses how to align investor and FI expectations on social and financial performance.

mission. Some institutions have declined donations and investments because they came from organizations whose interests were not aligned with their mission. Even if interests between the institution and new investors seem to align, your institution should include performance expectations in shareholder agreements.

New products, target clients, and/or geographic expansion. Your board should protect the institution's social goals when making decisions about new products and outreach to new target clients and geographic areas. They should consider both the commercial and social implications of such decisions, and they should use client data during the decision-making process. For example, if the board is deciding whether to add or adjust a savings product, they should consider what percentage of clients are currently saving, over time. If the number is low (i.e., only a small percentage of clients are savers) this suggests that the current saving product is a "finance-only" decision, meant to generate capital for the institution rather than to address the multiple needs of clients. Additionally, if average savings balances are higher than average loan sizes, it might suggest that the current savings product does not meet the needs of the majority of target clients. Using relevant indicators, your board will be well-positioned to ask critical questions about the social impact of their new product decisions.

Similarly, when deciding whether to pursue new target clients and/or a new geographic area, the board must question whether or not the institution already understands the needs of the new group, and if so, whether the institution is well-placed to serve those particular needs. Alternatively, does the institution need more time to research the needs of the new group and to consider which products and services will meet their needs? Additionally, the board should think through both the commercial and social advantages of expanding client outreach, and whether the institution will achieve both, or only one. An example of achieving both: the institution expands to more rural areas, meeting the social goal of financial inclusion and the financial goal of reducing the risk of client exit based on poaching from other urban lenders.

Juhudi Kilimo, Kenya reports SPM to the board

Juhudi Kilimo provides the board with an SPM board report each quarter. The contents were decided on by management and the board, and the report is used to track data that are relevant for board decisions. Board reports typically include some or all of the following data:

- A "social picture" of clients, which demonstrates their housing and family situations (flooring material, roofing material, habitable rooms, source of lighting, number of children in school, number of employees)
- Progress out of Poverty scores, segmented by new/existing clients
- Client monthly income and expenses (percentage in each income/expense range)
- Type of assets financed (dairy cows, poultry, farm equipment, irrigation systems, farm inputs, transportation assets, and other)
- Client drop-out rate, segmented by male/female
- Client satisfaction survey results
- Employee satisfaction survey results
- Results of any other social performance surveys/studies/audits
- Related financial performance data: total groups, new groups, total clients, active borrowers, client monthly growth rate, new male/female clients, PAR

Dimension 4: Treat Clients Responsibly[18]

Standard 4a. Prevention of Over-indebtedness—Client Protection Principle 2. Providers will take adequate care in all phases of their credit processes to determine that clients have the capacity to repay without becoming over-indebted. In addition, providers will implement and monitor internal systems that support prevention of over-indebtedness and will foster efforts to improve market-level credit risk management (such as credit information sharing).

4a.3 Monitor over-indebtedness. While credit staff carry out repayment analysis in the field, management should monitor the institution's portfolio for potential over-indebtedness problems. Management should review and analyze portfolio quality reports (non-performing loans, rescheduled loans, write-offs) on a regular basis—at least quarterly. They should also analyze credit bureau information at the aggregate level (if available), in order to inform decisions about products, expansion, and targeting. The board should receive and review portfolio reports at least quarterly.

Over-indebtedness is not an absolute level of debt, but is commonly understood as a situation where a client has to make unacceptable sacrifices in order to repay a loan. Management and board should develop a definition of over-indebtedness for the institution's context (i.e., "what does 'over-indebtedness' mean for our clients and how do we identify it?"), and they should define indicators and benchmarks that serve as early warnings for over-indebtedness. Examples of such indicators include: PAR by product, number/percentage of clients with multiple loans, number/percentage of clients repaying loans early, early repayment by product, calls on guarantees, delinquent loans, and client exit. In particular, track rescheduled loans and produce reports at least monthly, as a rising number of rescheduled loans[19] may reflect rising over-indebtedness.
Your institution should also gather client feedback on possible cases of over-indebtedness. This client feedback is important because over-indebted clients are not necessarily delinquent, as they may use informal sources or sale of assets to meet contractual obligations, especially in saturated markets. Moreover,

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[18] The Universal Standards contains all 30 of the Smart Campaign's client protection standards. These 30 standards describe adequate practice for each of the seven Client Protection Principles, and they are included in the Universal Standards as Essential Practices. Dimension 4 contains most of the client protection standards (21 of 30). The remaining nine standards are relevant to Dimensions 2, 3, and 6, and are located in those sections. To view all of the client protection standards in one place, please visit the Smart Campaign's website: http://www.smartcampaign.org/certification/certification-standards

[19] Rescheduled loans are loans whose term has been modified to permit a new repayment schedule, to either lengthen or postpone the originally scheduled installments, or to substantially alter the original loan terms, such as loan amount. The term "rescheduled loans" also usually comprises refinanced loans, which are loans that have been disbursed to enable repayment of prior loans for which the client was unable to pay the scheduled installments.

delinquency is a lagging indicator: by the time PAR starts rising, there is already a problem. Ask clients: Are you making major sacrifices to meet your loan obligations? Have you had to borrower elsewhere, use savings, or sell an asset to make a loan payment? These are questions that should be integrated into regular procedures (exit surveys, audit visits, etc.) as they will give management a more complete picture of over-indebtedness.

Such monitoring efforts should be heightened in high-risk markets—this includes markets where multiple borrowing is common, there is no credit bureau, the credit bureau is unreliable, and/or there are high FI growth and penetration rates. Under these conditions, your institution's credit approval policy should explicitly address borrower debt thresholds.[20]

[20] Debt thresholds can be known by different terms (debt coverage ratio, debt service ratio, repayment capacity ratio, etc.) and may be calculated in different ways. When it comes to calculating repayment capacity, the ratio usually involves looking at installment/disposable income (or vice versa).

Dimension 6: Balance Financial and Social Performance

Standard 6a. The institution sets and monitors growth rates that promote both financial sustainability and client well-being.

Essential Practice 6a.1 The institution establishes a policy on sustainable target growth rates, approved by the board, for all branches/regions and all product types, considering the institution's growth capacity and the markets being targeted.
Essential Practice 6a.2 The institution analyzes growth rates and market saturation to assess whether growth policies ensure both financial sustainability and client well-being.
Essential Practice 6a.3 The institution monitors whether its internal capacity is keeping pace with institutional growth in number of clients and amount of loans and deposits, and it enhances that capacity as needed.

6a.1 Set sustainable growth targets. Most microfinance institutions register positive growth rates of their customer base or portfolio. Annual growth rates are usually in the range of 5-30% but can reach 50% or more in markets where the market potential is still very large or in which the competition is very intense. Such high growth rates can be appropriate in some market contexts yet very dangerous in others where they can generate problems of over-indebtedness of clients or weaken the internal control systems of the institution.

Regardless of why your institution pursues growth (e.g., to achieve economies of scale and reach sustainability, to meet your social goal of financial inclusion), ensure that your target growth rates are sustainable. Sustainable growth rates allow you to maintain good customer service, respect clients' rights, and ensure manageable workloads for employees. In other words, pursue growth only as quickly as you can adapt and expand your quality-control systems such as employee training, and MIS capacity, as well as your risk monitoring.

Sets target growth rates by branch and/or region over a three- to five-year time horizon. During this process, analyze the following factors, keeping in mind the quality of customer service, client protection, and employee satisfaction:

- **External factors:** client demand, market penetration, market saturation, market infrastructure
- **Internal factors:** management team workload and skills, internal controls, operational procedures, human resources, management information system, financing

Analyze external factors. Your institution should analyze external factors, including client demand, current and future market penetration of competitors, and market saturation, for each branch and for each product. Careful analysis of these elements is necessary to set sustainable target growth rates. The institution should also

assess whether an “intensive” or “extensive” growth strategy is most appropriate: an “intensive growth” strategy means adding new borrowers within existing branches or a limited geographic market, while “extensive growth” strategy focuses on opening new branches and/or entering into new markets.[21]

[21] MIX data shows that intensive growth depletes the pool of ”good” borrowers faster than extensive growth, and intensive growth levels over 168% (growth rate of number of borrowers per branch) are associated with lower portfolio quality; while only extensive growth levels over 631% per year (growth rate of the number of branches per FI) are associated with worsening portfolio quality. These data do not suggest that your institution should never pursue “intensive growth,” but rather that you should consider whether the geographic diversification of your intended growth will promote positive outcomes for clients (e.g., financial inclusion) or negative outcomes (e.g., client over-indebtedness).

Analyze external factors to inform your growth policy

External factor	Analysis	Resources needed
Client demand (potential market)	Understand demand by client type in order to estimate the structure of portfolio (average disbursement, type of product, loan term, historical savings growth, trend in average daily savings balances).	• Market research • Credit bureau information Data available from national/regional network • Feedback from branches
Market penetration	Estimate the total market penetration (clients served by you and your competitors compared to the potential market) in your operational areas. Calculate the likely evolution of this penetration based on your target growth rates and that of your competitors. In the absence of other data, assume that your competitors will grow at the same pace as your institution.	• Competitors'[22] current outreach and estimated growth rates • MIX Barometer • Data from regulatory authorities, feedback from branch/regional teams.
Market saturation	Gather all data that can help you identify potential problems of market saturation (cases where the offer of credit exceeds the sustainable demand for credit): incidence of multiple loans, loan amounts compared to income levels, competitors' PAR levels over time, competitors' growth rates over time.	• MIMOSA[23] • Global Findex dataset[24] • Credit bureau information • National statistics institute (data on micro entrepreneurs) • MIX Market Cross Market Analysis[25] • Feedback from branches

[22] Competitor projections of growth or a national average growth projection may be difficult to find. FIs in some markets can get this information from the MIX Barometer, which collects growth forecasts at the individual institution and national levels. The projections in the MIX Barometer cover number of active borrowers, gross loan portfolio, and PAR > 30 days. In some countries microfinance markets are also quite dynamic (absorptions, mergers, new microfinance providers), and it is more difficult to analyze the competitor's growth forecast. In this case, it is useful to prepare three growth scenarios—conservative, normal, and optimistic—so the institution can be flexible enough to handle changes in market conditions.

Market infrastructure	Check information from the credit bureau and/or other client information exchange systems, as well as the estimated level of use of informal credit providers. Check whether all main competitors report to the credit bureau (including store credit information for example).	• Credit bureau data • Feedback from branches • Global Findex dataset indicators for informal sources of lending • MIX Market Cross-Market Analysis or MIX Market Country Pages[26]

[23] The Microfinance Index of Market Outreach and Saturation (MIMOSA) is an analysis of credit market capacity using the Global Findex dataset, offered by Planet Rating: www.planetrating.com/userfiles/file/MIMOSA 1_0 entire version FINAL.pdf

[24] The Global Financial Inclusion (Global Findex) Database is a World Bank project to measure how people in 148 countries—including the poor, women, and rural residents—save, borrow, make payments and manage risk. First published in April 2012, the data are updated annually. http://datatopics.worldbank.org/financialinclusion/RES/EXTGLOBALFIN/0,,contentMDK:23147627~pagePK:64168176~piPK:64168140~theSitePK:8519639,00.html

[25] www.mixmarket.org/profiles-reports/crossmarket-analysis-report

[26] http://www.mixmarket.org/mfi

"Using Global Findex Data"

If detailed information on your potential market size is not available, Global Findex data provide a good proxy (http://datatopics.worldbank.org/financialinclusion/). This database includes results from surveys on the use of financial services (formal and informal) conducted in 148 countries in 2011. It can provide useful information to estimate your institution's potential market (size of market, purpose of loans, sources of loans). For example, an institution could use the Findex indicator "Loan in the past year, older adults (% age 25+)" as a proxy of the total demand for credit. This indicator identifies the % of adults that declared having taken a loan in the past year, from any source. The potential market could be calculated as shown below.

Indicators and equations	**Calculations**
Loan in the past year (%, older adults 25+), (a)	23.6%
Population in the area of intervention area (b)	1,500,000
Population using loans (c = a*b)	354,000
Demand that can be served by financial institutions (d)	50%
Potential market (e= c*d)	177,000
Targeted market share (d)	30%
Total number of targeted clients (c*e)	53,100

Even in the most developed economies, financial institutions only serve about 50% of the persons who declare using loans in a given year.

Incofin defines "responsible growth"

Incofin Investment Management believes that all investors have a responsibility to assess market penetration before investing. When monitoring investees and potential investees, Incofin closely evaluates the level of market penetration where the institution operates (at the national, provincial, district and village level), the instances of multiple borrowing and the use of Credit Bureau information, the institution's growth target rates, the institution's past and present loan portfolio and client growth rates, and the internal capacities of the institution (MIS, risk management, credit underwriting policies, compliance culture, quality of field staff training, and delinquency management), to determine whether their loan portfolio growth rates are "responsible." For example, Incofin looks for growth that is broadly in line from the following rates:

- 50% to above 100% annually—Young FIs with good systems in place in market with low penetration rates.
- 30% to 50% % annually— Medium-sized FIs in markets with low to medium penetration
- Up to 30% annually—More mature FIs in markets with high penetration.

Analyze internal factors. Your growth policy should also take into account your institution's internal capacity for balancing growth with quality. **Error! Reference source not found.** lists six internal factors you should examine, and it summarizes the insights you can gain from each analysis.

Analyze internal factors to inform your growth policy

Internal factor	**Diagnostic**
Internal control	Assess whether internal controls are robust enough to support a larger portfolio and/or geographic area. This includes delinquency management controls.
Operational procedures	Check whether key operational procedures, including credit management policies, are sufficiently documented and updated to adjust to the evolution of the organization brought on by operational expansion.
Management team workload and skills	Assess whether managers have the capacity—in terms of workload and skills—to manage the increased responsibilities and pressures of expanded operations. Consider what your current staff will be required to manage: new technologies, systems, human resources, clients, products, etc.
Human resources	Assess the ability of your human resources to manage higher volumes of activity. Take into account: number of employees, their training and skills, employee turnover, employee productivity, and availability of qualified applicants for new positions, and your capacity to train new hires at the right pace.
Management information system (MIS)	Assess whether your MIS has the capacity to support an increase in operations. Consider its ability to process larger volumes and provide critical information for managing a larger portfolio, including the information necessary for more robust internal controls.
Financing	Consider the financing sources that you will need, and ensure that their terms are adapted to the products and services you want to offer to your clients.

6a.2 Monitor compliance with growth policies. Growth has a direct impact on the institution's ability to maintain high service quality and institutional sustainability. To maintain close control of institutional growth, the institution should monitor the following indicators each quarter:

- Internal indicators of growth, per branch and region, and for each product, including the following:
  - Number of loans outstanding
  - Outstanding portfolio

- Number of savings accounts and average balances
- New client recruitment
- Incidence of multiple borrowing (from the same FI and from other sources)
- Change in PAR 30
- Productivity (Borrowers/Employee or Borrowers/Field staff)

- The evolution of the local market conditions

Monitor internal growth. Taken together, the indicators above demonstrate how growth may be affecting service quality for clients and/or institutional sustainability. Quarterly monitoring is important, as an annual assessment does not capture periods of fluctuation, such as high growth followed by contraction. Additionally, it is important to monitor growth by branch, because sometimes problem behavior at a specific branch, such as excessive growth, is not evident in the aggregate data for the institution. Compare these indicators to your targets, analyzing any differences.

Monitor market growth. Analysis of local market conditions is described above. Watch the evolution of market conditions closely by analyzing market growth on a quarterly basis. If unexpected changes in the external conditions are detected, management should act to prevent negative consequences for the institution and clients. For example, if a new competitor enters a geographic area that already has high penetration by other institutions, consider whether preventive or corrective action is necessary, such as implementing more conservative debt limits for client loans or revising growth targets.

6a.3 Monitor whether internal capacity is keeping pace with growth. In addition to carefully tracking institutional growth, also monitor whether the institution's internal capacity is keeping pace with growth. The table below presents key indicators that management should monitor, as well as how to analyze these indicators, in order to address risks related to the institution's capacity to handle growth. Monitor these indicators for each branch or regional office, and for each product.

Monitor the institution's ongoing capacity to handle growth

Indicator	Analysis
Internal audit findings	Examine internal audit findings on how all branches/regional offices are implementing credit policies such as client debt thresholds, repayment capacity analysis, and loan restructuring. Give extra attention to new and high-growth branches.
Internal controls	Examine the quality and capacity of the internal controls, looking for areas where capacity should be augmented to ensure sufficient monitoring of all branches.
Staff capacity	Consider number of employees, employee training, productivity, turnover, clients per loan officer, and employees per manager. Determine whether employees have the skills, time, and resources

	to successfully manage portfolio growth.
Management information system (MIS)	Consider the quality control protocols for data, how much data the system can hold, how easily and accurately data can be exported, and how easily reports can be created. Determine whether the system allows managers to closely monitor the portfolio for each product and find growth-related problems before they become significant.
Service quality	Gather input from managers, internal audit, and clients to determine whether service quality is suffering as growth increases. Use this information in conjunction with PAR 1 and PAR 30 data.
Vintage analysis[27]	Vintage analysis per branch for each product, per loan officer or period can highlight credit risk issues that are minimized by a global analysis. Vintage analysis is useful especially during changes in the credit methodology, incentive scheme, or operational organization.

Standard 6b. Equity investors, lenders, board, and management are aligned on the institution's double bottom line, and they implement an appropriate financial structure in its mix of sources, terms, and desired returns.

Essential Practice 6b.1 The institution has clear policies, consistent with its social goals, on its desired level of returns and on how those returns will be used.
Essential Practice 6b.2 The institution engages with funders whose expectations for financial returns, timeframe, and exit strategies are aligned with the institution's social goals and stage of development.
Essential Practice 6b.3 When deciding on funding sources, the institution considers how cost of capital is passed on to the client.
Essential Practice 6b.4 The institution minimizes financial risk as it relates to its obligations to clients, such as savings and cash collateral.
Essential Practice 6b.5 The institution has a transparent financial structure, as reflected in its annual audited financial statements that incorporate any off-balance sheet sources of funding into leverage ratios.

6b.1 Define a policy on profits and their use. Management and investors must develop a shared understanding of the appropriate level of profit and the allocation of profits between investors, the institution, and clients. This requires both your institution and potential investors to be fully transparent on financial and social

[27] A vintage analysis details the evolution of credit risk of a certain type of loan during a period (for example, loans disbursed by certain branches or loan disbursed in a given period); the purpose is to compare it with the global performance of portfolio.

return expectations prior to investment, and it requires the board to play an engaged and ongoing role in oversight of profit and profit allocation.[28]
In order to facilitate this clear understanding between your institution and its current and potential investors, begin by setting a policy on profits that includes:

- the prices for products and services (discussed in standard 6c)
- the desired level of profits, and
- how net profits will be allocated.

Set a policy on desired profits. This policy should include targets or ranges for ROA, ROE, and margin caps. In addition to providing clarity to managers on financial goals, having these targets in place: 1) helps potential investors to determine whether your institution is pursuing a profit level that is in line with their own expectations, and 2) allows the board to check whether the institution is generating too much or too little profit, as compared to established targets.

Articulate the rationale for target profits. In addition to setting profit targets/ranges, your institution should articulate the rationale for these. Specifically, discuss and put into writing why these target ranges were chosen and how they promote balance between the institution's financial and social goals. It should not be automatically assumed that high profits are inconsistent with your social goals, but you should be able to articulate how they are justified by your social goals. For example, you may choose to seek higher margins on loans because you are exposed to specific risks given the country or area you work in (e.g., inflation, drought, etc.) or given the target population you work with (e.g., clients in difficult-to-reach areas).
The industry does not yet have established "norms" for profitability targets for FIs, but some social investors have identified acceptable profit thresholds for double bottom-line investees (e.g., maximum 5-7% ROA; 20-25% ROE). Many investors look at a combination of ratios, ROA, ROE, and proxies for costs to clients, such as the APR or portfolio yield. Some have a "traffic light" system to alert investment officers and decision makers in the organization to profit levels that are considered above or below targeted levels.
This is not to suggest that investors believe that higher profits and strong social performance are inconsistent, but that FIs must be transparent on target profit goals, and they must fully explain and reconcile their desired social and financial performance. Most investors recognize that each institution is unique and has its own cost structure and market circumstances to take consider.
In all cases, the following points should be taken into account for setting desired profitability ratios/ranges:

- How does the FI's pricing compare to market prices? Do profitability targets allow the FI to remain competitive relative to the market and its competition?

[28] The guidance for standard 6c discusses board oversight of whether the institution's profitability levels are consistent with the institution's policies on returns.

- What is the minimum pricing to ensure full coverage of product costs? If deliberately targeting a lower return on a product for social purposes, how sustainable is the "subsidy" from more profitable products?
- How does each product and service contribute to the institution's financial goals? Social goals? Which products/services can be justified based on their social benefits to clients, though they are not profitable in the short- or medium-term? How would termination of a product or service impact the clients?
- Can you be viable without needing large profits from the larger loans? If you establish a policy of targeting cost recovery and profit from the full range of products, evaluate whether the higher cost of smaller loans is within the means of those clients to pay.
- Can you set lower profitability targets that support the sustainability of the institution and attract new investors while at the same time enable clients to retain a greater share of their income?
- How much of the FI's growth—whether scaling up or development of new programs—should be borne by new investor capital vs. financed through retained earnings provided by clients? What level of profitability is needed to attract adequate investor capital?

Set a policy on use of profits. In addition to setting profitability ratios/ranges, institutional policy (statutes, shareholder agreements, etc.) should also cover the use and allocation of profits. It should detail how much of the current year's profit is expected to be distributed in dividends and bonuses for staff and/or management, how much should be allocated to general reserves to maintain a good capital adequacy in the context of growth, and how much might be allocated to special reserves for social performance. This refers to reserves that your institution might create to make investments in product design, investigation of client needs or satisfaction, to offer non-financial services to clients (social services, trainings, etc.), or to contribute to other philanthropic activities or social businesses beyond your direct scope of activities. The institution should also clearly state whether it has a goal to lower interest rates for clients as long as profits remains above a certain threshold.

6b.2 Align expectations upfront. When your institution is seeking equity investment, only engage with funders[29] whose expectations for financial returns, social returns, time horizons, and exit strategies are aligned with your own. It is important that in the structuring stage of an investment agreement, the terms of the transaction explicitly recognize and seek to preserve your institution's social goals, which include your growth and profitability targets, discussed above. If terms such as expected social outcomes and use of profits are left unarticulated in pre-investment negotiations, management will be forced to reconcile these inconsistencies once funding is already in place, which often leads to tension between the institution and funders.

[29] This applies to institutions that are externally funded and not to institutions such as cooperatives that are funded by members themselves.

As a starting point, each new equity investor should study the mission and social goals of the institution and its strategy for achieving them (see standard 1a).[30] Doing so ensures that the investor understands that the mission of your institution is not to maximize financial performance but to balance financial and social performance. A funding agreement should include an explicit articulation of the institution's approach and goals with respect to financial and social performance, which will be included in the formal documentation of the transaction.
The table below lists the terms that should be mutually decided on by your institution and potential investors, alongside discussion questions that will help both parties determine whether the terms are aligned with the institution's social goals.

Aligning social and financial expectations

Terms	Questions to determine alignment with the institution's social goals
Social outcomes	• Does the investor share the same social goals as the institution? What action will the investor take if the institution does not achieve the agreed-on social targets? • Do the investor's terms (e.g., lending rate, desired profits, etc.) reflect the "social returns on investment" (client, community, and environmental outcomes of the investment)? • How has the investor demonstrated commitment to social performance? (e.g., history of working with other double bottom-line institutions, signing the *Principles for Investors in Inclusive Finance*)
Profit expectations	• Do the funder's profit expectations align with what the institution believes is reasonable, given the institution's commitment to responsible growth (standard 6a) and responsible pricing (standard 6c)? For example, what does an investor's target IRR assume with respect to ROE and multiple expansion, and are targeted growth rates underlying the latter consistent with the institution's social goals? • Do profit expectations take into account the social returns that the institution expects to deliver? • Are debt and equity investors' financial return expectations aligned with the institution's own target ranges, given their cost of capital, the particular risks of investment, and the social returns generated by the FI? • What will the funder's profit expectations require of the institution in terms of pricing, growth, human resources, and

[30] The guidance for standard 1a discusses all of the elements of your institution's social strategy. Social investors should sign a written agreement that summarizes this strategy.

	risk management? Can the institution manage these requirements?
Use and allocation of profits	• What portion of profits should go toward: reinvestment in the institution to finance growth, reducing costs to clients, dividends for members or shareholders, bonuses for staff or management, activities designed to enhance the social outcome of the FIs (improvement in product design, investigation of clients' needs, non-financial services, etc.), other? • What portion of the institution's growth should be based on retained earnings? In other words, how much of future growth should be capitalized by clients and how much by investors?
Investment timeframe and exit strategy	• Is the investor's intended timeframe appropriate? If too short, it may require the institution to grow faster than is prudent, set prices too high, or compromise on its social goals to maximize short-term profitability. • Is there a secondary market for investment in your country? If so, how strong is it? Is it all venture capital, or is there a financial market that gives you other options for further investment once the original investors leave? • To whom can the investors sell their shares? Careful and deliberate due diligence to ascertain the buyer's intentions and commitment to the FI's mission will help the seller make a decision, as will judgments about the kind of capital and expertise the FI most needs.[31] • At what price should the investor sell? Cashing out nearly always entails giving up say over the investee's future social performance. Some investors use a two-step process in which they first screen buyers for suitability and then make their final selection based on the most attractive price. A focus on maximizing profit, even with a secondary consideration of social performance, could unintentionally force an FI toward a new strategy that reduces benefits to or even harms clients.[32]

[31] CGAP. *A Graceful Exit: understanding social responsibility during equity sales* (forthcoming publication).

[32] ibid

Deutsche Bank sets profitability limits that trigger close analysis

Deutsche Bank advocates for the microfinance industry to "gradually and proactively work toward an overall decline in interest rates," since such a reduction will likely "allow clients to maintain a greater share of the generated profits to help build assets and to better cope with cash flow uncertainties." While acknowledging that there is not a single responsible profit level, Deutsche Bank does set limits that, if exceeded, prompt the investor to further analyze the FI's interest rates and profitability before deciding to proceed with the investment. These limits are listed below.

Regional "Trigger Metrics"			
Region	**Portfolio Yield (PY)**	**Operating Exp. Ratio (OER)**	**Return on Assets**
Africa	58%	35%	7.5%
East Asia & Pacific	47%	35%	
Eastern Europe & Central Asia	45%	26%	
Latin America & Caribbean	53%	39%	
Middle East & North Africa	38%	29%	
South Asia	29%	18%	

If an FI's "trigger metrics" meet or exceed the levels above, Deutsche Bank analyzes the FI in three steps:

- Reviews trigger metrics as three-year averages and as the most recent rolling four-quarter ratios. If the FI's numbers exceed the limits on a three-year average basis, it will trigger a review and require a brief analysis. If the FI's numbers exceed the limits on a three-year average basis, but the most recent rolling four-quarter ratios do not exceed the limits, a positive trend is shown, and no additional analysis is required.
- If analysis is required, compares the FI's metrics with those of its in-country peers in order to determine whether country-specific contextual factors (e.g., growth potential or high cost of doing business) may be influencing high levels of yield, profitability, or inefficiency.
- Charts the FI's portfolio yield and OER against its average loan size in a scatter plot with the other institutions in its country. MFTransparency has shown the relationship between an FI's portfolio yield and operating expense and its average loan size, suggesting that there is a fairly predictable curve for each country. Based on curve, the analyst should be able to estimate an approximate expected level for each ratio and should take note of extreme differences.

Finally, Deutsche Bank considers the results of the above analysis, alongside pertinent data on the FI, such as: outreach to rural areas, average loan sizes, stage of maturity, donor subsidies, regulatory costs, and provision of non-financial services. Based on this careful analysis, the investor then decides whether to move forward with full due diligence for potential investments or determines what actions may be required in the case of existing borrowers.

6b.3 Understand which risks and costs are passed on to the client. Your institution is likely taking on costs that a more conventional company would avoid—for example, design and pilot costs for innovative "pro-poor" products and costs involved in targeting clients that are harder to reach. While in many cases these efforts will eventually yield a reasonable financial return from better product design, stronger competitive position, or enhanced client loyalty and lower client acquisition costs, there may be a period before they do so. In this regard, your institution must decide which of the "investments" in future profitability should be funded by the client through higher prices and which should be absorbed by investors, bearing in mind that when profits are generated, they will accrue to the benefit of the investor.

In addition, the management and board is responsible for preserving the capabilities and stability of the institution, given the relative vulnerability of your clients. While more affluent or secure clients may be better able to absorb reductions in lending, termination of a product, or closure of a branch, your institution should always consider the impact of such actions on your clients and place a premium on steady and sustainable growth.

Your institution should have an agreement with investors that hedgeable risks, such as foreign exchange and interest rate risks, should not be passed on to clients. Also, investors should agree to take on the risks of breaches in its fiduciary responsibilities, such as for the safekeeping of savings deposits or losses on insurance products. If losses result from these types of risks, product pricing should not be increased, nor services to clients reduced, in order to compensate investors for the losses. Instead, investors will bear the cost of these losses by accepting a lower return. Costs relating to product delivery (such as changes in local interest rates) can be passed on to the client, but the design of the products should protect them from unexpected fluctuations in the cost of the services.

6b.4. Safeguard client funds that you are holding. Besides its shareholders, the institution also has obligations to its clients for safeguarding funds entrusted to it such as savings and cash collateral. Your institution must have solid treasury risk management policies and procedures and robust internal controls in order to protect your clients' and investors' interests. The board must reinforce these prudent measures by defining and closely managing financial risks. Increasingly, some FIs are using an Asset Liability Management Committee (ALCO) tasked with a more rigorous review of treasury risks such as foreign exchange, liquidity and interest rates, and other contingent liabilities that may affect the FI's financial liquidity and long-term solvency, as well as its social commitment to clients.

One particular risk management responsibility is to safeguard client deposits and/or cash collateral. While most regulated institutions can expect supervisory authorities to provide an additional safeguard for public deposits, your board and management should also actively ensure that the institution complies with all laws, regulations, and best practices in terms of risk management, and it should prioritize the integrity of and access to client savings at times of stress or uncertainty.

These measures for protecting client obligations should be included in investor and shareholder agreements. This policy should establish liabilities to clients as a higher priority than the institution's obligations to its other debtors (lenders, shareholders), if not mandated by local regulation.

6b.5 Maintain a transparent financial structure. As described above, transparency regarding social objectives and return expectations is critical to a full alignment between funders and the institution. Your institution should also be transparent on the all risks it bears, notably financial risks. Transparency and risk management are not unique to microfinance—however, the responsibility weighs more heavily on an institution serving more vulnerable clients and operating in unstable environments with unreliable or non-existent deposit insurance.

Equitas Micro Finance, India sets profit policies and aligns management and investor expectation

Since 2007, Equitas has provided clients in Tamil Nadu, India with access to credit and other services. Equitas targets clients who are unable to access mainstream banks, and it prioritizes "transparency to clients, employees, society, regulators, government, lenders, and owners."
Equitas takes the following measures to ensure that profit expectations are clear to management, the board, and funders:

- **Establish a cap for ROE**: When Equitas commenced lending, the institution set a ROE cap of 25% (the target ROE for the company is around 20%) which is based on the typical ROE range of 20 to 25% for nationalized Indian banks. The cap helps ensure that even after the company tapers off growth, benefits of efficiency gains from lower costs of scale will go to the clients through reduced rates or other services.
- **Establish a policy on the use of profits**: Equitas has a policy of allocating 5% of the company's profits to fund social programs, including medical camps, skills development, and schools for clients' children. Additionally, Equitas has approval to use up to 15% of the company's net worth to create schools. These social programs are managed by an affiliated non-profit.
- **Establish social expectations**: In an attempt to align return expectations, the company clearly discloses the following to each potential investor prior to investment: the cap on ROE, use of profits to fund various social initiatives, and the Equitas philosophy on social interventions. Because the institution has been clear about its profit allocation policy from the onset, Equitas has been able to continue funding these programs to benefit its clients even in times of financial stress when ROE was under pressure.

Specifically, your institution should disclose in its financial statements all risks related to assets or liabilities (foreign exchange risk, interest rate risk, maturity

risk), delineate contingent liabilities[33], disclose off balance sheet items[34] and count them in leverage ratios if there is recourse (e.g., asset sales with recourse, securitizations, and law suits), and provide all details of your shareholding structure and participations in other companies.

Standard 6c. Pursuit of profits does not undermine the long-term sustainability of the institution or client well-being.

6c.5 Monitor whether prices for consistency with the institution's policy on returns. Your board should monitor prices to ensure that they reflect the double bottom-line social and financial goals.

Standard 6d. The institution offers compensation to senior managers that is appropriate to a double bottom line institution.

6d.1 Align CEO compensation to social goals. Your institution's board plays a critical oversight role in evaluating the performance of the CEO and other top-level executives and in determining their compensation (defined as salary, benefits, bonuses, stock options, and cash value of perquisites). Such oversight motivates managers to achieve specific social and financial targets, and it ensures that salaries reflect such performance.

Compensation levels will vary widely across different institutions, but all institutions should ensure that compensation is set by independent board directors and not by the CEO him/herself. Indeed, the board should meet separately from the CEO to discuss matters of compensation. Decisions on CEO compensation must take into account the results of the evaluation of the CEO's performance, including social performance goals.[35]

While your institution should pursue and incentivize sustainability, the CEO's performance expectations and incentives should not over-emphasize pursuit of profits, as this is likely to shift the focus of the organization away from what is best for clients, toward what is most likely to produce high profits.

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[33] Contingent liabilities are possible obligations, and they present obligations that are not probable or not reliably measurable. An example of such liabilities is a restricted grant that has been disbursed but not yet earned by completing the required deliverables.

[34] Off balance sheet items are those that are not included on the institution's balance sheet, because the institution does not have legal claim or responsibility for them. However, these may become liabilities for the institution. Examples include operating lease agreements and joint ventures.

[35] Guidance for standard 2a discusses how to evaluate CEO performance based on social performance criteria.

The board, including independent (non-management) members, should annually[36] review the compensation of the CEO and other senior managers to ensure that it is comparable to institutions with similar double bottom-line goals. If there are large differences, the board should examine the reasons for the differences, to determine whether or not the discrepancy is justified (e.g., high salary required to attract someone with a rare talent that is critical to the institution at the time). This measure will provide a reality check to the institution, and it may prompt an upward or downward revision of the salary scale, so that it is more in-line with industry standards for double bottom-line institutions.

6d.2 Include social performance evaluation in CEO incentives. The board should evaluate the CEO/Managing Director based on the social performance of the institution, taking the evaluation criteria directly from the social targets established in the social strategy.[37]

6d.4 Ensure the spread between the compensation of senior staff and field workers is aligned with the institution's social goals. The board is responsible for evaluating the performance of the institution's top-level executives. Additionally, the board should evaluate the compensation of these managers against the compensation of its field staff, and determine whether the spread between the two reflects the institution's commitment to its social goals. For example, an institution might find that the average management salary is 20 times that of the lowest paid loan officer. The board would discuss this finding, asking questions including: Is this salary spread consistent with our commitment to responsible treatment of employees? Do management salaries create positive or negative incentives to achieve the social goals of the institution? Do management salaries reflect a management focus on profit that might undercut social goals?

An institution committed to the responsible treatment of employees might find that a substantial spread between higher and lower paid employees does not appropriately reflect institutional values. The board should then discuss a proper course of action, such as reworking the pay structure for lower-paying jobs, reevaluating the salaries of top executives, and/or placing more emphasis on financial incentives for executives to achieve social performance targets.

[36] In *The Practice of Corporate Governance in Microfinance Institutions*, the Council of Microfinance Equity Funds (CMEF) provides the guideline that the board should "evaluate management performance and compensation at least annually."

[37] Guidance for standard 2b discusses how to evaluate the CEO based on social performance criteria.