The effectiveness of self-regulation in microfinance – lessons for Europe

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Purpose of the paper: This paper analyses the effectiveness of self-regulation of the microfinance sector based on an analysis of over 70 existing frameworks (guidelines, ratings and codes of practice). The study focused on the effectiveness of existing self-regulation through discussing the allowance for peer-group differentiation, use of external validation, production of scores and penalties for non-compliance. As the most extensive review of existing practice of self-regulation in microfinance to date, the paper offers insights into its potential future role in the European microfinance sector.

Design/Methodology/Approach: The study was based on a desk-based review of an exhaustive range of guidelines, ratings and codes of practice used in microfinance internationally. We used this method because it enabled us to compare and contrast how the frameworks addressed challenges associated with self-governance.

Key results: We found that governance and reporting standards were best covered by existing frameworks. We also noted a recent surge in guidelines and ratings focusing on customer protection. Conversely, management information systems and risk management were less well covered. Overall, existing frameworks were deficient in some important respects. First, the fact that only a minority of frameworks allowed for peer group differentiation limits their usefulness, as it does not take into account the diverse nature of the microfinance sector. Second, external validation of data and practice was limited to rating companies, mainly due to costs. Yet such validation is important to underpin investor and stakeholder confidence in self-regulation. Third, very few frameworks were found to have any explicit mechanism for dealing with noncompliance. This clearly dilutes the effectiveness of self-regulation, as without such mechanisms subscribing to a set of standards does not necessarily translate into actually compliance. We argue that the effectiveness of self-regulation in driving performance of the microfinance sector depends on effective mechanism for addressing noncompliance, standardised performance measures and requirements driven by best performing operators in sector.

Value: This study is the most extensive review of existing practice in self-regulation in microfinance. As such it offers some valuable insights into the effectiveness and limitations of self-regulation.

Key Words: Microfinance, governance, self-regulation

Introduction

Internationally, the microfinance policy agenda has shifted considerably since the inception of the modern microfinance movement in the 1970s. Early microcredit programmes were primarily concerned with disbursing relatively large, subsidised loans to defined target groups, usually small-scale farmers and microentrepreneurs, and funders of the programme were concerned with monitoring the disbursement and the use of loans by borrowers (Von Pischke and Adams, 1980; Goggin et al, 2010). There was fairly limited concern with institutional viability or the impact of the above practices on the MFIs.

However, since the 1990s, there has increasingly been a focus on the institutional viability of MFIs (Johnson, 1998; Labie, 2001). There are three main drivers behind this shift in emphasis. First, the lack of focus on institutional viability reduced the longevity of microfinance programmes. In particular, the limited capacity of early microfinance programmes to reuse loan capital, owing to high cost/income ratios, translated into short life-spans stifling ability to capitalise on staff and institutional learning. This is evident across developing and developed countries, as it was equally true for the soft enterprise loan schemes in the UK (Goggin et al, 2010) as for microcredit programmes in Latin America (Adams, 1972; Von Pischke and Adams, 1980). Second, as the microfinance sector has matured it has also increased in size. Between 1997 and 2010 the estimated number of microfinance clients rose more than fifteen-fold from 13.5 million to over 205 million (Maes and Reed, 2012). The average number of clients per institutions increased from around 22,000 in 1997 to over 56,000 in 2010 (Maes and Reed, 2012). This has put pressure on MFIs' capacity to issue, process, monitor and enforce loans, and enticed funders and international development agencies to seek to build capacity to enable MFIs to cope with these pressures. Third, over the past couple of decades shrinking public budgets has meant increasing public scrutiny of public spending. Funding of MFIs has not been exempt from this scrutiny and it has been recognised that there is a need for greater transparency, accountability and scrutiny of the value-for-money for microfinance funding.

Increasingly funders and development agencies have recognised that there is a need to strengthen the management, governance and operation of MFIs. Yet it has also been recognised that the national regulatory frameworks are not the most appropriate tools to do so. National regulation of the financial sector tends to be prudential focusing on preventing systemic risks to financial markets, but given their relatively small size and that few offer voluntary savings products, they pose only limited risk to the financial system. Moreover, there are numerous aspects of the management, governance and operation of MFIs that would not be covered by legislation, such as outreach, mission drift and correct use of donor funds.

Instead there has been a focus on developing, disseminating and promoting best practice through developing guidelines, ratings and codes of conduct. Today there are well in excess of 60 guidelines and manuals and there are several specialised MFI rating systems. More recently some voluntary Codes of Conduct and Practice have also been developed. This process has, with some notable exceptions, been driven by international development agencies and other funders. For example, the European Code of Good Conduct for Microcredit Provision was developed at the request of the European Commission (Dayson and Vik, 2011). Funding has increasingly been conditional on MFIs subjecting themselves to external reviews and ratings or meeting certain standards. Reflecting the need for external review and ratings, the Consultative Group to Assist the Poor (CGAP) and the Inter-American Development Bank (IADB) established the Microfinance Rating and Assessment Fund, which offered up to 80% of the cost of ratings for MFIs in developing countries. Similarly, MFIs benefiting from EU JASMINE funding had to submit to rating assessments to receive the funding.

Some of the perhaps most notable frameworks have been developed by CGAP, a consortium of bilateral and multilateral aid agencies, and private foundations. In 2003, the organisation published a series of guidelines called the Microfinance Consensus Guidelines. These guidelines were developed and endorsed by some of the main donors and international development agencies based on the recognition that even standard indicators were being calculated and applied in different ways. The Microfinance Consensus Guidelines series were intended to contribute to common understanding and expectations of financial indicators and disclosure. The Group of Eight (G8) endorsed the Key Principles of Microfinance, which had been developed and endorsed by CGAP's public and private member donors, at a meeting of heads of state in Georgia, USA in June 2004. These principles lent support to two aspects, which are at the heart of the institutional strengthening agenda. First, MFIs should be financially self-sustaining. Institutional capability is the main bottleneck and not the lack of funding so donors should focus on capacity building. Second, MFIs should disclose and measure performance. The Key Principles were translated into operational guidance for funders of MFIs.

This paper analyses the effectiveness of this self-regulation spearheaded by these international funders and stakeholders based on an analysis of over 70 existing frameworks (guidelines, ratings and codes of practice). The study focused on the effectiveness of existing self-regulation through discussing the allowance for peer-group differentiation, use of external validation, production of scores and penalties for non-compliance. As the most extensive review of existing practice of self-regulation in microfinance to date, the paper offers insights into its potential future role in the European microfinance sector.

We found that, overall, existing frameworks were deficient in some important respects. First, the fact that only a minority of frameworks allowed for peer group differentiation limits their usefulness, as it does not take into account the diverse nature of the microfinance sector. Second, external validation of data and practice was limited to rating companies, mainly due to costs. Yet such validation is important to underpin investor and stakeholder confidence in self-regulation. Third, very few frameworks were found to have any explicit mechanism for dealing with noncompliance. This clearly dilutes the effectiveness of self-regulation, as without such mechanisms subscribing to a set of standards does not necessarily translate into actually compliance. We argue that the effectiveness of self-regulation in driving performance of the microfinance sector depends on effective mechanism for addressing noncompliance, standardised performance measures and requirements driven by best performing operators in sector.

Methodology

Internationally, there are numerous frameworks, benchmarking tools, guidelines and codes of conduct and practice to guide the operation, management and governance of MFIs. In this paper we review three different types of frameworks. First, we look at handbooks and guidelines, which focus on improving MFIs through disseminating best practice. These are important in setting minimum standards for disclosure, processes and performance for MFIs. Second, we examine benchmarking and rating tools which focus is on measuring performance and risk through producing ratings and allowing for comparisons with other MFIs. Finally, we look at codes of good conduct and practice. These are voluntary codes governing various aspects of the conduct and constitution of MFIs.

In total we reviewed 72 frameworks of which there were 16 codes of conduct, 11 ratings and benchmarks, and 45 manuals. A complete list of the frameworks can be found in Dayson and

Vik (2011), whilst an overview of salient frameworks can be found in an annex to this paper. The frameworks cover, to varying degrees and detail, a variety of domains. Given the recognition that the lack of high quality managers is a serious bottleneck for the growth and viability of MFIs, it is not surprising that there most frameworks focus on the management of MFIs (e.g. HR management, internal control etc.). There are especially extensive coverage of internal control and external audit, including comprehensive manuals on external audits and appraisals. There are fewer frameworks looking at MFI boards, though an increased focus on this aspect of governance over the past few years may ameliorate this. Consumer protection has been a largely neglected field up until relatively recently with the launch of the SMART campaign in 2009. The guidelines and codes covering these areas tend to be lacking in specific detail focusing instead on the broad principles of consumer protection (e.g. right to redress etc.). Numerous frameworks cover this planning, some in extensive detail. For example there are numerous detailed operational manuals and guides covering financial projections. Risk management is covered to a less degree than some of the other domains. However, over the past few years the focus on this issue has increased. It is the main focus of the investment ratings (e.g. risk of investing). Considerable attention has been paid to and effort put into developing standardised ways of measuring and disclosing data so that MFIs can be compared. There are thus numerous frameworks on this and they tend to be very detailed. It is also an issue on which there is a greater degree of consensus among funders than other domains. Finally, very few frameworks cover MIS explicitly and, to the best of our knowledge, no guidance has been issued on the topic for the last 10 years. That said the frameworks that do cover the topic, do so in a very comprehensive manner.

We reviewed the frameworks according to how they deal with the following five aspects. First, in order to ensure that the data collected and disseminated are valid and accurate a key concern in terms of a code of conduct is external validation. Thus under this point we discuss the extent to which and how the different frameworks have sought external validation. Second, the issue of rating concerns whether or not the frameworks are linked to the production of a rating or score against which the institution's progress can be mapped over time and in relation to other institutions. Third, we examine the allowance for peer-group differentiation within the frameworks. The microfinance sector is diverse in many respects, including institutional and legal form, target market and services provided. This is especially the case for the enlarged EU. Direct comparisons and identical standards may not be fair or purposeful. Thus whether, the extent to which and how the frameworks allow for differentiation will be discussed. Finally, if signing up to code is to give customers, owners, investors, funders and regulators assurance of the quality of the institution then non-compliance must have some repercussions. Thus it will also be discussed how the different frameworks deal with this.

Findings

Peer group differentiation

Peer group differentiation is an important element of effective frameworks because it allows for comparisons between and the setting of standards for different types of institutions. There are two main ways frameworks can allow for such differentiation. First, they can develop so-called peer groups based on or more features of the MFIs or the environment in which they operate (e.g. size, region etc.). MFIs that are in the same peer group can then be compared against each other. Ideally these groups should be broad enough to generate a sufficiently large sample for meaningful analysis. Second, frameworks can define and specify the type of institutions that should implement the practices or procedures in question. This may be based on the idea that some standards are not relevant for certain institutions (e.g. prudential regulation may not be

appropriate for MFIs not taking deposits) or are no suitable (e.g. to extensive for smaller MFIs etc.).

Yet few frameworks, only nine out of 72, allow for peer group differentiation through creation of peer groups or by operating with different standards by types of institutions. Only one of the codes of practice, five performance frameworks and three manuals allow for such differentiation. Several codes of practice acknowledge full compliance may not be possible for all types of institutions but, to our knowledge, only the European Code of Good Conduct explicitly notes specific standards that only apply to large institutions. Explicit differentiation is more common among ratings and performance frameworks as a number of them operate with peer groups. The perhaps best example of this is the Microfinance Information Exchange (MIX), which is a US-based database with data from over 1,800 MFIs across the world. MIX operates with compound and simple peer groups to enable fair and purposeful comparisons. Simple peer groups look at MFIs on the basis of a single characteristic. There are currently ten characteristics on which simple peer groups are based: age, type (e.g. bank, credit union etc.), financial intermediation (percentage total assets funded by voluntary savings), lending methodology (group, individual), outreach, profit-status, region, scale, sustainability and target market (low-end, broad and high-end determined by balance as percentage of Gross National Income (GNI) per capita). Compound peer groups create benchmarks where institutions have a greater number of similar factors affecting performance. MIX tends to use region, scale and target market when constructing compound peer groups.

Another example of a performance framework that allows for such differentiation is the US CDFI Assessment and Rating System (CARS). CARS compares the rated CDFIs, the US and UK equivalents to MFIs, to similarly sized institutions. Similarly, the UK sector survey by Community Development Finance Association (CDFA) allows for differentiation by client group (i.e. housing, social enterprise, consumer lending, micro-enterprise lending etc.) and geographical area, whilst the European Microfinance Network (EMN) presents the findings of its survey of microcredit providers in Europe by country.

External validation

The validation of data and information supplied to and disclosed by frameworks is another important aspect that frameworks should address. Despite its importance, only two out of 72 frameworks have any explicit external validation of data both of which are ratings. This is not surprising given that ratings cater to investors and form a basis for their decision to invest or not. Consequently these investors demand assurances that the data on which the ratings are based is accurate and reliable. This translates into a business model for the funding of external validation, as rating agencies tend to be paid through subscription of assessment fees paid by investors or the MFIs themselves. This helps fund the site visits and the other costs associated with external validation. In the case of CARS, the US CDFI rating, investors pay a fee to subscribe to rating reports for one or more MFIs. Compared with Europe, there are a greater number of private investors in the sector in the US and there is more likely to be a market for such a system.

Other frameworks do not have a mechanism for independent verification of the data submitted but encourage the submission of data drawn from or supported by externally verified accounts. For example, MIX does not itself validate the data submitted but rates the reliability of the data. Data that is independently generated and verified or supported by audited accounts are deemed as more reliable than data just generated by the providers themselves. Similarly, the European Code of Good Conduct for Microcredit Provision will encourage providers to "as far as possible, submit data that has been independently generated or backed by accompanying

documentation" (Dayson and Vik, 2013, p. 15). Manuals and guidelines that are intended as internal management tools or to guide investors in developing support strategies, there is less focus on external validation. Many frameworks may involve such validation, as external consultants may conduct them, but there is no explicit demand that this be the case. The Microfinance Consensus Guidelines on Disclosure recommends that the data disclosed should be validated through incorporation into the external audit.

Rating/scoring

Four out of the frameworks reviewed produce some form of rating or scoring. These included GIRAFE (Governance, Information, Risk management, Activities, Funding and liquidity, and Efficiency and probability), ACCION CAMEL (Capital Adequacy, Management, Earnings, and Liquidity Management) and CARS. These investment or credit ratings measure the risk associated with investing in and lending to MFIs based on an assessment of a combination of the liquidity, asset quality, earnings and related factors. They tend to rate institutions on a scale from excellent (AAA) to poor (D) and they are intended for an external audience (i.e. investors) rather than managers. Although specialising in rating MFIs, rather than mainstream financial institutions, they are largely based on mainstream rating methodologies. GIRAFE and CARS also measure social performance. The paucity of frameworks producing ratings is not only a reflection of the difficulties associated with producing it but perhaps more importantly the relatively few investors and investment-ready MFIs.

Addressing noncompliance

The issue of noncompliance is of great importance and how a framework deals with it is an important indicator of its effectiveness in raising standards. Ultimately, if a framework is to provide a certain level of assurance to customers, investors, regulators and the public of the probity, efficiency and safety of individual providers or a sector as a whole, then noncompliance must have some repercussions. Yet this is the weakest area for all the frameworks with only four having any explicit mechanisms for detecting, let alone dealing with, non-compliance. For example, while the EMN Code of Conduct states that members "are expected to subscribe" to the Code, it does not specify any actions that may be taken in the case of noncompliance. The UK trade body CDFA states that members that are "unwilling to work towards full compliance" may be considered for removal as member by the board. However, the process for detecting noncompliance or the subsequent process for removing members is not specified. A further factor making it difficult to have an effective mechanism to deal with noncompliance is the recognition that standards may not be applicable for all institutions. The CDFA, for example, notes that no all the clauses in its Code of Practice are equally applicable to all institutions. Moreover, for most if not all codes the majority of clauses and principles are too vague to allow for identifying and dealing with noncompliance. Finally, the lack of public disclosure of compliance makes it difficult for anyone outside of the trade bodies to verify compliance. The European Code of Good Conduct for Microcredit Provision may be an exception to this, as its clauses are very specific and the process of verification has been specified (see Dayson and Vik, 2013). An external evaluator assesses compliance after MFIs express an interest in signing up to the Code. If the MFI fails to reach the threshold for compliance, it will not be recognised and listed as having signed up to the Code. This process will be repeated every two years. Furthermore, investors, customers and stakeholders can report non-compliance to an independent steering group, which will investigate such cases.

Conclusion

In this paper, we have discussed the effectiveness of self-regulation in microfinance based on a review of over 70 frameworks. What, then, are the factors determining the effectiveness of self-regulation and what are the lessons for Europe? We argue that there are three main factors determining the effectiveness of a self-regulation framework. First, the absence of an effective mechanism to deal with non-compliance will make a framework weak in setting standards and lacking in credibility, as there are no consequences for those providers that fail to meet the standards. It is worrying, then, that very few frameworks operate with meaningful and explicit consequences for non-compliance (e.g. exclusion from sector or trade body). Second, if a framework is to drive performance and standards of a sector, the standards set must be exacting. There is a risk that a code becomes a list of current practices of all providers, i.e. the lowest common denominator, rather than being determined by the interests of the sector as a whole and its customers. Third, we argue that transparent, standardised and publicly available performance measures enabling comparisons between providers to encourage peer learning and research on drivers of performance.

However, even if a framework contains all these features, it is not given that it is the most appropriate means of improving standards and practices of providers. A code of practice is useful where regulation of MFIs is inappropriate where the associated systemic risk and thus need for regulation is modest and where there is limited political appetite to formally regulate MFIs. A code is also beneficial where MFIs do not effectively self-regulate and yet there is a commensurate need to raise standards. In these circumstances, we would argue that a strong externally regulated code could minimise the political pressure for regulation and help drive up standards.

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Table 1: Guidelines, ratings and codes of practice for MFIs

Framework	*Indicators / domains*	*Peer group differentiation*	*External validation*	*Rating*	*Non-compliance*
EC					
The European Code of Good Conduct for Microcredit Provision	Voluntary code of practice for EU microcredit providers covering customer and investor relations, governance, risk management, reporting standards and MIS	Yes; Some clauses only applicable for large providers[1]	Yes. External verification by independent consultants	No	Providers must comply with 80% of clauses & all priority clauses to successfully sign up
EMN					
EMN Survey EU Microcredit Sector	Bi-annual survey of EU MFIs covering clients (socioeconomic & demographic characteristics), products (loan terms & interest rates, training, technical assistance), operational performance (financial ratios), funding & future (growth, sustainability)	Yes. Results presented by country	No	No	NA
EMN Code of Conduct	Code of conduct to which all EMN members "are expected to subscribe" covering namely consumer protection	No	No	No	No specific action on non-compliance though members "are expected to subscribe" to it
MFC					
Strategic Management Toolkit	Toolkit covering social performance, finance, operations management, customer management & human resources	No	No but workshops held as part of process externally facilitated	Produces a set of measures of how well MFI performs vis-à-vis its targets	NA
CDFA					
Code of Practice	A Code of Practice all CDFA members sign up to covering governance (board composition & operation), strategic planning (business planning, accounts, performance indicators), consumer rights & protection (advertising, marketing)	No explicit differentiation thought acknowledged full compliance not possible for all CDFIs due to different legal structures	No	No	Members "unwilling to work towards full compliance" will be considered for removal as member by the board of CDFA. Members submit annual statements of compliance & explanation filed as part of annual members survey returns & report reasons for non-compliance & timeframe for compliance

[1] Large institutions are defined as providers with more than 7,000 active borrowers and more than 70 employees.

Framework	*Indicators / domains*	*Peer group differentiation*	*External validation*	*Rating*	*Non-compliance*
Change Matters	Annual performance framework covering finance (financial ratios, portfolio quality), social impact (mission, outputs, outcomes) & business (HR, strategic planning, risk management)	Yes. Some differentiation by client (personal, social enterprise etc)	No	No	NA
Planet Rating					
GIRAFE	Rating system for MFIs covering governance (planning, management, HR), information, risk (internal audit, internal control), activities (credit risk, financial services management), financing (funding strategy, liquidity risk) & efficiency (operational efficiency, ROA)	No	Yes. Independent analysts conduct field trips & interviews	Yes. Produces 4 ratings: institutional (A++ to E), credit risk, social performance & social responsibility	NA
CGAP					
MF Consensus Guidelines – Definitions of Selected Financial Terms, Ratios, & Adjustments for MF	Set of definitions agreed by experts from major international development agencies & MFI rating agencies. Covers financial terms, financial ratios & analytical adjustments	NA	NA	NA	NA
MF Consensus Guidelines – Disclosure Guidelines for Financial Reporting by MFIs	Guidelines specifying information that should be included in MFI financial reporting	No, but notes may not be appropriate for MFIs younger than 2 yrs & below US$200,000 in total assets; small community-based MFIs; prudentially licensed MFIs; unsubsidised MFIs; non-credit-orientated MFIs	No, but suggests that compliance with disclosure guidelines could be included in external audit	No, but suggests fully comply, substantially comply & do not comply	NA
Good Practice Guidelines for Funders of MF – MF Consensus Guidelines	Guidelines based on 2004 key principles of MF	No	NA	NA	NA

Framework	*Indicators / domains*	*Peer group differentiation*	*External validation*	*Rating*	*Non-compliance*
CERISE					
SPI Indicators tool (integrated into MIX since 2009)	Social performance rating covering targeting (geographic, individual, pro-poor product design), adaptation of services (range, quality, innovation), benefits for client (economic, participation, empowerment) & social responsibility (towards staff, clients, community & environment)	Yes MFIs are organised into peer-groups to ensure useful & valid comparisons, including age, size, legal structure, region & lending methodology	No	Yes	No
ACCION					
ACCION CAMEL	MFI rating based on CAMEL (Capital Adequacy, Asset Quality, Management, Earnings & Liquidity Management) methodology developed by North American bank regulators. Rates MFIs on 21 indicators in same 5 areas	No	No mainly internal evaluation tool	Yes, scores from 0-5 corresponding to AAA, AA, A, B, BB, BBB, C & D	
MIX					
Micro Banking Bulletin	Annual benchmarking of MFIs covering institutional characteristics, outreach, financial performance (financial ratios, analytical adjustments), expenses, efficiency, productivity, risk & liquidity	MFIs are organised into peer-groups ensuring useful & valid comparisons, including age, size, legal structure, region & lending methodology	Not directly though quality & reliability of data graded according to amount supplementary & independently verified info	No	NA
WOCCU					
PEARLS	Rating for credit unions: Protection (adequacy loan loss provisions), Effective financial structure (assets, liabilities, capital), Asset quality (non-earning assets), Rates of return & costs (investment yields, financial costs, operating expenses), & Liquidity & Signs of growth (assets, loans, savings, external credit, shares, capital & membership)	No	No, mainly seen as management tool	No, but produces a set of comparable ratios. Also details how well credit unions should ideally score on ratios	NA

Framework	*Indicators / domains*	*Peer group differentiation*	*External validation*	*Rating*	*Non-compliance*
OFN					
CDFI Assessment and Rating System (CARS)	Proprietary fee-based rating system for US CDFIs whereby investors subscribe to access ratings reports of individual CDFIs. Covers capitalisation & capital structure, asset quality, earnings, liquidity & liquidity management, & management quality	Yes, part rating report compares CDFI to similar institutions (based on size)	Yes, has independent board & rating agency All participating CDFIs are reviewed by external analyst	Yes. One rating for social impact (AAA, AA, A & B) & one for financial strength & performance (1-5). AAA 1 is highest score and B 5 is lowest.	NA
US Treasury					
CDFI Certification	CDFIs must be certified to gain access CDFI fund (renewed on bi-annual basis) Covers governance (board composition), nature & size portfolio & target market, legal structure, & assets	No	Not directly though requires submission of audited year-end financial statements	No. CDFIs are either certified or not	Not complying with criteria means inability to access funding through CDFI fund

Abbreviations used: NA = Not Applicable, MFI = Microfinance Institution, MVI = Microfinance Investment Vehicles, CDFI = Community Development Finance Institution, OFN = Opportunity Finance Network, EMN = European Microfinance Network, CGAP = Consultative Group to Assist the Poor, CDFA = Community Development Finance Association, MFC = Microfinance Centre for Central and Eastern Europe and the New Independent States