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## Chapter 4

### **Assessing Microfinance: Striking the Balance between Social Utility and Financial Performance**

By: Florent Bédécarrats and Cécile Lapenu

#### **1. Introduction**

Microfinance was designed as a development tool, but remains firmly anchored in the market economy, creating an ambivalence that blurs the traditional distinction between the political and economic, the public and private, the commercial and social. Its hybrid nature makes it unique among development tools: microfinance benefits from financial, fiscal and regulatory support, while maintaining relative independence from governments and donors and their fluctuating agendas. The result is a heterogeneous and complex sector that articulates different scales: the local, given it is *microfinance*, and the national, as States closely supervise retail banking activities. But it is also a global field, involving various transnational actors: non governmental organizations (NGOs), cooperation agencies, investors, private entrepreneurs, multilateral agencies, and so on.

Operationally, the simultaneous pursuit of financial and social goals puts microfinance in a unique dialectic. A school of thought promoted by influential multilateral organizations has gained momentum since the late 1990s, based on the idea that building large-scale inclusive financial systems depends on making microfinance a profitable commercial sector linked to international finance, so as to access more capital and involve banks. The result has been a rise of regulatory mechanisms, the standardization of practices, an emergence of partnerships with commercial banks, increased access to refinancing on financial markets and the calling into question of subsidized support and non-financial

services. Credit with education, business development services and health-related trainings were pushed off the agenda even if poverty alleviation was still the overall goal. The market approach gave rise to assessment methods and information systems intended to bring microfinance into the global financial market (Littlefield & Rosenberg, 2004). But they offered only a partial picture of operations. From time to time, in-depth studies attempted to assess whether microfinance was achieving its social objectives<sup>1</sup>, yet they appeared marginal compared to efforts to perfect and systematize financial assessment methods. The introduction of more rigorous management in microfinance institutions (MFIs) was critical to their growth, but we will see that it has also had the effect of limiting their ability to meet some of their development objectives, increasing the risk of mission drift (Christen, 2001). It has induced the danger of deteriorating quality of services in particular in terms of proximity to clients, exposed the sector to the vagaries of the macro financial system, and threatened to tarnish the hereto positive image that has allowed it to benefit from the goodwill of regulators, donors and the general public. This context validates calls to make finance more responsible, and has led to a ramping up of efforts to assess the social dimension of microfinance.

Our purpose is to show how assessment methods reflect different visions of what microfinance should be (or is capable of doing). Despite these at times competing views, there is now an overall complementarity for balanced management of MFIs in order to improve practices and sustainability. Our research was conducted within CERISE, a microfinance network comprised of technical assistance providers and research institutions that is directly involved in the creation of indicators and assessment methodologies.<sup>2</sup> In Section 2, we begin by describing the factors that led to the

systematization of financial assessment in microfinance. We will show that despite its heterogeneity, the sector has been governed by increasingly standardized criteria for metrics, management systems and governance principles. In Section 3, we describe how the emergence of social assessment methods has served to counterbalance this approach. We argue that both the normative content of these methodologies and the way they are applied have diverging implications on the way the microfinance sector can grow. In Section 4, we will describe several innovative approaches for assessing the social performance of microfinance institutions, in particular the social audit tools (such as the CERISE Social Performance Indicators-SPI) that are now widely used by social investors, networks and microfinance institutions. We will also analyze how assessment methods influence regulatory frameworks and help MFI combine social and financial performance. Finally, Section 5 concludes.

## **2. Financial assessment: from the drive for sustainability to the threat of excessive commercialization**

### **2.1 Growth and commercialization of a diverse sector**

The microfinance sector has experienced intense growth worldwide since the late 1990s. The Microcredit Summit estimated that in 1997, 17 million people were served by MFIs; in 2009, the number had skyrocketed to more than 190 million (Reed, 2011). This expansion seems set to continue given potential demand, estimated at over one and a half billion people by sector stakeholders (Bouuaert, 2008). From the supply side, it is estimated that the number of MFIs is approaching ten thousand (Armendáriz & Labie, 2011, p.329), about 3600 of them reporting to the Microcredit Summit and 1900 reporting to the Mix Market<sup>3</sup>, the international platform for reporting in microfinance.

However, these aggregated figures mask the extreme heterogeneity of microfinance in terms of size, legal status, ownership structure, target clientele, type of products, and cost of services.

The now widely-accepted performance assessment criteria used in microfinance strive to consolidate financial sustainability. This is because unlike other development tools, microfinance is considered a market-based sector that ultimately will no longer need public funding. The seminal works that reflect this objective, such as the Pink Book by the Consultative Group to Assist the Poor (CGAP) (World Bank, 1995; CGAP, 2006), the MicroStart guide (UNCDF, 1997), the United Nations's Blue Book (UNDP/UNCDF, 2005), and other key references published by World Bank (Helms, 2006) argue that the way to create large scale inclusive financial systems is to build a commercial microfinance sector capable of recovering its costs, but also generating profits to fuel growth and attract private capital. This argument eventually gave rise to the adoption of for-profit models and operating systems based on market principles.

The idea took hold that public sector management, cooperatives and NGOs were inherently non-optimal, and that the professionalization<sup>4</sup> of MFIs could only occur by integrating the private sector. The 1990s gave rise to a phenomenon of corporatization of NGOs. Inspired by the creation of BancoSol in Bolivia, borne of the NGO Prodem, these transformations were necessary to be authorized to capture savings and earn the trust of investors.

## **2.2 Growing pervasiveness of norms for financial assessments**

The market approach drew heavily on management standards that promoted professionalization and sector sustainability (Christen, Lyman & Rosenberg, 2003), but

also risk reduction and profit maximization. In particular, its framework was based on the importation of prudential standards modeled on the Basel criteria, defined by the Bank for International Settlements (BIS).

Standards for risk assessment were gradually imposed on MFIs in several ways. Institutions that accessed international refinancing were progressively submitted to due diligence and monitoring of investment funds, while institutions that mobilized local savings had to conform to national regulatory frameworks. Defined by Central Banks, often independent of governments, the national frameworks were formulated with technical assistance from multi- and bilateral institutions, sometimes as part of national microfinance strategies supported by international donors (Duflos & Glisovic-Mezieres, 2008).

Under the Basel I framework, prudential rules were relatively simple, a translation of capitalization and solvency ratios promoted by the BIS, that countries ultimately adapted to their own macroeconomic policies. To avoid credit rationing,<sup>5</sup> Central Banks imposed interest rate caps and portfolio segmentation based on the types of activities financed (Trigo, Lee & Rhyne, 2004). But the gradual introduction of Basel II has induced the obligation to make weighted provisions for outstanding loans, depending on risk exposure. Parameters for risk assessment include, among others, client liabilities, uncertainties related to their activities, loan terms, loan guarantees, and so on. (Artus, 2005).

These prudential norms, which aim to disperse the risk of loss, mechanically pushed microfinance institutions to focus on less risky customers with more legally reliable guarantees. In Bolivia, regulation has contributed to a decline in joint liability loans,

alternative guarantees and agricultural financing, which are automatically assigned a high prudential index (Bédécarrats & Marconi, 2009). Institutions are also obliged to make additional provisions based on strict delinquency criteria poorly suited to agriculture, a sector in which natural hazards and market volatility often lead to late repayment without necessarily jeopardizing the loan.

Strict application of the Basel criteria incurs additional management costs that are particularly high in microfinance. This is because Basel II calls for financial institutions to create a specialized department for risk assessment and adapt procedures (management information systems, credit analysis) to collect exhaustive and standardized risk information. Moreover, the application of these criteria poses problems to supervisory authorities, which do not always have the operational capacity to oversee an entire MFI network of rural branches. It is estimated that the ratio of supervision-related expenses to assets can vary for a microfinance institution and a large bank by a factor of thirty-to-one (Barlet, 2003). The Basel criteria assume levels of risk, degrees of institutionalization and capacities to produce information that are in fact far removed from the reality of developing countries and especially the target market of microfinance.

Aware that many MFIs are straying from their original mission as a result of these norms, many actors are calling for change. The international network of the World Council of Credit Unions (WOCCU), for example, has repeatedly tried to introduce adaptations for cooperatives (Arnold, 2003; Grace, 2008). Other actors promote a pared-down version for microfinance (Matarrita, 2004; Bastiaensen & Marchetti, 2007). They argue that ensuring rigorous management is possible without transposing the formal standards of the conventional banking sector. The alternatives being put forward are based on

microfinance's strengths -operators' understanding of the activities they fund, capacity to assess risk in the informal economy thanks to proximity, and transparency based on direct dialogue between clients and local stakeholders - instead of reporting formats based on the massive aggregation of data that is collected and interpreted automatically. Specifically, these proposals suggest assessment of not only the skills of senior management, but of loan officers, branch managers and client representatives. They recommend including innovative forms of collateral with weak legal enforcement, but that have been proven effective (peer guarantee, assets without propriety title, warrantage, and so on). Finally, they strongly emphasize governance, understood more broadly than *corporate governance*, which is restricted to relationships between shareholders and managers, to include the MFI's ability to effectively involve all stakeholders affected by the institution's future. The recent questioning of financial system regulation that has come in the wake of the recent crisis echoes these proposals.

### **2.3 Risk of mission drift in microfinance**

By the early 2000s, international development aid had been largely discredited (Naudet, 2006), but microfinance was emerging as one of the few interventions that actually worked. Still, the growing influence of the market approach to microfinance eventually started to raise concerns. Some sector observers even warned against its role as a spearhead of neoliberalism (Weber, 2002). But the debate within the sector and in the press really broke out with the initial public offerings of Mexican MFI Compartamos (Epstein & Smith, 2007) and SKS India (Reille, 2010). More recently, the crises in India, Morocco, Nicaragua and Pakistan (Chen, Rasmussen & Reille, 2010; CGAP, 2010) have served as reminders of the acute risk of mission drift, prefigured by authors who have



studied the evolution of products and management practices in institutions that have undergone transformation (Dichter & Harper, 2007; Copestake, 2007). Commercialization, it would seem, can lead to mission drift. It also brings with it the danger of borrower over-indebtedness.

A survey by Deutsch Bank of major fund managers found that social utility is a primary motive for investment in microfinance (Dieckmann, 2007), and yet, in absence of transparency on the social dimension of its activities, reputation risk is a genuine threat to the sector.

### **3. Social norms**

#### **3.1 Proliferation of social assessment methods**

The social value of microfinance has long been taken for granted; the sector's number one priority has essentially been to scale up. In the mid-1990s, when attention was driven by growth and sustainability, focus was on the number of clients, profitability, subsidy dependency, reduction of delinquency, and operational and financial sustainability (Schreiner & Yaron, 2001). Through the mid-2000s, efforts to assess the contribution of microfinance to development were often denigrated by influential players in the sector, who did not want social concerns to "hijack" MFIs' focus on financial performance (Jacquand, 2005).

However, the aforementioned developments in recent years have led microfinance actors to make the social dimension of their activities more visible. The recognition of a double bottom line that marries financial and social performance is poised to become mainstream (Christen, Rosenberg & Jayadev, 2004). This shift has revealed that good social outcomes are indeed compatible with financial performance, as they improve client

retention, repayment and staff productivity (Gonzalez, 2010; Bédécarrats, Baur, & Lapenu, 2011). Some even propose to relax regulatory constraints for institutions that have proven their social utility (Lyman, Pickens & Porteous, 2008), or to introduce public or market-based incentives for institutions that contribute substantially to public interest (Cull, Demirguc-Kunt & Morduch, 2007; Morduch, 2005). Consequently, assessment practices have mushroomed. In 2008, SEEP Network (Small Enterprise Education and Promotion) counted 25 social assessment tools in microfinance (Woller, 2008).

Until the late 1990s, social assessment mainly took the form of client surveys through impact studies, usually commissioned by public donors eager to prove the usefulness of their contributions. To produce reliable and rigorous results, however, impact studies must be long and are often costly. They are fraught with methodological limitations that minimize their scope and, moreover, are often too academic to be exploited by practitioners. Since the early 2000s, there has been a rise in operational assessment methods that practitioners can apply themselves, thus allowing them to use results to improve their practices. More recently, highly academic impact studies have made a comeback, using a method borrowed from epidemiology<sup>6</sup> (Duflo & Kremer, 2008; Karlan, Goldberg & Copestake, 2009). It is an approach that resonates with donors' call to prove aid effectiveness (Ravallion, 2008) and presents an image of scientific rigor that very much reflects today's econometric culture. However, these impact studies pose some difficulties due to high costs, methodological flaws (Deaton, 2009; Bernard, Delarue & Naudet, 2011), and ethical issues (Duvendack, Palmer-Jones, Copestake, 2011).

The MFIs themselves appear to increasingly prefer simple and relatively inexpensive

methodologies based on individual interviews or focus group discussions to help better understand the interaction between clients and products and services. These methodologies are closer to market research and customer satisfaction analysis, in that they are primarily used to tailor products and services to demand, attract more users, retain loyalty, limit non-repayment and avoid over-indebtedness.

One of the breakthroughs in operational assessment methods is the ability to assess the economic level of clients. Based on a number of innovations (Henry, Sharma et al., 2003), two initiatives developed in parallel only a few months apart similar methodologies called “proxy means testing.” They are based on household consumption surveys conducted by national statistics bureaus, and consist of a dozen of observable indicators statistically correlated with poverty levels. When used on a representative sample of MFI clients, it is possible to determine the percentage of users who are poor and follow their evolution. The first instrument, called Poverty Assessment Tool (PAT), was developed at the request of United States Agency for International Development (USAID). The tool must be applied to all microfinance programs supported by USAID, in order to comply with a US congressional mandate to serve 50% of extremely poor people. The second tool, the Progress out of Poverty Index (PPI), was developed by CGAP, the Grameen Foundation and the Ford Foundation, for voluntarily use by MFIs. Some major networks like Accion and Finca have developed their own systems for assessing clients’ poverty levels, based on sophisticated statistical analysis (Welch, 2002; Hatch & Crompton, 2003). Several MFIs, such as the Ethiopian institution Buusaa Gonofaa (Buusaa Gonofaa, 2009) have developed their own tool for measuring poverty, less scientifically rigorous but directly integrated into their product strategy. Poverty

indices are becoming a norm for all MFIs under international accounting standards.

We are also seeing a mainstreaming of audit methodologies designed to assess what an institution does to fulfill its social mission. The first audit tools were the CERISE-SPI (Social Performance Indicators) (CERISE, 2005) and the Quality Audit Tool (QAT) of the Microfinance Centre (MFC, 2007). These audit methodologies draw on information already available within the MFI. However, some actors would like to see other aspects taken into account, which involves the collection of additional data. Thus, the Dutch Development Bank (FMO) is trying to push MFIs to inquire about the environmental impact of their clients' activities (Bierens & Van Elteren, 2008), while the International Labor Organization promotes a focus on decent working conditions in financed microenterprises (Breda, 2009).

Based on an audit, MFIs can select and calibrate indicators according to their own strategy, in order to create dashboards that allow for continuous monitoring, as have a number of MFIs in Cambodia, India and El Salvador (eMFP, 2011b; AMK, 2009), as well as the Confederation of Financial Institutions (CIF) in West Africa. In Latin America, such retooling of social audit indicators for monitoring purposes has resulted in 'balanced scorecards' that link strategic planning and management indicators (Labie, 2005; eMFP, 2011b).

Following the initial public offering of Compartamos, criticism reached new heights and prompted the emergence of initiatives to promote codes of conduct to guide the practices of microfinance providers. This movement was publicized by a declaration<sup>7</sup> calling for the establishment of ethical principles across the sector. A working group led by CGAP and Accion picked up on the momentum and developed what are now seven client

protection principles, promoted by the Smart Campaign: 1. Appropriate Product Design and Delivery, 2. Prevention of Overindebtedness, 3. Transparency, 4. Responsible Pricing 5. Fair and Respectful Treatment of Customers, 6. Privacy of Client Data, 7. Effective Complaint Resolution.<sup>8</sup>

Starting in 2005, microfinance rating agencies also began to develop methodologies for extra-financial assessment to round out financial assessment procedures already in place. It is increasingly common for social assessments to be commissioned at the same time as financial ratings and the Rating Initiative<sup>9</sup> has subsidized over 200 social ratings since 2008.

With regard to foreign investment in microfinance, there are several frameworks that orient social performance reporting. These include the Environmental, Social and Governance framework (ESG) set up by the investor initiative United Nations Principles for Responsible Investment which aims to provide an overall framework for all economic sectors to report on financial, social and environmental results. In addition to these guidelines, which are very general, CGAP, Argidius Foundation and Ford Foundation spearheaded the creation of the Social Performance Task Force (SPTF), an international working group to ensure consistency between the various initiatives in social performance. In 2006, at the impetus of actors active in social performance, the SPTF produced a common framework for social assessment in microfinance. Between 2006 and 2008, the SPTF served as a platform for international rating agencies specialized in microfinance to render their assessment methods compatible with each other. In 2008, the SPTF produced a list of standardized indicators, which are now incorporated into the reporting formats of Mix Market. In 2010, more than 300 MFIs had reported social

performance standards to the Mix Market.

Social performance reporting emerged earlier and more extensively in countries where microfinance has been questioned by governments, such as Bolivia, Benin, Ecuador and Nicaragua. In these countries, local microfinance networks have negotiated legal principles or policies in return for greater transparency on the social value of microfinance. They have set up reporting systems tailored to local contexts, to demonstrate MFIs' contribution to public good and to maintain their autonomy from state control (ForoLacFr, Redcamif & Mision, 2008; Consortium Alafia, 2008).

CGAP has worked to bring transparency in terms of social performance to the level of foreign investment, by including ESG indicators in their microfinance investment vehicles disclosure guidelines. The guidelines reflect both aggregated key social performance data for MFI investees, as well as factors relating to the practices of the funds themselves.

### **3.2 Norms that reflect different conceptions of microfinance**

At first glance, this multiplication of assessment methods seems confusing. But a closer look reveals that they are complementary and reflect different aspects of microfinance's social value. Such diversity reflects the vision and interests of the different stakeholders involved in the sector. Nevertheless, as the pressure is growing to set common norms, the stakes are rising regarding whose vision of microfinance will prevail.

Some evaluation standards have been designed at the request of MFI borrowers and savers, often the members of cooperative institutions, who are typically more vocal about demanding accountability. In these cases, the focus has been less on poverty considerations than proximity, quality of services, and member participation in

governance. Similarly, the types of indicators and the way they are applied are often different when the assessment is the result of a funder's request, whether a foreign investment fund, cooperation agency, or government-run program. Here, the underlying principles of the assessment and selected social indicators depend on the funder's mandate and the MFI's degree of dependency from that source of funds. For instance, following the injunction of the U.S. Congress to justify its role in poverty reduction, USAID developed a tool for measuring extreme poverty.

For their part, private equity funds have long been content with the bare minimum, but intensified public criticism of microcredit has pushed the investors of these funds to demand greater transparency regarding the social utility of microfinance, a primary motivation for their investments. As a result, investment vehicles have begun to apply client protection principles and transparency indicators.

The concept of 'social performance' is defined by the Social Performance Task Force as 'the effective translation of an institution's mission into practice in line with accepted social values' (Hashemi, 2007). We propose to characterize the content of the different approaches to social assessment based on a matrix composed of two axes. The columns show the different stages that make up the 'social performance pathway', a sequential approach commonly used in management to decompose the intervention from objective to results, that has been widely disseminated by the SPTF.

**Table 1: Analytical matrix: Social dimensions assessed**

Stage in the pathway  Social dimension	<b>Intent and objectives</b>	<b>Internal systems and operations</b>	<b>Outputs</b>	<b>Outcomes-Impact</b>
<b>Social responsibility</b> Applies to all sectors	SR towards clients	Client protection policies (ex: SMART principles)	Prevention of over-indebtedness, transparent pricing, ethical behavior, etc.	No harmful effects on clients
	SR towards employees	Adapted HR policies	Employee retention, satisfaction and motivation	Efficiency and institutional sustainability
	SR towards the environment	Prevention of environmental degradation at MFI and client level	Minimize environmental impact of MFI and its users	Reduce effects on global warming, biodiversity, etc.
<b>Social performance</b> Specific to the social mission of MF	Include the excluded	Client targeting	Inclusion of poor and excluded clients	Financial and economic inclusion
	Offer appropriate services	Diversification, quality and complementary services	Meet demand, satisfy and retain clients	Improved standards of living
	Provide benefits to clients	Participation, capacity building, cost reduction	Empowerment, increased income, increased activities	Integrated and sustainable development

According to the pathway, the study of the mission and social goals of an institution should come first, before questioning whether they are consistent with the actions and processes in place. Next, comes the examination of the short-term outputs and outcomes, that is, observable changes in the lives of clients and the environment, which are considered impacts if the changes can be attributed to the MFI's activities.

In rows, we show the social dimensions which microfinance can influence. We distinguish two fundamental areas: social responsibility of economic agents, which



applies to microfinance as well as any other economic sector, and involves preventing potential harm the activity may have on customers, the community and the environment. The other area is social performance, which is specific to microfinance and its ‘double bottom line’. The criteria here reflect microfinance’s specific development mandate, which is to serve a growing number of poor and excluded people, improve the quality and appropriateness of financial services and increase benefits for clients. The matrix shows the different aspects that are assessed along these two axis.

Working from the above matrix, we can map the social standards discussed above according to where they are in the social performance pathway and the dimension they relate to, as in the following figure 1.

This mapping exercise reveals three lessons for analyzing social norms in microfinance. First, the distribution shows that social control mechanisms of microfinance activities focus on diverse and potentially complementary aspects. Nevertheless, there is overlapping, indicating aspects for which the promoted standards are potentially in competition with each other, if they are not harmonized. Last but not least, these norms reflect different perceptions of what microfinance is capable of doing; the fact that some criteria are emphasized over others reflects a choice.

Actors who only promote responsibility generally see microfinance as a business like any other. This position tends to consider ‘financial inclusion’ the only positive externality of MFIs. Actors who emphasize social performance believe that the microfinance sector has a development mandate.

**Figure 1: Analytical matrix: Coverage of the different social assessment methods**

Stage in the pathway Social dimension	Intent and objectives	Internal systems and operations	Outputs	Outcomes-Impact
Social responsibility	SR clients	Consumer protection initiatives		
	SR employees	Social rating and audit	Audits on Decent Work (ILO)	
	SR environment		Environmental audit	
Social performance	Excluded populations	Poverty targeting tools	Poverty measurement tools	
	Appropriate services	Client study tools (AIMS, MicroSave)		Impact studies
	Build capacity			

There is also divergence among the latter. Some focus their attention on poverty, arguing that microfinance only makes sense if it improves the lives of the poor. Others stress the importance of targeting less vulnerable unbanked populations, pointing out that they are more creditworthy, and therefore better positioned to take advantage of investment opportunities and drive local economies.

#### 4. Application methods that correspond to different regulatory models

Social assessment methods have been developed by practitioners in an attempt to self-regulate the sector's activities. In other words, they are a voluntary effort to evaluate and improve practices. Methods differ depending on whether they are applied internally, externally or as a combination of the two.

Internal social assessments are common when an institution wants to set up its own social criteria for monitoring purposes or audit its strengths and weaknesses in order to integrate social performance into strategic planning. Audit methodologies, in particular, are

flexible and can be adapted to the needs and constraints of the institution. They are useful for creating linkages between decision-making and management strategies. More than 500 MFIs worldwide have conducted internal social audits.<sup>10</sup>

**Table 2: Type of social assessment methods**

<b>Assessment focus</b>	<b>Regulation model</b>	<b>Strengths</b>	<b>Challenges</b>
<b>Internal:</b> by the MFI management, with participation of stakeholders	Self-regulation	Useful for strategic planning	Lack of credibility and comparability
<b>External:</b> by a third party (typically a rater or public entity)	Mainstream regulation (Basel II model)	Reliability, standardization	Lack of appropriation by MFIs. Not in phase with the public & industry proposals
<b>Mixed:</b> by the MFI with review of a third party (support organization, network, investor)	Interface for combining regulation and self-regulation	Striking a balance between organizational learning and reporting	Depends on more complex design/ negotiation processes

In many cases, networks will adopt audits as a form of self-regulation. The case of CIF (Confédération des Institutions Financières) illustrates this dynamic. This network federates six of the largest MFIs in West Africa, which together reach nearly one in six households in the five countries where they operate. CIF provides crucial support for members in system development, human resource policies, product diversification and management strategies, including social performance. Growth has led CIF's members to professionalize their operations, which have become increasingly complex and technical. Conscious of the risk of relegating social goals to a non-priority position, CIF decided to conduct CERISE-SPI audits of each of its members. The audits revealed several key objectives in need of attention, like targeting the excluded, agriculture finance, and allocation of surpluses for improved community welfare. They also led to the definition

of a small set of social indicators that have been added to the financial dashboards of the member institutions to monitor their progress. What differentiates this internal process from an external audit is the participation of elected representatives, managers and field staff, and a series of peer reviews among members. The audit is completely appropriated and integrated into governance structures at the branch, federation (MFIs) and confederation (network) levels.

However, internal audits and monitoring, while ‘tailored’ to the user’s needs, do not allow for the verification or calibration of information. This can diminish comparability and reliability of results in the eyes of outsiders. To mitigate this weakness, the four main microfinance rating agencies each formulated their own social rating methodology based on existing audit formats. These rating tools ensure rigor and consistency, albeit to the detriment of some of the advantages of internal approaches, but because each agency has its own methodology, doubts persist as to the comparability of results. And while Mix Market has created a reporting format to collect social performance information from MFIs, it is so far mostly self-reported and thus of questionable reliability (McKee & Koning, 2011, p.6).

In light of these credibility issues, many stakeholders are turning to certification. The Smart Campaign is preparing a certification program for MFIs on client protection while the Microcredit Summit is working on a Seal of Excellence, which covers a wide range of social performance indicators, with a strong focus on poverty targeting. Also noteworthy are the efforts of some regional MFI networks to promote certification programs for MFIs, according to different priorities: rural focus, women outreach, development of productive activities, poverty reduction. Finally, the Social Performance Task Force has

begun to elaborate universal standards, which intend to synthesize all social measurement initiatives. This enthusiasm is a sign of the sector's yearning for regulatory mechanisms that include social performance and combine rigorous third-party verification. But the risk is to overwhelm stakeholders and foment competition between the different initiatives.

In addition, these initiatives rarely include clients, civil society or public authorities. The risk is that these labels in gestation will not have legitimacy in the eyes of local stakeholders. This explains why some governments are taking steps to pass regulation that aims to prevent MFIs from harming their clients. In countries like South Africa, Peru and India, policy makers are seeking to impose disclosure guidelines for financial products, ethical collection practices and even adequate evaluation of borrowers' repayment capacity (McKee & Koning, 2011). Consumer protection mechanisms are essential for aspects like price transparency, for which country-level microfinance networks have a hard time enforcing effective norms.

To avoid superposition of mismatched supervision, efforts are being made to strike an intermediate approach between internal and external assessment, industry and public regulation. Such initiatives combine self-evaluation, peer reviews and occasional external verification. This trend is driven primarily by microfinance networks in countries where government relations have been strained, such as Bolivia, Benin and Ecuador. In the latter, it is worth detailing the experience of the Ecuadorian Red Financiera Rural (RFR), a professional association with 40 members (savings and credit unions, banks, NGOs and local networks) that together reach 600,000 clients. RFR has set up a 'Social Responsibility System' for microfinance institutions, comprised of a strategic alliance

with a credit bureau, social performance evaluation services and a code of ethics (RFR, 2009). Together, these three elements play an important role in keeping the sector in check, by encouraging peer comparison and economies of scale for data collection and processing. In Ecuador and elsewhere where hybrid initiatives are being tested, MFIs participate in the design and implementation of assessment tools or verification, through a peer review process. The mediation role played by local microfinance networks combined with the vigilance of government authorities can ensure consistency. In Ecuador, the government ultimately adopted the social performance assessment framework developed by RFR for its own assessment purposes, to verify that the MFIs it refinances are truly committed to local development (Bédécarrats, Bastiaensen & Doligez, 2012).

The self-regulation of social performance we see at the MFI level applies to investors, as well. An increasing number of investment funds now include extra-financial data in funding applications and verify their veracity during due diligence (eMFP, 2011a). The initiative on the Principles for Investors in Inclusive Finance unites investors around the promotion of seven dimensions: range of services, client protection, fair treatment of investees, responsible investment policies and reporting, transparency, balanced return and, harmonized investor standards. Moreover, investors are increasingly open to analyzing their own systems and strategies. To this end, CERISE has developed a Social Audit tool for Microfinance Investment Vehicles/MIV (SAM). The tool was designed to analyze investment funds' strategies, activities and available data in view of strengthening and systematizing their social responsibility approach. SAM was applied by social performance pioneer Oikocredit in 2009 (Lapenu, Ledesma & Brusky, 2010)

and pilot-tested with investors beyond the microfinance sector, to integrate audits of the support to small and medium enterprises and social business. Similarly, the rating agency MCril has designed a framework for evaluating the financial and social performance of investment funds. As of 2011, it has been pilot-tested with four MIVs.

CGAP promotes disclosure guidelines that distinguish different types of funds based on social practices. The guidelines are regularly used by MIVs to glean trends and conduct peer analysis. They are currently supported through an online platform, powered by Symbiotics. Finally, LuxFLAG, the label agency, added a new dimension to its Microfinance Label in 2010, to ensure social, environmental and ethical issues are integrated into funds' methodologies and systems.

## **5. Conclusion and perspectives**

The assessment standards initially developed for microfinance have certainly contributed to the sector's sustainability and growth, but they also engendered unexpected consequences: they hindered the consolidation of non-profit MFIs, created obstacles for serving rural areas and the agricultural sector, led to the standardization of practices and pushed microfinance institutions to move away from their initial target population. This is because, beyond their technical dimension, assessment norms conceal strategic implications, interests, and worldviews. The prevailing approach to microfinance has been market-driven, motivated by the belief that its success hinges on commercialization. The metrics, management systems and governance principles that ultimately became the sector's norms reflected this vision. Today, the move is towards regulatory mechanisms that measure the sector's contribution to development. This rebalancing is largely due to sector stakeholders' concerns for consistency and commitment to the double and triple

bottom line, itself due to excesses and increasing reputation risk for the sector as a whole. The stakes are changing, and with them the rationales and power relations that underlie the creation of norms.

The proliferation of different social performance mechanisms bears witness to the fact that social criteria address multiple concerns. There are those that focus on corporate social responsibility, a generic approach whereby an MFI, like any business, strives to avoid causing harm to its employees, the environment, and customers. Other approaches go further and highlight microfinance's specific development mandate: financial inclusion, improved standards of living and creating benefits for clients. Attempts are underway to harmonize these mechanisms, to limit the risk of sending mixed messages and to simplify reporting burdens on MFIs. It is uncertain how industry norms will evolve. What is clear so far is the very marginal role of clients and public authorities in this process. Forgoing their direct involvement in defining industry norms risks stripping these norms of their legitimacy, possibly feeding the backlash against microfinance. On the other hand, there is growing evidence that social and financial performances are compatible and mutually reinforcing. Therefore, if adequately coordinated, this trend is likely to culminate in a highly responsible sector with a strong double bottom line.

## Notes

1. For example the assessments conducted by UNCDF:  
<http://www.uncdf.org/english/microfinance/microstart/programme.php>.



2. CERISE, Comité d'Echanges, de Réflexion et d'Information sur les Systèmes d'Epargne-crédit, <http://www.cerise-microfinance.org>.
3. Mix Market: <http://www.mixmarket.org/>.
4. The notion of professionalization in microfinance refers to a number of facets, including establishment of clear rules of governance, definition of job functions and skill sets, adoption of pay scales, establishment of information systems specific to MFIs and codification and oversight of the practices of loan officers.
5. Credit rationing occurs when loan portfolios are concentrated on less risky and more profitable loans. Limiting interest rates and segmenting portfolios help stimulate access to sectors deemed riskier or less profitable.
6. The method involves modifying the operations of assessed institutions so that they randomly select people that could be served, but who will not be for the duration of the study, in order to serve as a control group and thus overcome the difficulties the attributing impact.
7. The Pocantico Declaration: [www.db.com/de/downloads/company/the\\_pocantico\\_declaration\\_final\\_0515b](http://www.db.com/de/downloads/company/the_pocantico_declaration_final_0515b).
8. See [www.smartcampaign.org](http://www.smartcampaign.org).
9. <http://www.ratinginitiative.org>.
10. The CERISE-SPI has been administered over 600 times, by more than 450 MFIs; the majority of these audit findings are collected in the CERISE-SPI database; QAT by MFC has been used by about 40 MFIs, and technical assistance programs such as CRS-Mision in Latin America and Africa or Eda Rural in India have also conducted internal social audits with some of their MFIs partners.

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