Fair treatment of clients, code of conduct and institutional response—intense scrutiny?*

5

Chapter

Indian MFIs took their early lessons from experiments of Grameen Bank in Bangladesh in the late 1970s; and Bank Rakyat Indonesia (BRI) in Indonesia and Prodem in Bolivia in the 1980s. These interventions demonstrated that alternatives in lending to the poor are possible and viable. The core of these initiatives was offering customized products, substituting physical collateral with social collateral and delivering services at the doorstep of clients.

While savings was largely ruled out for Indian MFIs because of regulatory restrictions, credit delivery was largely through the joint liability model with a one-year loan repayable in weekly instalments. Customer focus was evident in design as low-income borrowers found it easier to pay smaller, more frequent instalments compared to monthly repayments of formal loans. Social co-guarantee obviated the necessity for existing physical assets or extensive documentation. The MFIs demonstrated strong viability and riding on their success, banks sought to lend to the 'bottom-of-the-pyramid' segment not only out of compulsion to meet priority sector lending targets but also because they recognized a large, untapped, resourceful set of customers to whom they could extend their outreach.

Initially the cost of service delivery was high, as providing low-ticket-size services at the doorstep and engaging in high person-to-person contact in the form of group meetings entailed higher operating costs. However, higher interest rates were excused since MFIs were perceived to be delivering customized services and building a symbiotic relationship with their borrowers rather than engaging in purely financial transactions. This tolerance for higher costs in credit delivery also factored in the assumption that microfinance would cater to the poor and unbanked population.

LOSING CLIENT FOCUS—NEGATIVE OUTCOMES OF HIGH GROWTH

In the rush for growth, what started as a client-focused service delivery model was reduced to a cookie-cutter template, which was replicated across states, irrespective of appropriateness to the local context. The original group loan concept became the sole innovation. The growth phase also saw practices such as competing in saturated markets, hijacking groups mobilized and trained by other MFIs so as to reduce pre-lending operating costs, misaligned staff incentives making them dispense with rigour of trainings and outsourcing of group-building activities to agents within the community. In all this, clients were relegated to outreach statistics—the focus was on lending to them, primarily to fuel the target achievements rather than inclusive finance to the poor.

Along with the focus on outreach, MFIs also had to ensure good repayment rates in order to maintain their flow of funds from banks and investors. A popular catchphrase of the time was 'zero tolerance for default', which placed tremendous pressure on staff to ensure 100 per cent collections. Inevitably, lapses in repayment led to an exchange of words between staff and clients, with demands on group members to make good the shortfall. Coercive behaviour from some of the staff was resented by defaulting clients and their families, resulting in unfortunate exchanges and incidents, some of which drew the attention of district authorities, religious groups and the media.[1] If MFIs had been evaluated

* First deaft of this chapter was contributed by Berenice da Gama Rose and Alok Misra, MCRIL.

on Client Protection Principles in 2009–10, severe lapses would have emerged:

1. Most MFIs had failed to avoid over-indebtedness, by entering already saturated geographies citing contiguity of operational areas, and extending outreach to existing clients of competitors, justifying that clients had capacity to absorb higher levels of credit.
2. Industry-wide, pricing had not been revised in tandem with increased efficiencies. Benefits were not being passed on to customers; instead, they were being accumulated to fuel further expansion, or were being passed on to investors and promoters.
3. Transparency had been relegated to the background by a few MFIs, which bundled compulsory credit-life insurance products with loans, often earning margins far in excess of what could be considered ethically permissible.[2] By recovering operational costs from insurance margins, these MFIs could afford to cut interest rates on loans, thereby increasing their competitive advantage at the expense of client welfare.
4. Even basic processes were being strained by growth—staff had begun to cut corners on training and spent less time at group meetings in order to serve greater numbers of clients.
5. Fair and respectful treatment of clients was severely compromised during repayment shortfalls, as MFI staff sought to protect their own incentives by pressurizing clients to repay.
6. Appropriate product design was relegated to the background in the light of excessive margins on insurance products and plain vanilla credit offerings.[3]

It is important to remember that the phenomenon of irrational and exuberant growth had manifested itself in other countries as well, with similar outcomes, as detailed in a paper published by CGAP, covering microfinance crises in Nicaragua, Bosnia-Herzegovina and Pakistan.[4] The microfinance industry in each of these countries experienced significant stress resulting from high growth rates and leading to local or national mass delinquency crises.

CRACKS ON THE SURFACE AND CRISIS

As client welfare was compromised further, cracks began to emerge in the Indian microfinance industry. In 2006, the Collector of Krishna district in AP shut down 50 branches of two leading MFIs, alleging that they were burdening borrowers with more debt than they could handle, and indulging in coercive recovery practices. In 2009, religious groups in Karnataka instigated a mass default in Kolar and Ramnagaram districts, citing humiliation of their community members by MFI staff accompanied with irresponsible lending practices and usurious rates of interest charged by most MFIs in the area.

Research revealed that the zero delinquency culture and group guarantees of microfinance loans had created an unfavourable environment by not allowing MFI staff the flexibility to negotiate or reschedule repayments even when clients were in distress. The common practices of sitting outside clients' homes till the payment was made good, encouraging group members to exert pressure on the defaulting client or insisting that they pay on her behalf had backfired and community leaders called for a mass default citing religious reasons.[5] The lending and recovery policies, operational processes and field staff behaviour came under criticism. The sector responded by designing a Code of Conduct (CoC) and also providing tools such as Social Rating to ensure that MFIs remained true to their mission in delivering services responsibly to clients.

BUILDING A CODE OF ETHICS

With emphasis on growth and repayment targets, client welfare was being neglected. Recognizing the dangers of such a trend, industry association Sa-Dhan released a CoC[6] in 2007 and urged its members to comply in letter and spirit. Given that this code was framed before the outcomes of MFIs' high growth became manifest, Sa-Dhan's foresight must be appreciated. While Sa-Dhan's Code was well drafted and covered the critical aspects of microfinance operations, it was pitched as a voluntary code or an aspirational guideline to MFIs. While most members signed the code, implementation levels were difficult to assess as these were based on self-report using a brief format developed by Sa-Dhan. Many member institutions reported that they were 'in process' of implementation; some reported the same levels of progress for 2–3 years consecutively. Due to the multiplicity of legal forms of MFIs, it was initially difficult to bring all institutions under a common code as NBFCs were governed by the RBI whilst others came under the ambit of other regulatory bodies.

Microfinance institutions network, the industry association of NBFC MFIs, was formed in 2009. Some institutions were members of both Sa-dhan and MFIN. Microfinance Institutions Network structured a CoC for its members in 2010 and compliance was made mandatory for its member MFIs. While it incorporated important elements from Sa-Dhan's

Code, it also added a few important clauses to deal with key concerns at the time, viz., over-indebtedness and poaching of staff across MFIs.

However, adherence to the CoC was not strictly enforced by these associations. The MFIs were encouraged to report on compliance levels, but reporting and enforcement were weak. However, the tenets of these codes were accepted on paper, while ground level operations reflected a different reality.

The various CoCs drew from international resources in client protection, SPM and ethical practices in microfinance while incorporating aspects which had emerged as challenges specific to the Indian context.

Association of Karnataka MFIs (AKMI) designed their own CoC.[7] The AKMI's Code of Conduct was devised as a response to the Kolar–Ramnagaram repayment crisis. It aimed to promote coordination and cooperation between all MFIs (irrespective of constitution and operational model) operating in Karnataka to ensure that they did not engage in unethical competitive practices or compromise their responsibility to clients by over-lending. The AKMI Code incorporated aspects of the Sa-Dhan and MFIN Codes of Conduct. Member MFIs undertook to provide their clients formal and informal feedback channels to elicit suggestions for building competencies to serve them better. The AKMI's members also started conducting district-wise monthly meetings to discuss operational issues and problems in the particular district, to seek information on staff/clients and inform other MFIs about operation of agents, fraudulent practices detected and imminent default risks in any locality. Such monthly meetings facilitated exchange of information and resulted in a few agents and fraudulent Centre leaders being eliminated from their positions of control. An Ethics and Grievance Redressal Committee was constituted by AKMI to address any unresolved inter-MFI issues.

A CLOSER SCRUTINY OF CONDUCT—ANDHRA PRADESH CRISIS AS THE TRIGGER

Many of the MFIs had not learnt their lessons from the earlier crisis in Kolar and Krishna. Warning signals of these two crises were brushed off as one-off incidents and the increase in client outreach with near-perfect repayment rate continued to be touted as evidence for soundness of the business model. It was argued that if services were not client-centric, it would be impossible to maintain near-perfect recovery rates in collateral free lending. However, not all were convinced that these proxies substituted client focus and a few voices in the sector warned that simplification of client–loan officer relationship to mere financial transactions, outsourcing client acquisition to external agents, lending in saturated markets, lack of product innovation, non-transparent pricing and insistence on zero delinquency were likely to push the sector towards crisis.

In October 2010, the AP state government promulgated an Ordinance, which severely curbed the operations of all MFIs and paralyzed recoveries state-wide. The state government used its powers under the Moneylenders Act and justified its action on grounds of coercive recovery practices, indiscriminate lending and usurious interest rates charged by MFIs. Though much debate has taken place on the demerits of the action and the intention behind it, the fact that MFIs had, by their field conduct, invited strong state action cannot be denied. In the months that followed, there had been grudging recognition of unethical practices such as hijacking groups of clients for disbursement, poaching staff and lending despite knowledge of prior debt levels of clients. However, the halt of operations gave ample opportunity to institutions across the country to do some introspection and take stock of where they had gone wrong. Field visits undertaken during and after the crisis by senior management of India's leading MFIs revealed evidence of severe gaps in operating systems, most of which were attributable to uncontrolled growth. Often, top management of large institutions had distanced themselves from the field and were unaware of the regressive and coercive practices which had been employed by their staff. Many realized the shortcomings of their incentive structures, which first rewarded staff for uncontrolled client acquisition and then severely penalized them for shortfalls in repayment. Most MFIs concluded from their post-crisis introspection that in the race for growth whilst maintaining impeccable repayment rates, they had lost their focus on client needs, client satisfaction and responsibility to clients.

The MFIs seem to have realized that in dealing with bottom-of-the-pyramid clients, outreach and access alone are insufficient; rather, the highest standards of client protection are needed.

POST CRISIS—INDIAN SCENARIO TO BRING BACK THE CLIENT FOCUS

The Malegam Committee[8] was set up by the RBI post crisis to investigate various operational and financial practices adopted by MFIs in India and it presented its report and recommendations in January 2011. Amongst the recommendations were

Box 5.1 Are MFIs serious about codes and standards?

Though there were multiple codes, none of them were implemented with the urgency or seriousness they deserved prior to the AP crisis. As the codes were voluntary adoptions and dependant on interpretation and initiative of MFIs, they remained more as information on display than as part of MFI's systems and practice. After the Kolar crisis, MFIN's capping of number of loans and maximum amount was implemented fairly strictly with respect to new disbursements. Some MFIs began submitting their data to credit bureaus in an effort to cooperate on limiting over-indebtedness. However, aspects of transparency, realistic assessment of repayment capacity and fair treatment of clients were more difficult to implement and compliance was harder to assess. Most MFIs responded that they were 'in the process' of complying with these requirements and that it would require time for designing new documentation and training of vast numbers of field staff.

references to the microfinance industry CoC, to which all MFIs would have to comply, failing which they would be penalized by the industry association concerned. Banks were also advised to ensure compliance with these Codes of Conduct by MFIs they lent to.[9] It became mandatory for MFIs to display either the Sa-Dhan or MFIN Code of Conduct at all their branches and to conduct detailed training in aspects of the codes for all operational staff. The MFIs were also encouraged to inform their clients about specific aspects of the Code(s) of Conduct so that clients could seek redressal for MFIs' non-fulfilment of obligations.

Flexibility of MFIs in aspects such as product design and pricing (which had been included in the CoCs of both industry associations) was indirectly curtailed with the release of the RBI Guidelines for MFIs, which came into effect in June 2011, and were further amended in December 2011 and August 2012. The guidelines were framed to regulate MFIs by ensuring that their products, processes and pricing did not place undue pressure or burden on their clients and that profiteering motives were curtailed. The guidelines are listed in the table below.

Table 5.1 The RBI guidelines for NBFC MFIs

Conditions	RBI policy announcement—from priority sector lending perspective
Annual income limit for eligible borrowers	Rural: ₹60,000; Urban ₹120,000
Loan size (maximum)	First cycle: ₹35,000; subsequently ₹50,000
Indebtedness of borrower	Limited to ₹50,000
Tenure	24 months for amounts exceeding ₹15,000
Loan use criterion	Minimum 75% of MFI portfolio for income generation loans
Repayment frequency	Weekly, fortnightly or monthly—at the choice of borrower
Margin cap	For MFIs with assets < 100 crore - 12%; and MFIs with assets > 100 crore - 12% (difference between borrowing cost and lending rate) + processing fee, 1% (not included in interest or margin cap) + processing fee, 1% (not included in interest or margin cap)
Collateral and group mechanisms	No collateral, individuals as well as SHGs and JLGs
Conditions	**RBI policy announcement—general guidelines**
Insurance products	No commission or excess of premium can be collected from clients
Other charges	No penalty can be charged on delayed payment. The NBFC MFIs should not collect any security deposits from borrowers
Indebtedness and due caution in loan approval	Not more than two MFIs can lend to the same borrower. Sanctioning and disbursement of loans is to be performed at a central location with involvement of more than one individual from the MFI
Transparency	Guidelines specify a standard format of loan agreement and loan card, reflecting charges and terms and conditions in a transparent manner in the vernacular language appropriate to the area
Fair treatment of clients	Non-coercive methods of recovery are emphasized

Source: RBI circulars RBI/2011–12/290, DNBS.CC.PD.No. 250/03.10.01/2011–12, dated 2 December 2011; RBI/2011–12/470, DNBS.CC.PD.No. 266 /03.10.01/2011–12, dated 26 March 2012; and RBI/2012–13/161, DNBS (PD) CC.No. 300/03.10.038/2012–13, dated 3 August 2012.

Compliance levels are to be checked by lending banks through a chartered accountant's certificate confirming that stipulations are met, qualifying loans to MFIs as 'priority sector'. However, the quality of adherence cannot be checked through documentation alone. Some MFIs have sought assessment of adherence levels in the field by appointing independent agencies to collect field data and compare it with documentation and reporting. 'Project Sameeksha'—an effort by Swayam Krishi Sangam (SKS) Microfinance to check adherence to RBI guidelines—covers a sample of 1,000 clients across 5–6 states with recent disbursements. Client profile and loan terms and conditions, credit bureau results and loan utilization are cross-checked and reported on.

UNIFIED CODE OF CONDUCT

The need to adhere to a common CoC in keeping with the RBI guidelines was met with a joint effort—by Sa-Dhan and MFIN, with support from International Finance Cooperation (IFC) and Dell Foundation. The result was the Unified Code of Conduct (UCoC), which was released at the ACCESS Microfinance India Conference on 14 December 2011. This code combines the most important elements from the earlier versions by Sa-Dhan and MFIN as well as inputs from the CPPs of the SMART Campaign, RBI's Fair Practices Code for NBFCs and clauses from the RBI guidelines. Most of the CPPs have been covered, while issues specific to the Indian microfinance environment such as staff recruitment practices have been given adequate importance. Client protection and good governance are emphasized specially, as these were identified as the two stumbling blocks which precipitated the crisis in 2010.

RBI FAIR PRACTICES CODE

The MFIs operating as NBFCs first adopted principles detailed in the RBI Fair Practices Code (2006)[10] and later adopted the RBI Fair Practices Code for

Table 5.2 Important provisions under the Unified Code of Conduct

Subject	Summarization of provisions
Values	Integrity, Quality of Service, Transparency, Fair Practices, Privacy of Client Information, Integrating Social Values into Operations, Feedback and Grievance Redressal Mechanism
Integrity and Ethical Behaviour	✓ Appropriate policies and operating guidelines to treat clients and employees with dignity; transparent and professional governance system to ensure that staff are trained to put this code into practice; education of clients on the CoC and its implementation.
Transparency	✓ The MFIs must disclose all charges and terms and conditions to the client for all services offered, in accordance with the RBI guidelines and Fair Practices Code. ✓ All terms and conditions for all products offered to clients must be communicated to clients in the official regional language or a language understood by them. ✓ The MFIs must communicate all charges in writing, and interest and fees must be mentioned as an all-inclusive Annual Percentage Rate (APR) and equivalent monthly rate. ✓ Formal records of all transactions must be maintained.
Client Protection	✓ Fair Practices: The MFIs must ensure that the provision of microfinance services to eligible clients is as per RBI guidelines and must obtain copies of relevant documents from clients, as per standard KYC norms. Products should not be bundled, except credit life, life insurance and livestock insurance products, with explicit consent of clients. ✓ Avoiding Over-indebtedness: Proper due diligence to assess repayment capacity of client, sanction of loans only in keeping with prescribed limits under RBI guidelines or central/state government laws. ✓ Appropriate Interaction and Collection Practices: The MFIs must have clearly defined guidelines for employee interactions with clients and must ensure that all staff respect clients by using courteous language, respecting cultural sensitivities and refrain from indulging in any threatening, coercive or inappropriate behaviour. Valid receipts must be provided for all repayments. Board approved processes will be employed in default cases. Collection shortfalls will not be made good from employees, except in the case of proven fraud. ✓ Privacy of Client Information: The MFIs must keep personal client information strictly confidential. Client information may be disclosed to a third party subject only if client has given permission in writing for such disclosure or it is legally required to do so or if it is done by MFIs in a closed-group reciprocal basis (for a credit bureau).

(continued)

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Subject	Summarization of provisions
Governance	✓ The MFIs must incorporate a formal, transparent and professional governance system, by appointing persons with good and sound reputation as members of board and ensuring that independent persons constitute at least one-third of its members. ✓ The Board must be actively involved in all policy formulations and other important decisions and must have an independent audit committee with an independent director as Chairperson. ✓ The MFIs should have a Board approved debt restructuring product/programme for providing relief to borrowers facing repayment stress. ✓ The MFIs must ensure transparency in the maintenance of books of accounts and reporting and disclosure of financial statements by qualified auditors and must put in best efforts to follow the Audit and Assurance Standards issued by the Institute of Chartered Accountants of India (ICAI). ✓ The MFIs must file a compliance report with respect to the CoC, specifically indicating any deviations and reasons, therefore, at the end of every financial year.
Recruitment	✓ Staff may be hired from other MFIs by legitimate means in the public domain. ✓ Whenever an MFI recruits from another MFI, it will be mandatory to seek a reference check from the previous employer, after an offer is made. The request must get a response within two weeks. ✓ The MFIs must honour a one-month notice period from an outgoing employee. ✓ No MFI shall recruit an employee of another MFI without the relieving letter from the previous MFI employer, except in instances where the previous MFI employer fails to respond to the reference check request within 30 days. ✓ Whenever an MFI recruits from another MFI, at a level up to the Branch Manager position, the employee shall not be assigned to the same area he/she was serving, for a minimum of one year.
Client Education	✓ The MFIs must have a dedicated process to raise clients' awareness of the options, choices and responsibilities vis-à-vis financial products and services available. ✓ New clients must be informed about the MFIs' policies and procedures to help them understand their rights as borrowers. ✓ Awareness and understanding of key terms of products availed should be checked through regular monitoring.
Data Sharing	✓ The MFIs will agree to share complete client data with all RBI approved Credit Bureaus, as per the frequency of data submission prescribed by the Credit Bureaus.
Feedback/Grievance Redressal Mechanism	✓ The MFIs must establish dedicated feedback and grievance redressal mechanisms to correct any error and handle/receive complaints speedily and efficiently with respect to operational matters or compliance on CoC. ✓ Clients must be informed about existence of such mechanisms as well as their right to approach the grievance redressal mechanism established by the industry.

Source: Condensed by M-CRIL from Unified Code of Conduct document, http://www.mfinindia.org/mfin-code-conduct

NBFC-MFIs (2012).[11] The RBI Fair Practices Code[12] for NBFC-MFIs focuses on providing transparent information to borrowers at the time of application, issuing receipts for all payments and written information to borrowers regarding loan terms and conditions as well as costs involved. Strong emphasis is placed on communicating costs and terms and conditions to borrowers in the vernacular language and in the most transparent manner possible. Guidelines are given for interest-rate setting so that institutions do not overcharge customers. Post disbursement supervision is strongly advised in terms of anticipating and addressing borrowers' repayment difficulties and providing a fair chance to borrowers to repay before seizing collateral or imposing penalties. The code has a separate section for NBFC-MFIs, requiring them to train borrowers adequately prior to loan disbursement and protect them from over-indebtedness through appropriate checks. It gives detailed guidelines for transparently communicating all terms and conditions to clients on the loan agreement and loan card. It adopts a stern position on coercive methods of recovery, stating that harassment of any kind is unacceptable. The code makes the Board of Directors responsible for making necessary organizational changes to ensure compliance. The UCoC has to take into account the requirements of the fair practices code of RBI, which sets out the regulatory minimum expected of MFIs.

ADHERENCE OF CODE OF CONDUCT BY INDUSTRY ASSOCIATIONS

With the release of the Unified Code, MFIs irrespective of their legal form or profit orientation have a common set of field practices and standards of staff behaviour. This has helped banks and investors too, in verifying adherence of MFI partners to a certain, known set of requirements, covering key aspects of responsible financing. All member MFIs of Sa-Dhan and MFIN were required to sign the UCoC within a specified time frame. Verifying compliance on this code has remained the responsibility of Sa-Dhan and MFIN.

The MFIN even as early as 2010 made it mandatory that the Boards of all member MFIs approve and supervise implementation of the CoC—however, self-reporting was relied on for establishing this. A 'scorecard' was devised and sent out to MFIs soon after the AP crisis, consisting of a series of objective questions to be answered by MFIs, based on which they were scored by MFIN. Around 80 per cent of MFIs got high scores in the range of 80–90 per cent. The scorecard was revised when the RBI guidelines were introduced and later adapted to include new aspects covered in the Unified Code. It also includes a section on data sharing with credit bureaus, which MFIN enforced among its members. The MFIN has taken steps to educate all member MFIs on the interpretation of various clauses in the Unified Code and RBI guidelines to foster a shared understanding and obviate confusion. A good indicator of compliance is in its Enforcement Committee (EC), which frequently receives and resolves complaints from MFIN members against each other for intentional and unintentional violation of CoC norms of RBI guidelines.[13]

Though all member MFIs of the two networks have become signatories to the Unified Code, exact levels of compliance have not been established yet as most MFIs are still in the process of revamping their systems. At a documentation and staff-training level, genuine efforts have been made by almost all leading MFIs. However, effectiveness in the field can only be established by independent assessments.

CODE OF CONDUCT ASSESSMENTS

Microfinance consultancy and support agencies in India have designed tools[14] to assess levels of compliance with the Code(s) of Conduct[15] as a response to the CoC assessments commissioned by Sa-Dhan and SIDBI. This task has been complex as the code is to be adhered to in spirit, and it is often difficult to assess this in a short time frame with a limited sample of clients and staff. However, with rigorous methodology, these difficulties have been minimized and there are now robust tools to evaluate compliance levels. The various assessment formats have included the following broad parameters:

- Integrity, Governance and Strategy
- Compliance with Regulatory Guidelines (targeting, pricing and product terms)
- Market entry and Competition
- CPPs
- Client Orientation and Education
- Client Data Security
- HR Issues and Staff Conduct
- Integration of Social Values into Operations

These aspects have carried different weightages, determined by each assessing agency in accordance with its perspective on the degree of importance attributable to that parameter. A comparison of the various CoC Assessment tools and reporting structures[16] designed by different agencies in India is given in Table 5.3.

Three CoC assessments were commissioned by Sa-Dhan and 13 by SIDBI, respectively. Not surprisingly, there has been very minimal demand for CoC assessments from commercial banks, as most of them were highly averse to taking any exposure in the microfinance industry given the events in AP and rumour of incipient instability in other states. The CoC assessment results are given in Table 5.3.

Limitations in code of conduct assessments

- **Subjectivity** - Since some of the CoC assessments were done when MFIs were in the process of introducing improved practices, rate of observance was low, but this did not reflect substantially in the scores assigned,[17] perhaps because the assessment teams took into account the fact that these were new policies. Institutions charging low rates of interest were penalized for communicating to the clients on a flat rate basis but not given any points for pricing their products more competitively than other institutions.
- **Rater bias** – Being the first round of assessments, the scores seemed to be influenced by rater biases on what constitutes best and worst performance and what scores should be awarded therefore. Scoring standards have to be evolved for adoption by raters so that even if multiple raters do the assessments, comparable scores result.

Table 5.3 Results of code of conduct assessments

Agency	Institutions covered/Period of assessments	Actual score/ Grade[18]	Percentage equivalent of grade	Legal form
SIDBI assessments				
m2i	1. Arohan Financial Services Pvt Ltd	100	**80.6**	NBFC
	2. Shree Kshetra Dharmasthala Rural Development Project (SKDRDP)	90	**72.6**	Trust
	3. ASA International India Microfinance Pvt Ltd	108	**87.1**	NBFC
	4. Bharatiya Samruddhi Finance Ltd	104	**83.9**	NBFC
	5. Equitas Micro Finance India Private Ltd	110	**88.5**	NBFC
	6. Cashpor Micro Credit	94	**75.8**	Sec. 25 Co.
	7. Bandhan Financial Services Pvt Ltd	105	**84.7**	NBFC
	8. Ujjivan Financial Services Pvt Ltd (September 2010–May 2011)	108	**87.1**	NBFC
M-CRIL	1. Madura Microfinance Ltd (MMFL)	β+	**66.5**	NBFC
	2. SHARE Microfin Ltd (August–September 2011)	β+	**67.3**	NBFC
iMaCS	1. SKS Microfinance Pvt Ltd	7.1	**71.0**	NBFC
	2. Future Financial Services Ltd (December 2011–January 2012)	6.6	**66.6**	NBFC
ACCESS Assist	1. Saija Finance Pvt Ltd (November 2011)	3.08	**77.5**	NBFC
Sa-Dhan Assessments				
M-CRIL[19]	1. Share Microfin Ltd	**NA**	**Under non-disclosure agreement**	NBFC
	2. Spandana Sphoorty Financial Services Pvt Ltd	**NA**		NBFC
	3. SKS Microfinance Pvt Ltd (October—November 2011)	**NA**		NBFC

Source: SIDBI Code of Conduct reports. Available online at http://www.sidbi.com/micro/codeofconduct.html

Learnings from code of conduct assessments

A review of the COCAs so far carried out had been commissioned by SIDBI to understand the utility and functionality of COCA. The review (excerpts in the following box) finds COCAs to be useful and suggested wider use by all lenders.

International initiatives on assessment of SPM

International initiatives were plenty, which focused on devising frameworks and tools for benchmarking, measuring and reporting on various aspects of social performance and responsible financing. These include the CPPs of the SMART Campaign and the USSPM of the SPTF. There is also the shift from credit and financial ratings to Microfinance Institutional Ratings, which give a balanced report on an MFI's operational, financial, managerial and social performance capabilities.

SOCIAL RATINGS—COMPREHENSIVE ASSESSMENT OF SPM OF MFIs

Social Ratings,[20] which evaluate an MFI on its efforts to implement and practice its social mission, were pioneered by M-CRIL in 2005–06 in India. This tool has gone through changes in methodology and nomenclature, from being termed as 'Poverty audit' to 'Development Rating' and finally to 'Social rating'. The significance of this initiative was the realization that social performance—which has client protection at the core—is as important as financial viability for the success of microfinance initiatives. Given that MFIs cater to a segment normally excluded from formal financial services, it is necessary to ensure that they are achieving 'responsible' financial services—i.e., that access to financial services are provided with good intent and are complemented with appropriate product design and

Box 5.2 What do we learn from COCA?

The COCAs has so far established the following:

- The MFIs are keen and focused on adoption of code and conduct.
- Customer protection concerns have become important in MFIs—right from the field to boards of governance.
- The staff have been trained on field behaviour as also organizational policies relating to interface with customer.
- The MFIs have achieved high scores in aspects relating to disclosure, staff behaviour with customers, grievance handling and process of recovery of defaults.
- The MFIs have had problems in quickly responding to changes in regulation and require time.
- Documentation of COC in operations manual and audit manuals will improve the quality of compliance and level of customer protection.
- Loan appraisals should take in to account client circumstances more elaborately than in the past to ensure compliance with RBI regulations.
- The MFIs should design processes by which client relationship is strengthened and their feedback actively taken in to account.

Though the 13 MFIs are located in different geographies, there are common features in their conduct of business. The COCAs found that:

- The MFIs' boards have increased their attention on code of conduct issues.
- Setting up appropriate disclosure norms that inform customers well has become a priority.
- Pricing transparency and interest rate cap compliance have been absolute, though proving difficult in a dear money environment.
- Inclusion of different elements of the COC in the process manuals and internal audit manuals is the most effective way of ensuring that COC is implemented and monitored as part of the internal processes of the MFIs.
- Staff training and documentation of processes have a significant influence over actual conduct in the field; hence, the MFIs should ensure that there is a clear written guidance on COC available to staff and followed by training.

Way forward

The COCA is an assessment at a point of time. It needs to be repeated at regular intervals. The findings, especially on areas of weaknesses and future actions, should be pursued and institutions asked to respond on the action taken from time to time. In some aspects causing concern, repeated visits should be undertaken to ensure that quality of compliance reaches a satisfactory level. When over a period COCA becomes fully established, there may be no need of external monitoring. Eventually COCA should become the responsibility of boards of governance of MFIs. The initial COCAs have been funded by SIDBI. A number of technical service providers have been brought in to carry out the assessments in order to have a wide and deep resource pool that is now available. If lenders pay attention to COCA findings and demand improvements, institutional response from MFIs, which are already keen, will improve.

The COCA represents a significant step forward in bringing customer protection agenda to the centre stage. Through a structured approach, it makes the sector pay attention to specific elements of policy, governance, operations, field behaviour, products and grievance handling. This approach is well suited to understand and inform the MFIs and others in the sector on the extent to which customer is being taken seriously. While code of conduct compliance is a necessary part of the MFI operations, incentives to those institutions that perform exceptionally well will go a long way to raise the bar in customer service and protection standards. SIDBI should engage the stakeholders in the sector to encourage wider use of COCA, set up benchmark scores based on a review of a number of assessments, incentivize exemplary performance and pass on the responsibility of actions based on COCA to the MFIs over time.

Source: Analysis of COCA assessment reports commissioned by SIDBI.

delivery systems to enhance the resources and capabilities of clients. It was hoped that double bottom line assessment would enable MFIs to remain true to their mission. The Social Rating pathway assesses the effective translation of an institution's mission into practice in line with accepted social values[21] and the framework incorporates insights from ImPact's work in SPM and inputs from the SPTF. The rating draws from an MFI's stated mission and traces its internalization across organizational hierarchy and implementation levels in operational processes and reporting systems. Fair treatment of staff and responsibility towards community are also assessed, while outcomes on relevant social indicators are reported. Social Rating demand has been limited to requests from a few social-minded investors.

Microfinance Institutional Rating: While social rating remains an in-depth tool for assessment of social performance, recent events have clearly shown that certain aspects of social performance such as client protection also have a bearing on institutional and financial sustainability. Integration of key social issues into the rating framework also addresses public policy concerns on institutional practices in lending to the poor. Realizing this, microfinance rating agencies such as M-CRIL worked on a global initiative during 2011, supported by the Ford Foundation and Rating Initiative, to refine the existing financial/credit rating product by integrating key areas of social performance. Initially termed 'Responsible Finance Rating' during the pilot phase, it has been renamed as Microfinance Institutional Rating (MIR) based on industry feedback and experience gained during the pilot. The MIR expands the holistic assessment framework used by specialized rating agencies as opposed to pure financial evaluations used by mainstream rating agencies. In addition to the risk aspects covered in a traditional financial or credit rating, MIR incorporates the CPPs,

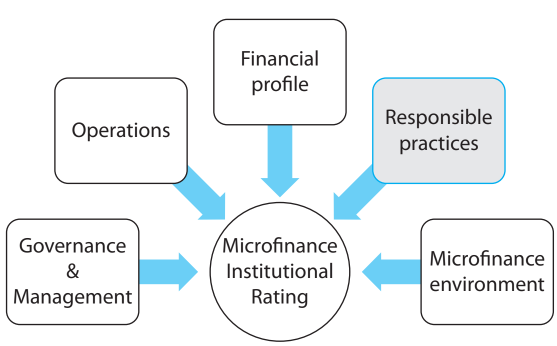

Figure 5.1 Microfinance institutional rating framework

Source: M-CRIL Microfinance Institutional Rating process document.

alignment of practices with stated social goals and responsible financial performance, thus providing a holistic opinion on the long-term sustainability and creditworthiness of MFIs.

SMART CAMPAIGN'S CLIENT PROTECTION PRINCIPLES

In response to a strongly recognized need to assure safe and responsible treatment of their clients, microfinance industry leaders from around the world came together in 2008 to agree on a set of CPPs to guide the microfinance industry. They recognized that when financial services are delivered in accordance with these principles, clients are enabled to use financial services well and providers build a foundation for healthy operational framework for years to come. To put the principles into action, the SMART Campaign was launched in October 2009. Today it is a global effort with over *3,000* signatories and endorsements from over 850 microfinance institutions serving more than *40 million clients in 130 countries*. The campaign is being led by the Centre for Financial Inclusion (CFI) with seed funding from ACCION International.

Box 5.3 The client protection principles

1. Appropriate product design and delivery
2. Prevention of over-indebtedness
3. Transparency
4. Responsible pricing
5. Fair and respectful treatment of clients
6. Privacy of client data
7. Mechanism for complaint resolution

Source: Information from SMART Campaign/ACCION representative, Hema Bansal.

The campaign works with industry support organizations (like CGAP, the SEEP Network, the specialized rating agencies, etc.) and with many of the 140 investor groups that have endorsed the CPPs. It collaborates with MF Transparency, which provides guidance on pricing transparency and works closely with the SPTF, which helps in integrating the CPPs into a broader framework of SPM and reporting for the microfinance industry. The campaign also collaborates with MIX Market in contributing the client protection indicators on its portal. It has also ensured that industry Codes of Conduct in various countries incorporate the CPPs. Microcredit Summit's Seal of Excellence initiative has aligned with the campaign to build upon established principles and standards.

The SMART Campaign in India works with major players in microfinance who are committed towards making client protection an integral part of the industry. In 2010, the campaign established its first partnership with SIDBI. With seed funding and endorsement from SIDBI, it was able to engage with SIDBI's partners at a deeper level to build a consistent understanding of the CPPs. In July 2011, the SMART Campaign received grant funding for two years from IFC to build greater awareness on adherence to the CPPs—as reflected in the UCoC. Under the project, the campaign is identifying the state of practices on client protection by assessing a range of Indian MFIs to create India-specific benchmarks on CPPs. The campaign has partnered with MFIN, Sa-Dhan and ACCESS-ASSIST to help with its efforts in this direction. The campaign is also disseminating knowledge and building capabilities amongst microfinance stakeholders by training them in Client Protection Assessments (CPAs). Till date, the campaign has conducted 10 CPAs in India under its SIDBI–IFC Project, covering client outreach of over 7.5 million clients. The assessments covered mainly select NBFC-MFI partners of SIDBI and IFC, based on criteria of size, geographic location, models and products. Learnings from CPAs are presented in the following table.

Table 5.4 Learnings from client protection assessments

CPP 1 - Appropriate Product Design	• Multiple or flexible product design is a challenge that few MFIs are able to meet. Most cite MIS issues or regulatory and operational challenges. • Severe pressures on financials compel small MFIs to offer more standardized products.
CPP 2 - Prevention of Over-indebtedness	• Both High Mark and Equifax are fully functional and have covered majority of the MFIs in India. Challenges are limited to specific regions, where a few MFIs are still in the process of contributing data due to MIS issues. • Most MFIs have put in place a credit bureau check as part of the loan appraisal process. • As SHG borrowers are not covered, the effectiveness of the credit bureau is affected. • Across MFIs, incentive structures have also been largely rationalized to avoid excessive emphasis on client acquisition or portfolio size. • With RBI specifying the debt threshold, majority of the MFIs indicate compliance. There is potential for training field staff in eliciting reliable information, especially on informal borrowing sources and levels. Majority of the MFIs are basing repayment capacity assessments on Grameen methodology and self-declared household income. Only a few MFIs use household surplus to determine the repayment capacity and the loan size. Internal audit checks on repayment capacity analysis need strengthening.
CPP 3 - Transparency:	• In order to comply with regulatory requirements, MFIs have taken steps to simplify their pricing structure and have revised their loan cards to reflect declining balance method of interest application and quote fees and insurance charges separately. While MFIs meet the regulatory pricing requirement norms, some MFIs were not communicating the APR or total loan cost to the customers. • The MFIs are educating clients on the interest rates at different points during the credit process. While most MFIs prefer to explain the loan pricing during pre-loan training, some have provided leaflets, used innovative games and reiterate the loan pricing information and insurance charges during disbursements. • Loan passbooks and contracts are in local language and outline the loan pricing and terms; however, there is scope to enhance client's understanding on pre-closure options available. • While introducing micro-pensions or insurance products that require clients to save for longer periods, MFIs need to carefully explain the amount of returns and the lock in period thereof.
CPP 4 - Responsible Pricing	• All MFIs assessed after introduction of pricing regulations had complied by revising pricing in a band of 24–26%.

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CPP 5 - Fair and Respectful Treatment of Clients	• The industry has responded with seriousness to implementation of this principle—MFIN and Sa-Dhan conduct independent investigations in case violations are reported. • Most MFIs assessed have included acceptable and unacceptable behaviour as part of the induction training provided to all staff. Some MFIs have made it compulsory for staff to pass CoC test as part of the induction process. • Sanctions for any behaviour violations are not always included in HR policies, but staff is aware that unethical behaviour would be viewed unfavourably. With MFI's increasing tolerance of defaults, staff field behaviour in recovery of loans has improved. • The MFIs still need to work at defining staff values and ethics in a manner that can be imbibed and monitored as part of staff performance. The MFIs could recognize and reward field staff for maintaining high standards of ethics while handling clients.
CPP 6 - Privacy of Client Data	• Most MFIs assessed did not have a client data privacy policy. This does not imply that client data privacy was compromised by MFIs. Their IT systems are secured, with responsibility based controls on access to data. • When using third-party services, most MFIs ensure that they include a clause on not permitting sharing of client-related information. However, this is not always consistent and requires MFIs to have standard formats for ensuring that client information is not shared. • While sharing client information with credit bureaus, MFIs as part of regulatory compliance were found to be procuring client information in the loan contracts. However, clients were not always aware of this. • Use of client photographs in promotional material requires greater attention. Currently, very few institutions obtain explicit approval from clients for using their profiles as part of publicity material.
CPP 7 - Mechanism for Complaint Resolution	• Most MFIs have started working on a grievance redressal policy or framework that requires customer's complaints to be seriously investigated and resolved in a timely manner. • Many MFIs have provided a toll free number for customers to access to take up grievances. However, most MFIs have observed that majority of complaints are addressed at field level and have therefore begun establishing human channels at the branch level. • Dissemination of toll free numbers during CGTs and disbursements have shown a remarkable increase. However, not all clients are aware of how and when they can use the toll free numbers. • Complaints have been too few to warrant any changes in products or policies.

Source: Information from SMART Campaign/ACCION representative, Hema Bansal.

SMART Certification: Since January 2010, the SMART Campaign has been working with the microfinance industry (through a task force of over 30 experts) to develop a Client Protection Certification Program. The Certification Program will enable financial institutions worldwide to demonstrate their adherence to the campaign's core CPPs as verified by third parties. During 2012–13, the four global microfinance rating agencies will be the certifying agencies. In India, M-CRIL will be undertaking pilot certifications during the pre-launch phase until the end of 2012.

SOCIAL PERFORMANCE TASK FORCE

The CGAP, Argidius Foundation and Ford Foundation brought together leaders from various social performance initiatives in the microfinance industry to develop a common social performance framework and an action plan to move social performance forward.[22] The SPTF was constituted to set standards for social performance and design tools for implementation of SPM in MFIs worldwide. The SPTF has pioneered design of social performance assessment tools, conducted trainings and framed action plans for institutions to incorporate SPM in their activities. It has developed standards for social performance over the years, involving a global team of practitioners, funders, networks, technical service providers, rating agencies and researchers. In June 2012, SPTF has released its USSPM for MFIs, which establish clear guidelines on SPM integration in strategy, operations and reporting. The process involved obtaining feedback from over 1,300 members of the SPTF as well as external experts. The USSPM have been incorporated by specialized microfinance rating agencies in their rating frameworks and the MIX market social performance reporting template for MFIs. The standards are based on the following metrics.[23]

Box 5.4 Universal standards in SPM

1. Define and monitor social goals
2. Ensure board, management and employee commitment to social performance
3. Treat clients responsibly
4. Design products, services, delivery models and channels that meet client needs and preferences
5. Treat employees responsibly
6. Balance financial and social performance

MULTIPLE CODES, ASSESSMENTS AND RESULTING CONFUSION

After the AP crisis, the microfinance industry has moved from neglect of social performance to an overdrive with multiple codes, guidelines, standards and benchmarks. This inevitably led to confusion around which is the best practice for MFIs to follow and what would be assessed or certified. Recognizing an overlap and convergence around general principles and values of client protection and drawing on this convergence, EDA Rural Systems has developed a straightforward and relatively short guide[24] that sets out the RBI guidelines as well as UCoC within the framework of the CPPs. Using this guide, MFIs can plan modification around products and processes in compliance with regulatory requirements, CoC and CPPs together without having to refer to multiple documents.

But the MFIs still should navigate their way through different assessments, ratings and certification processes. With investors and lenders endorsing different frameworks for adoption, MFIs may have to get a certificate on client protection from one institution, Social rating from another and report information to a third platform, etc. In a stagnant business, the effort spent on multiple initiatives that go towards the same final objective could be fatiguing and the costs debilitatingly high. If the external actors that carry out these narrow-focus assessments come together and set up a single rating instrument such as the MIR referred to earlier, the MFIs will be able to breathe easier. The example of MFIN and Sa-Dhan coming together to unify the CoC for MFIs is worth emulating.

WAY FORWARD: CRACKING THE CODE

Compared with the government's attitude of benign neglect in the early stages of the MFI sector's growth in India, regulation has been intense following the AP crisis. Jolted by the paralysis of microfinance in the birthplace of India's biggest MFIs, the Government of India and RBI have sprung into action. Indian and international institutions have engaged in assessing compliance with Codes of Conduct, promotion client protection and social performance.

Given the increased pressure on MFIs to ensure efficiencies by lowering operational costs, it will be difficult to comply with the multiplicity of guidelines, principles and Codes all at once. Enforcement and implementation may prove daunting for MFIs as they struggle with operational difficulties like fund shortages and demotivated staff. However, steps have been taken to establish a clear path for MFIs in the form of the UCoC, using RBI guidelines as a yardstick and weaving other important aspects around them. The Microfinance Bill under the consideration of the parliament provides for industry associations (such as Sa-Dhan or MFIN) to supervise the observance of CoC of members. The MFIs are at present putting in place systems to be RBI regulation and fair practice code compliant and at the same time ensuring that the UCoC aspects are also adhered to.

Inclusive finance can only be ensured if institutions focus on maintaining the fine balance between financial sustainability and client needs. Codes, guidelines and regulations can only provide guidance; however, internalization of the canons of responsible finance by MFIs is critical to their survival. Responsible finance with client focus is the only way forward. The keen interest shown and steps taken by external stakeholders in MFIs' code of conduct compliance and social ratings should be strictly seen as a handholding exercise in the initial period leading to orienting MFIs towards the proper direction. Third-party assessments like that of CoC assessments will lend credibility to the efforts of MFIs who have suffered reputation risk. Such assessments will provide comfort to lenders and social investors about the MFIs they are partnering with. However, over a period of time, the urge to do assessments from outside should be balanced/replaced by helping the MFIs carry out the same internally as part of their normal review and governance processes. Over time, the MFIs should take care of their customers' interests in order to protect their institutional sustainability. The MFIs must view adherence to the code as a means of ensuring sustainability, a tool for strengthening relationships with their clients and a safeguard against external risks posed by political, religious and social establishments.

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12. The original version of this Code, which was applicable to all NBFCs, was issued in 2006. It was followed by a few NBFC-MFIs between 2006 and 2010, until the release of the MFIN Code. The Fair Practices Code was revised to include NBFC-MFI specific clauses and was released in March 2012. The RBI Fair Practices Code, 2012, is distinct from the RBI guidelines for MFIs, issued in June 2011.
13. For instance, in the initial days of the credit bureau, limited data from MFIs led to a green signal for some disbursements, which resulted in some MFIs unintentionally becoming the third lender to clients.
14. The tool was first designed by M2i consulting.
15. Assessment tools were designed separately for the Sa-Dhan Code (for assessments commissioned by Sa-Dhan) and for a combination of Sa-Dhan and MFIN Codes (for assessments commissioned by SIDBI). Some of the agencies also incorporated RBI guidelines for assessments performed after June 2011.
16. All reports are available on SIDBI's website: http://www.sidbi.com/micro/codeofconduct.html (accessed 1 August 2012).
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18. M2i awards points out of a maximum of 124; M-CRIL awards eight grades ranging from a+ to g; iMaCS awards points out of a maximum of 10; ACCESS Assist gives scores ranging from 1–4 with six corresponding grades assigned.
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