PROPOSAL FOR ESTABLISHING AN ENVIRONMENT, SOCIAL, AND GOVERNANCE (ESG) GROUNDWORK: CREATING A CLOSED SYSTEM WITHIN THE MICROFINANCE SECTOR

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**Abstract**

The current microfinance industry is unprepared for Social Responsible Investment\(^1\), which it inevitably starts to attract on its course towards the status of mainstream asset class. Derived from unsolved inner philosophical tension, the gap between differently used concepts in the sector is widening, while identical terms indicate different contents. Microfinance is becoming too varied to be presented under few single terms with discrepant meanings. Development of the microfinance industry, predominantly a phenomenon of local markets, thus does not keep up its local pace with its increasing reliance on international capital markets, with their globally coherent corporate expectations. The lack of clear definitions and transparency of the sector can discredit microfinance, once SRI systems open their gates. MIVs\(^2\), States, corporate investors and multilateral institutions must therefore in a concerted action impose basis of

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\(^1\) Sustainable and Responsible Investment concept incorporates Environmental, Social and Governance issues into fund management.  
\(^2\) MIV: microfinance investment vehicle
standards coordinates, otherwise differently perceived concepts might mislead the global public. Therefore, formation of a closed system, ruled by Global Microfinance Authority using own currency unit and complemented with an ombudsman, comparable to United Nations in world of politics yet applied in microfinance market and financed by the contributing players, could impose globally understandable structure in local chaotic environment.

Keywords: microfinance; funding; inefficiency; coordination; MIV; guarantee; SRI; social impact

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INTRODUCTION

The capital flows originating in the developed countries provide key link between local needs and international financial sources. 29% of the total of funding into microfinance sector today is channeled internationally.

SRI market, gradually opening to microfinance, is today an enormous market, encompassing more than a tenth of all professionally managed assets, estimated by CGAP at €7.5 trillion in 2009. The potential of the market is enormous. Within the period 1995 – 2010, the SRI registered 380% growth reaching $7.06 trillion (Threadneedle, 2011). During the crisis period 2007 - 2010 the universe of professionally managed assets has remained flat while SRI assets have enjoyed growth (Greenmoney, 2010).

Within this market, ever more investors are conscious of impact of their investments and seek double bottom line.3 So far, among ESG4 issues, the environment and governance have attracted most attention, while the importance of the social issues lacked behind. Microfinance is therefore a logical target of SRI. While mere 0.02% of the total of European SRI flows in 2009 were channeled to microfinance, Eurosif 5 concludes that microfinance will be of significant interest to SRI investors in the near future. The total investment to the sector is expected to triplicate from USD 6.6 bn in 2008 to USD 20 bn by 2015 (Harris, 2009).

Albeit the role of microfinance as SRI asset is marginal for SRI market, it is crucial for the future of microfinance. SRI is already the largest source of international microfinance funding, reaching 47% in 2005 (Eurosif, 2010). Yet despite the importance of SRI for microfinance, the sector is unprepared for the expectations of the SRI investors, who are 92% institutional and who will demand accountability (Eurosif, 2010).

There are several reasons for the lack more profound involvement. Although SRI

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3 Combination of financial return and social impact
4 Environment, Social, Governance
5 The European Sustainable Investment Forum
investors are interested in industry’s social impact, good image and return/risk profile, they perceive several unsolved obstacles such as lack of transparency and disclosure on ESG practices, a highly volatile currency risk and lack of appropriate products. Reputation risk associated with lending to the poor appears high and finally, assets managers are not sure where to place microfinance (CGAP, 2009)

Microfinance harbours a philosophical tension between supporters of social justice grounding and supporters of robust extension of financial system6. On the top of this tension, deep differences reign between the corporate presentations and the local reality. Growing numbers of practitioners are relying on practices considered unethical in mature financial markets, such as untrue information, usurious interest rates and lack of adequate customer protection, opening the door to exploitation of the poor. (Park, C.K., 2007) In consequence, the global media focusing on few salient cases, antagonistically oversimplify the industry as a profit-making financial predation, while at the same time denoting microfinance as the most promising tool to combat poverty. Abysmal differences can be found not only in terminology used by MFIs, but also in nomenclature applied by MIVs and rating agencies.

In order to establish microfinance as a social development promoting industry, the sector evolution needs to be guided and oriented from above, through a set of standards and criteria, defining expectations and setting the bar for acceptable lending policies, excluding profiteering MFIs. Funders, government agencies, and technical assistance providers, must in a concerted action define “social microfinance”. If they do not, the reputation of microfinance as social industry, may reap unwelcome volatility of SRI sources, leading to detriment of all involved. This paper proposes creation of a Global Microfinance Financial Authority (GMFA), formed by representatives of the sector, multilateral institutions and states, in order to establish sector standards related to social impact measurement, unification of terminology, audit certification, ratings and bankruptcy procedures. Such multitasked endeavor could synergically concentrate knowledge, strategically act on planetary level, create transparent space for microfinance evolution as a strategy to fight poverty.

Fig. 1: Growth in cross-border investment in microfinance between 2005-09 in $bn

6 Monitor Institute: Investing for Social and Environmental Impact
MISSING MICROFINANCE TAXONOMY

Insufficient Impact Assessment Tools

Three decades after global popularization of microfinance, there is still no convincing body of evidence related to social impact measurement, readily incremented by MFIs. MFIs are recently starting to report en bloc on social performance, due to requirements of the funders, nevertheless, recently invented social performance indicators only speculate on achieved social impact.

Standard methods for measuring poverty have proven impractical given the scarce resources and technical constraints, problems with data collection, analysis, and interpretation. Zohir and Matin (2004:301) argue that the 'impact of microfinance intervention is being under-estimated through conventional impact studies'. Impact assessment studies led by external stakeholders are often of little use to MFIs themselves as they tend to be too complex, time consuming and costly and do not generate information that is sufficiently timely, regular, reliable and cost effective (Simanowitz, 2006). The indicators such as CERISE, CGAP Poverty audit, the IRIS-PAT developed by USAID, and PPI created by Grameen Foundation or the SEEP/AIMS, are not representative. They do not provide control nor feedback in the field, costly and are more likely to be used by an MFI only when funded by a donor (Simanowitz, 2006), limited to relatively small sample of countries with available household expenditure data and making no distinction between urban and rural households, with different poverty characteristics. Besides, they require technical skills not possessed by all MFI's, or are prone to selection bias due to sampling design while validity of new clients as control group is questionable (SIM Pilot Project, 2008).

Social ratings provided by rating agencies are dynamic products of the consulting industry, based on quantitative and qualitative analysis of the MFI's social performance. The major weakness of the social rating lies in its cost and superficiality of the validation of data provided by MFIs, but also in the fact that rating agencies view the social ratings as their core business.

On the top of the problem, only few MFIs measure their social performance. Out of 1928 MFIs reporting to Mixmarket as of 12/2010, 350 MFIs (18%) reported on their social performance. Most of those committed use the methods described above, exemplifying lack of the microfinance social impact measurement at present. Applied measurements focus on social performance of the MFIs that may or may not result in a social impact. Although lenders are becoming conscious of the non-income aspects associated with poverty, in the sector reigns an absence of an industry-wide framework for social impact reporting and it is arguable if any MFI could stand the test of external social auditing, since the current auditing tools for such task are either frail, speculative or non-existent.

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7 Social impact refers to outcomes that can be directly attributed to programs. Social performance encompasses the process by which impact can be achieved.
8 PAT = Poverty Assessment Tool; PPI = Progress out of Poverty Index
9 Currently PlanetRating, Microfinanza, M-Cril and Microrate
The lack of accountability, the difficulty in proving impact given the questions related to doubts in assigning effects to cause may in the future imply reduction of credibility for public investors.

Failing client protection
Failures of microfinance become threatening, once the MFIs funded by MIVs, cause detriment to the clientele, due lack of ethics, despite proclamations expressed during the fundraising. The ethical failures usually concentrate in lack of pricing transparency, excessive rates and abusive loan recovery. The effective interest rate paid by a borrower may differ from the stated interest rate. Non-transparent pricing, common in microfinance, creates imperfections generating opportunities for higher margin. Pricing transparency is therefore essential to promote efficiency, as well as consumer protection.

The case of Andhra Pradesh in 2006, where private microfinance program clashed with development programs organized by government of Andhra Pradesh, which led to accusations of MFIs of charging excessive interest rates and lack of transparency and eventually caused closure of several tens of branch offices, only exemplifies the need for neutral criteria and detailed definitions of the microfinance operation code.

MFIs organizations routinely hide the actual interest cost by charging interest on the original value of the loan rather than on declining balance, charge up-front fees, force security deposits deducted from the loan amount and compulsory savings as well as insurance premium charges.

The potential for consumer exploitation in the case of microcredit is a direct result of market failure, caused by little competition as some MFIs exercise significant local market power resulting in high interest rates, or by the ill information of the consumers of microcredit.

![Fig. 3: Most disclosure requirements out of 137 countries sample group seldom apply to nonbanks in many development countries (Financial Access 2010)](image-url)
Lack of environmental linkage

As pointed by Allet (2011), a growing number of MFIs are developing environmental programs, as stakeholders are increasingly willing to monitor environmental impact, however no methodology currently exists to do so. In a survey conducted with 160 MFIs (Allet, 2011), 78 per cent believe that they should actively protect the environment, yet, most of them do not know how. Microfinance investors also seem interested in knowing the environmental performance of MFIs (De Bruyne, 2008), but the microfinance industry does not have any measuring and monitoring instruments, nor adapted methodology. In a survey realized by the Social Performance Task Force in 2007, 62 per cent of the respondents expressed their interest in knowing the environmental performance of MFIs (De Bruyne, 2008). The Microfinance Investment Vehicles (MIVs) Survey carried out by Symbiotics revealed that, 46 per cent seek to assess MFIs’ environmental risks, and 45 per cent seek to integrate environmental issues into their investment decisions (Symbiotics Research & Advisory, 2011).

Measuring MFIs’ environmental performance through standardized comparable indicators could also serve as an information treasury, responding to stakeholders’ as well as research interests. Although, as part of their Social Performance rating products, rating agencies M-CrIl, MicroFinanza, and PlaNet Rating have defined indicators for assessing MFIs’ environmental responsibility, these indicators are not very precise and do not cover all aspects of MFIs’ environmental performance (Allet, 2011).

When the microfinance sector started to promote social performance measurement in the early 2000s, there was initially reticence in the industry, as social performance indicators were seen as too complex for MFIs (Jacquand, 2005). Today, the sector has come to an agreement on the need for monitoring microfinance performance on a double bottom line (Doligez & Lapenu, 2006; Gutiérrez-Nieto, et al., 2009; Hashemi, 2007; Lapenu, et al., 2009).
There are no mandatory standards determining ESG compliance. However, the ad hoc evolution of definitions is positive is necessary to meet the beliefs of a global population. The more institutionalized these principles become, the greater will be the stigma associated with delisting. Therefore, not accepting environmental dimension of the ESG microfinance investment concept, which is taking increasing precedence over SRI as it encapsulates the three key aspects of responsible investing (Threadneedle, 2011).

Fig. 5: MIVs integrate ESG (Symbiotics, 2011)

International Bankruptcy procedures and data control
Due to nature of MFIs, leveraging capital without significant own equity or other assets, MIVs in most cases take portfolio as a pledge. However, the frailty of the microloan portfolio, due to its integrity-based instead of asset-based character, is paltry.

Cases of bankrupt MFIs, caused by mismanagement due to uncontrolled growth fueled by investment inflow, inadequate internal controls, over-indebtedness of the clientele and failures of the rating agency to spot the coming crisis, are frequent, but receive few publicity and thus keep on being repeated in time and space, without collective knowledge being created. This fact is partially caused by confidentiality agreements between MIVs and MFIs conserving the commercial secret at the cost of long-term welfare of the sector. Collaboration between creditors would allow failing MFIs to survive, saving their valuable assets. In order to reduce the risks of hidden reality of the sector, funds should be as transparent as possible about their business model and practices, the intercreditor agreements among lenders should become widely used practice, imposition of standardized loan documents whenever possible respecting national laws and introduction of worldwide bankruptcy procedures would increase the efficiency of the sector.

Many times, misleading information causes bankruptcies. The control of hard data presented by MFIs, executed during due diligence, is however at present as diverse as the universe of MIVs, in most cases deficient and speculative. The control is typically performed prior to disbursement on behalf of investors verifying that performance is accurately reflected in the financial statements and reports, and that management and operating systems are strong enough to sustain the capital inflow and handle its performance. Financial statements are often compiled to present only the positive face of the MFI. Auditors, who approve the financial statements, can belong the
acquaintances of those interested in disbursement. Due diligence methods learned in regulated sectors in developed markets, where the analysts rely on the information provided available, are insufficient in social economy in developing countries.

The inaccurate representation of portfolio quality belongs to the principal weaknesses. Discrepancies between real and reported portfolio quality are usual in MFIs and many well-known MFIs have experienced at least one significant portfolio crisis, sustaining delinquency and default rates above what they reported to the public (CGAP, 2009). Out of the methods currently massively used for MFI appraisals, there is currently none that entirely faces the portfolio quality issue, the key element for a stability of any MFI. 11 The sample controls, during which the analysts compare randomly chosen files against the client interviews in the field, are often orchestrated to correspond to funder’s expectation. Also, the riskiest regional portfolios are usually geographically far away from the headquarters and not likely to be visited. It is truly impossible for a single analyst to acquire a complete view of a microcredit portfolio, consisting of tens of thousands of clients, in a few days. No concerted solution of this issue was developed in the past, also because the MIVs guard their methodologies as a commercial secret.

ESTABLISHMENT OF GLOBAL MICROFINANCE FINANCING AUTHORITY

The authors propose establishment of a Global Microfinance Financial Authority (GMFA), based on international general assembly formed by representatives of the sector, multilateral institutions and states, and electing management, in order to create intersector synergy and tackle taxonomic and organisational inefficiencies take place. The institution is autonomous and strives to be self-financed by interest margin paid by MIVs and MFI members. It would be imprudent not to recognize that impact assessments as well as other segments of the market are “battle fields of knowledge” (Long and Long 1992) in which different actors seek to influence the knowledge creation process so that it meets their needs (Hulme 2000). GMFA therefore, as one of its primary functions, tackles the issues mentioned above: social impact measurement, customer protection, taxonomy and definitions, conciliation board, nonexistent global credit bureau on wholesale level, audit methodology and imposition GMFA definitions.

Determining a social development sector open for investments by MIVs, happens under the rules depicted below.

MFI are certified according to GMFA criteria focused on transparency, social impact, MIV debt management and client protection, are allowed to use the registered mark of Development Microfinance Institutions (DMIs).

The DMIs, under full scrutiny of GMFA supervisors, regarding social impact measurement as well as audits, are thus present for MIVs entities suitable for investment under full disclosure of conditions, using standardized loan contracts and financial products according to GMFA imposed limits.

11 Several public tools exist, such as ACCIÓNs CAMEL, WOCCU’s PEARLS, CGAP’s Tool for appraising MFIs.
By assuring transparency, DMIs acquire access to SRI capital sources and the MIVs, conversely, gain more certainty on the investment impact.

In case of default, GMFA procedures imply standardized bankruptcy proceedings, postulated in code of conduct and global credit bureau registering all MIV-DMI microfinance debts.

The endeavor of social impact measurement making use of economies of scale, global terminology standardization, certified audits, qualification of MFIs, alignments of ratings and bankruptcy procedures, could reap synergies due to its concentration of knowledge, strategic acting on planetary level, creating transparent space for microfinance evolution as a true strategy to fight poverty. The GMFA membership goal is to snowball, creating robust benchmarks in the midst of uncertainty and becoming the basis of healthy microfinance industry.

The institution can be financed by both MFIs and MIVs through special tax, dedicating a fraction of the interest earned annually to GMFA. If only considering that currently, 0.1% of the assets of MIVs presents 59,06 MM USD (out of 5,906 MM assets).

**ESTABLISHMENT OF GMFA GLOBAL OMBUDSMAN**

The GMFA body is complemented by the institution of global ombudsman, protecting the clientele through local partnerships networks present to lesser or major extent in most developing countries. The ombudsman institution is elected by the MIVs and supervises the work of MFIs as well as GMFA. Global ombudsman thus protects interests of the clients of microfinance institutions, whether considering clientele in the field or investors represented by MIVs.

**ESTABLISHMENT A CLOSED CURRENCY UNIT SYSTEM**

While 76% of total fixed-income investments to MFIs made by international funds are denominated in Euros or dollars, CGAP indicates that 50 % of MFIs have nothing in place to protect them from foreign exchange risk and that only 25 % of target MFIs are hedged against depreciation or devaluation risk. (CGAP 2006)

International hard currency investments leave MFIs with large foreign exchange exposure, and while lending in hard currency protects investors, it shifts the FX risk to MFIs with microcredit portfolios denominated in local currency. As the number of MFIs relies on commercial sources of funding, the foreign exchange risk issue is becoming a concern for the sector.

Only few MFIs have the ability to deploy the FX risk solutions, and even if they do, the market solutions may not be available, as capital markets in developing countries often offer a limited range of financial instruments.(Holden, 2004) Lack of solution to FX related issues discriminates against whole regions.
Global solution to the problem could be introduction of a GMFA Currency Unit, conceived as a basket of currencies of the GMFA member states, used as the unit of account. The GMFA could be used in international financial transactions, where its advantage was that securities denominated in GMFACUs would provide investors with the opportunity for foreign diversification without reliance on the currency of a single country. The MIV loans to MFIs could thus be provided in ECUs and converted into local currencies offsetting the fluctuations of the rest of the pool of currencies within the basket.

CONCLUSION

Microfinance is enwrapped in a disarray of terms and denominations and may not stand the test of a serious asset class claiming social development. If the password to international SRI capital is ESG, then apex institutions are to set detailed environmental, social and governance benchmarks, understandable and applicable worldwide.

The current situation, with non-existing global client ombudsman nor debt register will eventually deter SRI investors. Increasing dependency on globally thinking sources, yet inadequate local correspondent development may cause discrepancies. Concepts will blend and reputation of microcredit will suffer due to dichotomy between rhetoric and reality, highlighted by superficial media reports.
The current groundwork has succeeded in attracting many actors, but has neglected to build the regulatory base, in order to protect the poor and investors alike. Thus, it is urgent to set up a central authority, centralizing archive of experience, progressing scientifically, supervising and guide of the development of the sector in one, in order to save social mission, coherence as well as reputation of the microfinance concept.

The goal of GMFA is not to form another bureaucratic body and fetter the sector, but to establish a structure securing space for specific SRI interests devoid of misapprehensions, inefficiencies and duplicities.
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