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Guidance Sheet

Responsible Credit

Purpose of the guidelines

This guidance sheet is part of a series of tools developed to support SDC staff and partners in designing and implementing projects aimed at financial inclusion. This specific guidance sheet introduces the concept and key aspects of responsible credit. It provides guidance on how to design, prepare, implement, and monitor SDC projects effectively.

Key Issues

1. The MSME finance gap is enormous. About 41% of formal MSMEs in developing countries have significant unmet financing needs, an equivalent of USD 5 trillion or 1.3 times the current level of MSME lending. For informal companies, the numbers are even bleaker. However, it should also be understood that clients cannot simply borrow themselves out of any social and economic hardships. The situation is in most cases more complex, with multiple, interlinked socio-economic challenges.

2. Lending products and practices should be transparent, responsible and fair. In practical terms, this means that credit should serve a productive purpose (for the SDC's focus) and be inclusive. The intended financial and socio-economic effect on the borrower should be positive while yielding a positive outcome for the lender too. In this context, MSME and corporate finance project goals and measures can differ significantly from consumer lending, microcredit and entrepreneurship finance. Each of these requires specific modifications when implementing target-group oriented projects.

3. In practical terms, responsible finance concepts bring a multitude of opportunities on the supply and demand side (e.g. supplying diversified products, adapted to clients' needs) but also operational challenges for financial institutions (e.g. understanding clients' needs through data collection and effective use of data, balancing social and financial objectives).

4. In addition, financial institutions need to comply with more stringent formal requirements, covenants, and disbursement conditions by the international donor and investor organisations. This flip side of the coin should be addressed early and openly with the partners involved.

What is responsible credit?

Responsible credit (RC) refers to lending products, processes, and policies that aim to avoid harmful or unfair practices[1] while balancing the interests of providers, staff and clients as well as the environment. The practical implications range from bare minimum standards on client protection and providers' codes of conduct ('do no harm' strategies) to strategies aimed at social and environmental performance: the double (financial and social) or triple (financial, social and environmental) bottom line (or 'do good' strategies).

Following the global financial crisis of 2008, triggered not least by irresponsible sub-prime mortgage lending in the US and the financial inclusion crisis in the developing world (with cases of over-indebtedness, irresponsible pricing and unfair practices[2]), there was an international paradigm shift to the regulation of consumer credit. Concepts such as 'responsible lending', applicable throughout the duration of a credit contract, have been mainstreamed into financial sector regulation and consumer protection laws worldwide.

A general shift of opportunities and risks towards individuals is also creating financial consumer protection challenges. Due to rapid technological change[3] and new distribution channels[4], direct access to a widening range of financial services is now a reality. As a consequence, savings and loan products, securities and derivatives, insurance and other non-bank financial services, such as leasing arrangements, are now more readily available. However, low-income and less experienced consumers[5] can easily be exposed to fraud, unsuitable products and misconduct. Responsible credit is one of the key aspects in this context as credit is one of the most widely available and accepted financial products, with certain systemic risk implications.

Numerous international institutions are leading the way to effective financial consumer protection and responsible lending principles, both in the public and private sectors:

Institution	Description of initiative	Key issues and publications on responsible credit
G20 / OECD	High-level principles on financial consumer protection.	Provide a general framework based on nine principles in coordination with financial sector regulators and standard setters such as the World Bank.
CGAP	Series of Research and Technical Guides on the implementation of client protection principles for digital lending.	Series of Practical Guides (e.g. Digital Credit, DFS, Responsible Risk Management for FIs, etc.)
Cerise + Social Performance Task Force	Universal Standards for Social and Environmental Performance Management providing guidance from standards to implementation for financial service providers, investors, regulators.	Pathway and certification framework: comprehensive set of standards and hands-on 'essential practices' for all stakeholders, available in English, French, Spanish, Arabic, Client Protection. The Responsible Digital Financial Services (DFS) Standards Working Group is also working to propose standards by the end of 2023
Alliance for Financial Inclusion (AFI) working groups	Working groups among regulators and central banks on policies and practical solutions around seven financial inclusion policy areas.	Knowledge sharing and peer learning among regulators and practitioners, Maya Declaration on responsible and sustainable financial inclusion. Policy model on consumer protection for digital financial services.

1 Referring to MFIs which do not look at clients' needs and instead focus on generating profits.
2 Chen, Greg, Stephen Rasmussen and Xavier Reille, 2010. 'Growth and Vulnerabilities in Microfinance'. Focus Note 61. Washington, D.C. CGAP. www.cgap.org/sites/default/files/CGAP-Focus-Note-Growth-and-Vulnerabilities-in-Microfinance-Feb-2010.pdf
3 Mobile money, etc..
4 Agent banking, finance kiosks, mobile banking
5 This phenomenon is not limited to developing or emerging countries alone. In fact financial consumer protection is a major concern worldwide.

PRI PIIF	Principles for Investors in Inclusive Finance (PIIF) under the Principles for Responsible Investment (PRI) Initiative, for investors.	Practical guidance on responsible investment practices (part of wider ESG governance framework), i.e. from an investor perspective.
Global Partnership for Financial Inclusion (GPFI)	Platform to coordinate better quality access to/use of sustainable and formal financial services	G20 Financial Inclusion Action Plan 2020 prioritising DFI and SME Finance, SME Finance Forum
World Bank	World Bank Group's Global Financial Development Report on Financial Inclusion	Responsible lending - overview of regulatory tools

Further initiatives
UNEPFI Principles for Responsible Banking Guidance Document, Responsible Finance Forum / Center for Financial Inclusion.

This Guidance Sheet focuses less on subsistence/social lending and more on economically productive purposes. However, any such credit transaction is a type of 'bet'. This bet builds on expectations about the future. To put it simply, the borrower and the lender should, in principle, agree that the most likely scenarios will allow for timely repayment of the loan in full. These expectations can take very different forms. They can result from to-be-improved market conditions, e.g. better transport infrastructure or access to larger marketplaces. There may be expectations of new procurement and sales markets, or longer and better storage capacities to sell commodities at higher margins. In any event, the lender and the borrower enter into a 'joint risk' relationship. The parties should take responsibility for this relationship instead of relying solely on collateral or credit ratings. That is the true spirit of responsible credit: both parties are living up to their responsible lending or responsible borrowing obligations.

Why are responsible credit principles important?

Based on the discussion above, it is recommended that two levels of responsibility be distinguished:

Level 1 refers to the 'do no harm' (DNH) principle.

DNH protection measures ensure that entrepreneurs and consumers are protected against over-indebtedness in the mortgage and entrepreneurial debt segments. Here, the stakes are particularly high (substantial loan amounts, longer repayment period, and in the case of collateral repossession, loss of capital/home) and macroeconomic shocks could be triggered. Specifically, it is imperative to define and adhere to the following client protection standards:

1. Appropriate Product Design & Delivery
2. Prevention of Over-Indebtedness
3. Transparency
4. Responsible Pricing
5. Fair & Respectful Treatment of Clients
6. Privacy of Client Data
7. Mechanisms for Complaints Resolution
8. Committed Governance & HR

The 'do no harm' principles should seek to avoid negative effects on:

- the rights of the borrower under the client protection standards (ensuring economic wellbeing, safety, dignity, information availability, etc.),
- decent working conditions of staff (transparent and decent human resource policies, health and safety at work, etc.),
- the functioning of communities (inclusion of marginalised groups, participation, independence, solidarity, peace, prudent governance),
- the local economy (legal standards, equal access, market principles, competition),
- the environment (carbon footprint, biodiversity and habitat conservation, health).

Although it should not be applied as an absolute principle, there should be an institutionalised focus on minimising negative effects in any project. The DNH principle is also required through laws or by-laws in most jurisdictions worldwide, including those of many developing countries. In operationalising them, many private and public institutions refer to the IFC's Environmental and Social Performance Standards[6]. They comprise eight individual risk areas focusing on pre-investment assessment and mitigation approaches. A common point of criticism is that they neither present mechanisms for project monitoring throughout the entire financing life cycle nor options for later-stage intervention, so that they could:

- improve transparency, for both the demand and supply side of the SME finance marketplace, to reduce information asymmetries and to decrease financing costs by making offers accessible and comparable,
- ensure that price ceilings and lending targets (investing in areas that improve the lives of communities, such as housing, employment, social outcomes) are respected,
- monitor and evaluate publicly funded programmes to enhance MSME finance against a pre-defined baseline.

In addressing these shortcomings, Level 2 needs to be more targeted and therefore often more complex. Yet it directly builds on the Level 1 DNH principles.

Depending on the given impact goals and the socio-economic context of the project, the **Level 2** framework might raise very different questions to ensure credit responsibility. Consequently, the Level 2 framework should be project or programme-specific, i.e. by linking funding to the achievement of positive results: usually development impact indicators or policy reforms. The Universal Standards for Social and Environmental Performance Management, which is aligned with the IFC performance standards, propose a concrete roadmap for assessment and implementation both at LEVEL 1 (client protection, responsible human resource development, environmental performance management) and at LEVEL 1 (social strategy, committed leadership, client-centred products and services, responsible growth and return). A selection of possible Level 2 principles and their implications for responsible credit is provided below:

- **Getting ambitions straight**
  Setting meaningful strategic targets to ensure transparency and accountability. Any project should also keep an eye on 'additionality' (outcomes that would not possibly have occurred without the intervention). For example, defining and monitoring indicators that focus on direct impact on the target group, e.g. improved cash flows, lower degree of asset depreciation, etc. Incentivise the financial intermediary with a view to servicing these new target groups with better (more tailored) services. One should understand the needs of the customer and find appropriate solutions.

- **Transformative power of good practices and the 'positive contagion effect'**
  Financial institutions that successfully apply responsible credit principles quickly become industry[7] role models. Thanks to their leverage, they have the power to set quasi-standards either by design or en passant. Good practices and positive contagion effects can be more impactful than any regulation or technical assistance measure.

- **Creating opportunities by properly analysing risk**
  Using several relevant risk information sources (credit agency information, financial transaction data points, qualitative and quantitative assessment by the loan officer, etc.) to assess creditworthiness facilitates access to funding for MSMEs. 'Impartial' data sources produce benefits in terms of job creation, gender equality and economic growth. Rigorous underwriting standards thus promote MSMEs with productive investment ideas rather than collateral-based financing decisions.

- **Build a sustainable business model**
  Small-scale entrepreneurs and SMEs face a systemic disadvantage compared to corporates when it comes to accessing finance, as they are perceived to have a higher risk/return ratio by most lenders. Opacity[8], absence of adequate collateral, high transaction costs and lack of financial documents and skills add to this problem. However, when lending cycles and organisational structures are adapted to these realities, e.g. by creating dedicated MSME units inside commercial banks or by providing consumer-friendly information and marketing material[9], these challenges can be turned into a strategic competitive advantage for the financial institution.

6 Available online: www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Sustainability-At-IFC/Policies-Standards/Performance-Standards
7 Many financial markets are dominated by less than a dozen institutions that tend to mutually monitor their strategic initiatives.
8 Lenders may not have sufficient time or the market knowledge to fully assess small-scale loan applications.
9 For example, ProCredit Banks feature colour-coded product factsheets for their clients to guide decision-making on the suitability of financial products.

How to design responsible credit projects using a market systems development (MSD) approach

When planning a project to support the development of inclusive, self-sustaining market systems in partner economies, the SDC uses the MSD approach in order to progressively decrease their dependence on external aid and avoid market distortion. The focus of this approach is to identify and consider the underlying causes hindering market systems development and financial inclusion to ensure that responsible credit (RC) aspects are addressed throughout the project cycle.

1. Prepare responsible credit projects

Most donors and international financial institutions opt for funding-based approaches. This means that funding via credit lines or other instruments is linked to complementary technical assistance measures to achieve pre-agreed financial and socio-economic results, which are directly relevant for development or indirectly relevant for the development and implementation of (sector) policy reforms.

Since project success usually depends a lot on the commitment of the participating financial institution and on a conducive regulatory environment, it is recommended that a 3-step approach to project preparation be followed:

Analyse current portfolio and identify potential high-impact RC areas.

↓

Ensure management commitment to RC targets and transparency.

↓

Set DNH and positive targets and define the action plan incl. milestones.

The results chain below (see Figure 1) illustrates how FE programmes can be embedded in a market systems development approach. It also highlights the overall impact of FE on increased income and inclusion. Taking an MSD approach to FE, it is crucial to understand the target.

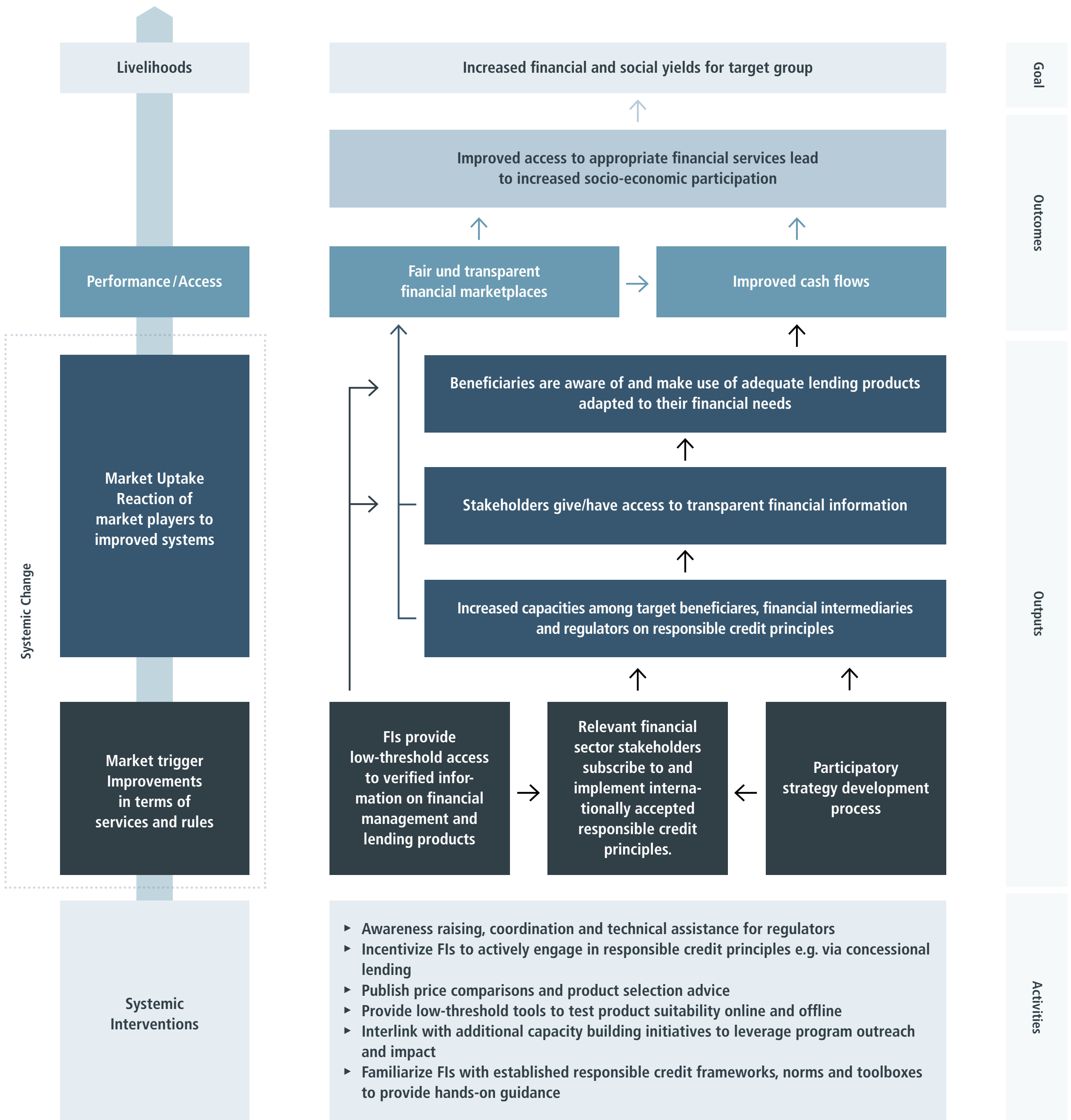
The SDC already builds on good RC practices in the context of several projects. Between 2017 and 2021, the SDC supported the application of the Universal Standards for Social and Environmental Performance Management (USSEPM) via inclusive financial service providers by promoting responsible, client-centric financial services[10]. The 'Social Performance Task Force' (SPTF), in cooperation with REDCAMIF and partnering inclusive financial service providers in the Central America and Caribbean region, were led through these analytical stages. The ultimate goal was (i) putting the USSEPM into practice with a clear strategic focus on low-income clients and (ii) making reliable and transparent financial information and social performance available to the market.

10 Available online: www.eda.admin.ch/deza/en/home/aktuell/news.html/content/dezaprojects/SDC/en/2018/7F09903/phase1

2. MSD-based intervention design

Based on the results of the above portfolio analysis, a clear understanding of the wider project context is required to effectively address shortcomings and to trigger systemic, lasting change. The MSD approach builds on the following premises:

- Institutions operate in systems. Systems are complex and often unpredictable: they are made up of complex and ever evolving interactions between individuals and institutions. MSD-based project design builds on a thorough analysis of market systems to identify underlying causes for exclusion rather than symptoms at the surface.
- A conducive role for funders and implementers who need to facilitate systemic change, which requires understanding the dynamics of the system itself.
- Interventions should play a temporary role to nudge the whole system toward a new equilibrium that works better for the target group.



Since implementing RC standards is often considered a cross-cutting project activity, its underlying principles will likely manifest themselves in different aspects of those financial sector projects. They will have an impact on a wide range of micro, meso, and macro-level stakeholders as well.

The following diagram depicts a typical MSD-aligned RC project and results chain:

The analytical process around the MSD is a suitable starting point for a better understanding of the underlying constraints in the financial system: what does lack of access to responsible financial services mean in a given country? Are the banks' risk aversion and excessive collateral requirements causing the restrictions? Is the pricing excessive or non-transparent? Is the main issue insufficient knowledge resulting in clients selecting unsuitable financial products? In most cases, a combination of factors is involved.

As a second step, it is essential to consider how these issues should be properly addressed. How should awareness among the key stakeholders be raised? How should lasting change within the target groups be initiated? Who are the key change agents that need to be convinced? What sequence of activities makes most sense? What are suitable financial instruments[11] to complement these technical assistance, research, and networking measures?

3. Monitoring and metrics

In order to assess the actual uptake of project outputs (such as number of downloads of client factsheets on specific financial products; levels of attendance at financial education events; number of grievance mechanisms initiated) it is essential to consider the following monitoring and evaluation (M&E) aspects across the entire project cycle:

- Consider using the Universal Standards for Social and Environmental Performance Management, together with their assessment tools on SPI Online, to assess and benchmark where the FIs stand at the beginning of the projects, to identify gaps and propose potential support, and to analyse the situation and potential improvements at the end of the projects.
- Develop a Monitoring & Metrics (M&M) Framework for any project defining how, when and what data will be collected and how, when and what information will be disclosed to which audience.
- Align the framework with the results chain model as described above. Include assumptions on expected results and at the same time allow for flexibility[12] on the moving targets.
- Focus on sustainability indicators[13] specific to responsible credit (e.g. # of trained RC trainers and subsequent standalone training sessions, share of target group clients (m/f) in the financial institution's portfolio (baseline vs. endline target), improvement in the alignment of cash flows with debt service (debt service coverage ratios in percentage points).
- Public relations and marketing outreach indicators. Possibly even conversion rates in the context of FI online marketing measures (e.g. usage of RC education tools before opening accounts / applying for loans over time).
- Substantiate lessons learned and good practices with facts and figures using the M&M framework to illustrate the effectiveness of the measures in the given project context. Ideally, financial institutions and important financial industry stakeholders contribute to the framework by providing data and by spreading the word.

11 Instruments range from financial products such as loans, (quasi-)equity and grants to a combination of non-financial and financial offerings (see TEB Turkey example).
12 Instead, define interim review periods to reassess the targets and indicators.
13 One can also refer to standard outcome indicators for FIs, aligned with the SDGs, as proposed here: www.e-mfp.eu/sites/default/files/resources/2022/03/Outcomes%20Management%20for%20FSPs_%20A%20proposed%20standard%20framework%20aligned%20with%20the%20SDGs.pdf

Annex I: Suggested reading

Cerise+SPTF, eMFP, 2022. Outcomes Management for FSPs – A proposed standard framework aligned with the SDGs, www.e-mfp.eu/sites/default/files/resources/2022/03/Outcomes%20Management%20for%20FSPs_%20A%20proposed%20standard%20framework%20aligned%20with%20the%20SDGs.pdf

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