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This study outlines a rating approach for microfinance investment vehicles as part of global initiatives supported by the Swiss Agency for Development and Cooperation (SDC) in promoting accountability and transparency on social performance in microfinance. It forms part of a series of thematic case studies of SDC's Employment + Income Network.

Promoting accountability and transparency on social performance of microfinance investment vehicles

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1. Rationale for SDC promoting social performance at investor level

SDC has supported Financial Sector Development for the past three decades as a key instrument for poverty alleviation. Microfinance particularly is seen as a double bottom line sector, with financial sustainability the means to achieve social goals.

SDC has supported microfinance institutions (MFIs) in partner countries and global initiatives that help measure and report social performance (SP), like the Social Performance Task Force (SPTF)[1], the MIX SP Standards reporting[2], the Rating Initiative[3], the Smart Campaign[4], and collaboration with CGAP[5].

SDC has also engaged with microfinance investors, notably the Swiss managers of Microfinance Investment Vehicles (MIVs) who manage/advise above $ 3 billion (around 1/3) of global private cross-border microfinance investments. As the share of private investments is growing steadily (around 30% of global $21,6 billion in 2009), MIVs can have a positive leverage effect on their investees in improving SP. In 2007, SDC brought Swiss investors together with international investors to exchange on SP reporting (next section).

In sum, SDC has promoted global standard setting for SP measurement and reporting at both MFI and MIV level so as to help create better accountability and transparency. To ensure the social mission by mitigating current 'sub-prime' and irresponsible trends of client over-indebtedness in selected microfinance markets has become more urgent than ever.

2. Bern Workshop with Swiss investors

In March 2007, SDC with CGAP organised a workshop for Swiss investors, the first SP workshop for MIVs and their funders.[6] At a time when SP reporting indicators for MFIs were under development, this was an opportunity to share SP tools and indicators, and explore how these could be best aligned to investor perspectives.

The starting point was the global consensus around SP as: "The effective translation of an institution's social mission into practice in line with accepted social values that relate to serving larger numbers of poor and excluded people; improving the quality and appropriateness of financial services; creating benefits for clients; and improving social responsibility of an MFI." [SPTF, 2007]

MIV managers and funders' perceptions of 'social' reflected similar values. Funders emphasised achieving the Millennium Development Goals and social responsibility.

Four social investors - responsAbility, EFSE, Triodos, and Shorebank - shared their SP reporting which differed widely in SP dimensions and indicators covered. New methods for *social rating* developed by the specialist rating agencies, and *social audit* developed by Cerise, were also shared.

Participants appreciated CGAP's initiative since 2006, to develop MIV disclosure guidelines, on both financial indicators and outreach. Feedback from the workshop on the CGAP draft guidelines was subsequently incorporated (next section).

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3. Emerging MIV reporting standards

MIV reporting standards emerged through discussions of the SPTF social investors' working group and MIV reporting developed by CGAP. Since 2008, the annual CGAP MIV surveys, managed by Symbiotics, started in 2006, have included **E**nvironment, **S**ocial and **G**overnance (ESG) indicators.[7]

[29] ESG indicators reported in CGAP MIV survey

E - Environment: [4]	**S - Social: [19]**
Compensation for carbon emission, exclusion list, included in investment screening, risk assessment **G - Governance**: **[6]** Reporting ESG information to funders, staff training, requirement of anti-corruption policies with MFI, board representation of the MIV (equity investors)	**Outreach** [5] - active borrowers, av. Loan size, % rural, % urban, % women **Product range** [7] - MFI loan use (investment/household); % MFIs offering savings, insurance, non-financial services; voluntary savers **Client protection** [7] - MIV endorsement of CPP; aspects of implementation including information to MFIs, part of financing agreement, role of equity investors

Another emerging player is LuxFLAG, the Luxembourg Fund Labelling Agency, created in 2006 to provide a label to MIVs essentially to confirm (to potential funders) that they were actually investing in microfinance. In 2010, LuxFLAG announced its intention to add a social dimension to its microfinance label.

Parallel to CGAP's survey, LuxFLAG is launching a web platform (LUMINIS) to collect and disseminate information on labelled MIVs. This service will be managed by the microfinance rating agency MicroRate which has, since 2006, conducted MIV assessments on financial performance and risk indicators, in the context of hedging foreign exchange risk. These have not so far included any SP criteria.

4. Pilot MIV Rating Initiative [8]

While the principles of financial and social performance rating were quite widely applied at the level of MFIs this was not yet the case at MIV level. The pilot MIV rating initiative took place to address this gap. The pilot was funded by Anthos (a Dutch social investor) and SDC and implemented by M-CRIL who pioneered MFI social rating. The pilot ratings were carried out with the MIV holding companies Blue Orchard, Incofin – 2 funds: CVSO and Rural Impulse Fund (RIF), and Oikocredit.[9]

The rationale of the pilot was to promote transparency of MIVs for:

- prospective funders to offer a way to assess investment purpose and performance in relation to their own investment goals and social values and to compare different MIVs directly.
- MIV management to provide a systematic profile and analysis of strengths and issues.
- prospective investees (MFIs) who are beginning to look for differences between the investors that approach them.

Rating framework

M-CRIL adapted the existing financial and social MFI level rating framework to apply to the MIV level. The adaptations were made to reflect assessment at the level of the MIV manager, the MIV and the investees.

Key MIV rating dimensions and indicators

MIV manager	**Institutional assessment (financial & social)** Board composition/engagement, management capability, policy on 'sustainable growth' and MFI CEO pay, staff culture, engagement with social performance initiatives, women staff ratio, market positioning
MIV financial assessment	**Funder processes**: subscription process, fees for funders, anticipated returns, repayment and exit **Risk mitigation**: partner monitoring, liquidity, foreign exchange risk (Forex), geographic risk management, diversification of portfolio, internal control **Financial performance, MIV level**: profitability, efficiency, portfolio quality
	Financial performance, investee level: Rate on Return (RoA), portfolio quality, capital adequacy ratio, diversity of funding, rating grade
MIV – social assessment	**Social orientation and supporting systems**: social goals and monitoring their achievement, screening process and weightage to SP criteria, local currency investment, social covenants, guidance to investees **Client protection and supporting systems**: guidance to investees on client protection principles, monitoring costs to clients **Other social responsibility**: monitoring human resources policies of investees, gender issues (beyond number of women clients), environmental issues incl. in investment decision, own environmental practices
	Investee feedback on the MIV: on transparency, reporting requirements, shared values **Social performance systems in place at investee level**: client protection systems, market intelligence, social rating/audit and grade
	Outreach, investee and end clients: tier category of MFIs, countries of low development by Human Development Index, rural/urban, women, client exit rate

Through the pilot experience and discussion, the framework has evolved as follows:

Selected findings (with a focus on social performance and 'responsible investment'):

Mission and values: The MIV holding companies have and believe in mission statements that reflect the social values of microfinance (*'Empowering disadvantaged people'… 'Socially responsible investments' 'Demonstrable social impact'…).* But they are yet to define and demonstrate their achievement. Two examples of outreach objectives, are Oikocredit aiming at (25)% investment in South Asia and sub-Saharan Africa; and Incofin – Rural Impulse Fund (RIF) specifying minimum (20)% MFI branches catering to rural populations.

The MIV holding companies have endorsed the Client Protection Principles, and to different degrees have become engaged with other international initiatives to promote SP (such as social rating/audit, poverty assessment tools, sustainable environmental practices).

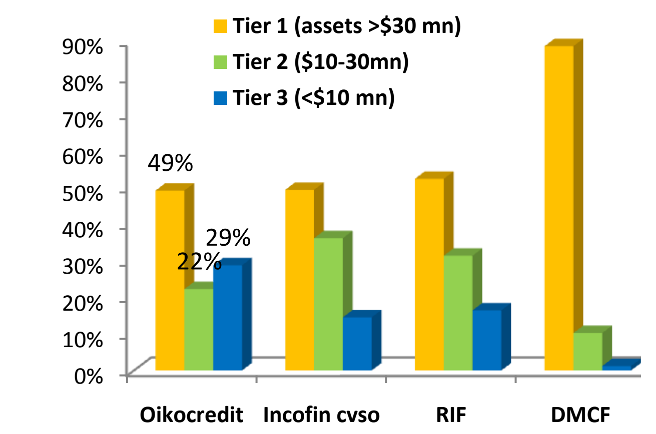
Staff capacity and orientation: The MIVs have skilled and motivated managers and analysts, with high levels of microfinance expertise, especially in financial performance. Social performance capability is beginning to grow, becoming integrated within management systems and processes (screening, monitoring), and specified responsibilities for SP within the investment teams.

Selection of MFI investees: The MIVs have established systems for financial screening, including: the due diligence visit by the analyst (usually 2 days), use of audited financial reports and a financial score sheet that analyses key financial ratios: profitability, efficiency and portfolio quality.

Systematic screening of investees on social performance is an emerging area. Incofin has used a social score card since 2007, as part of due diligence of all potential investees. The score card covers aspects of customer service, outreach, human resources, corporate social responsibility, and social mission/vision. An investee must score more than 50% on both financial and social indicators. Oikocredit now has a similar tool, and Blue Orchard is moving to a similar approach.

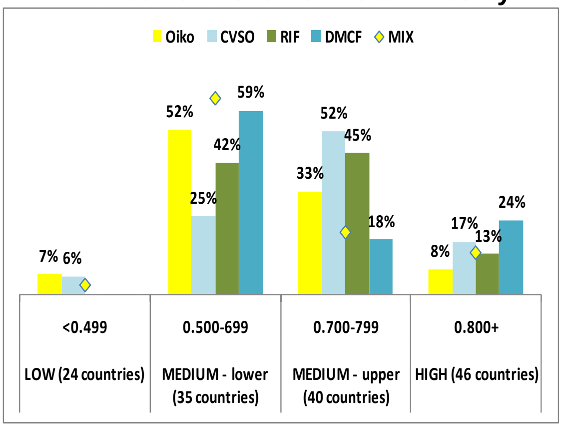
Investment by size of MFI investee: MFIs can be categorized by asset size. 'Tier 1' MFIs are established, more mature institutions with assets over $30 million. 'Tier 3' MFIs are smaller scale, including start-ups and niche players, with assets under $10 million. Adjusting for country concentration of MFIs, the social performance rating gives a higher score to MIVs investing in 'Tier 2 and 3' MFIs as it represents a more socially oriented approach in terms of supporting smaller institutions to grow and develop their potential.

Size distribution of investee MFIs (2009/10)

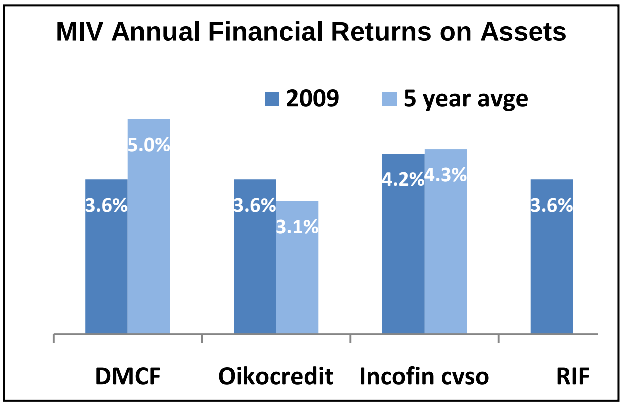


Outreach to countries by development level: MIVs report on the distribution of their investments by region and country. From a social perspective, an additional analysis is in terms of the development level of different countries - which can be captured by the Human Development Index (HDI). MIV support to outreach in less developed countries, relative to industry presence, represents significant social value in extending financial services to less developed countries.

MIV financed end clients in countries by HDI



MIV reporting and financial performance: MIVs provide regular financial reports to their funders, quarterly (Incofin), monthly (DMCF) or annual (Oikocredit). The MIVs yield good returns on assets: 3.6% to over 4% in 2009, and 3.1% to 6.0% average over the previous five years.



All charge market rates to MFIs, with a premium for country risk. Oikocredit provides a discount of up to 1% in case of 'exceptional social relevance' of a project.

Financial risk management: Portfolio monitoring and diversification are an important component of the risk management processes. DMCF has not had to make provisions for loan losses until now but is adjusting quickly to the current situation of MFI risk in some regions. Internal controls and audit have been strengthened recently by both Oikocredit and Blue Orchard but, in any case, all have fairly strong operational processes to ensure compliance with policy. All MIVs have appropriate policies on liquidity and an investor environment that focuses on minimal redemptions.

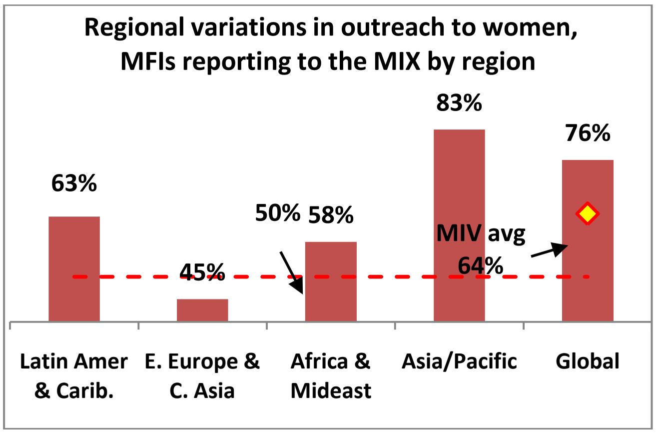
Incofin's MIVs (particularly CVSO) have significant equity exposure, Oikocredit's equity exposure is somewhat lower but growing. Only Oikocredit has recorded a couple of exits so far, earning a substantial real return on the investments.

Responsible investment - sustainable growth and client protection: MIV managers recognize that in the past they have put pressure on investees to grow - which may have contributed to excessive growth rates and competition between MFIs in some countries (such as Bosnia, India, Nicaragua, Cambodia). Awareness of responsible rates of growth for MFIs has to be reflected in the MIV due diligence process. It is partly a financial indicator, since it relates to MFI financial sustainability, but also a social indicator, since very high growth may strain MFI systems, affecting staff management and client relationships.

The related questions around client protection at MFI level have emerged as a focus globally: reflected in CGAP investor guidelines and the Smart Campaign's client protection principles. In line with the questions asked as part of CGAP's MIV benchmarks, the MIV social rating scores each fund on their engagement, capacity and monitoring of the client protection principles. For all the MIVs, this is work in progress.

Reporting 'social returns': Social reporting by MFI investees to MIVs has covered some of the ESG indicators. Data for outreach to rural populations and to women represents in many countries a significant effort towards financial inclusion. Though there are issues in measuring 'rural' and regional differences to take into account.

Performance data for poverty outreach and effectiveness of services for the end clients, is usually not available. Data for poverty



outreach is beginning to be reported as some MFIs begin to implement poverty assessment tools, such as the 'Progress out of Poverty Index'. [Note: available data for average loan outstanding (the total portfolio outstanding divided by total loan accounts) is a widely used but very limited indicator of poverty outreach, and does not distinguish between potential changes over time].

Data beginning to be reported by MFIs on their market intelligence (e.g. client satisfaction, client dropout) provide an indication of the relevance of MFI services to their clients. As MFIs report on these indicators as part of the SPS MIX reporting, and as MIVs begin to monitor such questions, this systems data will add to the assessment of the relevance of microfinance services. A rating will include this information.

Rating reports and scoring
M-CRIL rating reports are ten pages per MIV. Each dimension of financial and social performance (listed on page 2) is scored. A summary score sheet is provided in Excel so that users can apply their own weights, for example, the relative weight between financial performance and social performance, or between specific dimensions within social performance. M-CRIL does not assign an overall grade, but provides a recommendation on both financial and social performance of the MIV, and a summary highlight of strengths and issues.

5. Initial results in social performance mainstreaming at MIVs

In reaction to their experiences of the global financial crisis, investors are developing more awareness of transparency and 'responsible finance' and engaging with the different initiatives and tools available to support social performance.

MIV managers are increasingly committed to disclosure on ESG performance. Of the 73 MIVs reporting to CGAP's annual survey with data for 2009, 95% reported on the Environmental and Governance indicators and have endorsed the client protection principles. Two-thirds or less reported on the Social indicators - client outreach and actions to implement client protection principles in their investment processes.

The pilot ratings helped to map out for the MIVs concerned the different dimensions of SP, and ways in which they can strengthen their systems and reporting, with more transparency on social returns for funders.

MIV managers are beginning to realize that their policies, the questions they ask investees, what they include in their investment covenants, what is reported and monitored and how they use that information, can all influence good practice at MFI level. The due diligence has always represented a learning process for investees and the questions on financial performance are well accepted. As MIVs introduce social performance questions into the due diligence and subsequent reporting, this will also contribute to the learning process and developing standards.

As understanding of social performance and values deepens, investors are beginning to see a synergy between financial and social performance. Strong financial performance can support systems for social performance; good social results - putting values into practice - in turn support sustainability. Incofin has used data from its financial and social score cards to compare financial and social performance across its portfolio - and found a positive correlation. As more data becomes available, the correlations and 'balance' of the double bottom line will emerge more clearly.

6. Emerging issues in responsible investing

In the current scenario, MIVs need a clear policy/view on issues at investee level that have emerged as trade-offs in managing the double bottom line. For example:

- What is a *reasonable, sustainable* rate of MFI growth (number of accounts, portfolio) for different Tier categories: growth over 50% should be viewed with caution.
- What is a '*fair*' profit at MFI level: maximizing profits is not an appropriate option when it involves high costs to clients; other criteria to be screened include costs to clients, efficiency versus client relationship, HR systems and depth of outreach); and what is a 'fair' return to investors, taking into account risks (from a investor perspective) and the declared social mission of microfinance, as a 'social business'.
- What is an appropriate level of remunerating the CEO in absolute amount (compared to private banks) and relative to remunerating the lowest paid field staff.

MIVs can influence good practice at MFI level through commissioning social ratings or audits, and specifically supporting the integration of social performance into management, as Oikocredit is doing.

MIV managers are also beginning to realize that their policies, the questions they ask investees, what they include in their investment covenants, what is reported and monitored and how they use that information, can all influence good practice at MFI level. The due diligence has always represented a learning process for investees and the questions on financial performance are well accepted. As MIVs introduce social performance questions into the due diligence and subsequent reporting, this will also contribute to the learning process and developing standards.

The features of integrating SP into the investment partnership apply to both debt and equity investment. Though, the opportunities for engagement with investees are higher for equity investors, through longer term involvement and representation on the investee Board.

7. Challenges / outlook for MIV ratings

The challenges in MIV rating relate to:

a) The absence of information on social performance systems at investee level.
b) The lack of consistent information about end clients (and dropouts from MFIs).
c) Consolidating and tracking investee information - both social and financial - at the MIV level.
d) Adjusting indicators according to 'peer group' categories of MIVs (potential classifications are under review).

These challenges are beginning to be addressed through related initiatives in the microfinance industry and among social investors. For rating of MIVs, the M-CRIL pilot has mapped out a framework that reflects the relevant indicators for both financial and social performance. For funders in MIVs, particularly development finance institutions and pension funds, there is added value in the combination of financial and social rating. It is cost-effective to implement, achieves fuller transparency and can clarify potential trade-offs.

MIVs are now committing to disclosure on their ESG performance in line with current disclosure guidelines from CGAP (footnote 7). These are a useful step in introducing systematic reporting and building transparency. But there seems scope for these to go further, to fully support the claims that MIVs make in raising funds. MIVs can consider the relevance of rating of themselves, just as rating is relevant at MFI investee level.

Funders of MIVs, the indirect investors in microfinance, have a role to play in the questions they ask, and the information they seek and are prepared to pay for, to reflect not only financial returns but also their social values and expectations.

The Microfinance Label being promoted by LuxFlag will in future include social performance criteria to support responsible investment, beyond just confirming investment in microfinance. Rating of MIVs is an ideal tool to back up such an initiative - to define the relevant indicators, and to verify what is reported.

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[1] SPTF is the global platform to set SP standards, define SP 'good practice', and coordinate SP initiatives in microfinance: http://sptf.info/.

[2] Social Performance Standards reporting to the MIX started through a pilot process with the SPTF. In 2011, SP reporting will be integrated with organizational reporting.

[3]The Rating Initiative aims at creating a viable global market for financial and social microfinance ratings: http://www.ratinginitiative.org/.

[4] The Smart Campaign has since 2009 worked to develop industry consensus on principles of client protection in microfinance, and on how MFIs and MIV can comply with them: http://www.smartcampaign.org/.

[5] CGAP is the global platform dedicated to "advancing financial access for the world's poor": http://www.cgap.org.

[6] Workshop report by Koenraad Verhagen in European Dialogue No1, 2008. http://www.e-mfp.eu/resources/european-dialogue.

[7] CGAP MIV disclosure guidelines (9/2010) are: http://www.microfinancegateway.org/p/site/m//template.rc/1.9.47765.

[8] Overview paper in European Dialogue No3, 2010: http://www.e-mfp.eu/resources/european-dialogue. The Incofin rating report is at: http://www.incofin.be/media/Incofin-CVSO-and-RIF-Abbreviated-11-24-2010.pdf.

[9] The following four MIVs were rated:
1) Dexia Micro-Credit Fund (DMCF) of Blue Orchard www.blueorchard.com/jahia/Jahia/pid/1
2) Oikocredit International Share Foundation www.oikocredit.org/en/home
3) CVSO (Cooperative) of Incofin www.incofin
4) Rural Impulse Fund (RIF) of Incofin.