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# Codes of Conduct and the Role of Microfinance Associations in Client Protection

2012

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# Codes of Conduct and the Role of Microfinance Associations in Client Protection

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Microfinance Institutions Network (MFIN, India)

Pakistan Microfinance Network (PMN)

ProDesarrollo (Mexico)

# ACRONYMS

| | |
|---|---|
| COCEC | Code of Conduct Enforcement Committee, MFIN |
| MFI | microfinance institution |
| MFIN | Microfinance Institutions Network, India |
| MFN | Microfinance Network |
| MIX | Microfinance Information Exchange |
| NBFC | nonbank financial company |
| NBFC-MFI | nonbank financial company–microfinance institution |
| PAR | portfolio at risk |
| PMN | Pakistan Microfinance Network |
| RBI | Reserve Bank of India |
| SAMN | South Asian Microfinance Network |

# Introduction

SEEP has an extensive global network of members, representing over 135 international organizations committed to microfinance and enterprise development in over 170 countries around the world. Through its relationships and communications with members—especially the more than 60 microfinance association members—SEEP has encouraged and promoted client protection for many years. This *Technical Note* represents the next step in SEEP's ongoing commitment to this important task in the industry (box 1). SEEP strives to advance its members' state of practice with respect to client protection, both broadly and by developing and applying their own codes of conduct.

Codes of conduct are fundamentally an effort at self-regulation, whether they apply to one organization, such as a microfinance institution (MFI), or an association and its members. This *Technical Note* explores the variety of reasons why and how microfinance associations may choose to adopt and promote self-regulation through a code of ethics or code of conduct. In this Note, three case examples are presented that illustrate three different approaches to this task:

1. Adopting self-regulation as a response to crisis, the case of the MFIN Code of Conduct in India;
2. Proactively managing political risk through a voluntary Code of Conduct, the case of PMN in Pakistan; and
3. Industry building through a Code of Ethics, the case of ProDesarrollo in Mexico.

This Note attempts to build on the foundation of SEEP's previous work on consumer protection, extending the thesis that self-regulation can contribute significantly to promoting effective client protection practices. The Note adds to previous work the idea that microfinance associations are the most effective and appropriate level for this kind of self-regulation. A code of conduct administered at the microfinance association level has greater impact than codes implemented by individual MFIs. Association-level codes can have greater visibility among international and government stakeholders and also broader results, as many microfinance associations are able to unite the majority of MFIs in their national market under one code. Self-regulation through a code of conduct can also have a positive impact in terms of the reputation of the local microfinance industry, characterizing it as one guided by responsible financial principles. It also has an impact on operations, since codes of conduct specify minimum practices to which members must adhere. Other potential benefits of self-regulation include:

- A cost-effective mechanism to engage large numbers of MFIs;
- More effective management of differing cultural, legal, and economic contexts through greater flexibility than that permitted by more general global standards;
- A feasible nonregulatory alternative in environments where a government's supervisory capacity is limited;
- The inclusion of unregulated service providers that may not be subject to local laws pertaining to consumer protec-

**Box 1. History of SEEP's Work on Consumer Protection**

2001 – Created Consumer Protection Task Force.

2002 – Consumer Protection Task Force becomes a formal Working Group.

2003 – Publication. Patrick McAllister authors a report for SEEP entitled "Trust Through Transparency: Applicability of Consumer Protection Self-Regulation to Microfinance," which argues that MFIs should embrace self-regulation to protect consumer rights.

2005 – Consumer Protection Working Group creates list of pro-consumer principles, which are adopted by SEEP membership.

2007–2010 – Citi Network Strengthening Program. SEEP supports 12 networks, many of which work on topics related to consumer protection, such as transparency, financial education, and advocacy.

2010 – Tools for Microfinance Associations. SEEP creates a series of tools for association professionals, some of which directly address client protection topics, such as the *Technical Note* "Promoting Credit Bureaus."

2011 – Project on Client Protection for Associations. SEEP launches a project in partnership with the global Smart Campaign (www.smartcampaign.org) to build the capacity of microfinance association staff with respect to client protection.

tion. In many markets these entities represent a significant percentage of microfinance providers; and

- An impact on the industry that goes beyond the members the association seeks to influence.[1]

The following case studies highlight three microfinance associations facing similar challenges in promoting both self-regulation and good practices among their members, yet with different contexts and motivations for launching a code of conduct. The Note also explores the actions through which associations can promote positive outcomes from this type of self-regulation, as well as those that limit the effectiveness of such efforts.

# How and Why Microfinance Associations Implement Codes of Conduct

Member-based associations have an important role to play in promoting codes of conduct as a means of self-regulation in the microfinance industry. As collaborative structures, associations can be effective mechanisms for the collective action required for setting standards of behavior and/or updating industry norms.

At the same time, associations can provide their members support in implementing the practices necessary to adhere to a code of conduct, as well as advocate for the importance of codes among other stakeholders in the industry, making the latter actors aware of association members' efforts at self-regulation. Through this type of collaboration, associations can leverage their position as the voice of the industry in their local markets to inform policy makers, investors, regulators, competing MFIs, and even clients about the commitment of member MFIs to a code of conduct and what this implies in terms of expected behavior in the market.

SEEP has supported microfinance associations for more than a decade and its commitment to promoting their development and leadership potential will remain a focus in the future. In 2007, SEEP welcomed microfinance associations as members, and in 2010, dedicated one of its three Communities of Practice to association development. Through institutional assessment and technical assistance, SEEP has supported the maturation of its member microfinance associations and promoted their ability to act confidently as the voices of their local microfinance industries, acknowledged by their respective members and government regulators, as well as by international organizations. Many associations are ideally positioned to take the lead in creating and promoting adherence to codes of conduct, which will have more visibility, consistency, and impact in terms of self-regulation than anything an individual MFI could achieve on its own. In this way, SEEP supports association members in establishing, disseminating, and enforcing codes of conduct for their MFI members, helping them clearly delineate acceptable and unacceptable practices for microfinance institutions, and improving the health of their local markets by defining the consequences of noncompliance with these specified practices.

## 1. Self-Regulation as a Response to Crisis: The Case of MFIN in India

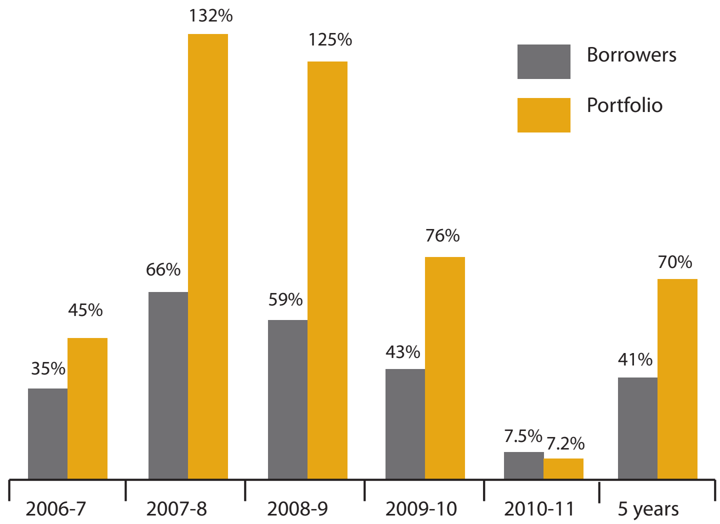
As nonbank financial companies (NBFCs) grew as a proportion of the microfinance sector in India, many of these institutions began to see the need for an industry body that could demonstrate their commitment to good practices and greater self-regulation. Microfinance Institutions Network (MFIN) in India was accordingly created in 2009 and promptly developed a code of conduct for its members, which outlined key components of responsible practice. Commitment to these practices represented an effort on the part of some NBFC MFIs to address warning signs that they observed in the national Indian microfinance sector.

1. Ben Clark, Stephanie Lazicki, and Suba Sivakumaran, 2008, "Principles for Ethical Equity Investing in MFIs," Kennedy School of Government, Harvard University, Cambridge, MA.

Much has been written about the over-indebtedness crisis in the southern Indian state of Andhra Pradesh, which came to international attention in late 2010. The crisis developed after several years of very rapid growth during which many MFIs grew at over 100 percent a year (figure 1). This rapid growth had several negative unintended consequences for clients, MFIs, and the microfinance sector as a whole in India, including:

- Geographic concentration of client loans;
- Multiple lending and over-leveraging of clients;[2]
- Loans made for consumption and other nonproductive purposes;
- Conflict and competition between MFIs and government programs;
- Challenges in human resource management among MFIs, and
- Coercive collection practices, due in part to a culture of zero tolerance for delinquency.[3]

Figure 1. Annual Growth Rates of MFIs in Andhra Pradesh




*Source*: M-CRIL, 2010, "M-CRIL Microfinance Review 2010," Gurgaon, India.

Government bodies in India then took swift and heavy-handed action to restrain the microfinance sector, making it almost impossible for many MFIs to sustain operations. The state government of Andhra Pradesh took a number of actions to address the crisis and in 2010 passed the Regulation of Money Lending Ordinance. This ordinance made it mandatory for all MFIs to register with the District Rural Development Agency. It also specified that collections could occur only at branch offices (as opposed to clients' homes or group meetings), all loans had to have monthly repayment schedules (as opposed to the industry norm of weekly repayments), and new loans would require prior government approval. These requirements all but ended the ability of MFIs to operate in Andhra Pradesh. The average Portfolio at Risk (PAR) rate for MFIs in the state went from consistently less than 5 percent prior to 2009 to just over 30 percent in 2010.[4]

The central government of India also became involved in the response to the crisis, passing a Microfinance Bill and creating a central regulator for the industry. In May and October of 2011, based on the Malegam Committee Report,[5] the Reserve Bank of India released a series of regulations specifying that:

- Interest rates be capped at 26 percent, calculated on a reducing balance basis;
- Profit margins be capped at 12 percent for all MFIs;
- Security deposits and collateral be disallowed;

2. Multiple borrowing is not always correlated with clients being over-leveraged, especially in India, where self-help groups often provide loans that are insufficient for clients' needs, leading them to take out loans from multiple sources.
3. Presentation by Alok Prasad, CEO of Microfinance Institutions Network (MFIN), November 3, 2011, at SEEP annual conference, Washington, DC.
4. M-CRIL, 2020, "M-CRIL Microfinance Review 2010," Gurgaon, India.
5. The report was released January 19, 2011, by the Central Board of Directors Sub-Committee of the Reserve Bank of India, which was tasked with studying issues related to the crisis in the microfinance sector.

- Lending limits per client be set at Rs 35,000 (about US$690[6]) in the first loan cycle and Rs 50,000 (about US$985) for all subsequent cycles;
- Annual household income for qualifying MFI clients be pegged at Rs 60,000 (about US$1,180) for rural clients and Rs 1,200,000 (about US$2,365) for non-rural clients;
- Total indebtedness of individual clients be capped at Rs 50,000 (about US$985); and
- A separate NBFC-MFI category be created for the purposes of regulation and supervision.

As can be seen from the above list, these regulations are very proscriptive and created a significant challenge for the Indian microfinance industry.

As MFIs operating in India struggled to combat the damage to both their reputations and portfolios, it became clear that significant steps would be necessary to restore the confidence of clients and regulators, among other stakeholders. This case study examines MFIN's response to the situation created by the crisis and resulting regulatory changes. As a rule, the association seeks to work closely with regulators and other key stakeholders to achieve greater financial inclusion through microfinance. Its primary objective is to work towards the robust development of the microfinance sector by promoting responsible lending, client protection, good governance, and a supportive regulatory environment. In order to achieve these objectives, MFIN concentrates its work in three main areas:

1. Self-regulation
2. Policy advocacy
3. Sectorwide developmental initiatives

The MFIN Code of Conduct was created to support the self-regulatory aspect of the association's work (box 2). In addition, MFIN has launched initiatives to support the use of credit bureaus by the microfinance sector; as of September 2011, 31 of its members had shared the details of approximately 58 million loan accounts with the two credit bureaus currently operating in India. Its recently revised Code of Conduct (box 3) requires all MFIN members to join both credit bureaus; members have also been asked to submit action plans to the association to ensure the sharing and use of credit information. Information sharing is another way in which MFIN members have demonstrated their commitment to good practice in the area of client protection.

### Box 2. MFIN Code of Conduct: Structure

All member MFIs of the Microfinance Institutions Network (MFIN) are regulated by the Reserve Bank of India. In addition, they have chosen to adhere to MFIN's more stringent Code of Conduct. The Code encompasses the following topics, outlining acceptable and unacceptable practices, as well as offering guidance on how to adhere to its tenets:

i. Integrity and Ethical Behavior

ii. Transparency

iii. Client Protection

iv. Governance

v. Recruitment

vi. Client Education

vii. Data Sharing

viii. Feedback / Grievance Redress Mechanism

6. Currency conversion based on 50.7 Rupees to $1 as of November 18, 2011.

### Box 3. MFIN and Sa-Dhan's Common Code of Conduct for Microfinance Institutions in India

In light of the rapidly changing operating environment for MFIs in India and the concerns of different stakeholders, the MFIN Code of Conduct was revised in November 2011 through a process of intense consultations with member MFIs. Furthermore, in order to bring greater consistency to microfinance practices in India, MFIN collaborated with Sa-Dhan, another microfinance association in the country, to develop a Common Code of Conduct for all MFIs in India. The Common Code of Conduct was created by harmonizing the individual codes of MFIN and Sa-Dhan. It will be applicable to all MFIs in India, regardless of their legal structure or business model.

Many of the tenets of the Common Code of Conduct represent a direct effort to address and prevent a reoccurrence of the kind of practices that led to the microfinance crisis in Andhra Pradesh. The Code creates fair practice guidelines for member institutions that cover both an MFI's responsibility toward its clients and its obligations toward its peers. The Code establishes limits on multiple lending, creates guidelines for fair collection practices, promotes transparency, and requires standardized recruitment and training practices for the staff of member MFIs. It also encourages data sharing among members and establishes mechanisms for promoting transparency in the industry, such as setting up external help lines and formulating whistle-blowing mechanisms. One particularly useful part of the Code is a set of guidelines for client protection and MFI operations. These guidelines specify a list of "dos" and "don'ts" designed to help MFIs operationalize the principles of fair practice set forth in the Code.

Monitoring and enforcement of members' compliance with the Common Code of Conduct is always a challenge. MFIN has accordingly instituted both financial and reputational consequences for its members should they be found not to be in compliance with the Code. Serious and/or repeated violations of the Code can result in the suspension or expulsion of an MFI from the association. This can have serious reputational consequences for the MFI, since investors and funders increasingly require potential investees and/or borrowers to be members in good standing of MFIN. The Common Code jointly promoted by MFIN and Sa-Dhan is also supported by the Lenders' Forum; therefore, any violation of the Code would be noticed by these groups and negatively impact bankers' and funders' perceptions of an institution. In addition, a financial penalty can be levied against a member found to be in violation of the Code, but only after the Code of Conduct Enforcement Committee (COCEC) conducts a thorough investigation. The size of the penalty is determined by the COCEC and depends on the nature of the violation.

### Box 4. MFIN Code of Conduct: Enforcement

The network uses several important mechanisms to enforce its Code of Conduct:

- A five-member Code of Conduct Enforcement Committee (COCEC).
- Stringent guidelines and strict timelines established by the COCEC regarding Code violations, reporting, and inquiry procedures.
- Whistle-blowing and peer-reporting mechanisms that monitor MFI adherence to the Code.
- Reputational and financial penalties for Code violations by MFIN members.

MFIN's strategy to address the crisis in the Indian national microfinance sector developed organically based on the needs of its members and through careful observation and analysis of the local market. Interestingly, some of MFIN's actions mirrored the recommendations made in a recent CGAP paper on the origins and outcomes of crises in several microfinance markets. (See, for example, the association's compliance mechanisms in box 4.) In early 2010, CGAP studied markets in four countries that had recently had problems with client over-indebtedness and client movements against repayment. These markets included those in Nicaragua, Morocco, Bosnia and Herzegovina, and Pakistan. In each of these countries, the microfinance repayment crisis occurred after a period of intense growth in the sector. The global economic recession was not found to be a primary cause of these repayment crises, though it was among the factors that affected the repayment capacity of borrowers. Investigation into the causes of these crises revealed that three primary vulnerabilities existed within the national microfinance industry in each country including:

- concentrated market competition by MFIs and multiple borrowing by clients;
- overstretched MFI systems and controls due to rapid growth; and
- erosion of MFI lending discipline.[7]

Each of these vulnerabilities is an area that can be addressed through the type of self-regulation often contained in

7. Greg Chen, Stephen Rasmussen, and Xavier Reille, 2010, "Growth and Vulnerabilities in Microfinance," CGAP Focus Note 61 (February). CGAP, Washington, DC.

a code of conduct. Microfinance associations can assist their members to combat the development of these types of market weaknesses by committing to and enforcing good lending practices and healthy competition. Based on its study of these troubled markets, the paper recommended the following steps to reduce the chances of similar crises in the future:[8]

- Promote balanced growth objectives among MFIs.
- Improve the quality of client services and develop long-term client relationships.
- Promote the use or development of credit bureaus.

The work of MFIN addresses all three of these recommendations. All of MFIN's member institutions are also regulated by the Reserve Bank of India (RBI); this regulatory status is, in fact, a pre-requisite for membership in the association. This requirement implies that each member must already adhere to the laws and guidance issued by the RBI and has, in addition, chosen to affiliate itself with MFIN to demonstrate its commitment to excellent practice in the areas of client protection, prevention of over-indebtedness, sharing of client information, recruitment of staff, and handling of client complaints. MFIN is currently working to devise a scorecard to evaluate member compliance with its standards in these areas.

## 2. Proactively Managing Political Risk through a voluntary Code: The Case of PMN in Pakistan

As early as 2006, the Pakistan Microfinance Network (PMN) was aware of certain warning signs within the local microfinance market that did not bode well for the health of the MFIs or the sector, especially in its most competitive area—the city of Lahore. PMN consequently conducted a study to document the extent of multiple borrowing and competition among the 12 MFIs operating in Lahore at that time, identifying that the co-location of branches by competing MFIs resulted in certain segments of the market being over-served, leaving many other segments without access to financial services.[9]

By 2008, the co-location strategy had resulted in rising delinquency rates. Many MFIs that had had an average PAR rate of around 2 percent in 2008 saw it rise to an average of 13 percent in 2009.[10] This increase in the PAR rate was followed shortly thereafter by a borrowers' revolt, which affected several districts. In 2009, PMN again conducted research to identify the main causes of the revolt and found that the strategy of clustering MFI branches around competitors' branches was the primary culprit. Although the tactic was designed to reduce operational costs, it instead resulted in a high level of parallel borrowing by clients, which was increasingly tolerated by the MFIs. Additionally, an informal but very entrenched system of commission agents had taken hold of the client recruitment process, leading to weaker customer relationships on the part of MFIs at a time when their internal controls were weak.[11] Taking into account all of these circumstances, PMN determined that the informational asymmetries between clients and MFIs, as well as increasing competition among MFIs, had resulted in client over-indebtedness, increased credit risk for MFIs, increased transaction costs for borrowers, and weakened lender-borrower relationships (due to the existence of informal intermediaries).[12]

8. Greg Chen et al. 2010, "Growth and Vulnerabilities in Microfinance," CGAP Focus Note 61.
9. Burki Hussan-Bano and Mehr Shah, 2007, "Dynamics of Microfinance Expansion in Lahore," Pakistan Microfinance Network, Islamabad, Pakistan.
10. Greg Chen et al. 2010, "Growth and Vulnerabilities in Microfinance," CGAP Focus Note 61.
11. Burki Hussan-Bano, 2009, "Unraveling the Delinquency Crisis in Punjab," Pakistan Microfinance Network, Islamabad, Pakistan.
12. Presentation by Mohsin Ahmed, November 3, 2011, SEEP annual conference.

To address these difficulties, PMN decided that industrywide action was necessary. It identified three important areas for the association's intervention:

1. Information sharing (through a credit and staff bureau),
2. Mapping of competitive areas (currently in development), and
3. Coordinated consumer protection strategies, which include:
   a. creating codes of conduct,
   b. implementing these codes (i.e., on conduct, ethics, lending), and
   c. designing a nationwide grievance redress system.

PMN has made responsible finance an important part of its work because the microfinance market in Pakistan is characterized by a low level of financial literacy and weak legislation, especially regarding nonbank financial institutions. As a result, PMN pursues a multifaceted strategy that aims to improve the health of the sector by undertaking such initiatives as launching credit and staff bureaus; promoting social performance reporting and capacity enhancement; pursuing a Code of Conduct for association members (box 5), promoting member compliance (box 6); creating additional codes to guide MFI operations (box 7); and working to build an industrywide system for the redress of client grievances.

### Box 5. PMN Voluntary Code of Conduct: Structure

All of PMN's various types of members are signatories to its Voluntary Code of Conduct, which includes the following core values:

- Transparency
- Fair practice
- Dignified treatment
- Privacy and fair disclosure
- Governance
- Client satisfaction

### Box 6. PMN Voluntary Code of Conduct: Statement of Agreement

By signing this code, we, the members of PMN commit to:

1. Adhere to both the letter and spirit of the values and practices outlined in this code.

2. Apply this code -
   a. no matter the legal structure of the MFI
   b. to all types of microfinance activities.

3. Promote and strengthen the national microfinance movement by providing low-income clients access to mainstream financial services.

4. Conduct our activities by means of fair competition and not seek competitive advantage through illegal or unethical practices.

5. Display this code prominently in our premises, make copies of it freely and readily available to stakeholders, and put measures in place to ensure compliance.

Box 8 below summarizes PMN's experience with developing and implementing its Code of Conduct. Naturally, the primary beneficiaries of the Code's implementation are microfinance clients. Nevertheless, PMN foresees such benefits for its members' as customer loyalty and retention, due to improved trust and confidence; well-informed clients able to act as better financial managers; more client information available to MFIs to aid them in management decisions; and healthy competition leading to a stronger microfinance sector.[13]

### Box 7. Main Points of the PMN Lending Code

- Maximum of 3 PMN members may lend to one borrower
- Individual client debt capacity may not to exceed 40 percent of net income
- No loans will be made available to defaulters
- Loan process requires use of credit bureau and verification check with the national ID database
- Maximum of 3 concurrent loans per household

As part of its multifaceted approach to advancing client protection, PMN is pursuing several initiatives related to its Code of Conduct. These initiatives include facilitating the establishment of a nationwide mechanism for receiving and resolving client complaints. PMN has been discussing possible options for the structure of this mechanism with both the microfinance apex funder and the government regulator in Pakistan. Another initiative involved the launch of a pilot credit bureau in 2010 in the districts

13. Presentation by Mohsin Ahmed, November 3, 2011, SEEP annual conference.

with the highest penetration of microfinance services. In parallel with this pilot testing, PMN members sought to send a standardized message to the market in order to make the credit bureau initiative effective. In response to this wish, PMN developed a "lending code" (box 7), which was debated and finalized by PMN's membership and is currently being promoted as best practice.

### Box 8. Managing Political Risk through a Voluntary Code of Conduct: The Case of PMN

PMN decided to create a Code of Conduct for its members in 2009. Since the global Smart Campaign had been launched less than a year before, PMN solicited support from the Campaign on the best principles and indicators for evaluating MFI practices in client protection. PMN then took this information and adapted it to its local market, structuring it to best meet members' needs. The final Code centers on a set of six core values. PMN then incorporated adherence to the Code into the association's membership criteria. To properly implement the Code, PMN established additional processes to promote its application and acceptance, including dissemination, monitoring, and standardization.

***Dissemination*** to its members is a key component of PMN's strategy for its Code of Conduct. The association has taken the following steps to ensure its widespread visibility:

- In 2009, PMN published the Code in regional languages and disseminated posters to members for display in branch offices. The following year association staff visited a subset of those branches to follow up on the implementation of the poster campaign.
- PMN has advocated for the Code with other industry stakeholders, such as the Pakistan Poverty Alleviation Fund, the microfinance industry apex fund, which has now incorporated core values from the PMN Code into contracts with its partners.
- PMN developed, and in 2012 plans to launch, a two- to three-year communications campaign that uses both MFIs and the mass media to target microfinance clients nationwide with public service messages about microfinance clients' rights, responsibilities, and obligations.

***Monitoring*** of PMN members' compliance with the association's Code of Conduct has also followed a multifaceted approach:

- Late in 2009, PMN designed a self-monitoring tool for members to evaluate client protection. This tool was piloted during 2010 by five MFIs and launched more broadly in early 2011. The internal audit departments of MFIs are the key target, as well as external audit firms that serve these MFIs.
- In 2012, PMN plans to conduct client protection assessments using this diagnostic tool to help members pinpoint areas for improvement, as well as to provide data for a planned baseline survey for a "state of the sector" report on client protection in Pakistan.
- PMN will continue to advocate the monitoring of client protection practices by external auditors, with the aim of having local technical assistance providers provide such services to MFIs.

***Standardization*** is an important topic for the local microfinance industry, and PMN has adopted a staggered approach to its promotion—addressing credit pricing first, with plans to follow up with similar guidelines for savings and insurance.

- In early 2011, a standard repayment schedule was developed (based on a template of MF Transparency), adapted to the local context, and disseminated to all PMN members. The association is now in the process of advocating more widespread adoption of this tool.
- In 2012, PMN hopes to engage a third-party pricing research firm, such as MF Transparency, to conduct a pricing disclosure initiative in Pakistan.

PMN's Code of Conduct is broad reaching—the Letter of Agreement signed by association members specifies that each member will abide by both the letter and the spirit of the Code. By putting compliance with the spirit of the Code in the hands of MFIs, PMN's members are empowered to resolve situations and establish practices in accordance with their changing needs, based on their understanding of the intent embodied in the core values of the Code. This approach has led to gaps in the level of implementation among members, as some have adopted the Code simply by signing it, while others are taking steps to uphold its core values and monitor client protection within their operations. Nevertheless, the arrangement allows each member MFI to implement its own optimal level of client protection, based on its capacity and mission, permitting a flexibility that would not be possible under formal sector regulation.

In August 2010, PMN launched a "staff bureau," a system similar to a credit bureau, which makes any negative information related to MFI staff available to other PMN members once an instance of fraud by a staff person has been confirmed. The bureau functions as follows: when an MFI experiences fraud, identifies the staff member(s) responsible, and terminates their employment, it can submit an entry about the event to the staff bureau database, using a secure login. Only one staff person at each member MFI has access to the database—this person is the focal point for the staff bureau project at that MFI. Once an entry is posted to the database, PMN staff validate the information by contacting the point person for the staff bureau at the affected MFI, as well as representatives from human resources and/or operations departments, as appropriate. The CEO of the given MFI is also contacted to verify the incident. Once the details of the case have been validated and proof made available that implicates the staff person, PMN accepts the database entry and it becomes visible to other association members. To date, PMN has received about 40 entries, of which 28 have been validated and posted in the staff bureau. Upon launching the staff bureau, PMN members felt the need to create a Code of Ethics for their respective staffs. In 2011, this Code of Ethics was developed, debated, and finalized by members; it is now promoted as a best practice for PMN members.

## 3. Industry Building by Promoting Members' Impact and Sustainability: The Case of ProDesarrollo in Mexico

ProDesarollo, the largest microfinance association in Mexico, began to investigate the idea of a code of ethics in 2004. The association was responding to both a growing need for such a code within the local industry and to the misbehavior of some local players. It wanted to embrace a set of principles that would govern its member MFIs and differentiate them from their competitors. In order to inform the development of its code, ProDesarrollo reviewed existing antecedents at the time, such as the Statement of Principles developed that by the Microfinance Network (MFN) and adopted by ACCION International in 2004. ProDesarrollo also organized a separate transparency project because Mexico is a difficult market in terms of transparency and the association recognized the need for collective action if any progress was to be made. By 2006, the association had reached consensus among its members on a code of ethics that would protect clients and encourage fair competition among member MFIs. In 2007, the network designed the procedures and defined the terms of the ProDesarrollo Code of Ethics (box 9) and determined the required level of compliance each of its members would need to achieve on an annual basis. This code serves as a strong foundation for the self-regulation of MFI members (for a full description of the association's work on the Code, see box 10). Its objectives include:

- Facilitating trust and sustainability;
- Providing a guide to enhance transparency and impact; and
- Promoting ethical conduct.

**Box 9. The ProDesarrollo Code of Ethics: Structure**

- Objectives
- Scope
- Principles
- Values
- Commitments to:
  - Other member MFIs
  - Clients
  - MFI staff
  - Representatives of the government and the association
  - Donors
  - Civil society
- Procedures for Resolving Issues
- Glossary of Terms

At the time, the association realized that increasing competition in the market was leading to disputes among its own members. Therefore, the first commitment of the Code is to other members of ProDesarrollo. It also contains procedures for resolving conflicts among member MFIs, which are designed to prevent bad practices and promote members' commitment to the terms of the Code of Ethics. These commitments include:

- Promoting an industry that is professional and competitive;
- Facilitating the development of clients in terms of their economic and social well-being; and

• Providing adequate financial services to communities with scarce resources.

In order to promote adoption of the Code and facilitate its transition from a document to a living entity, the association pursued a systematic dissemination and uptake process, shown in figure 2.

Figure 2. ProDesarrollo's Process for Developing its Code of Ethics


**Box 10. ProDesarrollo: Industry Building through a Code of Ethics**

**1. Signing the Code of Ethics**

Each member of ProDesarollo must sign a Letter of Agreement with its Code of Ethics. Additionally, each MFI must have its own institutional Code of Ethics or Code of Conduct. An MFI may adopt ProDesarrollo's Code as its own, but in this case, the institution must demonstrate that it is making a concerted effort to promote and disseminate the Code to its staff and clients.

**2. Transparency**

Mexico has strong regulatory guidelines related to transparency and a government body, the National Commission on Banking, dedicated to its oversight. Each of ProDesarrollo's members must present audited financial statements and a fact sheet summarizing its interest rates and financial performance to the association. These financial performance data are used to create indicators for ProDesarrollo's annual benchmarking report. There are several levels of adherence to this standard:

***Good*** – To receive this designation, an MFI must present audited financial statements signed by a representative of the MFI and submit a fact sheet in accordance with the terms laid out by the National Commission.

***Satisfactory*** – To receive this designation, an MFI must present financial statements and submit its fact sheet. This means reporting its financial data in a manner that may not be exactly in accordance with the terms required by the National Commission, but which is complete enough to permit analysis.

***Unsatisfactory*** – MFIs that receive this designation have presented financial statements and submitted a fact sheet that reports their financial data, but the data is presented in a manner that is not in accordance with the terms required by the National Commission and does not permit analysis.

**3. Reporting to a Credit Bureau**

All of ProDesarrollo's members must report their clients' credit information to one of the existing credit bureaus in Mexico.

The policy manual that describes the structure of ProDesarrollo's Code of Ethics also presents guidelines for adherence to the Code and steps for resolving infractions. These procedures include monitoring and enforcement by the association, as well as the leveling of sanctions against members found not to be in compliance. The Code is organized into several chapters, the first of which describes the structure of the Code itself and its oversight body, an Honor Committee. This committee is composed of members of the board, who are elected on merit, and has the task of reviewing and resolving any complaints or infractions brought to its attention by ProDesarrollo members. The Code goes on to spell out the process for evaluating the conduct of members, as well as the procedures for making a complaint.

The second chapter of the Code covers enforcement and member certification (figure 3). Certification is a two-step process, with an initial step that occurs when a member joins the association and an annual renewal process for all existing members. Additionally, there is an advanced level of certification that is voluntary. This voluntary certification commits an MFI to additional requirements with respect to human resources, transparency, and client protection. Those institutions that choose to commit themselves to a more stringent level of ethical conduct than that required of all ProDesarrollo members may take additional steps to become certified at the advanced level. The third level of certification is designed to align with the client protection evaluation process of the Smart Campaign. The certification chapter also includes descriptions of the processes used to make inquires about compliance with the Code, report violations, and submit claims against members.

Figure 3. The ProDesarrollo Code of Ethics: Certification

| | |
|---|---|
| Level 1 | **Signing the Code of Ethics**<br>Requires an MFI to have its own individual Code and to promote it diligently, as well as to endorse the network's Code |
| Level 2 | **Letter of Agreement**<br>Signing this letter demonstrates an MFI's commitment to upholding both the letter and spirit of the tenets of the Code |
| Level 3 | **Voluntary Advanced Level**<br>Covers personnel management, transparency, and client protection in a more stringent way than the Code alone |

ProDesarrollo began the promotion of its Code by launching a year-long training program to teach members about the importance of its Code of Ethics and the procedures for their certification. After a member is a certified adherent to the ProDesarrollo Code, it may choose to enhance its transparency through reporting to the Microfinance Information Exchange (MIX). Each year the MIX produces a report on the state of the microfinance sector in Mexico, based on member data collected by ProDesarrollo. The MIX benchmarking report presents members' compliance with the Code, as well as their financial performance. In this way, the association's Code of Ethics allows ProDesarrollo to ensure certain standards of conduct among its members and to distinguish itself and its members in the eyes of the industry and the government with respect to ethics, transparency, and reporting.

# Future Efforts

## 1. Challenges for Self-Regulation

There are definitely challenges associated with the application of self-regulatory systems such as codes of conduct. One of the main challenges of such a system is monitoring members' compliance and enforcing standards. Self-regulation offers a flexible and pragmatic approach that can be tailored to member needs, one that will likely lead institutions to meet client needs more effectively than a government-based enforcement program. The primary disadvantages of such a system include a lack of incentives for discontinuing bad practices among institutions expelled from a voluntary association and the possibility that a significant subset of industry players will fall outside of an association's sphere of influence and continue to use practices that tarnish the reputation of the industry as a whole.[14] These possible difficulties in enforcement make it crucial that any microfinance association hoping to launch an effective voluntary code have a strong reputation and representative membership. This status gives it the authority to encourage good practices by members and influence nonmembers to modify their practices to more closely resemble those of member MFIs that subscribe to the association's Code.

14. CGAP, 2005, "Protecting Microfinance Borrowers," Focus Note 27 (May). CGAP, Washington, DC.

Similarly, a more recent review of the literature on self-regulation listed the primary challenge for such systems as the lack of incentives for their application in the absence of a credible threat of formal regulation.[15] Additionally, conflicts of interest may arise when those who are charged with promoting and enforcing a code are also running businesses that must be bound by it, that is, businesses that may be negatively impacted financially or otherwise by their compliance. Other challenges include lack of visibility of a code, if it is not sufficiently promoted or disseminated among the intended beneficiaries. There is also the downside that, in general, codes of conduct offer only a minimum standard of good practice, rather than a standard of excellence. One danger of offering a minimum standard is the risk that institutions which might otherwise excel in this area lose their incentive to exceed minimum practices and revert to meeting only required standards.

Other potential challenges for associations that implement systems of self-regulation include monitoring members' behavior and adherence to code norms. The monitoring process can be expensive, which may limit an association's ability to oversee members' compliance with desired standards. For this reason, some associations employ a reactive system based on complaints, rather than a proactive monitoring system aimed at discovering noncompliance. Reliance on complaints is problematic for several reasons. If, for example, member MFIs are supposed to monitor the behavior of their peers, an implicit practice may develop whereby no member points out fellow members' transgressions in order to avoid discovery of its own transgressions. Also, if a monitoring system relies on client complaints, it implies a high degree of education and empowerment of the client base, both of which are needed to generate a significant and representative level of complaints on noncompliance. Ultimately, the type of monitoring, complaints handling, and compliance procedures that work best must be decided on by each association, based on its political and national context and the characteristics of its members and their clients. Finally, all systems of self-regulation function better if government regulators are sufficiently interested in the sector to create a credible threat of formal regulation should self-regulation prove ineffective.

Clearly not all the general disadvantages of self-regulation apply to the codes of conduct highlighted in this *Technical Note*. A well-established association with a strong reputation that is not directly engaged in the business of running MFIs can credibly promote and oversee compliance with such a code. And in the case of many microfinance markets, there exists a very real threat of formal government regulations, which would almost surely be more prescriptive and less attuned to the needs of the market and its clients than a code developed by a microfinance association. As seen in ProDesarrollo's voluntary advanced level of certification, a code may in some cases offer both a standard of excellence and a minimum standard, if that choice is of interest to its members. Certainly it is difficult to effectively execute a system of self-regulation; however, mature microfinance associations in politically risky markets are well positioned to make a significant contribution to the health of local microfinance industries through the creation, promotion, and monitoring of a credible code of conduct for their members.

## 2. Next Steps for Associations

With respect to effective implementation of codes of conduct, microfinance associations may pursue many different activities to overcome the difficulties described above and implement a system of self-regulation for their members. For a number associations, including SEEP, these activities could include:

- Assessing the best means to ensure adherence to global consumer protection principles and standards, while ensuring adaptability to local contexts;
- Extending research on self-regulation and codes of conduct to examine the practices of other successful associations;

15. Clark, Lazicki, and Sivakumaran, 2008, "Principles for Ethical Equity Investing in MFIs."

- Monitoring the implementation of a code over time to assess its impact on MFI practices;
- Sharing knowledge on effective designs for and practices of self-regulation; and
- Studying the relationship between systems of self-regulation and governmental systems of regulation.

Adherence to global principles of good client protection offers a good first step for associations interested in doing more in this area. However, this adherence must then be followed by concrete actions that establish a system of self-regulation, perhaps through a code of conduct (box 11), as well as procedures that ensure the diligent monitoring and enforcement of members' commitment to the global standards set forth in the code. For the three associations highlighted in this Note, the way forward includes activities that attempt to address the associations' commitment to good consumer protection holistically—not exclusively through a code of conduct (table 1).

### Table 1. Next Steps for Case Study Associations

| Association | Next Steps |
|---|---|
| **MFIN** | • Respond to tighter prudential regulations (e.g., reorient the association's business model to align with the emerging regulatory framework)<br>• Institute stronger self-regulation, that is, work with regulators and/or other stakeholders to ensure a generally favorable regulatory environment<br>• Emphasize greater customer focus and commitment to responsible lending by member MFIs<br>• Focus on perception management<br>• Certify field staff on client protection<br>• Expand participation in credit bureaus |
| **PMN** | • Implement national rollout of the credit bureau piloted in May 2010<br>• Pilot test national client complaint handling mechanism<br>• Support members in doing more extensive social performance reporting<br>• Deliver client education<br>• Map competitive markets (i.e., plot delivery infrastructure against other indicators) |
| **ProDesarrollo** | • Continue publishing benchmarking data on local microfinance providers<br>• Elaborate terms of advanced certification with greater specificity<br>• Increase promotion, education, and training related to the association's Code of Ethics<br>• Continue working with the Human Resources Working Group on the Code of Ethics and certification issues<br>• Create an integrated certification process for MFIs that includes transparency, client protection, risk management, and corporate governance |

## Box 11. Steps for Creating an Association Code of Conduct

The following steps detail how the Smart Campaign, a global microfinance client protection initiative, recommends that networks and/or associations establish a Code of Conduct:

1. **Form a Committee on the Code** - This group should be comprised of members from the board of directors, legal department, human resources department, and other areas to provide diverse representation and an integrated understanding of an institution's ethics and/or values. It is recommended that the number of people in the group be odd in order to avoid ties when making decisions and facilitate periodic renewal of its members.

2. **Establish the Powers of the Committee** - Once the group is formed, it is important to determine the extent of its authority. The group will develop the association's Code of Ethics or Code of Conduct and can have a longer-term role as an enforcement body or panel for consultation or resolution of cases when the Code has been violated.

3. **Provide Notice to Employees and Members** – While the document is in the development and approval process, notify employees of progress and invite them to participate. Work with the human resources, communications, or other applicable departments to develop a communication strategy to update and solicit feedback from employees.

4. **Draft the Code** – The objectives of the document are to establish ethical principles and norms of behavior to govern the internal and/or external relations of all members of the institution, regardless of their powers or responsibilities.

5. **Provide a Mechanism for Revision of the Code** – The very basic form of a Code of Conduct should focus on the mission, organizational values, and vision of the institution. As organizations are constantly evolving and reacting to various factors, it is recommended that the Code be reviewed periodically to ensure that it is keeping up with the current institutional environment.

6. **Review the Draft Code** – Upon timely completion of the document, it should be distributed to employees of the organization—from the executive and managerial level to staff and members—for discussion and feedback, as they are an integral part of upholding and maintaining the integrity of the Code.

7. **Approve the Final Code** – The Committee or Commission should review all comments and suggestions made and take them into consideration during their revisions and the finalization of the Code.

8. **Disseminate the Code of Conduct** – There should be a formal presentation of the Code to employees, members, and strategic partners. The main objective is to have employees and members agree to what is outlined in the Code and promise to uphold the standards by signing a copy of the document. Afterwards the Code should be made publically available to both internal and external stakeholders.

9. **Identify Ambassadors of the Code** – For the Code to be meaningful, managers and guardians of the Code in their respective work teams should become its ambassadors among staff and members, using simple strategies to keep the Code alive. Also, it is important to establish processes for monitoring and enforcement of the Code.

10. **Train New Employees and Members on the Code –** People who join the network should receive a printed copy of the Code when signing an employment contract. This is a good opportunity for human resources staff to answer questions about the Code and the conduct expected of new staff joining the institution. This is also the time to offer new and old employees the possibility of signing a formal commitment to the contents of the Code.

*Source:* Adapted from Alexandra Annes da Silva, n.d., "How to Develop an Institutional Code of Ethics," Smart Campaign, Washington, DC, http://www.smartcampaign.org/tools-a-resources/84 (accessed November 18, 2011).

## About the South Asian Microfinance Network

The South Asian Microfinance Network is a regional microfinance network established in 2008. Its vision is to improve financial inclusion among low-income populations in the countries of South Asia. SAMN achieves this objective by improving the knowledge, business environment, and capital of the microfinance industry in the region. Today, SAMN membership consists of the leading national microfinance networks in six countries of the region, representing over 1,000 microfinance providers and industry players that serve more than 60 million low-income clients.

## About the Micro Finance Institutions Network, India

Micro Finance Institutions Network was established in October 2009. It is the newest industry association for the microfinance sector in India; at present, its member organizations consist of 47 leading NBFC-MFIs in the country, the combined business of which constitutes over 80 percent of the Indian microfinance sector. MFIN seeks to work closely with regulators and other key stakeholders in the industry to achieve larger financial inclusion through microfinance.

## About the Pakistan Microfinance Network

Beginning as an informal association in 1997, the Pakistan Microfinance Network (PMN) was formally established in 2001 with the goal of improving the outreach and sustainability of microfinance in Pakistan. The 27 current members (including microfinance banks and nonbank MFIs) of the network were serving 2.03 million active borrowers as of June 2011.

## About ProDesarrollo, Finanzas y Microempresa, A.C., Mexico

ProDesarrollo, Finanzas y Microempresa is a national network of institutions providing financial services that contribute to economic development and poverty alleviation in Mexico. Members provide credit, savings, financial counseling, and training to the poor as part of their effort to support the sustainable development of Mexico's low-income communities. Currently, the network has 94 members from both the private and nonprofit sectors, which together provide financial services through more than 1,500 branches, reaching over 5.5 million people, 82 percent of whom are women.

## About Sa-Dhan

Sa-Dhan, The Association of Community Development Finance Institutions, is a microfinance association established in 1999 with the mission to "build the field of community development finance in India to help its member and associate institutions to better serve low-income households, particularly women, in both rural and urban India, in their quest for establishing stable livelihoods and improving quality of life." Sa-Dhan currently has 251 members and plays a crucial role in increasing capacities, affecting the evolution and adoption of best practices, increasing the number of service providers and contributing to improving the policy and operational context for Microfinance in India.

# About The SEEP Network

The SEEP Network (www.seepnetwork.org), founded in 1985 and headquartered in Washington, DC, is an association of 120 international organizations that support micro and small enterprise development programs in 171 countries around the world. SEEP works towards a vision of sustainable income in every household by connecting microenterprise practitioners in a global learning community. SEEP plays a unique role by connecting these practitioners so that they may access, co-create, and exchange the tools and experience needed to strengthen their respective organizations and programs, and, ultimately, their impact.

SEEP
*Powering connections*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