

# **Motivating your Board of Directors to Actively Promote and Deepen the Social Mission**

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# Motivating your BoD to actively promote and deepen the social mission

## **Introduction**

During the last decade, the microfinance industry has experienced impressive growth rates and its attention has mainly been oriented towards financial performance and growth, commercialization and the increased flow of private resources to the sector. Nevertheless, key components of microfinance include poverty alleviation and financial inclusion, combined with a notion of economic development and social responsibility. Microfinance institutions' missions, therefore, must focus on their social and development functions, but at the same time, these institutions must play by the rules of the traditional commercial financial institutions. This creates an intrinsic tension within the sector since financial sustainability does not necessarily imply accounting for social performance. Although it is widely accepted that financial sustainability is a necessary condition for the success of the microfinance industry, this aspect alone is not sufficient to accomplish the social missions stated by the MFIs.

This is the main challenge that the governing bodies of microfinance institutions face in their day-to-day work: maintaining a balance between enhancing the financial profitability of the institutions and fulfilling a clear and unambiguous social mission, which includes the application of responsible finance practices.

Recent studies in the microfinance arena identify missions drifts of MFIs away from their socially responsible ambition and highlight that their boards of directors might lack motivation to commit to this key promise (Copestake, 2007). These tendencies to digress from the stated social mission, coupled with irresponsible institutional behavior, besides representing a governance failure, pose a systemic threat to the microfinance sector as a whole.

The recent crises of the microfinance sector in some countries have underlined the need to integrate social performance measurement and management as a key parameter to both

maintain the reputation and ensure the success of the sector. The primary issue, therefore, is how the MFIs can “create systems so that the management and the governing bodies can react properly to the diverse and evolving threats of mission drifts, and, more generally, to social under-performance” (Torres from the Social Performance Management/SPM Network’s discussion forum).

In this context, this workshop paper written for the Microcredit Summit Campaign explores some topics that have the potential to motivate the MFIs’ BoD to promote and deepen the social mission of their organizations.

This paper starts by discussing the important implications of mission drifts and the reputational risk for the microfinance industry and later considers the extent to which the promotion of social performance can help in mitigating these risks. The second section focuses on the role of governance in microfinance institutions and its incentives to focus on social performance and social mission promotion. This portion of the paper also introduces the concept of “social governance” and concentrates on the BoD’s responsibility to achieve an appropriate balance when handling social and financial concerns. The third section focuses on why it is important to “put social into governance” and illustrates the current practices and weaknesses in social governance. The fourth section explores the potential financial advantages of promoting and deepening the social mission of microfinance institutions, based on research results from MicroFinanza Rating’s social-financial information database and an extract from a study conducted by CERISE. Section five concludes.

## **1. Mission drifts and the reputation crisis: What are the implications for microfinance institutions?**

**The commercialization of the microfinance sector, coupled with the enhanced role played by private equity, may encourage prioritizing profitability and disregarding the social mission.**

While it is generally accepted that private capital is required to mainstream the microfinance sector, injections of considerable amounts of capital in MFIs “can create strong incentives for continued levels of high growth and profitability to drive higher valuations” (CGAP, page 2). The commercialization of microfinance can foster irresponsible lending practices and unjustified remuneration for shareholders and top management, if the **governing structure is not strongly committed to its social mission** and systems<sup>1</sup> are not strong enough to support rapid growth.

Indeed, when social commitment and effective control systems are weak, the pressure to meet ambitious growth targets and match the high, often unfair, competition, carries with it the risk of poor lending practices. These irresponsible actions ultimately lead to client over-indebtedness<sup>2</sup>, unacceptable collection practices, and exorbitant interest rates charged for clients, as compared to management compensation and returns on equity.

**The high expectations regarding poverty reduction and financial inclusion expose the microfinance sector to constant public scrutiny.** This public examination implies a **reputation risk** that can be defined as “the current and prospective impact on earnings and capital arising from negative public opinion” (Comptroller’s Handbook, 1998). The social mandate of microfinance implies that the reputational and mission drift risks are closely related. Straying from the stated mission entails a reputational risk to the extent that the expectations regarding poverty alleviation and financial inclusion are not met. The image of the sector may not only be affected by abusive client practices, but also by irresponsible practices towards the staff. The reputational risk should then be interpreted

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<sup>1</sup> Internal control, credit policies, human resources (training, incentive systems, etc).

<sup>2</sup> Without proper incentive systems, loan officers can be encouraged to relax the credit discipline, increase the loan size without adequately assessing clients’ repayment capacity.

in a broad way, accounting for the potential prioritization of financial profitability over the upholding of ethical standards and social objectives. The recent crisis in India both shows the extent to which irresponsible practices of some MFIs can damage the overall reputation of the sector and demonstrates that a few specific cases may be generalized by the media and therefore affect the credibility of the entire industry. The damages produced by a reputation crisis are significant and may have a contagious effect. The multiple crises in mature markets such as those in Bolivia (1999), Nicaragua, Pakistan, Morocco, Bosnia Herzegovina (2008 and 2009)<sup>3</sup> and India (2010), provide clear evidence of **the high relevance of this risk**. Indeed, the 2011 Microfinance Banana Skins highlights reputation as the second biggest risk of the industry, as “the good name of microfinance is increasingly under attack”.

As the sharp drop in SKS<sup>4</sup> shares value<sup>5</sup> shows, a **reputation crisis can translate into a worsening of financial performance**, through the degradation of portfolio quality and client drop-out. This crisis also creates the risk of political interference, hindering the sound functioning of the microfinance sector and can ultimately lead to a reduced access to funds. Indeed, in the case of a reputation crisis, both the commercial and the social investors may reorient their support from microfinance to other sectors, particularly those with a lower risk profile.

With the recent cases of violation of client protection principles, particularly those related to over-indebtedness, staff behavior, and collection practices, there has been a greater deal of criticism surrounding the subject of lending practices. This public critique, along with a sense of doubt regarding clients’ actual social benefits and the considerable profits generated by recent IPOs, have all led to a **call for more effective mechanisms of guidance, support and accountability** for the **governing body** of a given MFI.

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<sup>3</sup> These countries have been, in fact, characterized by such high growth rates that markets became extremely competitive and aggressive, with a consequent increase in the over-indebtedness of clients. They are some important examples of what just described that culminated in national crises.

<sup>4</sup> SKS Microfinance is one of the biggest MFI in India.

<sup>5</sup> 985 Rps at the moment of the IPO (8/2010), and 559 Rps as of 21/12/2010, i.e. about 43% drop.

## 2. The role of governance

### **Promoting the social mission of the institution falls within the mandate of the BoD.**

Governance can be defined as “the process by which a Board of Directors (BoD), balancing the interests of all the stakeholders and working through management, guides an institution in **fulfilling its corporate mission and protecting the institution’s assets preventing and overcoming crisis**”<sup>6</sup> (Vita, 2009). This definition underscores the importance of effective and responsible governance in the decision making process to account for the expectations of a larger group<sup>7</sup>. However, the BoD remains the key player in the governance process.

A BoD of a MFI has then a **dual mandate** a) to guide the institution in fulfilling its corporate mission and b) to protect the institution’s assets over time (Campion, Frankiewicz 1999).

As indicated by the aforementioned definition, **the first reason why the BoD should promote the social mission stems from its mandate to fulfill the corporate mission.**

The ultimate responsibility lies indeed with the BoD as it is entrusted, by the stakeholders, with the achievement of the social mission in a sustainable way. More specifically, the precise duties of the BoD include guiding the MFI towards reaching a target client group and subsequently meeting their needs and contributing to a positive change in their lives.

**The dual mandate** of the governing body also calls for the **protection of institutional assets**. This function implies that the BoD is also responsible for both preventing and managing institutional risks. Risk Management has mostly focused on more traditional financial and operational risks while other risks become relevant in the current microfinance context, such as those related to reputation, mission drifts, and poor client and staff treatment.

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<sup>6</sup> This definition taken from a recent publication by PROMIFIN (2009), combines the main elements of different definitions given in two previous publications by Rock, Otero and Saltzman (1998) and by CERISE/IRAM/IFAD (2006).

<sup>7</sup> Some stakeholders are rarely represented in the BoD and mainly consist in the clients, the staff, the communities and other external supporters.

**The governing body's responsibility to manage the reputational risk of the MFI serves, then, as a strong incentive for the BoD to promote its social mission and consequently calls for an enhanced governing role in improving social performance.**

The tools for putting the social mission into practice, such as effective systems for social performance management (SPM) and client protection programs, are powerful in minimizing the probability of losses that are typically caused by damages to the institutional image. Therefore, **promoting the social mission** can be considered an **effective strategy for keeping the aforementioned risks under control.**

**The BoD of a given MFI should thus provide the top management with effective guidance, taking into consideration the social and financial strategies.**

The Board's commitment to the double and triple bottom line, indicate good practices of governance. With a clear set of shared objectives, a balanced background and a constant flow of both social and financial information, all members should ideally be able to account for social, environmental and financial considerations when taking strategic decisions.

In the long term the social and financial objectives are likely to converge as (financial) sustainability relies heavily on the MFI's achievement of its social mission while its reputation depends on its commitment to responsible practices, efficiency and accountability.

### **Social governance: a shared responsibility**

Owners, institutional and private investors, and donors each have their own particular social expectations. MFI managers are increasingly required to account for the achievement of their stated mission, however enhancing social performance is not only the responsibility of MFIs, but also of its investors and fund managers. Responsible investors and fund managers need to further integrate social considerations into their decision making process in order to send a clear message to the market about their commitment towards social performance issues and to differentiate from the exclusively profit-seeking players. As members of the governing body, the socially responsible

investors should seek for a controlled and balanced growth, providing guidance to avoid the risk of mission drifts, client over-indebtedness and unacceptable collection practices. Thinking and acting socially should be a characteristic of any effective governing body. For the sake of this article, **social governance** refers to governing bodies thinking and acting socially and with the capacity of making effective decisions to guide the institution towards the sustainable achievement of its social mission. The ability to govern in such a manner, however, requires that the top management possess a strong commitment to societal well-being, a solid set of social performance professional skills, and effective monitoring and reporting systems. As all these factors are mutually reinforcing, they generate an honorable social governance structure. While the social commitment largely depends on the personal background and motivations of the owners, investors and BoD members, the social performance management skills can be built through specific training and exposure to the best practices.

Successful social governance starts with a clear and shared mission. It provides clear guidance by balancing social and financial performance in the overall strategy, as well as setting specific objectives in line with the mission. A well-balanced strategy would include fair compensation of the management, reasonable returns to the owners and promoters, and fair distribution of the efficiency gains to the clients as well. The clients' benefit should be one of the top priorities in particular during intensive expansion phases and also when systems are overstretched and the existence of well-functioning protection systems is all the more important. Transition phases, like IPOs (Initial Public Offering), also bring about an inherent risk of losing sight of the ultimate social goal and consequently permitting the owners' financial interests to prevail.

The effectiveness of social governance can be measured by monitoring mechanisms that supervise the progress towards the achievement of the stated social objectives. Ideally, the CEO incentive scheme and evaluation system should include specific social criteria. The monitoring system and the risk management framework should clearly identify possible gaps between the mission and the actual results so that both the possibility of reputational damage and the risk of mission drift can effectively be reduced and managed.

A transparent distribution of power within the BoD, coupled with an effective organizational system, complete with manuals and committees, is a necessary prerequisite for effective social governance. In this sense, the existence of a Social Performance Management (SPM) committee within a BoD can contribute to achieve social performance objectives.

### 3. Relevance of Social Governance and State of the Art.

**Social governance and BoD buy-in are crucial in encouraging MFIs to put in place effective systems to manage and monitor social performance and client protection policies.**

MicroFinanza Rating’s experiences support the importance of the role of governance, and it is well illustrated by the following case study.

Case study: MFI from South-East Asia	
Good social governance	Good SPM and client protection systems
<ul style="list-style-type: none"> <li>• Genuine BoD commitment to the mission and client protection</li> <li>• The BoD Social Performance (SP) committee evaluates the results concerning outreach, client satisfaction and over-indebtedness reported in bi-annual reports of client surveys conducted by the research department</li> <li>• The BoD has a high level of awareness with respect to the risk of decreasing the depth of outreach caused by product diversification (urban and larger loans); this awareness prompts BoD to require</li> </ul>	<ul style="list-style-type: none"> <li>• The social performance monitoring system (target reached, quality of services and change in clients' lives) is very good. The system’s reliability is constantly monitored by the SP committee.</li> <li>• The products’ design allows to reach the intended target clients</li> <li>• The internal audit department verifies cross-indebtedness, collection practices and knowledge of product conditions during client visits.</li> <li>• The strategy is based on expansion to the un-served rural villages and</li> </ul>

<p>management to disaggregate, by product, their monitoring of poverty incidence.</p> <ul style="list-style-type: none"> <li>• The BoD provides the management with clear social objectives and targets regarding reaching the poor, adapting the products to their needs (e.g. developing micro-saving), and primarily targeting existing clients with larger, individual loans.</li> <li>• The CEO is accountable for achieving the social objectives; his incentive scheme consists of both wide social outreach (depth of target reached) and fair financial returns.</li> <li>• Because new potential shareholders are made aware of their binding legal commitment to the mission in their shareholder agreement, the risk of mission drift is significantly reduced.</li> </ul>	<p>on the delivery of micro-saving services through the mobile money technology.</p> <ul style="list-style-type: none"> <li>• The business plan projections include indicators regarding poverty incidence, client satisfaction, drop-out rates and saving accounts.</li> <li>• There are adequate mechanisms to collect and address clients' complaints, along with a follow-up system in place to ensure the resolution of conflicts.</li> <li>• Clients are charged fairly with respect to loan size, the extent of rural area coverage and return rates.</li> </ul>
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In particular, Social Ratings<sup>8</sup> detects a positive correlation between effective social governance and the institution's alignment to the mission, with particular regard to the functioning capacity of the information system, human resources management and the product design.<sup>9</sup> The case studies below encourage the involvement of the BoD in

<sup>8</sup> Database of 85 Social Ratings conducted by MicroFinanza Rating from 2007 to 2010. The governance effectiveness assessment is based on the compliance to the international best practices and the capacity to balance social and financial guidance and supervision.

<sup>9</sup> The system's alignment to the mission refers to the adequacy of the MIS, product design, human resource management and internal control to translate the mission into practice and protect the clients. Having aligned systems in place increases the likelihood to accomplish the social goals thanks to the use of relevant

promoting the social mission as they illustrate that successful SPM systems are more likely to be in place in MFIs with effective social governance.

**Positive correlation between the effectiveness of social governance and social performance monitoring system:**

*Effective social governance requires the MIS to produce a complete set of information, including the indicators necessary to verify the achievement of the social objectives. This availability of information, in turn, reinforces the effectiveness of social governance.*

**Case Study from Central Asia**

The company is owned by a local association and an international network strongly committed towards social performance. The directors adhere to and uphold the social values of the company that had been set by the funders. The BoD members form a well-balanced team in terms of social and financial expertise, combining representatives of a local women’s business association with other international microfinance practitioners. The board members play a proactive role in both guiding the company and supervising its regular activities. From time to time, members also embark on field visits both to clients and branch staff. Despite the considerable expansion over the last ten years, the Board has managed to enforce several tool and practices to guide and control the social orientation of the company at all levels. Only those shareholders, who share the same social goals and values and agree with a clear exit strategy, will be considered for membership during periods of company growth.

Effective decision making at the governance level relies on a good social performance monitoring system and reporting, particularly one that accounts for social progress in addition to financial data.

The Management Information System (MIS) includes relevant information on the clients<sup>10</sup> and their businesses and this information is then used to monitor both the clients’ profiles and the extent of outreach to the intended target population. Data concerning the business sector, loan purpose, rural coverage, and gender and poverty outreach is frequently checked to ensure

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social information in decision making, the design of products to protect and meet the needs of the clients, the commitment of the management and staff to the mission, as well as the verification of the compliance to the client protection policies.

<sup>10</sup> I.e. gender, civil status, education level, number of children, number of dependants and number of household members and clients business: i.e. sector of business activity, number of employees, jobs created, etc..

that certain targets are met. Job creation indicators are used to track the progress of clients' businesses while an ongoing survey measures the living standards of target clients. Additionally, the collaboration of a dedicated program with International Labour Organization (ILO), has allowed for increased female empowerment within the community. The clients' needs are assessed in both a formal and informal manner, including drop-out monitoring and exit interviews to assess reasons for drop-out. Data regarding household income and assets, as well as job creation, is incorporated into the MIS to monitor the progress towards the goal of increasing economic welfare.

Reporting flow to the BoD is systematic and managers are actively involved in the meetings when strategic guidelines need to be implemented or when achievements have to be crosschecked. Strategic meetings are held bi-annually to discuss company positioning, business opportunities, and future goals, and approximately 15 to 30% of key managers and board members are in attendance at such gatherings. These meetings also prove very useful in reinforcing the corporate values, sharing different experiences, and developing new practices.

Board members also actively concentrate on improving consumer protection practices. The endorsement of consumer protection principles (CPP) and the personnel's obligation to adhere to such protection policies are monitored by numerous activities, including mystery shopping<sup>11</sup>, hot line and annual staff evaluations. Outcomes of such evaluations are shared with the remainder of the organization to encourage better personnel performance and keep the BoD updated.

Profit sharing and ESOP (employees share ownership plan) are being considered as they have been deemed effective tools in staff promoting staff retention and in ensuring adherence to the company's values and goals.

**Positive correlation between the effectiveness of governance and alignment of the product design with the mission:**

*A Board of Directors, which actively manages the risk of mission drift, ensures not only that the products offered to the clients do not present barriers to access, but also that outreach extends to the most vulnerable segment of the population .*

**Case study: MFI from South Asia**

The BoD demonstrates a very strong commitment to the mission due to the personal

<sup>11</sup> Mystery shopping or a mystery consumer is a tool used to measure quality of service or compliance to regulation, or to gather specific information about products and services.

background of its members, who bring with them development and human resource management experience. The composition of the BoD reflects a participatory approach as the clients represent the main stakeholders. Half of the directors are Self Help Group's (SHG) elected leaders. The clients' representatives on the board ensure consistency between the clients' needs and product development. The direct client feedback, collected during SHG's meetings and brought to the BoD by client representatives, has served as a key driving force in BoD product development decisions, such as the introduction of micro-insurance, micro-pension and housing loans.

The SHG systems and procedures to deliver their services are in line with the mission, facilitating outreach to the poor and deprived communities. Poor clients can easily join, thanks to both minimum guarantee requirements and to the simple application process. Illiterate members are strongly supported by specialised loan officers who are experienced in working with clients that cannot read and write. The SHG approach largely facilitates the empowerment of poor communities, in line with its mission.

**Positive correlation between the effectiveness of governance and alignment of human resources management with the mission**

*MFIs with a solid social governing structure, that remain strongly committed to incorporating their mission into daily practices and incentives, are more likely to include social criteria in their staff management analysis.*

**Case study: MFI from Latin America**

In addition to financial sustainability, the social mission is strongly supported by the BoD, which can count on a strong social, academic, research, and legal background. The BoD has set the clear objective to expand outreach to the most vulnerable segments of the target population, namely, women and low-income farmers. Such decisions have been made based on the evolution of the client segmentation by gender and by value of fixed assets owned as reported annually to the BoD. These reports indicate a decrease in the share of the more vulnerable segments of the overall population. With the guidance of the BoD, the management was successfully able to design a set of products targeting women and low-income farmers called *development portfolio*.

The good communication between the management and the BoD ensures both an adequate

information flow to the BoD for social performance assessment and decision making, as well as a correct interpretation of BoD recommendations by the management.

BoD's guidelines have been incorporated into the human resource management systems for the effective translation of social strategy into the daily activities of the staff.

The BoD and top management systematic monitoring of the MFI's growth path, loan officers' turn-over and client drop-out rate has resulted in the inclusion of the adherence to institutional values and the staff attitude towards clients in the staff performance appraisal.

The BoD identified the slow growth of the *development portfolio* in the first period thanks to the reporting on the planned and achieved portfolio by product. This constituted the starting point for deciding to better align the incentive system for loan officers and branch managers to "social" achievements. This system takes into account parameters such as the client retention rate and the loans belonging to the set of products specifically designed for women and lower income farmers.

**The cases presented above illustrate the relevance of BoD buy-in for the successful implementation of SPM systems.**

The results obtained from the case studies above are promising and suggest that governing bodies which account for social performance (effective social governance) are those effectively able to put SPM systems into practice. There is however still limited evidence of a clear relation between the SPM systems in place and the achievement of an MFI's social mission. MicroFinanza Rating provides an initial analysis of such a relation. The Social Rating database shows a positive correlation between the adequacy of the social performance management systems and the social performance results relating to outreach and the quality of services provided. Such a correlation indicates that a SPM system serves as a powerful tool in the achievement of the stated mission. The BoD should promote the social mission by strengthening SPM systems as they allow for the achievement of the mission and thus, the fulfillment of the BoD mandate.

**A BoD that encourages investment in systems to manage MFI social performance will increase its likelihood of achieving its mission of providing a target client base with good quality services.** The case below illustrates the positive correlation between

the implementation of SPM systems and the subsequent social impact in terms of outreach and quality of the services.

**SPM systems adequacy and favorable results with respect to outreach and quality of the services**

*An MFI with effective SPM systems in place will be more likely to achieve good social performance results.*

*Solid social governance, coupled with the implementation of SPM systems, will facilitate the MFI in achieving its social mission and thus, producing favorable results with respect to social performance.*

**Case study: MFI in Eastern Europe**

The strong social commitment of the BoD and management has contributed to maintaining a strategy with a good social and financial balance throughout the years. The compatibility of the product design with the social mission, the internal control and human resource management systems are accompanied by a very positive performance in terms of outreach and quality of the services. A sound SPM system is an effective tool to mitigate the reputation risk, generating positive results in line with the social expectations of the stakeholders.

The wide breadth of outreach, and the client concentration in rural areas, where living standards tend to be more precarious, indicates progress towards the goals of the mission.

The quality of the services provided represents one of the organization's main strengths, as it offers a wide range of products tailored to client needs, a short disbursement period and excellent customer service.

**Weaknesses in governance**

Although the governing structure must play a key and active role in assuring the sustainable achievement of the social mission and institutional risk management, many MFIs still lack this sense of involvement from their directors. The 2011 Microfinance Banana Skins highlights the inefficiency of corporate governance in providing guidance to the MFI; particularly during periods of crisis and in managing conflicts. Some of the most serious problems in MFIs are largely due to bad decision making and controls, which are the result of weak corporate governance.

According to MicroFinanza Rating, effective governance is commonly hampered by the director's weak knowledge and experience, poor information systems, conflicts of interest, and the lack of both risk tolerance limits and policies to manage crises.

The effectiveness of the strategy to fulfill the social mission is often hindered by minimal SPM knowledge among the directors, the complete absence of a SPM committee, the lack of specific social objectives, and poor monitoring systems. Moreover, when broad social goals are established, they are seldom translated into specific objectives and concrete plans of actions and thus, rarely facilitate the decision making process. In some cases, the capacity to manage the risk of mission drift is also hampered by the BoD's excessive fixation on profit generation and strategic decisions are mainly driven by financial concerns

#### **4. Financial advantages of promoting the social mission: social and financial performance synergies**

This section explores the potential synergies between social and financial performance. In particular, it focuses on the relation between social performance management and social responsibility on one side, and profitability and sustainability on the other side. **The financial advantage of putting in place reasonable social performance management systems and investing in appropriate social responsibility serves as yet another pragmatic motivation for the BoD to promote the social mission.**

On the one hand, the compatibility between social and financial performance is visible through client protection policies, customer satisfaction, and strengthened systems. On the other hand, many players in the microfinance sector largely take into consideration that social performance entails immediate costs, even if it is necessary for long term sustainability. With an analysis conducted of the validated financial and social information in MicroFinanza Rating's database<sup>12</sup>, the authors try to contribute to the open

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<sup>12</sup> See annex 1 for a description of the dataset .

debate regarding the following issue: **Is there a trade-off or a mutually beneficial relationship between social and financial performance?**

The results of a recent analysis conducted by MicroFinanza Rating<sup>13</sup> indicate that social and financial performance remain highly compatible, provided that a balanced strategy is followed to adequately manage the trade-offs between the two. For example, there is a clear correlation between portfolio quality and the establishment of a good SPM system, particularly, a good MIS system to track and monitor clients profile and progress towards social objectives. Social Responsibility towards staff encourages enhanced staff productivity and reduces staff turn-over and the drop-out ratio. This potentially indicates that providing the staff with adequate working conditions and development support enhances their efficiency levels and fosters loyalty.

Moreover, the overall social rating score is closely associated with several dependent variables and above all, with the PAR 30 (Portfolio at risk more than 30 days) and FSS (Financial self-sustainability). This means that social performance, in general terms, is strongly linked to financial profitability and the two exist in a mutually reinforcing relationship. When social performance is accounted for, the portfolio risks are lower, while the level of sustainability is higher.

An increasing number of studies in recent years have tried to address the same question (what relation between social and financial performance?) from different angles. A recent study by CERISE (Bédécarrats, Baur and Lapenu, 2011) also confirms the importance of social performance in the enhancement of financial performance (see box at page 20).

Further investigations of MicroFinanza Rating's database have been conducted by the University of Andrews. In order to investigate the interaction between social and financial performance, Hoepner, Liu and Wilson from the University of St. Andrews and University of Glasgow conducted a multivariate regression analysis of MicroFinanza Rating's data<sup>14</sup>. The method used is the pooled regression a la Cull et al. (2007), that can also highlight nonlinear relationships between social and financial performance. The

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<sup>13</sup> The multivariate linear regression models analyze the financial performance indicators as dependent variables. The independent variables include social performance scores obtained in various areas of social ratings, social indicators at MFI and client level, as well as controls (MFI institutional characteristics, operation model and key financial indicators).

<sup>14</sup> Work in progress to be published by the end of 2011: Do microfinance institutions (MFIs) pay for social responsibility? Evidence from social ratings of MFIs, 2011

analysis focused on both social performance management and responsibility on one side, and on sustainability and profitability indicators – ROE (Return of Equity) and FSS, on the other side.

As the social rating a relatively recent tool, the sample of MFIs is too small to be representative of the entire microfinance sector, and the conclusions are not to be generalized. Moreover, while it is possible to infer the causality between social to financial performance, such a relation cannot be statistically proven due to the contemporaneity of the social and financial measures.

Linear models are very interesting; however, they may not always produce significant results. The results seem indeed to suggest that a significant nonlinear relationship exists between an MFI's social performance management and social responsibility on one side, and the FSS and ROE on the other side. The marginal gain or loss in financial performance may reduce and even switch from gain to loss (or vice versa) depending on the level of social performance already achieved. The rest of this section focuses on the significant relationships between social and financial performance, as described by the nonlinear model.

The relationship between the **social mission, governance and strategy** (SPM1)<sup>15</sup> on the one hand, and the financial performance, on the other hand, is described by an inverse parabolic function (inverse “U-shaped”), resulting from a positive and significant coefficient of the linear term and negative and significant coefficient of the quadratic term (see graph 1).

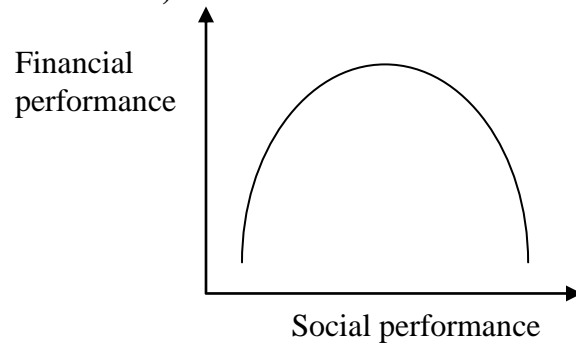
This result seems to suggest that there is a trade-off between social and financial performance only after a certain level of social performance. While there is a positive relationship between social and financial performance when the level of social performance is low, after a certain level, social performance will grow only to the detriment of financial performance. Therefore, the cost and benefit of increasing the

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<sup>15</sup>Our social rating methodology includes three sub-dimension for the area of Social Performance Management system: a) SPM1, called *Social mission, Governance and Strategy* mainly refers to the clarity of the stated social mission and objectives, the effectiveness of social governance and the compatibility of the strategy with the social mission. B) SPM2, so called *MIS and Social Performance Monitoring System*, mainly refers to the quality of the social information and the social reporting system. C) SPM3 refers to the compatibility of the operational systems (HR, Internal Control, etc) to the social mission.

social performance should be carefully analyzed, and striking a good balance between the social and the financial expectations and results is in the MFI's best interest.

**Graph 1: Inverse parabolic relation between social (SPM1) and financial performance (ROE and FSS)**



The **social responsibility (SR) towards staff** shows a similar inverse U-shaped relationship with the ROE, due to positive and significant coefficient of linear terms and the negative and significant quadratic terms. Up to a certain level (adequate), an improvement in SR towards staff is reflected in a better. However, the additional costs of staff remuneration and development for high and very high levels of social responsibility towards the staff, translate in lower financial profitability. The inverse U-shaped relationship suggests that once the staff satisfaction has reached an adequate level, the financial costs of improving the social responsibility towards the staff would be higher than the financial gains. In other words, marginal improvements in labor conditions, which are already standing at a good level, do not have a significant short term effect on staff commitment, productivity and staff retention so as to make the financial gains outweigh the financial costs. However, improving the staff conditions up to “decent” levels is reflected in improved financial performance. MicroFinanza Rating had already found synergies with other financial performance indicators (see above) confirming the relevance of this social responsibility aspect for enhanced financial performance.

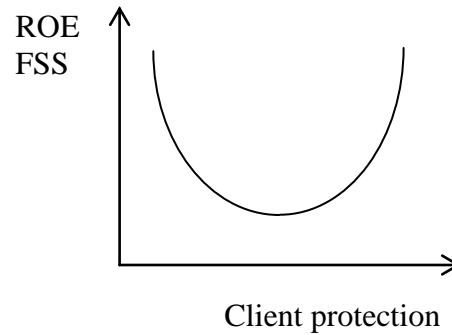
The analysis of **client protection** is interesting, as the regressions show significant negative signs on the linear terms and significant positive signs on the quadratic terms, both for ROE and for FSS<sup>16</sup>. This indicates a parabolic (“U-shaped”) relationship

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<sup>16</sup> It is important to note that the parabolic (U-shape) relationships are stronger than the inverse parabolic relations: in particular, the client protection is related to both the ROE the FSS with very high significance.

between financial sustainability and profitability, on one side, and client protection on the other side (see graph 2).

**Graph 2: Parabolic relation between client protection and financial performance (ROE and FSS)**



Improving the client protection, from a weak to an adequate level, results in lower financial gains, but upgrading the client protection from an adequate to good and very good goes along with higher ROE and FSS. Building client protection systems from scratch can be costly, but the MFI's efforts to implement client protection will pay off once the MFI has reached the client protection "minimum critical mass" necessary to build the clients' loyalty and the trust of the government and investors. The composite nature of the client protection and financial performance relationship is in line with CERISE results (Bédécarrats, Baur and Lapenu, 2011), where avoiding over-indebtedness reduces productivity, while reasonable interest rates increase the portfolio quality. The social - financial interaction is not linear -- The marginal loss in financial performance, associated with an increase in the social performance, reduces for higher levels of social performance, and even converts from loss to gains, once a certain level of social performance is achieved. Investing in client protection is in the MFI's best interest not only because the reputation risk needs to be managed, but also because the financial benefits of client protection are very likely to outweigh its costs once adequate practices are achieved.

The box below reports on some of the results related to client protection emerging from a recent study of CERISE<sup>17</sup> on its dataset of social and financial information coming from social audits.

**Client protection can be expensive, but related aspect strengthen financial performance**

By Bédécarrats, Baur, Lapenu, CERISE

Motivating board member to engage with social performance and client protection can be challenging if they only see it as a cost. Nevertheless, new econometric results help build the case of further emphasizing social mission in the operational strategy. A recent study by CERISE run with multivariate linear regression on a database of 344 social audits (SPI tool) from 295 MFIs revealed significant positive relationships between aspects of social and financial performance of MFIs<sup>1</sup>. We develop the findings related to consumer protection, as it often represents a necessary first step towards social performance. In line with the study implemented by MicroFinanza Rating, CERISE research reveals that Social Responsibility to clients, measured through a compound index weighting the implementation of the Client Protection Principles, generally implies higher costs, at least on the short run. Nevertheless, on related aspects, we find evidence of synergies with economic sustainability.

Client participation supports not only productivity, measured as borrowers per staff, but also MFIs' profitability, measured by ROA. The study further finds statistical significance for reasonable interest rates. An effective interest rate below cost of funds plus 30% goes along with higher productivity, better portfolio quality (i.e. PAR30 and write-off ratio), and consequently lower operating costs. Retaining clients, too, is found to improve MFIs' financial sustainability due to a reducing effect on write-offs and operating expenses. CERISE also finds in its dataset significant synergies between an MFI's efficiency and its SR to the community and the environment.

With growing competition and reputation risk in the sector, social responsibility (SR) becomes crucial for MFIs in order to be accepted in the community, to avoid interference by national governments and in order to guarantee external funding.

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<sup>17</sup> Refer to Bédécarrats, Baur, Lapenu: *Combining social and financial performance: a paradox? 2011*

The relationship between the **social responsibility towards the community and environment** and the ROE also shows significant negative signs on the linear terms and significant positive signs on the quadratic terms, forming a U shape. Starting to introduce socially and environmentally friendly practices, can improve the social responsibility of the MFI from a poor to an adequate level, but it is also quite expensive due to the fixed costs of putting in place new systems. However, once an MFI has reached an adequate level of social responsibility towards the community and the environment (53% score), the additional cost of improving the social performance in this area is lower than the financial benefit produced by the better image of the MFI. In this manner, the financial gains produced by a positive reputation, would then overcome the additional expenses.

## **Conclusion**

Promoting social performance is part of a variety of tasks for the BoD of an MFI for three primary reasons:

1. It stems from its mandate of fulfilling the corporate mission. The ultimate responsibility lies indeed within the Board of Directors (BoD) because it is entrusted, by the stakeholders, with the responsibility of achieving the social mission in a sustainable way. Guiding the MFI towards reaching the target clients and their needs, along with contributing to a positive change in their lives, is precisely the responsibility of the BoD.
2. It is an important component of the risk management of an MFI. The mandate of the BoD includes both the prevention and management of institutional risks. These risks are related to both the financial and social performance of an institution and include reputational risks, risk of mission drift, along with those relating to client and staff abuse.
3. It affects the financial performance. There is a significant relationship between social and financial performance. MFIs must understand and manage their social performance as it has a significant impact on their financial performance.

Despite the key role of the governance for the sustainable achievement of the social mission and institutional risk management, the current state-of-the-art microfinance governing body often does not follow the best practices.

The synergies found between the social and the financial performance show that, if wisely directed, the progress in SPM and social responsibility can also enhance financial performance. Making good use of social performance to obtain financial gains involves analyzing the global costs and benefits of each social performance improvement. In some cases an adequate or good level of social performance, would maximize the financial returns. This is the true for the following social performance dimensions: social mission, governance and strategy, the social performance monitoring system and the social responsibility towards the staff. In other cases, functioning at an average social performance level may be not ideal as the synergy with financial performance would appear only after a “critical mass” of social performance investment is achieved. A higher level of social performance may be necessary to build the trust of external stakeholders; however, once a solid relationship with the clients, the community and the investors is established, the improved social performance will also produce financial benefits.

The trade-offs between the social and the financial performance should not lead MFIs with a double bottom line to systematically neglect social performance. Rather, these aforementioned trade-offs should be managed. When upgrading the social performance in a particular area up to a specific level involves a trade-off, the financial cost and the social benefit should be carefully assessed case by case. In each phase of the organizational development, the resources should be strategically allocated in order to maintain a good balance between the sustainability and the achievement of the mission, which are the backbones of the BoD mandate.

For the reasons highlighted above, it appears evident that the BoD plays a key role in the promotion of social performance in the MFIs. Social governance, however, is a shared responsibility. Owners, institutional and private investors, and donors have all their own

social expectations. Responsible investors and fund managers need to further integrate social considerations into their decision making in order to give a clear message to the market about their positioning and to differentiate themselves from the exclusively profit-seeking players. The socially responsible investors involved in the governance should strive for a “controlled and balanced growth,” providing guidance to avoid the risk of mission drifts, client over-indebtedness and unacceptable collection practices.

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## Annex 1: Sample characteristics

The empirical analysis is based on a database generated by MicroFinanza Rating through the social rating missions conducted between 2007 and 2011. The database includes 87 MFIs with both financial and social variables; for 57 MFIs clients surveys have been conducted (comprehensive social rating). The 87 MFIs are spread in 35 countries worldwide. They are quite mature, with on average 17 years of experience, the oldest was set up in 1959, while the youngest in 2007. The legal forms adopted by these MFIs are quietly heterogeneous and the most common lending methodology combined individual and solidarity group lending. The majority of MFIs in the sample have a broad target market. More detail are provided in the graphs below.

