Pakistan Microfinance Network

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MicroNOTE

CLIENT PROTECTION: THE STATE OF PRACTICE

A look at client protection practices in Pakistan's microfinance industry

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INTRODUCTION

Due to its developmental origin, it is in the nature of microfinance that clients be placed at the heart of it. Given the reputational risks faced of late, it is pertinent to ensure that the industry – practitioners and investors alike – stay true to the clients they serve. Without doing so, it exposes itself to significant reputational and political risk that can have serious consequences for the industry's growth and viability. For this reason, wider industry stakeholders have been promising long term sustainability to microfinance practitioners (MFPs) who place clients at the center of their work and subscribe to attaining the minimum standards of client protection, as defined by the global microfinance industry.

Indeed, protecting clients is the bare minimum that MFPs ought to do while aiming to reach their social or business objectives. In this respect, tenets of client protection serve as the lowest common denominator for benchmarking practices, as these apply to all microfinance practitioners – irrespective of social mission (which can be quite variable from one institution to the next, ranging from bringing the most marginalized populations out of poverty to simply providing access to formal finance).

Over the past few years, momentum has been building for such a global movement – to place clients at the heart of microfinance. The need for this has been brought home a number of times with delinquency crises seen in many microfinance markets across the world, from Nicaragua to India, including delinquency pockets witnessed in parts of Pakistan during 2008. Research conducted that year found that informational asymmetries between clients and MFPs as well as increasing competition among MFPs had resulted in client over-indebtedness, increased credit risk for the institutions, increased transaction cost for the borrower, and weakening of lender-borrower relationships.[1] This pointed to an imminent need to refocus the sector back onto the client. To this end, an industry-level Code of Conduct for Consumer Protection was developed by Pakistan Microfinance Network (PMN), the national association of MFPs in the country. This was voluntarily signed on to by all association members in January 2009, and subsequently signed onto by all new MFPs that have attained membership with the association, with a total of

[1] Hussan-Bano Burki (2009) *Unraveling the delinquency problem in Punjab (2008-2009)*. Pakistan Microfinance Network.

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BOX 1: MFP's commitment statement to the Code of Conduct for Client Protection

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 MFP.
   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 for stakeholders, and put measures in place to ensure compliance.

It includes the following Core Values that all signatory MFPs have committed to abide by:

1. **Transparency**
   The dissemination of transparent and truthful information to clients is at the heart of microfinance services. Clients deserve to be provided with complete, accurate and understandable information regarding the products offered to them.

2. **Fair Practice**
   In order to fulfill their core objectives, we believe that microfinance services should be completely devoid of unethical, illegal and/or unfair practices. It is our duty to provide these services to our clients in a manner that is legal, ethical, nondiscriminatory and free of deception.

3. **Dignified Treatment**
   We are cognizant of the need to be fair, disciplined and respectful in the provision of our services. We realize the necessity of preserving our clients' dignity at all times as well as being respectful of cultural and gender differences.

4. **Privacy and Fair Disclosure**
   We realize that, given the nature of our business, it is our responsibility to safeguard client information provided to us and maintain client privacy and uphold fair disclosure.

5. **Governance**
   We realize that in order to provide our clients with services that are fair transparent and efficient we must act in accordance with the highest standards of governance and management.

6. **Client Satisfaction**
   We feel that in order for microfinance services to capitalize on their full potential, formal channels of communication should be in place for clients to provide their feedback and for us to track client satisfaction.

44 signatory MFPs to date. Such a Code sends a strong message to not just MFPs, but policymakers, clients, and non-member MFPs that responsible finance is a priority for institutions throughout the country. **BOX 1** gives the main stipulations of this Code.

Since its adoption, this Code has been supplemented by a range of client protection initiatives at the sector level to ensure that a commitment to client protection is etched into the DNA of its operations. **BOX 2** gives some of the main sector-wide initiatives led by sector stakeholders. One of these has been the carrying out of independent third party client protection assessments of MFPs in Pakistan. As of mid 2014, 14 such assessments have taken place, with the purpose of offering practitioners a client-focused lens with which to view their institutions and to adequately fill any gaps highlighted. Ten of these assessments were conducted within a space of several months during 2013, with generous funding support from State Bank of Pakistan (SBP) through the UK-Aid's Department for International Development (DFID) sponsored Financial Inclusion Program (FIP). These provide us with a unique opportunity to document the overall state of practice in client protection in the seven key areas of client protection. The following sections give an overview of the methodology of this review; highlight the summary findings on the state of practice in client protection; provide detailed analyses on by client protection area; and offer recommendations, primarily for MFPs, to improve client protection in the sector, respectively.

BOX 2: Sector-wide initiatives by sector stakeholders State Bank of Pakistan (SBP), Pakistan Poverty Alleviation Fund (PPAF) and Pakistan Microfinance Network (PMN)

As the banking sector regulator, SBP oversees all microfinance banks under the ambit of Microfinance Ordinance 2001 and the Prudential Regulations for Microfinance Banks. Although a banking ombudsman does exist for providing independent dispute resolution for financial sector clients, awareness about the ombudsman is limited especially within the target communities of microfinance. The SBP is thus a key player in strengthening client protection practices, especially in the context of MFBs. In June 2014, SBP revised the Prudential Regulations (PRs) for MFBs, amending the existing regulatory framework to address current and upcoming trends in the microfinance market.* MFBs are required to implement the revised stipulations within a six month time frame from revisions issuance.

The revised regulations cover risk management, corporate governance, money laundering, and operations. Before the revision, two PRs dealt particularly with issues of consumer protection, PRs 15 and 30.** The revised regulations cover additional issues in client protection under PR 0-4, and provide detailed provisions regarding financial literacy, transparency and disclosures, complaint redressal mechanisms and appropriate debt collection practices. These are in line with globally accepted best practices, especially in area of *transparency and adequate disclosure*. Under this regulation, MFBs are now required to develop a mandatory basic financial literacy program covering areas of interest rate calculation, types of fees, and explanation of loan terms. MFBs must disclose principal, interest and fees separately on repayment schedules, and draw up terms and conditions in English and Urdu (or relevant regional language) to ensure client understanding. They are required to institutionalize a formal client complaint redressal cell, with stipulations on procedures of complaint logging, assessment, resolution and generate quarterly reports on complaints for top management to identify and evaluate any recurring problems. Finally, MFBs must develop and implement a code of debt collection practices, prohibiting disrespectful treatment of clients and allowing only lawful and professional business language and conduct in customer interactions. These revised regulations are a clear indication of SBP's commitment to client protection and promoting responsible microfinance practices in the industry.

Recently, SBP has further intensified its focus on this area and has supported several initiatives within the sector that promote responsible finance and client protection. For example, through its Financial Inclusion Program (FIP) funded by UK-Aid's Department for International Development (DFID), it has supported: (i) setting up of a microfinance credit information bureau in 2012, (ii) enabling external client protection assessments i.e. Smart Assessments for MFPs since 2013, and (iii) a transparent pricing initiative for publication of standardized product pricing across all MFPs regardless of legal status in 2013. The SBP also has a National Financial Literacy Program in place since 2012, rollout for which is in the pipeline.

PPAF is another important player in Pakistan's microfinance landscape by virtue of being the apex wholesale lender to MFPs across Pakistan. The PPAF has also played a key role in developing the market and strengthening institutions in the sector. PPAF has incorporated tenets of client protection into the loan agreements with their partner MFPs. It carries out frequent monitoring and evaluation of their partners, and reviewing basic elements of client protection practice are part of such evaluations. In 2013, the PPAF also co-funded the transparent pricing initiative for publication of standardized product prices across MFPs. The PPAF has also been proactive in encouraging partners to seek certification on social transparency and impact via Truelift, which certifies pro-poor initiatives that have demonstrated poverty reduction. It has also organized in country trainings in other areas of social performance for its partners.

PMN is the national association of microfinance practitioners in Pakistan, with 44 member MFPs as of mid-2014. The PMN has a voluntary code of conduct for consumer protection in place since early 2009, to which all members are signatories. A range of client protection initiatives are in place. These include being the implementing partner for the setting up of a microfinance credit information bureau, enabling external client protection assessments for member MFPs, and carrying out the transparent pricing initiative for the microfinance sector in Pakistan. In addition, the PMN also carried out a print-based campaign in 2012 employing the branch networks of members MFPs to educate clients on their rights and responsibilities as microfinance clients. In future, the PMN aims to expand this campaign to employ a range of media; carry out advocacy for setting up of an independent grievance redressal body for microfinance clients; and to continue supporting its member MFPs in strengthening client protection measures at their institutions.

* Detailed information on the revised Prudential Regulations for MFBs is available at: http://www.sbp.org.pk/acd/2014/C3-Annex.pdf

** Regulation 15 covers pricing of microfinance products and services, under which MFBs are advised to implement appropriate pricing policies, which ensure access to affordable financial services by the poor.

Regulation 30 covers disclosure of lending and deposit rates by MFBs, requiring them to make adequate efforts to educate their clients regarding important terms and conditions of all their products, provide complete disclosures and read out terms and conditions to clients. It also requires MFBs to display important terms and conditions of their products visibly in their branches as well as educate clients with respect to other services like automated teller machines (ATMs), micro insurance, etc.

METHODOLOGY

The aforementioned third party assessments follow the Smart Campaign's *Smart Assessment* methodology.[2] The Smart Campaign, housed within the Centre for Financial Inclusion at Accion International, was set up in 2009 and has worked on developing a universal set of minimum client protection standards for the global microfinance industry. These set of standards are known as the Client Protection Principles (CPPs) and Smart Assessments are designed to assess institutions around these principles. These CPPs have been established through global industry consensus, including MFPs, international networks and national associations to ensure a set of standards for ethical and responsible microfinance. These include: (i) appropriate product design and delivery, (ii) prevention of over-indebtedness, (iii) transparency, (iv) responsible pricing, (v) fair and respectful treatment of clients, (vi) privacy of client data, and (vii) mechanisms for complaint resolution. **FIGURE 1** gives additional information on the CPPs.

FIGURE 1: The Smart Campaign's Client Protection Principles (CPPs) and definitions

Appropriate product design and delivery	Prevention of over-indebtedness	Transparency	Responsible pricing
Providers will take adequate care to design products and delivery channels in such a way that they do not cause clients harm. Products and delivery channels will be designed with client characteristics taken into account.	Providers will take adequate care in all phases of their credit process to determine that clients have the capacity to repay without becoming over-indebted. In addition, providers will implement and monitor internal systems that support prevention of overindebtedness and will foster efforts to improve market level credit risk management (such as credit information sharing).	Providers will communicate clear, sufficient and timely information in a manner and language clients can understand so that clients can make informed decisions. The need for transparent information on pricing, terms and conditions of products is highlighted.	Pricing, terms and conditions will be set in a way that is affordable to clients while allowing for financial institutions to be sustainable. Providers will strive to provide positive real returns on deposits.

Fair and respectful treatment of clients	Privacy of client data	Mechanisms for complaint resolution
Financial service providers and their agents will treat their clients fairly and respectfully. They will not discriminate. Providers will ensure adequate safeguards to detect and correct corruption as well as aggressive or abusive treatment by their staff and agents, particularly during the loan sales and debt collection processes.	The privacy of individual client data will be respected in accordance with the laws and regulations of individual jurisdictions. Such data will only be used for the purposes specified at the time the information is collected or as permitted by law, unless otherwise agreed with the client.	Providers will have in place timely and responsive mechanisms for complaints and problem resolution for their clients and will use these mechanisms both to resolve individual problems and to improve their products and services.

Source: http://www.smartcampaign.org/about/smart-microfinance-and-the-client-protection-principles

MFPs are assessed on these broad CPPs via a set of uniform indicators for each of these principles. These encompass microfinance operations beyond just credit to include savings and insurance services as well, with the main focus at present being on credit products.

[2] **Source:** www.smartcampaign.org/about/campaign-mission-a-goals Retrieved on March 28, 2014.

This MicroNote primarily draws on the results of the 10 Smart Assessments conducted for MFPs in Pakistan during 2013, of which five were microfinance banks, three rural support programs and two large microfinance institutions.[3] These 10 MFPs account for approximately 70 percent of the market in terms of number of clients and approximately 65 percent in terms of gross loan portfolio. Therefore, the results can be considered as largely representative of current sector practices of *large* to *mid-sized* MFPs. The same findings, however, cannot be inferred for smaller MFPs in the sector since most of the reviewed institutions did not fall in this category. Nevertheless, given that the standardized assessment methodology enables a reliable comparison of results across institutions, and the institutions assessed cover the majority of the clients in the sector, the findings can be said to impact at least 70 percent of microfinance clients in Pakistan.

The analysis that follows in the next section is organized by each of the seven CPPs and attempts to summarize the current state of client protection practices in Pakistan. This analysis is based on a compilation of results by indicator for the 10 Smart Assessments that form part of our data set. **BOX 3** gives information on the Smart Assessment methodology.

BOX 3: The Smart Assessment methodology for institutional client protection assessments

How is client protection assessed at an institution?

To gauge the extent to which the seven CPPs are institutionalized in an MFP, Smart Campaign has developed a comprehensive list of indicators based on the seven CPPs. The indicators cover the main issues that should guide the implementation of that principle through the triple perspectives of policy, procedures and actual practice.

Who carries out a third-party Smart Assessment?

Third-party Smart Assessments are usually conducted by independent Lead Assessors who have been accredited by the Smart Campaign in use their assessment methodology. These Lead Assessors are in turn supported by at least one Smart Campaign accredited Support Assessor, together forming the Assessment team.

What does an assessment look like?

These rigorous third-party assessments span over one week at the MFPs head office and sample operational areas. Various methods are employed, including policy and manual reviews, interviews with staff at various levels throughout the MFP and client focus group discussions or interviews. A detailed review of the MFP's procedural manuals and policies; in-depth interviews with top management, Board members, relevant managers and field staff; on-site visits and client interviews together ensure a holistic and exhaustive evaluation of the MFP on the indicators.

How is an MFP scored on the Smart Assessment indicators?

Evidence gathered through these methods is used to score each indicator according to the following criteria:

Score	0	1	2
Meaning	**Does not meet the indicator**	**Partially meets the indictor**	**Meets the indicator**

Each indicator within a CPP is equally weighted for an average score per CPP. In turn, each of the seven CPPs also has an equal weightage. The results for each CPP provide an overall picture of how well (or not) the institution is doing on minimum standards in each of the seven areas.

How are the results shared with the institution?

The assessment week includes a final debriefing session with the top management of the MFP where preliminary areas of strength and gaps in the seven CPPs are shared and feedback received to incorporate into the assessment scoring. This is followed by a confidential detailed assessment report by the Smart Assessment team, which highlights areas of strength and gaps and includes recommendations on the way forward for the institution to come up to the minimum standards of client protection to be implemented.

In addition to Smart Assessments, institutions can also choose to go for a Smart Certification, which is a public endorsement by the Smart Campaign of the MFP if it meets all the indicators on which assessments are based.*

* Additional details on the assessment methodology, as well as information on Smart Certifications can be found at http://www.smartcampaign.org/certification

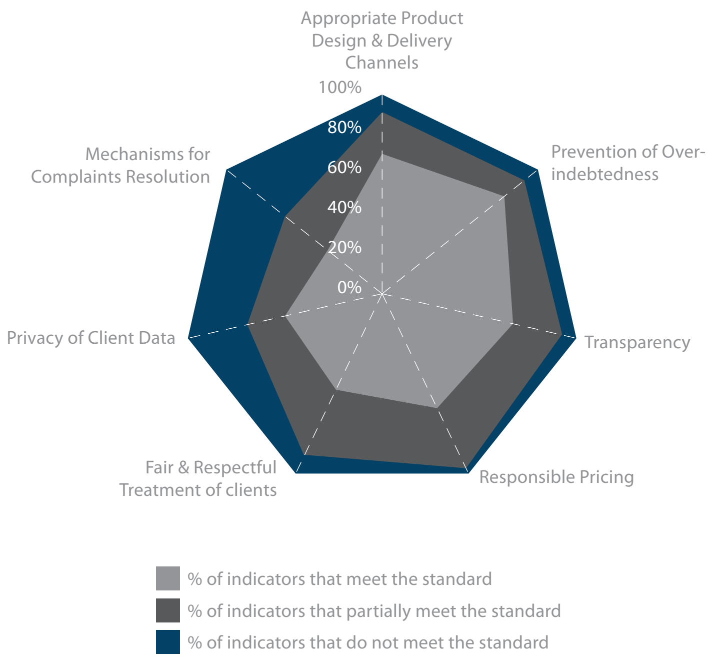
[3] These include: Khushhali Bank Limited, The First MicroFinance Bank, FINCA Microfinance Bank, Pak Oman Microfinance Bank, NRSP Microfinance Bank, Kashf Foundation, BRAC Pakistan, National Rural Support Program, Thardeep Rural Development Program and Punjab Rural Support Program.

SUMMARY RESULTS – CLIENT PROTECTION PRACTICES IN PAKISTAN

This first look at the state of the sector in client protection is heartening – it provides evidence of the client centric nature of microfinance in Pakistan. Though there is room for improvement in each of the CPPs, and in some more than others, there seems to be a positive base of pro-client practices for the sector to build upon as we move towards full compliance to the minimum standards of client protection.

FIGURE 2 shows the sector-wide CPP compliance levels, based on scores received by the assessed MFPs. The three colored areas in this chart show the overall compliance levels on client protection indicators for the sector. The light grey core denotes the percentage of indicators within each CPP that were fully met; areas in dark grey show the percentage of indicators that were partially met, and areas in blue represent the percentage of minimum standards of practice that were weak or absent.

FIGURE 2: Overall compliance to the CPPs by the Pakistan microfinance sector

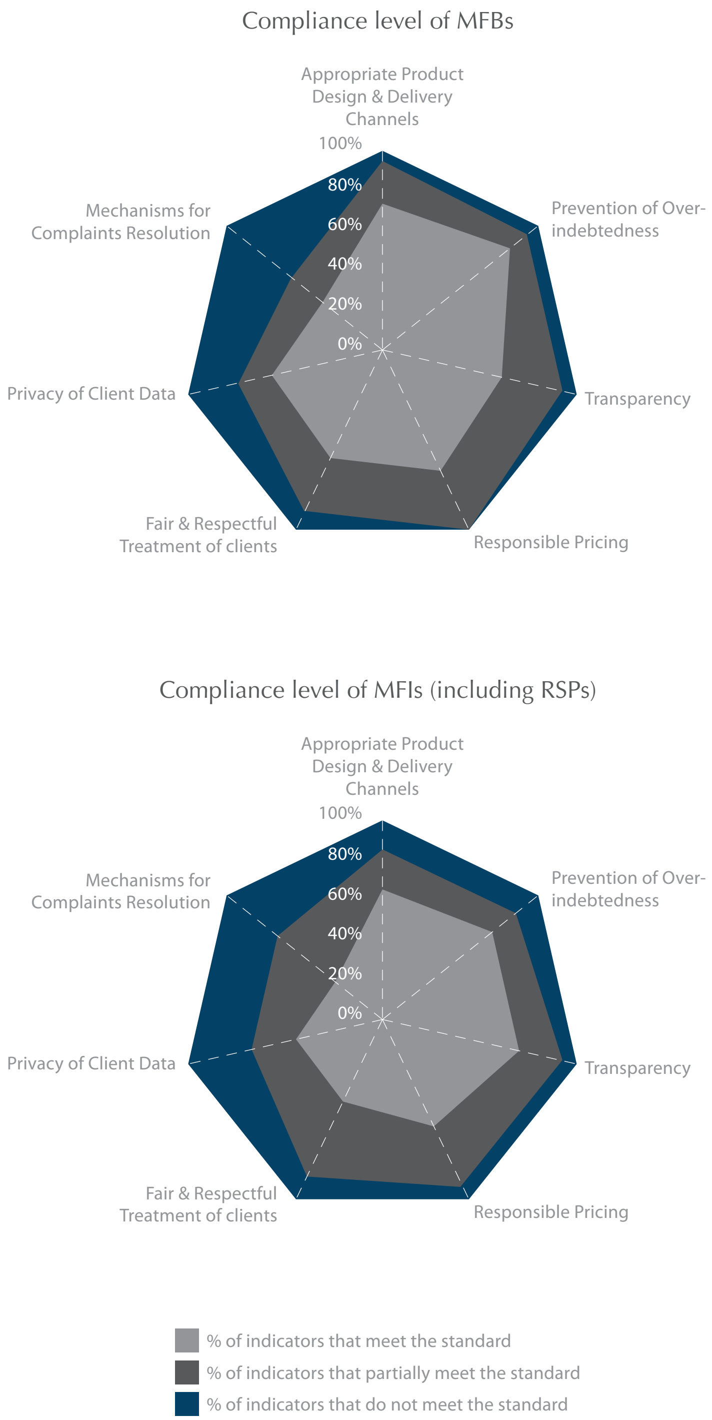


At a broad level, the results indicate that large-scale MFPs are performing well on the CPPs of (i) *appropriate product design and delivery*, (ii) *prevention of over-indebtedness*, (iii) *transparency*, and (iv) *responsible pricing*. However, despite the high level of compliance on indicators for these principles, there are opportunities for improvement. There is substantial room for improvement in practices relating to *fair and respectful treatment of clients*. Finally, the results reflect a pronounced absence or weakness in minimum standards of practice relating to the principles of *privacy of client data* and *mechanisms for complaints resolution*.

FIGURE 3 presents the aggregated results for the five microfinance banks (MFBs), and five microfinance institutions (MFIs) that were part of the dataset, respectively. Analysis at the peer group level helps to bring out common strengths and weaknesses in client protection practice by type of institution, if any, given the different regulatory and legal frameworks they operate within.[4]

[4] MFBs in Pakistan are set up under the Microfinance Banks Ordinance 2001, and are regulated and supervised by the central bank, the State Bank of Pakistan (SBP), under the Prudential Regulations for Microfinance Banks. MFIs are non-bank, specialized microfinance service providers, the majority of whom are registered under the Companies Ordinance 1984 by the Securities and Exchange Commission of Pakistan (SECP). To date, they do not fall under any regulatory or supervisory umbrella as do the MFBs.

FIGURE 3: Summary compliance level of MFBs and MFIs to the CPPs



Comparing the two charts, it can be observed that with the exception of *mechanisms for complaints resolution*, MFBs in the dataset were moderately better at implementing the other six CPPs than MFIs. It is interesting to note that MFIs in the dataset performed equally well on the principle of *transparency* as MFBs despite not being bound by regulations around disclosure. The biggest gaps common across both types of institutions is the absence of or weak practices in *mechanism for complaints resolution* and *privacy of client data*.

STATE OF PRACTICE – RESULTS BY PRINCIPLE

In this section, we take a deeper look into each of the CPPs in turn to highlight common areas of strength and gaps in MFPs' practices.

Areas of Strength

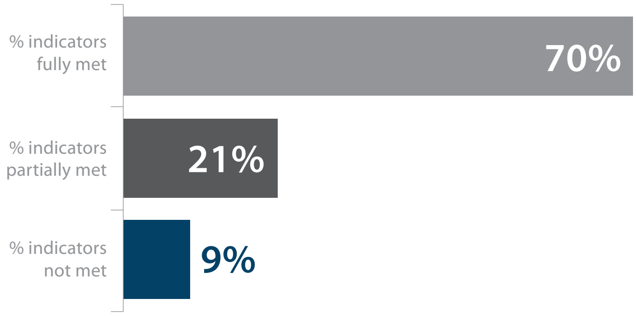
The MFPs in our dataset exhibit relatively strong practices for the principles of *appropriate product design and delivery channels*, *prevention of over-indebtedness*, *transparency* and *responsible pricing*. We now look at each of these in turn.

Appropriate Product Design and Delivery Channels

In order to meet minimum standards of practice in *appropriate product design and delivery*, MFPs actively consider the characteristics of target clients as part of the product design process. Products should inherently be simple (avoid bundling) and flexible while catering to the needs of clients. At the same time, suitable product delivery should be given due consideration as well. Products should provide value for money to clients and not be deceptive in design to avoid taking undue advantage of inexperienced and vulnerable clients.[5]

On this principle, we find that the assessed MFPs performed well, as seen in **FIGURE 4**, with 70 percent of the indicators being fully met. It was observed that generally MFPs have some kind of a formal product development process. In fact, the majority of large-scale MFBs and MFIs such as the First Microfinance Bank (FMFB), Khushhali Bank Limited (KBL), FINCA Microfinance Bank Limited (FINCA MFB) and Kashf Foundation (KF) have institutionalized strong, systematic product development processes which include conducting client focus group discussions and in-depth interviews at both the concept testing and pilot phases. In addition, client feedback is routinely collected through satisfaction and exit surveys, all of which feeds back into product design and delivery. All MFPs in the dataset *at least partially* met the indicator of not offering products that may create negative value for clients. This indicates that the majority of MFPs are cognizant of the need for adequate care in designing products and delivery channels so they do not cause clients harm.

FIGURE 4: MFPs' overall compliance level for Appropriate Product Design and Delivery Channels



With 21 percent of the indicators being partially met and an additional nine percent that are unmet, there is some room for improvement in this CPP, despite the strengths: firstly, although mid-sized institutions do collect client feedback informally through regular field interaction with clients, there is need to formalize the research and collection mechanism to ensure a robust feedback loop into the product design process. Secondly, many MFPs are now seeking to offer diversified products to suit the distinctive needs of various target groups, such as emergency loans. However, with this move towards collateralized products, a recurring gap identified for institutions offering them is a lack of clear policies regarding pledges of collateral. Such policies can be improved to better suit client needs, based on input from clients in the product design and feedback processes.

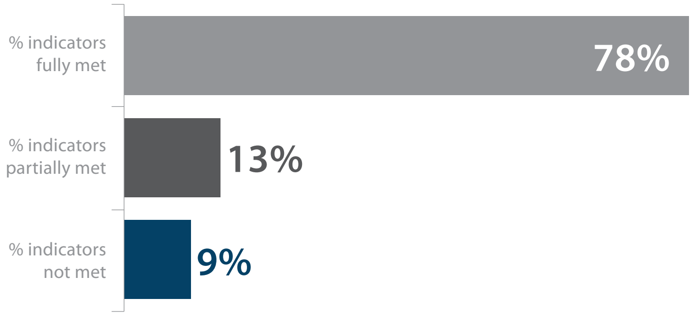
[5] (September 2011) Putting the Principles to Work: Detailed Guidance on the Client Protection Principles, The Smart Campaign. This resource is available online at the following URL:
http://www.smartcampaign.org/storage/documents/20110916_SC_Principles_Guidance_Draft_Final.pdf
Definitions for all succeeding CPPs have also been taken from this resource.

Prevention of Over-indebtedness

The principle of *prevention of over-indebtedness* applies to the entire credit process in an MFP, from sales through collections, to curtail over-lending to clients by determining their true repayment capacity before loan disbursement. Although the risk of over-indebtedness is closely related to credit risk, the two are not the same. An over-indebted client may still be able to make repayments by selling assets (including livelihood-generating assets), forgoing essential expenditures on food, and making other sacrifices that may result in a decline in quality of life which can cause substantial harm to both the client as well as the MFP.[6] The principle addresses how well MFPs implement and monitor internal systems that support prevention of over-indebtedness and participate in market level credit risk management initiatives. The primary elements considered under this principle include (i) the client underwriting process; (ii) loan terms and conditions; (iii) sales techniques; (iv) staff incentives; (v) monitoring systems; and (vi) participation in market initiatives.

Overall, the sector is complying with the principle of *prevention of over-indebtedness* better than any other CPP; MFPs in the dataset met 78 percent of the indicators for this principle (see **FIGURE 5**). In fact, an interesting observation to emerge was that two MFPs fully met each indicator under this principle, showing strong overall practices. All MFPs in the dataset conduct a reasonable analysis of client repayment capacity. Moreover, some MFPs such as KF, National Rural Support Programme (NRSP), and FMFB have institutionalized a rigorous process that covers household and business cash flow analysis, client visits and credit bureau checks, all of which are uniformly used in practice. All assessed MFPs were found to be monitoring Portfolio at Risk (PAR) regularly, with management taking corrective action if the need arose. Our findings also reveal that detailed client evaluations are backed up by incentives on portfolio quality by the majority of assessed MFPs. All MFPs in the given sample were found to be contributing data to the microfinance credit information bureau, and using it for repayment analysis at least in the first loan cycle. Nevertheless, some MFPs still lack formal policies regarding application of findings from the credit bureau, especially in determining debt thresholds.

FIGURE 5: MFPs' overall compliance level for Prevention of Over-indebtedness



A common gap highlighted by the findings was lack of awareness on preventing client over-indebtedness at the MFP Board level. One possible explanation is that most of MFPs have been unable to clearly define over-indebtedness as it applies to its clients. Consequently, it has been hard to measure, monitor and report on.

In summary, the results for this principle display the sector's awareness and relevant efforts to limit burdening the client as well as protecting the sector from delinquencies. Comparing globally, over-indebtedness was not found to be a major concern for the microfinance sector in Pakistan, like it has been in regions of Sub-Saharan Africa, and East Asia and the Pacific.

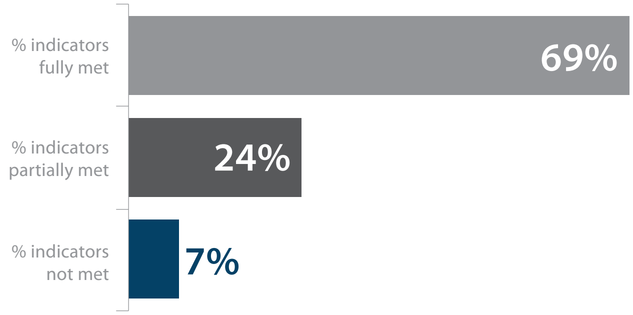
[6] Sergio Guzman (2013) *Study of Client Protection Practices in Latin America and the Caribbean*, Accion International and Multilateral Investment Fund: Washington D.C.

Transparency

In order to meet the minimum standards for the principle of *transparency*, MFPs must communicate clear, sufficient, and timely information in a manner and language clients can understand so that clients can make informed decisions. Microfinance clients typically have low levels of education and may be inexperienced with financial products and their terms and conditions, therefore the onus is on the MFP to communicate the loan terms using plain wording and straightforward terms in the client's own language, verbally and in written. A core component of transparency is pricing disclosure, including how clearly and understandably a provider presents interest rates, fees, and commissions. The primary elements considered within this principle include: (i) clear use of language; (ii) complete cost and non-cost information; (iii) timely provision of information; and (iv) informing clients of their rights.

Assessed MFPs fully met 69 percent of the indicators for *transparency*, as shown in **FIGURE 6**. They demonstrated some strong practices in this principle, for example, the majority uses multiple channels in communicating product terms, including introductory meetings, brochures, posters in branches and websites. However, evidence revealed that given the literacy limitations of clients, verbal communication was determined to be the most effective channel compared to the rest. Institutions were also found to be giving customers sufficient time to discuss and review the contract terms and conditions prior to signing by verbally communicating the terms at various stages of the loan cycle, in line with the minimum standard requirements for the principle of *transparency*.

FIGURE 6: MFPs' overall compliance level for Transparency



An area of concern is the lack of clear disclosure on the total cost of loans by most MFPs constituting the dataset. Moreover, the sector as whole does not provide hardcopy contracts or summary documents listing terms and conditions of the loan to clients. Another area for improvement is the lack of a standardized pricing disclosure methodology in the sector, making it difficult for clients to compare prices and make informed decisions. There is room for improvement in full disclosure of breakdown of pricing and adopting one standardized pricing methodology across the sector, moving away from flat interest rate disclosures. However, challenges remain in bringing all microfinance practitioners to standardized pricing disclosures due to lack of a regulatory ambit for non-bank MFPs, and the perceived first mover 'disadvantage' that a move away from flat rates will bring about.

Given that half of the MFPs in the dataset are unregulated, it is encouraging to note good practices in *transparency*; in some cases, they do even better than MFBs.[7]

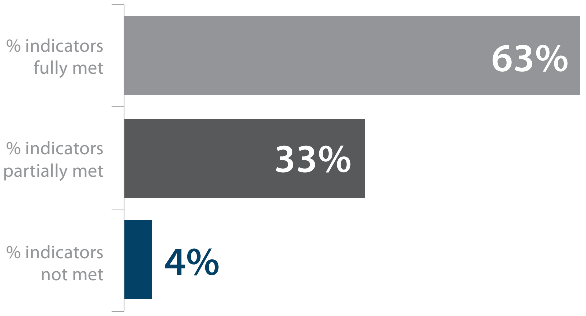
Overall, there is focus on communicating accurate terms and conditions to the clients verbally, due to low levels of literacy in clients. This reflects the sector's consideration towards raising its clients' understanding of loan terms and conditions.

[7] Unlike MFIs, none of the MFBs in the dataset scored high on the indicator of using "simple non-technical language in contracts" i.e. MFB contracts were found to be complex. Additionally, results gathered showed that MFBs in the dataset are not disclosing complete information on early repayment fees and conditions, late payment penalties, and possible changes to product terms, on loan documentation. This information is rather made part of the contract in fine print so the client is many times unaware of these conditions.

Responsible Pricing

For the principle of *responsible pricing*, MFPs are assessed on their ability and willingness to price their products and services in a way that contributes to the long-term financial health of their clients while meeting their own needs for financial sustainability. MFPs should strive to achieve efficiencies that allow prices to be as affordable as possible while providing value for money. In the process of defining product prices, due consideration should be given to the client's ability to pay, along with a look to institutional operational efficiency and profit levels. The two elements forming the core of this principle include pricing procedures and fees.

FIGURE 7: MFPs' overall compliance level for Responsible Pricing



Assessment results for our dataset affirm that MFPs in Pakistan are cognizant of and consciously implementing client-centric practices, with almost 63 percent of indicators for this principle being fully met (see **FIGURE 7**). The majority of MFPs in the dataset fully complied with the standard of offering non-discriminatory (do not differ on gender, disability, religion etc.) and market-based pricing; while the rest met it partially. This suggests that at least 70 percent of the market is being offered competitive prices.

All MFPs in the dataset charge one processing fee, all of these were found to be in line with peers. There was one case in which the processing fee was found to be excessive for smaller loan sizes, suggesting that the high operational cost on smaller loan sizes is being passed on to the client, but this was a rare occurrence.

This principle also assesses the efficiency of MFPs to gauge how responsibly priced their products. This is where some MFPs from the dataset have been observed to be unable to keep their efficiency ratios in line with peers, causing related indicators to be partially met or unmet.

Areas to Improve

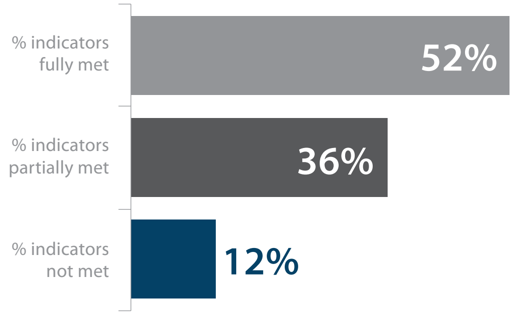
Next, we turn to the principles where some areas for improvement and gaps were identified for MFPs in our dataset. These include *fair and respectful treatment of clients, privacy of client data* and *mechanisms for complaints resolution*.

Fair and Respectful Treatment of Clients

With recent public critiques of microfinance, in which heavy-handed collections practices have been prominently vilified, this principle seeks to assess MFPs practices relating to client selection and treatment. The core elements of the respectful treatment of clients include: (i) commitment to code of ethics; (ii) non-discrimination; (iii) appropriate incentive structure and sales practices; (iv) responsible use of agents; (v) preventing staff corruption; (vi) informing clients of their rights; and (vii) client feedback.

Overall, MFPs in the dataset met only 52 percent of the indicators for this principle, with 48 percent of the indicators being met only partially or not met at all (see **FIGURE 8**). With the exception of two cases, MFIs scored poorly on this principle as compared to MFBs. This variance is explained by the lack of formalization of policies and procedures at MFIs, a gap common to a majority of MFIs. Codes of ethics were found to be insufficient at most MFIs, essentially missing concrete sanctions and penalties in case of violation of acceptable conduct by field staff, especially during collections. Little evidence was found of field staff receiving training on issues relating to client protection or any other form of communication on client treatment policies. Not surprisingly, the majority of field staff was unable to relay the repercussions they would face in case of client mistreatment.

FIGURE 8: MFPs' overall compliance level for Fair and Respectful Treatment of Clients



Although MFBs generally scored better, there is room for improvement at mid-sized MFBs. Large-scale MFBs' strength in this principle is explained primarily by formalization of policies and procedures, for example, appropriate debt collections practices are spelled out in a credit policy manual. Some MFPs such as KF, KBL and FINCA have displayed some exceptional practices by integrating client protection as a core human resource value. For example, staff compatibility with institutional values is verified through background checks, and staff recruitment, training and performance evaluation are aligned with the institution's standards of ethics and treatment towards clients. Similarly, the code of ethics provides guidance on appropriate conduct with clients that promotes fair treatment and prevents fraud, signed on to by all employees at the time of their induction. These practices, however, were common only to large-scale MFBs; the results cannot be applied to all MFBs. There is a need to incorporate client protection policies in institutional manuals and train staff accordingly, at both mid-sized MFBs and MFIs alike.

Privacy of Client Data

The principle of *privacy of client data* covers protection of individual client data in accordance with laws and regulation. Privacy of personal financial information of clients is particularly important for MFPs because it helps to prevent losses due to theft and fraud. This principle includes the following standards: (i) existence of complete policy and procedures; (ii) information security protocols; (iii) information provided to clients about their rights and responsibilities; (iv) waivers of privacy rights; (v) safeguarding data that could be used for discriminatory purposes; and (vi) sharing of client data with third parties.

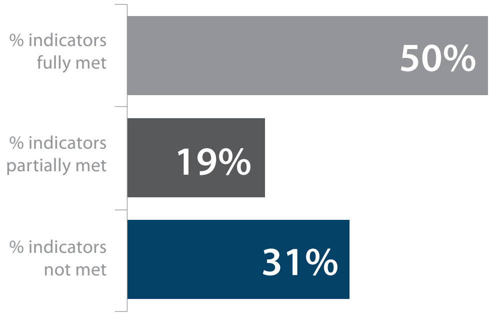
Overall, MFPs in our dataset only met 50 percent of the indicators for this principle. **FIGURE 9** shows that practices for 31 percent of the indicators were absent. No particular variance emerged based on the institution type in this principle; and with the exception of two institutions, both MFBs[8] and MFIs scored poorly. The 'legalese' used in legal agreements is complex and difficult for microfinance clients to understand. Although the majority of MFPs have a privacy clause in the loan contract, on-site evidence suggested that clients are not informed of the importance of this clause.

MFBs scored well on existence of policies that safeguard client data, but they too performed low in actual implementation and monitoring of this policy: client understanding of the privacy clause was limited as it was not explained by field staff. The

[8] Clause 26 of SBP's Microfinance Ordinance specifically bars MFBs from sharing client information with any other entity, and according to the SBP, this is followed rigorously in that permission to share client information even with law enforcement agencies is first sought from the SBP.

majority of MFPs in the dataset did not have a concrete policy on protection of clients' data; likewise, sanctions for employees in case of violations were missing. The practice of safeguarding client files in locked cabinets was missing especially in rural locations. On the other hand, information technology (IT) systems at the majority of MFPs were adequately secured, with password protection, routine back-ups and a tiered data access protocol.

FIGURE 9: MFPs' overall compliance level for Privacy of Client Data



Most assessed MFPs scored low on this principle due to lack of written policies. It is crucial for MFPs to have a privacy policy that governs the gathering, processing and distribution of client data in order to curtail the risk of fraud that they face, if policies and systems relating to client data handling are lax. Moreover, field staff must be trained on these policies and systems.

Mechanisms for Complaints Resolution

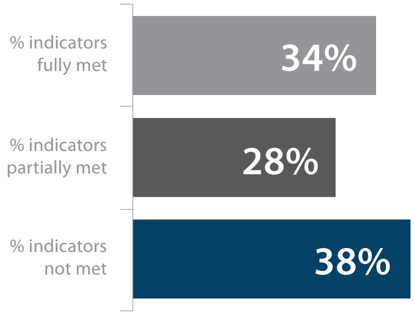
The principle of *mechanism for complaints resolution* seeks to evaluate whether an MFP provides clients a responsive and effective mechanism through which they can lodge their complaints and provide feedback. MFPs have a responsibility to ensure clients are aware and educated on how to use this mechanism, that complaints are handled appropriately and that they are resolved in a timely manner. The main elements for this principle include: (i) communications with clients about their rights and about how to register complaints, (ii) the mechanics complaints handling process itself (intake, resolution, appeals), (iii) oversight of the complaints process, and (iv) use of complaints to identify broader problems.

Based on assessment results for our dataset, it is clear that MFPs in Pakistan are lagging behind on the global minimum standards for effective complaints resolution mechanisms. Generally, MFPs performed poorly on this principle, with 38 percent of the indicators not met i.e. practices were missing from the institutions altogether as evident in **FIGURE 10**. Additionally, 28 percent of the indicators were only partially met. Three MFPs from the dataset had no formal complaints resolution mechanism, although field staff had some implicit understanding on how to handle complaints. Most MFPs use suggestion boxes in branches only: this is an ineffective strategy given literacy limitations of clients.

MFPs need to enact formal and independent systems for complaints receipt and resolution. While evidence revealed that field staff took a proactive approach to addressing client's grievances even in the absence of a formal system, this is not a substitute for a formal institutional mechanism. Evidence from some assessments suggests that clients felt they could only approach the loan officers with their concerns. This presents a risk to the institution because the all-important client feedback loop is non-existent.

A few MFPs in the dataset, however, performed exceptionally on this principle, and should be taken as examples of best practice in this area. KF, KBL and FINCA have implemented independent and effective system of complaints resolution, including a hotline, complaints boxes and routine client satisfaction survey calls. Field staff communicates the details of the system to clients at different stages of the loan cycle and information about the mechanism in printed on posters and client passbooks.

FIGURE 10: MFPs' overall compliance level for Mechanisms for Complaints Resolution



Moreover, complaints are routinely monitored at the head office and cases of mistreatment of clients by staff are dealt with in a systematic and timely manner. Tameer Bank has also implemented a strong complaints handling mechanism which uses preemptive, outbound calls to clients to enhance client satisfaction.[9]

There is ample scope for improvement for this principle for MFPs in Pakistan. Although MFPs consciously try to collect and resolve complaints through field staff and client interaction, compliance to the minimum standards requires formalization of the policies and procedures already being implemented in the field.

CONCLUSION AND WAY FORWARD

Overall, the assessment results are quite positive. There is a strong foundation of client centric policies already in place and a commitment to build upon them to further strengthen the client protection framework in the sector.

This analysis provides a clear way forward: there is room for improvement in principles related to *appropriate product design and delivery mechanisms*, *avoidance of over-indebtedness*, *transparency* and *responsible pricing*. There are considerable gaps to be filled for the principles of *fair and respectful treatment of clients*, *privacy of client data* and *mechanisms for complaints resolution*.

1. While larger MFPs have strong **product design and delivery mechanism**, mid-sized players need to further formalize their product development mechanisms to better align their products to client needs and to modify them over time based on any changing demands. This can be done by incorporating appropriate research elements into the product development process to ensure client-centric products. Additionally, MFPs with collateralized credit product must develop clear, client-friendly policies regarding pledges of collateral.

2. To strengthen **avoidance of over-indebtedness**, MFPs must formulate policies regarding use of data from the microfinance credit bureau and determine acceptable debt thresholds for clients. Furthermore, instances of over-indebtedness amongst an institution's clients must be systematically monitored and reviewed by management. This is important to minimize the instances of clients being routinely burdened beyond their debt thresholds, and also presage the quality of portfolio and minimize PAR.

3. There is a lack of standardized pricing disclosures in the sector, coupled with evidence of use of flat interest rates by a number of MFPs in calculating and disclosing interest rates. For **enhanced transparency**, it is imperative for MFPs to move together towards standardized disclosures on the annualized percentage rate (APR) interest calculation formula, and to move away from flat interest rate pricing, to ensure a level playing field among industry players. While MFTransparency has recently published pricing data for the majority of the sector in Pakistan, there is a need for all MFPs in Pakistan to come on board and publish their interest rates on this standardized platform.[10] More importantly, for enhanced transparency to the client and to allow them to better compare prices across institutions, MFTransparency calculated APRs should be used by MFPs in price disclosures and communications with clients.

[9] A note was published by the Smart Campaign highlighting Tameer Bank's complaints handling system. This can be accessed at the following URL: http://www.smartcampaign.org/tools-a-resources/589-smart-note-responding-to-client-complaints-at-tameer-bank-pakistan

[10] The MFTransparency data for participating Pakistani MFPs can be accessed online via the following URL: http://www.mftransparency.org/microfinance-pricing/Pakistan/

Additionally, clients need to be given clearer information about their legal rights and obligations. This can be accomplished through including a short summary of the loan terms and contract stipulations, included on the back of repayment schedules or on passbooks for better awareness and understanding.

4. While prices are generally considered responsible in the microfinance sector in Pakistan, as evinced by the MFTransparency analysis,[11] steps can be taken to further improve **responsible pricing**. One of the ways this can be done is to ensure that institutions are not placing the additional cost of its own inefficiencies onto its clients. This can be monitored through a strict watch on the efficiency ratio of the institution, setting a realistic target in line with best practice benchmarks for its own peer groups, and instituting a strategy to bring the institution towards greater operational efficiency. This will help the sector towards more responsible and competitive prices.

5. To comply with minimum standards of practice for **fair and respectful treatment of clients**, most MFIs as well as mid-sized MFBs must formalize policies and procedures. Codes of ethics need to be strengthened further: the 'Do's and Donts' of interfacing with clients clearly spelled out, the overall scope of such codes made more 'client-facing' as opposed to addressing only intra-MFP ethical standards, and clear sanctions and penalties in case of violation of the code included. Moreover, these codes of ethics and policies must become 'living documents' via detailed familiarization of staff on its stipulations and consequences in case of non-compliance.

6. Maintenance of **client data privacy** is important for MFPs to take seriously: not only is it a client right, but is also important to uphold to protect against internal and external fraud. To this end, the first step towards strengthening practice on this principle includes putting in place written policies which govern the gathering, processing, distribution and access of client data. To ensure adequate implementation and protect client data, all staff must be trained on client data privacy protocols as defined by institutional policies.

7. The lack of **formal complaints handling mechanisms** at MFPs points to a lack of channels for client voices to get through to MFP management, which is a worrying sign. Since MFPs exist to serve their clients, it is necessary for them to create avenues for clients to air their suggestions, concerns and grievances. This is not only important for better operational flow, but also to raise any red flags before problems become systemic or unavoidable, such as delinquency crises, or loss in revenue due to inferior product design. Such problems can be gauged in advance and averted with a well-functioning client complaints handling system that clients are aware of and know how to use.

   Complaints handling mechanisms should be designed to be independent of field operations to ensure an unbiased feedback loop with no leakages. Complaints data should be gathered for analysis and regular reports on the incidence as well as kinds of complaints should be reviewed by management. In addition to well-functioning complaints handling mechanisms at the MFP level, there is also a need to set up an independent grievance resolution authority at the national level to provide recourse as a last resort, like ones that exist for other industries, such as in the commercial banking industry with the State Bank of Pakistan's Consumer Protection Department's complaints cell and the Banking Mohtasib (Ombudsman) Pakistan serving these roles.[12] The national association of MFPs, Pakistan Microfinance Network, could also have a role to play in rallying industry stakeholders around a model for such a mechanism.

Through taking the steps outlined here, MFPs can improve their client protection practice to better align their operations with the minimum standards defined by industry consensus through the CPPs. Tools and resources, highlighting best practices in client protection by microfinance practitioners from around the world, are available for MFPs' use and adaptation.[13]

Beyond protecting clients from harm, adopting the CPPs will also have other benefits for MFPs, such as a more agile product development and design system leading to attractive products for clients, strengthening of internal controls, and development of a positive reputation among clients, leading to greater retention. Collectively, the importance that the sector places on protecting clients from harm, and placing clients at the centre of its business will also govern how MFPs tackle challenges in advancing financial inclusion and move towards its goals with a sustainable growth trajectory.

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[11] This was presented at the data launch event for microfinance prices in Pakistan in late January 2014, in Islamabad, Pakistan.

[12] Details on the Banking Mohtasib Pakistan can be explored on its website, available at the following URL: http://www.bankingmohtasib.gov.pk/

[13] An extensive range of tools and resources relating to each of the CPPs has been developed by the Smart Campaign and available at their website, at the following URL: http://www.smartcampaign.org/tools-a-resources

Pakistan Microfinance Network

MicroNOTE:
CLIENT PROTECTION: THE STATE OF PRACTICE
A look at client protection practices in Pakistan's microfinance industry

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