



Client Protection in Middle East and North Africa

Regional Implications of the Smart Campaign

For several decades, stakeholders in the development arena have recognized the microfinance sector as an effective tool for poverty alleviation and a cornerstone of financial inclusion. However, more recently, several markets, including Morocco, Bosnia and Herzegovina, Nicaragua, Pakistan, and India have witnessed microfinance crises. In parallel, several MFIs in Latin America, most famously Banco Compartamos in 2007, launched IPOs that were over-subscribed and saw impressive increases in share prices. These issues combined, particularly cases where MFIs demonstrated irresponsible financial practices, have raised a number of questions about their practices, which led to the establishment of the Smart Campaign in September 2009. Keeping the microfinance industry's clients as the driving force of its mandate, the campaign was launched to champion financial inclusion and responsible finance for low-income populations¹.

By leveraging a team of international microfinance practitioners, the campaign has pioneered a set of globally relevant Consumer Protection Principles (CPPs) that can be adhered to by microfinance institutions (MFIs). Essentially a set of standards that ensure MFIs provide their services in an accountable, transparent and ethical manner and represent the minimum service standards that clients should expect to receive, the core CPPs are:

- Appropriate product design and delivery
- Prevention of over-indebtedness
- Transparency
- Responsible pricing
- Fair and respectful treatment of clients
- Privacy of client data
- Mechanisms for complaint resolution

By adopting these principles, financial institutions demonstrate they are protecting and empowering their clients whilst simultaneously propelling the efficacy and sustainability of the industry. MFIs that successfully adhere to the CPPs are certified by the Smart Campaign for successfully embedding client protection in their operations.

To encourage MFIs in MENA to pursue the certification, the International Finance Corporation (IFC) has offered technical assistance to aid its partner MFIs in meeting the campaign's criteria. Building on this experience, it is important to open a discussion on the capacity of globally set standards to match the local landscape. While many players in MENA are looking to improve access to finance, it is interesting to observe how local peculiarities interact with global ideals of responsible finance, given the different regulatory environments and cultural backdrop. This discussion aims to shed light on some of these issues.

IFC advocates and promotes Smart Certification in MENA

Recognizing that client protection is critical to financial inclusion, the IFC MENA team has worked in close coordination with the Smart Campaign to support MFIs in MENA in obtaining the certification. At the time of project approval, only one MFI in Tunisia was certified. As part of this initiative, IFC worked on:

¹ Smart Campaign, Campaign Mission and Goals

1. **Capacity Building:** Increasing the capacity of IFC staff and identifying and training local consultants to conduct client protection assessments and help improve institutional practices.
2. **Awareness-Raising:** Organizing workshops and/or panel discussions in selected countries to highlight the importance of responsible finance.
3. **Assisting with Certification:** Together with the Smart Campaign, IFC's staff assessed and aided six MFIs in preparing for the process of certification. Three have actively pursued the certification.
4. **Working with Regulators:** In coordination with the World Bank, IFC introduced the Smart Campaign's CPPs to regulators from countries including Egypt, Jordan, Tunisia, and the West Bank and Gaza, and also organized a workshop in Amman to promote dialogue between regulators and practitioners on relevant issues.

Smart Campaign's Core Principles of Client Protection

While a number of MFIs in MENA are already meeting many of the Smart Campaign's indicators and one Jordanian MFI has already obtained the Smart Certification in July 2019, it also became clear during the different assessments that several indicators were commonly not being met or only being partially met. The reasons for this are two-fold; in some cases, MFIs need to update their practices to meet the indicators, while in others, external factors such as local regulations limit their ability to follow them. The following points address each principle separately and discuss the challenges associated with each application.

CPP1- Appropriate Product Design: Taking one step backward to move forward

Under CPP1, providers have the responsibility to “design products, services and delivery channels” that are suitable for clients' needs. Assessing clients' capacity to repay based on enterprise and household cash flow, for example, was one way that MFIs in MENA succeeded in fulfilling this principle. However, in many cases, loan officers were unable to fully understand how to match different products, services, and channels to specific clients. This was mainly due to insufficient training, but also a lack of tools for profiling clients and analyzing dormancy, drop out, and cancellation. Additionally, service providers have limited mechanisms for monitoring front-line staff and third-party sales to impede aggressive tactics. Indeed, 75 percent of assessed MFIs had no clear framework for addressing aggressive sales.

To develop a greater capacity for client-appropriate product design, the starting point for MFIs may be to take one step backward and address this issue at a more strategic level. Conducting research on consumer behavior and adopting analytical models to examine its key elements can assist MFIs in providing a more tailored product portfolio. Defining organizational policies and integrating mechanisms for client follow-up as well as staff monitoring will help limit aggressive sales. Most importantly, once guidelines set the tone for the institution, training is necessary to ensure these guidelines are translated to front-line staff who are fundamental in converting strategy into results. All these measures can help position MFIs toward meeting the criteria necessary to satisfy CPP1.

CPP2- Prevention of Over-Indebtedness: Continuous training and market awareness is key

CPP2 works to ensure that financial providers examine clients' capacity to repay during every phase of the loan process to avoid over-indebtedness². Assessed MFIs proved to have sound policies and well-documented processes for loan approvals, as well as actively conducting repayment analysis with every loan renewal. Moreover, MFIs maintain a sound portfolio quality and their incentive systems also value portfolio quality as highly as other factors including portfolio growth.

While the majority of MFIs review incentive schemes periodically, they do so under the narrow lens of an individual organization. Therefore, to expand on this strength, widening their focus of review to incorporate the market's performance and risks, as well as observing industry benchmarks, could prove worthwhile in cementing and evolving their practice. Another area of improvement is training—new staff are not trained adequately on the loan analysis and credit approval process. Additionally, although there is some training for credit staff, most do not receive annual refresher training. Going forward, consistent training is significant in ensuring MFIs continue to avoid over-indebtedness and maintain healthy loan portfolios.

CPP3- Transparency: Market norms, public awareness, and the legal environment pose a challenge

The Smart Campaign tries to ensure that clients have full pricing and product information to allow them to compare products and make an informed decision. IFC observed that one of the MFIs' main strengths was communicating with clients on policy and procedure. However, key indicators of CPP3 were not aligned, such as not disclosing product prices in the public domain, disclosing prices to clients on a flat basis, and lastly—a common practice in some markets—making clients sign a blank promissory note. The causes underlying this discrepancy include insufficient formal communication between MFIs and clients, unfavourable market norms, and restrictive legal systems.

Full pricing information

According to CPP3, MFIs are requested to clearly disclose accurate and full cost information, and terms and conditions to clients, to allow them to understand and compare different product offerings on the market. Through the various assessments conducted, it was found that MFIs disclosed information on all their product features in the public domain, except for pricing. This tended to be disclosed verbally but not through any formal communication channels, such as branches, websites, or marketing materials. It was also noted that in some cases clients signed to obtain access to products without reading terms and conditions. It may therefore be worthwhile for MFIs to not only increase their use of formal channels of communication, but also to educate and encourage clients on how to read and compare pricing information.

Standardized Pricing

² Putting the Principles to Work: Detailed Guidance on the Client Protection Principles. (2019, June). Retrieved from https://www.smartcampaign.org/storage/documents/2019_06_19_Principles_Guidelines_FINAL2.pdf.

In addition to providing full product and pricing information, the Smart Campaign mandates financial providers to communicate cost information to clients in a fashion that permits full comparability. For clients to have access to the full cost of products (including all fees and charges), MFIs are requested to use a standardized interest rate calculation such as the Annual Percentage Rate (APR) or Effective Interest rate (EIR)³. Using a standardized pricing calculation allows the client to understand and compare loans and financial products in the market and make an informed decision, by comparing the total cost of products and not just the installment size.

During the assessments, the IFC team realized it was not easy for financial providers to apply the new metric without a market-specific level of acceptance. Even though MFIs are willing to use a standardized rate, they find this challenging if it is not a requirement by the regulator, and no one wants to take the lead in using standardized interest rates in a market that mainly uses a flat interest rate, as it will suggest their rates are much higher. This puts clients in a position where they do not have proper information to compare products.

In Jordan and Tunisia, where the Central Bank of Jordan (CBJ) and the Control Authority of Microfinance (ACM) has mandated the microfinance sector to employ a standardized interest rate, the entire sector is now using the same calculation. Here the market regulations and relevant authorities played a significant role in streamlining the application of client protection principles across the industry, in compliance with the Smart Campaign's criteria for transparency. This is not the case in Egypt, for example, where the regulator requires that MFIs disclose flat interest rates, making it harder to encourage them to switch to standardized pricing measures. In order to encourage MFIs to utilize and disclose a standardized interest rate, it will likely be most effective to work with regulators to make this a requirement, as opposed to encouraging MFIs to do so in the absence of regulations.

Another issue faced by MFIs operating in markets where flat interest rates are the norm is inadequate public awareness. MFIs in these markets fear that disclosing the cost structure of standardized rates may lead to undue criticism from uninformed politicians and, in turn, ineffective government intervention, such as interest rate caps. This places MFIs in a difficult position as many are keen to embrace the client protection principles but fear they will have negative repercussions on the sustainability of their institutions and the industry at large, if regulators do not enforce the client protection transparency requirements on all players.

Promissory notes

In most MENA countries, MFIs require clients to sign a promissory note along with the loan agreement contract as a means of guaranteeing the repayment. In some cases, it is common practice that the note is left blank instead of including the full loan amount. The promissory note can later be filled out with the balance of the loan due if the client defaults. These promissory notes are mainly used as a reaction to poorly enforced legal systems. Addressing breaches of contract in civil court can take several years and eventually be dismissed altogether if the loan sizes are too small, making contract enforcement time consuming and ineffective. Promissory notes, on the

³ There are two dominant methods for standardized interest rate calculations which are annual percentage rate (APR) and effective interest rate (EIR). Both methods incorporate all fees and charges in its calculation. The only difference between both methods is that EIR accounts for the effects of compounding but APR does not.

other hand, allow for more extensive and faster legal recourse, as they are processed through the more efficient criminal court system.

This practice is unlikely to be resolved until the legal system can more effectively and inexpensively enforce contracts. Until then, regulators have a role to play as they can ban the use of promissory notes and encourage MFIs to resort to other forms of guarantee. Not only will this improve client protection, but it would also bring MFIs one step closer to achieving the Smart Campaign's requirements.

It is important to note here that none of the MFIs with whom IFC worked on the Smart certification process has ever taken a client to court, even with a promissory note, instead typically trying to resolve issues at the lowest possible level. However, promissory notes act as a preventive measure against default for the institutions. In addition, borrowers' willingness to sign them generally reflects their commitment to repay the loans.

CPP4- Responsible Pricing: Flat interest rates overcharge clients

Responsible pricing requires MFIs to set pricing in an affordable and sustainable manner. Using a declining interest rate, which, as discussed under CPP3, is unfortunately not a common practice among MFIs in MENA unless required by the regulator, ensures the client is paying interest on the remaining balance of a loan⁴ only. Most financial markets in the MENA region, including both Lebanon and Egypt, use flat interest rates to benchmark the cost of credit, because they parallel simpler fixed repayment schedules that clients are accustomed to⁵. Mandating declining rates will automatically mean that pricing, as well as terms and conditions, are fair to clients.

Under this principle, the Smart Campaign also emphasizes the importance of ensuring that MFIs do not have excessively high profit levels, to ensure that pricing for low-income clients is fair. Most of the assessed institutions' financial ratios fell within accepted ranges, except for Return on Assets (ROA), which was consistently higher than the accepted ceiling. The campaign states that a given institution's ROA should fall between 1 percent and 3 percent and that anything outside this range requires further analysis to assess whether these profit levels can be justified. In many MENA markets, the elevated ROAs are indeed justifiable for several reasons. Given that many MFIs in MENA are NGOs and not-for-profit companies, they tend to have lower financial leverage. This means they need a higher ROA to have a reasonable Return on Equity (ROE), which is equal to, or above, the inflation rate in the market to at least protect the purchase value of their investments.

In addition, many MFIs in MENA operate in local currency as opposed to hard currency. A ROA of 1-3 percent on the US dollar is relatively high; however, this is not true of a ROA of 1-3 percent on the Egyptian pound or the Yemeni riyal for example. The reason for this is that MFIs can invest their money in certificates of deposit in some MENA countries, which can easily provide a return of 15 percent and, in turn, a higher ROE. When MFIs are only leveraged by two to three times, they will need to have a ROA of at least 5-7 percent to match the ROE they would make if they

⁵Outlawing Flat Interest in Cambodia. (2011, October). Retrieved from <http://www.mftransparency.org/wp-content/uploads/2012/05/MFT-BRF-302-EN-Outlawing-Flat-Interest-in-Cambodia-2011-10.pdf>.

invested their money in local certificates of deposit. Other reasons for elevated ROAs include high inflation rates, unstable political environments, and riskier target segments, such as refugees. Having said that, MFIs should monitor their ROAs closely to ensure they remain aligned with client protection principles as much as possible.

CPP5- Fair and Respectful Treatment of Clients: Evident with room for improvement

The Smart Campaign's principles stipulate that all MFIs treat their clients in a respectable and fair manner while avoiding discrimination. Fortunately, fraud and unethical actions are prohibited and sanctions clear and enforced by three-quarters of the assessed MFIs. In addition, loan terms and conditions for individuals differ according to a risk-based analysis and target markets. Also, the loan collection process is clearly defined across all MFIs, most of which reschedule, refinance, or write off loans on an exceptional basis for struggling clients who are willing but unable to repay. Insurance claims are also settled within one month or less, as required by local law.

However, in order to fully meet the requirements of this principle, MENA MFIs need to exert more effort to inform their clients of their organizational values and standards of professional conduct, including prohibited behaviors, as well as clients' rights and responsibilities. There is also room for improvement in policies that define appropriate and inappropriate debt collection practices, and for enforcing sanctions when inappropriate collections behavior is observed. Overall, there is little management oversight of key results related to fair and respectful treatment of clients and few measures for improvement have been observed.

CPP6- Privacy of Client Data: Data sharing yet to request client consent

The Smart Campaign believes that individual client data should be private and confidential at all times. Assessed MFIs had strong data security measures in place to protect against unauthorized access and conducted daily backups of client data. However, client privacy fell short as not all MFIs requested consent for data sharing with third parties, including credit bureaus, regulators, or donor agencies. Thus, client contracts could be presented more clearly and should include a concise explanation of how client data will be protected, and how it may be used or shared and with whom. There is also a clear need to strengthen agreements with third-party providers that have access to client data to maintain security and confidentiality.

CPP7- Mechanism for Complaints Resolution: Effective communication and training necessary for improvement

Since dissatisfied clients and their complaints are inevitable, CPP7 states that MFIs should enforce "timely and responsive mechanisms for complaints resolution."⁶ Throughout the assessments conducted, it was apparent that clients submitted complaints through someone other than their

⁶ Putting the Principles to Work: Detailed Guidance on the Client Protection Principles. (2019, June). Retrieved from https://www.smartcampaign.org/storage/documents/2019_06_19_Principles_Guidelines_FINAL2.pdf.

point of contact for obtaining the product, or his/her supervisor. Information on how to submit a complaint is not always visible in branch offices, through agents, and/or in product fact sheets.

Fortunately, mechanisms to submit complaints are adapted to clients' needs and preferences and are easily accessible. The resolution of complaints, however, is not always prioritized based on severity, nor always resolved within the recommended time span (one month). In most MFIs, providers do not have sufficient training for staff on to handle complaints. This should involve how the complaints mechanism works, the role of complaints staff, how to appropriately manage complaints until they are resolved, and how to refer them to the appropriate person for investigation and resolution. It should be noted that managers need to dedicate more time to review KPIs related to complaints resolution and take corrective action to ensure this is done in a timely manner.

Conclusion:

This article aims to reflect on IFC's experience in providing technical assistance to MFIs in MENA looking to meet the Smart Campaign's criteria for client protection. While the campaign's indicators are global ideals, they would generally prove highly beneficial to the microfinance sector at large. However, IFC has noted some factors, both external and internal, that need to be resolved to improve the adoption of the CPPs in MENA.

External factors comprise unfavorable government regulations and market norms, poor legal enforcement, and nascent public awareness. These forces can undercut MFIs' potential and ability to meet client protection standards, although they may be intrinsically willing and able to do so. This was especially true for the CPPs on Transparency and Responsible Pricing. In this case, regulators must first set a path for client protection in the microfinance market by mandating the use of comparable standardized rates on financial products. Additionally, more efficient contract enforcement, and raising political and public awareness of the potential benefits of standardized metrics, would allow MFIs to move toward a more ideal level of transparency and responsible pricing.

Internally, two issues characterized the inability of MFIs to meet the CPPs: a lack of organizational direction and limited staff training. At the strategic level, MFIs need to partake in formal measures to institutionalize client protection in organizational culture, through policies, guidelines and monitoring mechanisms. Staff training is then essential to translate these ideals into standard practice. Both these factors are especially relevant for the campaign's principles of Appropriate Product Design, Prevention of Over-indebtedness, Fair and Respectful Treatment of Clients, Privacy of Client Data, and Mechanisms for Complaints Resolution, where a little fine tuning could help MFIs more easily meet the requirements for certification. At the very least, awareness of these external and internal issues sets a starting point for strengthening client protection practices for MFIs in the MENA region.

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