Principles for Responsible Investment

Principles for Investors in Inclusive Finance

CGAP

PIIF SIGNATORIES' REPORT ON PROGRESS BASED ON PILOT PRI REPORTING FRAMEWORK 2012

INTRODUCTION

The Principles for Investors in Inclusive Finance (PIIF) were launched in January 2011 to provide a framework for responsible investment in inclusive finance.[1] Inclusive finance carries with it the responsibility for all actors in the financing chain—investors, retail financial service providers and other stakeholders—to understand, acknowledge and act in accordance with the interests of the ultimate client. These clients typically have low incomes and are constrained by asymmetries in financial knowledge, power and influence. As such, access to finance must be provided in a way that protects client interests.

The PIIF, aligned with the United Nations-backed Principles for Responsible Investment (PRI), are signed by direct investors or fund managers and indirect investors investing via funds or holding companies. By signing, investors signal their intent to uphold the Principles in their own investments, and to support other actors in the financing chain to implement the Principles. The PIIF provide a framework to enable signatories to share emerging good practice and collaborate to achieve this objective. The Principles were designed by and for institutional investors (pension funds, insurance companies, development finance banks, foundations, endowments and investment managers). As of February 2013 there were 51 PIIF signatories, mainly private institutional investors (15 asset owners and 36 investment managers), across 11 different countries.[2]

The Principles are accompanied by a self-reporting framework with different indicators for direct and indirect investors. The Framework is primarily designed to encourage transparency and accountability and to support dialogue between direct and indirect investors.

This report provides a summary of the submissions made by participating PIIF signatories to the pilot of the Reporting Framework in June 2012. Fifteen direct and 13 indirect investors participated, but the results from direct investors only are presented here because this group reported against more indicators. The report offers insights into investors' collective responsible investment practices in inclusive finance for the first time. It enables signatories and others to see the progress being made to translate the PIIF into action, with examples of emerging good practice and areas for improvement.

HIGHLIGHTS – NEW FINDINGS

Fifteen direct investors participated in the pilot, of 24 eligible to do so at the time (June 2012).

- All participants have endorsed the Client Protection Principles[3] and the majority are incorporating these into their policies and practices.
- Most participants' investment decision making takes into account social performance of investees, but staff incentives are not always linked to social performance.
- Just over half collect data on the proportion of the retail providers in which they invest that provide financial products beyond credit; on average, 48% provide savings and 44% offer insurance.
- Nearly 90% report a procedure to integrate environmental issues into their investment decision making.
- Active involvement in corporate governance is mixed; on average, equity investors report having board seats with half of their investees.
- Areas where there is room for improvement include incentivising social returns, playing an active role in corporate governance, investors' transparency and their encouragement of investees' transparency on pricing and other terms and conditions to the ultimate client.

SCOPE OF THE PILOT

The PIIF Reporting Framework captures qualitative information on the policies, processes and systems in place to support implementation of the PIIF, as well as some quantitative data. It complements data from other surveys, for example the MicroRate and Symbiotics MIV surveys, which focus primarily on financial trends in microfinance investment.

The participating direct investors are mainly based in Europe and North America, which is representative of the wider PIIF signatory base. Between them, they manage a reported US$ 6.5bn of the estimated US$ 9bn managed by PIIF direct investor signatories overall. On average, 59% of participants' portfolios are invested in Eastern Europe and Latin America, 41% in Africa and Asia and 2% in Western Europe and North America. Half report that 100% of their assets are in inclusive finance.

1. Inclusive finance includes any investment in a retail institution (i.e. company, bank, microfinance institution) that provides financial services (credit, savings, insurance, mortgages, remittances, payments) to clients who have traditionally been excluded from such services, whether consumers, microenterprises or SMEs. This could be in emerging or developed markets.
2. The full list of PIIF signatories is available at www.unpri.org/piif
3. http://www.smartcampaign.org/about-the-campaign/smart-microfinance-and-the-client-protection-principles

THE PRINCIPLES FOR INCLUSIVE FINANCE (PIIF)

Investors or fund managers that sign the PIIF, while upholding their fiduciary duty, commit to adhering to and promoting the following:

1. Expanding the **range of financial services** available to low-income people;
2. Integrating **client protection** into all policies and practices;
3. **Treating investees fairly**, with clear and balanced contracts, and dispute resolution procedures;
4. Integrating **ESG factors** into policies and reporting;
5. Promoting **transparency** in all operations;
6. Pursuing **balanced long-term returns** that reflect the interests of clients, retail providers and end investors; and
7. Working together to develop common investor **standards** on inclusive finance.

Each Principle is accompanied by a set of possible actions, from which the Reporting Framework indicators are derived.

A few caveats are necessary. The data is self-reported and not audited, and the sample size is relatively small. The self-selecting nature of participation in the pilot and the fact that not all participants reported against all indicators means findings cannot be generalised to the entire signatory base. However, the pilot provides new and interesting data related to implementation of responsible investment in inclusive finance.

PIIF 1: SUPPORTING A RANGE OF FINANCIAL SERVICES

All 15 direct investor participants reported actively supporting retail providers to offer a diverse range of financial services that respond to client needs. Of these, 11 out of 13 that reported against this indicator provide some level of technical assistance to retail providers, particularly for organisational capacity building and new product development, and also encourage knowledge-sharing among their investees.

Participants support both microenterprise and consumer lending, with the bulk of investees' portfolios being in microenterprise loans.[4]

All participants reported investing in retail providers that offer savings and insurance services. 80% of participants also support investees that offer other financial services, including agricultural loans, SME loans, housing loans, education loans, remittances, mobile banking, leasing, factoring and micropensions (Figure 1).

Figure 1:

Type of service offered by investee MFI	Number of pilot signatories which invest in MFIs that offer service	Average % of signatories' investees offering service	To compare: % of MFIs reporting to MIX[5] offering service
Microenterprise credit	NA	78%	90%
Consumer credit	NA	26%	63%
Savings	15	48%	59%
Insurance	15	44%	27%
Other financial services	12	32%	52%

60% support investees that provide non-financial services, including financial literacy, business skills development and basic health and nutrition education, with on average 58% of their investees providing such services.

PIIF 2: IMPLEMENTING THE CLIENT PROTECTION PRINCIPLES

All those who took part in the pilot have endorsed the Client Protection Principles (CPP). Nearly all include client protection measures in investment policies, due diligence processes and financing agreements (Figure 2).

Figure 2:

Action	Total no. reporting	% Yes of those reporting
Have you publicly endorsed the Client Protection Principles (CPP)?	15	100%
Do you report on your actions in relation to the CPP to your investors?	13	92%
Do you provide training or technical assistance for your investees in implementing the CPP?	13	77%
Do you incorporate CPP into investment policies, due diligence processes and financing or shareholder agreements?	15	93%

However, fewer support investees in implementing the CPP, with 11 out of 13 reporting that they provide training or assistance to investees in implementing client protection measures. Activities include educating one's own investment staff on the CPP so they can share best practices and provide suggestions on implementation of the Principles during monitoring visits; funding workshops for investees on the CPP; and funding country-level over-indebtedness studies that lay the groundwork for discussions on the topic.

"The Client Protection Principles are explicitly included in our due diligence process and are an essential part of our investment decisions. We have a continuous dialogue with all our investment partners and monitor the implementation of client protection measures."

PIIF 3: TREATING INVESTEES FAIRLY

Fair treatment of investees can be expressed in different ways. The Reporting Framework looks at proxies such as the tenor and currency of finance provided and the transparency of terms and conditions. All debt providers offer local currency loans, but the typical term of loans varies widely (Figure 3).

Figure 3:

Loan Maturity	Number of pilot signatories reporting maturities in this range	% current direct investments (median)	Range for % current direct investment
12 months or fewer	10	5%	0-73%
13-24 months	12	30%	1-70%
25-60 months	13	45%	5-82%
Over 60 months	10	5%	0-88%

4. Microenterprise loans were defined as loans whose purpose is to finance a microenterprise (five or fewer employees). Consumer loans were those defined as loans for immediate household needs, destined to finance consumption and other household needs.
5. Microfinance Information Exchange, see www.mixmarket.org

Debt investors also indicated that they ensure investees have full understanding of financing terms, covenants and the implications of breach.

> *"Conversations on covenants, breach of covenants implications, working out process, are clearly discussed at the occasion of term sheet negotiations and when sending drafts of loan agreements."*

The responses from the 13 direct investors that reported equity investments suggest that equity holders take a fairly long-term investment perspective, with investment periods typically five or more years (Figure 4). Most seek minority stakes.

Figure 4:

Equity Investment	Typical Terms
Term (for 13 who provided information)	Over 5 years
Target annualised IRR (for four who provided information)	10-15%
Maximum equity exposure (for seven who provided information)	Minority stakes, ranging from 10% to 49%

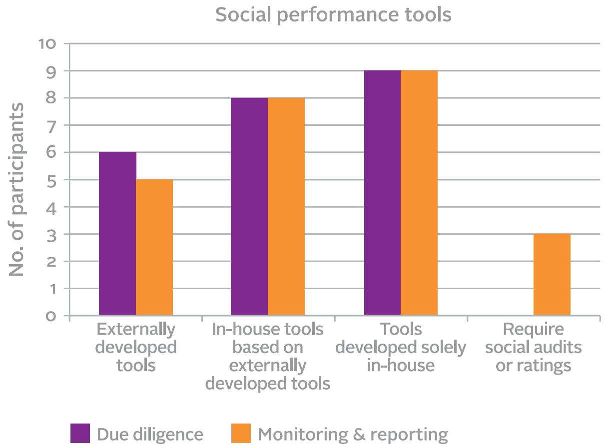
Reported data also suggests that equity investors seek to ensure social value is maintained post-exit by seeking buyers who are committed to the investee's social mission.

> *"It is explicitly stated in our policies that we try to preserve social value created when we exit. In practice, this means that we are selective as to whom we sell to. Buyers are carefully screened."*

PIIF 4: INTEGRATING ESG ISSUES

Participants report integrating social performance measures into their due diligence and monitoring and reporting processes. Different organisations take different approaches, with some developing in-house tools and others relying more on external tools (Figure 5).

Figure 5:

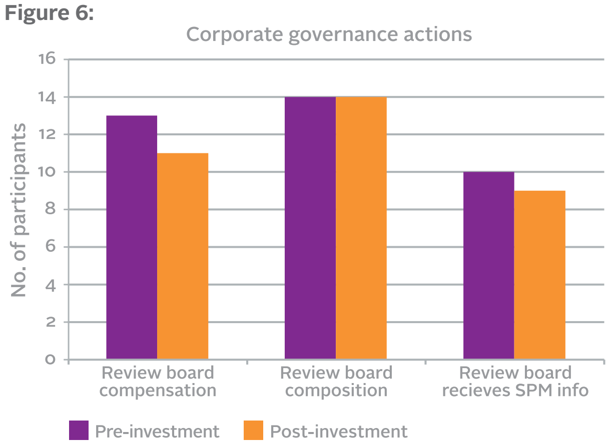


Environmental issues are of concern with nearly 90% reporting a procedure to integrate environmental issues into their investment decision making. This is a larger percentage than reported by MIVs in Symbiotics 2012 survey (66%).[6] For most, this takes the form of compliance with environmental exclusion lists (typically, IFC or FMO exclusion lists), but three investors reported that some investees are developing positive environmental policies and practices and some encourage investees to finance environmental-friendly agriculture or renewable energy businesses.

> *"A growing number of our MFI partners are developing environmental policies: 43% have an environmental policy for their clients. Most of them don't finance activities with a negative impact on the environment; 44% have an environmental policy for their own organization's practices (reducing energy and water consumption, using recycled paper and reducing waste production)."*

In terms of ensuring good corporate governance, most participants review the composition and compensation of investee boards (Figure 6). This includes ensuring the board has the depth and breadth of skills for the organisation's stage of development. Some participants specifically look at gender diversity.

Figure 6:



However, active involvement in corporate governance is mixed. Ten out of the 14 equity investors that reported against this indicator have board seats with on average half of their investees (although the range reported was from 2%–100%). Eight provide training or assistance to investees on corporate governance.

> *"The equity team provides training and assistance for investees on corporate governance. We seek [..] to drive value creation in portfolio companies through corporate governance by: adding or changing board members; creating board committees; implementing a systematic approach to strategic decision making; establishing strong risk, audit and controls; adjusting human resources and remuneration based on performance."*

PIIF 5: PROMOTING TRANSPARENCY

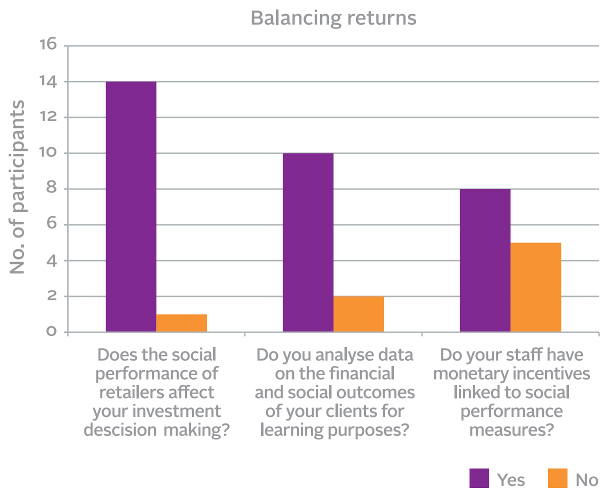
80% of participants disclose information to investors aligned either to the MIV Disclosure Guidelines[7] or Impact Reporting and Investment Standards (IRIS).[8] Nine out of 11 reporting against this indicator disclose their own policies, criteria and related conditions of products and services on their websites. Fourteen participants of 15 report ensuring that, among investees, pricing is fully explained in a form understandable to clients.

6. See http://www.syminvest.com/papers/d68ef4bc-3806-4b65-aa5f-5e17678e8ae3
7. The MIV Disclosure Guidelines provide a set of standardised indicators against which microfinance investment institutions / vehicles can report to investors.
8. See http://iris.thegiin.org/

PIIF 6: STRIVING FOR BALANCED, LONG-TERM RETURNS

All reported taking social performance into account at the investment decision making stage and would decline to invest if social performance did not meet minimum standards (Figure 7). Only a few incentivise social performance by considering a price reduction in debt funding and/or a technical assistance grant if social performance is high, or by having staff incentives in line with social performance measures.

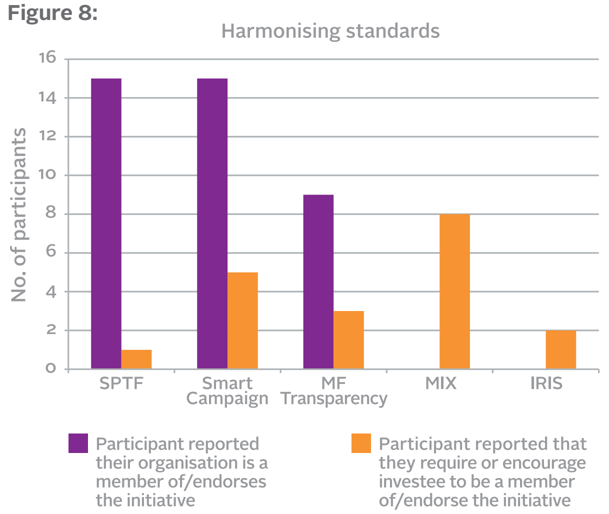
Figure 7:



PIIF 7: COLLABORATING TO SET HARMONISED STANDARDS

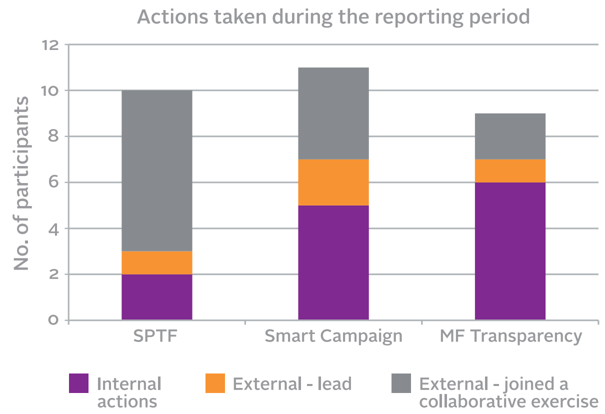
There is a high level of direct engagement with industry initiatives but less encouragement for investees to endorse and/or participate in such initiatives (Figure 8).

Figure 8:



Generally, participants value the knowledge sharing and opportunities for joint working facilitated by these global initiatives, although they participate in these to different degrees (Figure 9).

Figure 9:



NEXT STEPS

The pilot found high commitment among direct investor participants to invest in retail providers that offer a range of services, as well as adopting client protection practices themselves, providing both debt and equity with a range of terms and conditions to investees and participating in industry-wide initiatives to develop common standards. Areas where there is room for improvement include incentivising social returns, playing an active role in corporate governance, investors' transparency and their encouragement of investees' transparency on pricing and other terms and conditions to the ultimate client.

We look forward to seeing progress in a year's time following the launch of the PRI/PIIF Reporting Framework in October 2013. Reporting will be mandatory for all signatories. The aggregated report will be complemented by individual responsible investment reports for direct and indirect investors. These will be publicly available. At the same time, individual assessments will also be piloted, for private use by signatories as a feedback and evaluation exercise.

This information is expected to provide a rich, new source of data on implementation of responsible investment practices and help share progress and good practice among signatories, other stakeholders and new entrants to the field of inclusive finance.

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CGAP is an independent policy and research center dedicated to advancing financial access for the world's poor: www.cgap.org