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# European Code of Good Conduct for Microcredit Provision



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# **European Code of Good Conduct for Microcredit Provision**

# Foreword

The European microfinance market is a young and growing sector which has considerable potential. However, this market is still quite heterogeneous, due to the disparity of the legal and institutional frameworks in the Member States and the diversity of the microcredit providers. In the EU, microloans are provided by financial institutions, such as commercial banks, savings banks, cooperative banks and public banks, as well as by a number of non-bank entities, such as microfinance institutions, foundations, credit unions, charities, NGOs and others.

As a result, microcredit lending practice vary considerably depending on the type of institution providing microloans, its legal setup, the environment in which it operates and its own ability to apply sound and efficient management procedures.

Under these circumstances, the design of a widely accepted voluntary European Code of Good Conduct for microcredit provision was identified by the Commission as an important part of its initiative<sup>1</sup> to promote best practices in the field of microcredit. By setting out good practice guidelines and identifying expectations and common standards, the Commission is seeking to support the sector in facing the challenges of accessing long-term finance, maintaining and raising the quality of services and moving towards sustainability.

The principles regarding governance and management presented in this document are generally not new, but they reflect best practices across the sector. The purpose of this document is to detail a set of approved standards recognised in the European Union as essential in terms of the operation and reporting of microcredit providers.

The work to develop this European Code of Good Conduct has been carried out<sup>2</sup> in close consultation with many actors and stakeholders from the microfinance sector, such as funders, investors, customers, owners, regulators and partner organisations. It drew on the expertise and valuable experience gained by many microfinance actors in the EU, in particular the trade associations the European Microfinance Network (EMN), Microfinance Centre (MFC) and Community Development Finance Association (CDFA).

It is our hope that the European Code of Good Conduct for Microcredit Provision will contribute to enhancing good practice and further improving governance and sound management in the microfinance sector in the European Union.

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1 Communication "A European initiative for the development of microcredit in support of growth and employment" (COM(2007) 708 final/2 of 20.12.2007)

2 The European Code of Good Conduct for Microcredit Provision was prepared by Dr Karl Dayson and Pål Vik of Community Finance Solutions, University of Salford (UK) under a contract signed with the European Commission

# Acknowledgement

The organisations listed below in alphabetical order have contributed to the development of the European Code of Good Conduct for Microcredit Provision:

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- Association pour le Droit à l'Initiative Economique (ADIE)
- Banca Etica
- Bundesverband Öffentlicher Banken Deutschlands
- Centre for European Research in Microfinance (CERMI)
- Community Development Finance Association (CDFA)
- CoopEst
- Deutsche Sparkassen- und Giroverband (DSGV)
- Deutsches Mikrofinanz Institut (DMI)
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- European Association of Co-operative Banks (EACB)
- European Association of Public Banks (EAPB)
- European Banking Federation (EBF)
- European Investment Fund (EIF)
- European Microfinance Network (EMN)
- European Network of Credit Unions
- European Savings Banks Group (ESBG)
- Evers & Jung
- Express Finance IFN SA
- Fair Finance
- Fédération Nationale des Caisses d'Epargne
- Good.Bee Holding
- Groupe Banques Populaires Caisses d'Epargne (BPCE)
- Kreditanstalt für Wiederaufbau (KfW)
- Luxflag
- MicroBank
- Microfinance Centre for Central Europe and New Independent States (MFC)
- MicroFinanza Rating
- NRW.Bank
- Planet Rating
- Qredits
- The Department for Business, Innovation and Skills (BIS)
- The Financial Services Authority (FSA)
- Wirtschaftskammer Oberösterreich (WKÖ)

Many other participants were involved in the process through questionnaires

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# About the Code of Good Conduct



The European Code of Good Conduct for Microcredit Provision provides a set of standards in terms of management, governance, risk management, reporting, and consumer and investor relations that are common to the microcredit sector in the European Union. These standards are for the benefit of customers, investors, funders, owners, regulators and partner organisations.

### How was the Code developed?

The Code has been built on recognised best practice in the microfinance sector and developed in close consultation with the microcredit sector in the EU and its stakeholders. The development of the Code of Good Conduct has been guided by the following principles:

- An emphasis on incorporating specific and measurable content, on the basis of which microcredit provider managers and boards can take action to enhance their organisations.
- An emphasis on developing a Code that is adjusted to the diversity of microcredit providers in the EU in terms of market conditions, institutional forms and legal frameworks.
- An emphasis on raising standards by balancing the need for introducing best practice with realistic operational expectations of the providers.

### Why a Code of Good Conduct for microcredit providers in the EU?

The development of the Code was based on the recognition that – in light of the disparate regulatory frameworks in which microcredit providers in the EU operate – there was a need for a unifying set of expectations and standards that was common to the sector. The goal is to benefit the sector itself as well as its funders, investors, customers, owners, regulators and partner organisations. The Code sets out good practice guidelines that will better enable the sector to face the challenges of accessing long-term finance, maintaining and raising the quality of services, and moving towards sustainability.

The purpose of the Code is not to introduce or replace existing regulations of microcredit providers. Rather it is intended to detail a set of common standards in terms of the operation and reporting of microcredit providers.

### Which institutions are covered by the Code of Good Conduct?

The Code of Good Conduct is primarily designed to cover non-bank microcredit providers which provide loans of up to €25 000 to micro-entrepreneurs. However, the microcredit sector in the EU is diverse in terms of size, institutional set-up and the markets in which they operate. Consequently, not all practices can be considered good practice or even possible for all microcredit providers. In some cases, regulations may already exist which cover certain domains and practices. The Code recognises this and, where applicable, it specifies the type of institutions not covered by the clause in question.

### Who are the intended audience of the Code of Good Conduct?


This Code of Good Conduct is intended for microcredit provider managers, directors, customers, investors, funders, owners, regulators and partner organisations. It is designed to be a tool for microcredit provider board members, stakeholders and managers in improving the operation of the sector. For customers, it is a tool to ensure that they are treated in a fair and ethical way. For investors and funders, it ensures that the sector operates with transparent and pan-EU reporting standards. For regulators, it gives some reassurance that the sector operates according to sound business practices and principles, and that it is well governed.

## How should this document be used?

The Code is divided into five sections:

- Customer and investor relations: This section covers obligations of microcredit providers towards customers and investors, and rights of customers and investors.
- Governance: This section covers standards for both management and the board of microcredit providers.
- Risk management: This section details common approaches and procedure for managing risk.
- Reporting standards: This section details which indicators microcredit providers must collect, report and disclose.
- Management information systems: This section details common standards for management information systems.

The clauses are presented as illustrated below:


**Clause 1.1** 

For loans of duration of 12 months or longer, microcredit providers will provide clear and accurate information to their customers about their loan in an annual statement.

The annual statement must include the amount paid (interest and principal), the balance left (interest and principal) and the structure of the remaining payments (timing, amounts, interest and principal). The annual statement may be transmitted electronically, on paper or face-to-face.

### Priority clauses –




Throughout the document, several clauses have been identified as priority clauses. These clauses are seen as particularly important and are presented as illustrated below.

**Clause 1.2** 


**Microcredit providers will disclose the cost as an Annual Percentage Rate of Charge**

The Annual Percentage Rate of Charge must be disclosed in a credit agreement and in any advertising. This refers to the annual value of all commitments, drawdowns, repayments and charges, including fees and taxes paid by the customer and known to the creditor.

### Level of difficulty –

The level of difficulty in implementing a clause is indicated by  (low difficulty),  (medium difficulty) and  (high difficulty)

### Large institutions only –

Where a clause only applies to large institutions, this is indicated by the symbol , displayed after the clause. Large institutions are here defined as providers that have more than 7 000 active borrowers<sup>3</sup> **and** more than 70 employees. In the further guidance to the clauses, references are also made to small and medium providers. Small providers refer to organisations with fewer than 4 000 customers and 35 employees, while medium providers have 4 000 to 7 000 customers and 35 to 70 employees.

All the clauses are summarised in a matrix at the beginning of the document. In the matrix, the priority clauses are in bold red font.

A glossary also explains some of the terms used.

<sup>3</sup> Active borrowers are individuals who currently have an outstanding loan balance with the microcredit provider or are primarily responsible for repaying any portion of the gross loan portfolio. Borrowers with multiple loans should be counted as a single borrower.

# Overview matrix

Clause number	Clause	Priority	Difficulty	Large Only	Page
<b>I. Customer and investor relations</b>					
<b>Sufficient information to customer</b>					
<i>Microcredit providers will...</i>					
1.1	Disclose costs in advertising		🏠		22
<b>1.2</b>	<b>Disclose costs as Annual Percentage Rate</b>	<b>P</b>	🏠		22
1.3	Provide pre-contractual information to customer		🏠		22
1.4	Provide clear information in annual loan statement		🏠 🏠 🏠		22
1.5	Take measures to ensure customers understand terms and process		🏠 🏠		22
<b>Customer rights</b>					
<i>Customers have the right to...</i>					
<b>1.6</b>	<b>Withdraw from credit agreement or repay within 14 days</b>	<b>P</b>	🏠 🏠		23
1.7	Enough time to review terms of contract and ask questions		🏠		23
1.8	Early repayment		🏠 🏠		23
1.9	Have credit history reported to national credit bureaux		🏠 🏠		23
<b>Avoiding over-indebtedness of customers</b>					
<i>Microcredit providers will...</i>					
1.10	Assess repayment capacity and loan affordability		🏠 🏠		23
1.11	Have credit policies addressing borrower debt thresholds		🏠 🏠		23
1.12	Inform borrower without delay of non- or under-payment		🏠		23
<b>Customer care</b>					
<i>Microcredit providers will...</i>					
1.13	Regularly assess customer satisfaction		🏠 🏠 🏠		23
1.14	Have policy requiring that complaints be investigated		🏠 🏠		24

Clause number	Clause	Priority	Difficulty	Large Only	Page
<b>1.15</b>	<b>Have mechanism to deal with customer complaints</b>	<b>P</b>	🏠		24
1.16	Ensure customers are informed of right to complain		🏠		24
<b>Ethical staff and institutional behaviour</b>					
<i>Microcredit providers will...</i>					
1.17	Not discriminate in selection and treatment of customers		🏠		24
1.18	Set out acceptable and unacceptable debt-collection practices		🏠 🏠		24
1.19	Have explicit policy on acceptable pledges of collateral		🏠		24
1.20	Conduct regular staff appraisals		🏠		24
<b>Customer data protection</b>					
<i>Microcredit providers will...</i>					
1.21	Have written privacy policy concerning customer data		🏠 🏠		25
1.22	Have systems to protect customers' personal and financial information		🏠 🏠		25
1.23	Train staff to protect customers' personal and financial information		🏠 🏠		25
1.24	Inform customers about use of information and rights to withdraw permission		🏠		25
1.25	Require written customer consent to publicly disclose information		🏠		25
<b>Investor relations</b>					
<i>Microcredit providers will...</i>					
1.26	Take responsibility not to mislead investors		🏠		25
1.27	Provide relevant information to enable investors to make informed decisions		🏠		25
1.28	Endeavour to target investors equipped to understand risk		🏠		25
1.29	Take steps to verify investors' identity to prevent money laundering		🏠		25
<b>II. Governance</b>					
<b>Business planning</b>					
<i>Microcredit providers will...</i>					
<b>2.1</b>	<b>Produce a business plan that is reviewed regularly</b>	<b>P</b>	🏠 🏠		28
2.2	Produce a business plan covering a minimum of 3-5 years		🏠 🏠		28

Clause number	Clause	Priority	Difficulty	Large Only	Page
<b>2.3</b>	<b>Ensure that the business plan covers a minimum number of aspects of business</b>				28
2.4	Measure, disclose and improve financial and social performance				28
2.5	Use management control and performance tools				29
<b>Board</b>					
<b>2.6</b>	<b>Microcredit providers will have a board of directors or equivalent</b>				29
2.7	The board will have an audit or supervisory committee				29
<i>The audit or supervisory committee will...</i>					
2.8	Be independent of management				29
2.9	Meet with external auditors on annual basis				29
2.10	Have expertise in financial analysis and accounting				29
<i>The board will...</i>					
2.11	Have a minimum number of members				29
<b>2.12</b>	<b>Be composed of a majority of independent board members</b>				30
2.13	Be selected by Annual General Meeting or equivalent body				30
2.14	Be reviewed by Annual General Meeting or equivalent body				30
2.15	Supervise the performance of the senior management				30
2.16	Be accountable for compliance with laws and regulations				30
2.17	Review whether provider is carrying out the mission and business plan				30
2.18	Monitor financial performance on a regular basis				30
2.19	Be represented on interview panel when hiring chief executive				31
2.20	Have the right to veto executive management appointments				31
2.21	Decide level of remuneration for executive management posts				31
2.22	Approve any changes in pricing policies				31
2.23	Be given portfolio quality and financial performance reports				31
2.24	Have members with understanding of banking and finance				31
2.25	Have members that will develop understanding of credit risk				31

Clause number	Clause	Priority	Difficulty	Large Only	Page
	<i>Microcredit providers will...</i>				
2.26	Have rules excluding improper persons from becoming board members		■		31
2.27	Have rules stipulating term limits and rotation		■		31
2.28	Require disclosure of conflicts of interest of board members		■		32
2.29	Have board members with qualifications in finance, business, management and law		■ ■	▲	32
	<i>The board will...</i>				
2.30	Meet at least four times a year		■		32
	<i>Microcredit providers will...</i>				
2.31	Have quorum preventing staff or management majority on board		■ ■		32
2.32	Disclose proportion of related-party lending in annual report		■ ■		32
	<b>Management</b>				
2.33	Management will be qualified to undertake key management functions		■		32
	<i>Microcredit providers will...</i>				
2.34	Have succession plan for executive management		■ ■		32
2.35	Have personnel policies set out in personnel manuals		■ ■	▲	32
2.36	Have a formal training and induction programme		■ ■		32
2.37	Have operational manuals covering financial operations and management		■ ■		33
2.38	Have operational manuals covering treasury		■ ■ ■	▲	33
	<b>External audit</b>				
<b>2.39</b>	<b>Microcredit providers will have external audit on annual basis</b>	<b>P</b>	■		33
2.40	Auditor will be appropriately qualified		■		33
2.41	External audit will adhere to national or international standards on auditing		■		33
2.42	External audit will be accompanied by letter from auditor		■		33
2.43	Microcredit provider will address issues raised by auditor		■		33

Clause number	Clause	Priority	Difficulty	Large Only	Page
<b>III. Risk management</b>					
<b>Risk management framework</b>					
<i>Microcredit providers will...</i>					
<b>3.1</b>	<b>Have processes to identify, assess and prioritise risks</b>	<b>P</b>	👤 👤 👤		36
<b>3.2</b>	<b>Appoint senior manager to be accountable for risk management</b>	<b>P</b>	👤		36
3.3	Assign responsibility for implementing risk controls		👤		36
3.4	Assign responsibility for monitoring and providing management with relevant data		👤		36
<b>Managing credit risk</b>					
<i>Microcredit providers will...</i>					
3.5	Take into account risk when designing loan products		👤 👤		37
<b>3.6</b>	<b>Limit credit risks by requiring that two people approve all loans</b>	<b>P</b>	👤		37
3.7	Review aggregate exposure to concentrations of credit risk		👤 👤 👤	⚠️	37
3.8	Ensure any staff incentives are not linked only to loan origination		👤 👤		38
3.9	Measure and track loan portfolio performance		👤		38
3.10	Revise loan loss provisioning rates and methodology regularly		👤 👤		38
3.11	Disclose loan loss provisioning methodology to funders and investors		👤		38
3.12	Have explicit policy on write-offs and apply it consistently		👤 👤		38
<b>Managing fraud and security risk</b>					
<i>Microcredit providers will...</i>					
3.13	Specify lending limits for various ranks of officers and credit committees		👤		38
3.14	Have procedures for rescheduling loans		👤 👤		38
3.15	Have policies and procedures on dealing with collateral		👤 👤		39
3.16	Have policies classifying restricted and unrestricted fund account activity		👤 👤 👤		39
3.17	Limit handling of cash through banks or using electronic transfers		👤 👤		39
3.18	Have the following measures in place when handling cash...				39
3.18.1	Sufficient security measures to protect cash and assets		👤 👤		39
3.18.2	Standardised and consistent procedures for cash transactions		👤 👤		39



Clause number	Clause	Priority	Difficulty	Large Only	Page
3.18.3	Segregation of duties for handling and recording cash transactions		👤 👤		39
3.19	Segregate duties for approving and disbursing loans		👤		40
<b>Internal audit</b>					
<b>3.20</b>	<b>Microcredit providers will have explicit internal audit function adjusted to size of organisation</b>	<b>P</b>	👤 👤 👤		40
3.21	Internal auditor will report directly to board		👤		40
3.22	Internal audit will determine:				40
3.22.1	The reliability of existing information		👤 👤		40
3.22.2	The reliability and accuracy of financial and operational information		👤 👤		40
3.22.3	Violations of internal controls		👤 👤		40
3.22.4	Existence of uncontrolled risks		👤 👤 👤		40
3.23	Internal audit will be conducted regularly		👤 👤	⚠️	40
<b>IV. Reporting standards</b>					
<b>Common financial reporting standards</b>					
<i>Microcredit providers will...</i>					
4.1	Adhere to common way of measuring and reporting:				44
4.1.1	Current loan portfolio		👤		44
4.1.2	Gross loan portfolio		👤		44
4.1.3	Net loan portfolio		👤		44
4.1.4	Active borrowers		👤 👤		44
4.1.5	Financial revenue		👤 👤		44
4.1.6	Operating revenue		👤 👤		44
4.1.7	Personnel expense		👤		45
4.1.8	Administrative expense		👤		45
4.1.9	Financial expense		👤		45
<b>4.1.10</b>	<b>Portfolio at Risk</b>	<b>P</b>	👤		45
4.1.11	Write-offs		👤		45
4.1.12	Impairment loss allowance and provision expense		👤		45
4.1.13	Assets		👤		45
4.1.14	Liabilities		👤		45

Clause number	Clause	Priority	Difficulty	Large Only	Page
<b>4.1.15</b>	<b>Operational sustainability ratio</b>	<b>P</b>	■		46
4.1.16	Financial sustainability ratio		■ ■		46
4.1.17	Adjustments to sustainability ratios taking into account subsidies		■ ■ ■		46
<b>Common social reporting standards</b>					
<i>Microcredit providers will...</i>					
4.2	Publicly disclose...				
<b>4.2.1</b>	<b>Social mission</b>	<b>P</b>	■		46
4.2.2	Average disbursed loan size		■		46
4.2.3	Median loan size as % of gross national income		■		46
if relevant for target market and mission...					
4.2.4	% of female customers		■		46
4.2.5	% of rural customers		■		46
4.2.6	% of poor customers		■ ■		46
4.2.7	% of customers graduating to mainstream finance		■ ■		46
4.2.8	% of ethnic minority or indigenous customers		■		46
4.2.9	% of start-up businesses funded		■		46
4.2.10	% of customers on welfare benefits		■		46
<b>Common disclosure standards</b>					
4.3	Members of public will be able to access information		■		47
<i>Microcredit providers will...</i>					
4.4	Publicly disclose...				
4.4.1	Number of active borrowers		■		47
4.4.2	Number and value of loans issued and outstanding		■		47
4.4.3	Value of current, gross and net portfolio		■		47
4.4.4	Portfolio at Risk		■		47
4.4.5	Total value of assets and liabilities		■		47
<b>4.4.6</b>	<b>Operational sustainability ratio</b>	<b>P</b>	■		47
4.4.7	Financial sustainability ratio		■		47
4.4.8	% of cost per loan subsidised		■		47
4.4.9	Number of loan officers and (total) personnel		■		47

Clause number	Clause	Priority	Difficulty	Large Only	Page
4.5	Record complaints by applicants and past and current customers		■		47
<b>4.6</b>	<b>Publicly disclose data on complaints</b>	<b>P</b>			47
4.6.1	Number of complaints by applicants and past and current customers		■		47
4.6.2	Complaints as % of applicants and past and current customers		■		47
<b>V. Management information systems</b>					
<b>Functional completeness and expandability</b>					
<i>Microcredit providers will have a MIS that...</i>					
<b>5.1</b>	<b>Produces key operational and financial reports</b>	<b>P</b>			50
5.1.1	Income statement		■		50
5.1.2	Balance sheet		■		50
5.1.3	Daily loan and delinquency report, ratios and trends		■ ■		50
5.2	Enables provider to perform full range accounting activities		■ ■		50
5.3	Operates in accordance with recognised accounting standards		■		50
<b>5.4</b>	<b>Can monitor and manage loan portfolio quality and functions</b>	<b>P</b>	■ ■		50
<b>5.5</b>	<b>Can manage and maintain information about clients</b>	<b>P</b>	■		50
5.6	Can facilitate prompt access to relevant information for management, staff and board		■ ■		50
5.7	Can handle and incorporate new products, multiple offices, services and delivery channels		■ ■		51
5.8	Can cope with planned growth		■ ■		51
<b>Security &amp; staff support</b>					
<i>Microcredit providers will...</i>					
5.9	Restrict access to data captured by a MIS		■ ■		51
5.10	Operate with different levels of user access		■ ■		51
5.11	Have provisions to store and restore information		■ ■		51
5.12	Have a MIS that can perform regular back-ups		■ ■		51
5.13	Have safeguards to prevent illicit or accidental alteration of data files		■ ■		51
5.14	Have a MIS that can produce audit trail on crucial operations		■ ■		51
5.15	Provide training and/or manuals to staff		■ ■		51



# 1 – Customer and Investor Relations



## Introduction

Microcredit providers have clear obligations towards customers and investors. The well-being of customers is intimately linked to the mission of microcredit providers to combat poverty and social and financial exclusion, while private and public investors are increasingly important in the funding of the sector. Hence, establishing principles that guide the treatment of customers and principles that ensure transparency and reliability in dealing with investors is of great importance. This section of the Code sets out a series of obligations incumbent upon microcredit providers towards their customers and investors. This includes a fair and transparent lending process, right to redress, avoidance of customer over-indebtedness, protection of customer data and transparency vis-à-vis investors.

## Customer relations

### Sufficient information provided to customer

#### Clause 1.1

Microcredit providers will disclose lending costs in their advertising.

This will include borrowing rates, charges and an illustrative example.

#### Clause 1.2

##### Microcredit providers will disclose the cost as an Annual Percentage Rate of Charge

This clause has been identified as a **priority clause** because disclosing the cost of borrowing is crucial in enabling the customer to make informed financial decisions. The Annual Percentage Rate of Charge must be disclosed in a credit agreement and in any advertising. This refers to the annual value of all commitments, drawdowns, repayments and charges, including fees and taxes paid by the customer and known to the creditor.

#### Clause 1.3

Microcredit providers will provide the following pre-contractual information to the customer and set it up in the credit agreement:

Clause 1.3.1: the identity and geographical address of the lender

Clause 1.3.2: the amount

Clause 1.3.3: the duration of the credit agreement

Clause 1.3.4: the borrowing rate

Clause 1.3.5: total amount payable

Clause 1.3.6: charges for late repayments

Clause 1.3.7: right of early withdrawal

Clause 1.3.8: debt-collection practices

#### Clause 1.4

For loans of duration of 12 months or longer, microcredit providers will provide clear and accurate information to their customers about their loan in an annual statement.

The annual statement must include the amount paid (interest and principal), the balance left (interest and principal) and the structure of the remaining payments (timing, amounts, interest and principal). The annual statement may be transmitted electronically, on paper or face-to-face.

#### Clause 1.5

Microcredit providers will take adequate measures to ensure that customers fully understand the products, process and terms of the contract.

This may, where necessary and appropriate, include training customer-facing staff to communicate effectively with all customers, reading contracts out loud for visually impaired or illiterate customers, or providing materials in local languages.

## Customer rights

### Clause 1.6



**Customers have the right to either**

**a) withdraw within 14 calendar days of the signing of the credit agreement or**

**b) repay their loan in its entirety without incurring extra costs within 14 calendar days of the signing of the credit agreement, without having to give a reason.**

This clause has been identified as a **priority clause** because it is an important and widely recognised customer right. This right will be enshrined in the credit agreement.

### Clause 1.7



Customers will be given adequate time to review the terms of contract and given the opportunity to ask questions and get answers prior to signing.

### Clause 1.8



Customers have the right to early repayment, though the microcredit provider can claim compensation for reasonable costs linked to early repayment.

This right will be enshrined in the credit agreement. The costs linked to early repayment should also be set out in the agreement.

### Clause 1.9



Customers have the right to have the credit history they accumulate with a microcredit provider reported to national credit bureaux and databases where these exist.

Where applicable this right should be set out in the credit agreement. This is so that customers can build a credit score. This clause only applies in countries where national credit bureaux and databases collecting positive credit history exist.

## Avoiding over-indebtedness of customers

### Clause 1.10



Microcredit providers will assess repayment capacity and loan affordability on the basis of sufficient information from the applicant, database and/or competitors.

At a minimum this must involve calculating the customer's working capital, business and household surplus, and assets and liabilities. It should include an investigation of the capacity to carry forward the project. In that sense, referring to internal business development services or external partners to assist in the assessment is considered good practice.

### Clause 1.11



Microcredit providers will have credit policies which give explicit guidance on borrower debt thresholds and acceptable levels of debt from other sources.

The credit policy may indicate debt thresholds that a borrower can reasonably be expected to manage. This should be based on a realistic assessment of disposable income, allowing for fluctuations and including an allowance for other debts.

### Clause 1.12



If there is significant non- or under-payment exceeding one month's credit, the microcredit provider should inform the borrower without delay of the non- or under-payment through the appropriate medium.

This will include the amount involved, the borrowing rate, and penalties, charges or interest applicable on arrears.

## Customer care

### Clause 1.13



Microcredit providers will regularly assess customer satisfaction.

For large microcredit providers, this must entail more formalised and regular assessments involving the use

of recognised market research methods, such as focus groups, surveys, questionnaires or customer panels. For small providers, the assessment may be more informal, involving customer conversations or group discussions.

### Clause 1.14



Microcredit providers will have an explicit policy known by all staff members requiring customer complaints to be fully investigated and resolved in a timely manner.

For large microcredit providers, this policy will be written. For small and medium microcredit providers, this may be an unwritten but explicit and well-known policy or it may be incorporated into other policy manuals.

### Clause 1.15



**Microcredit providers will have a mechanism for dealing with customer complaints with dedicated staff resources.**

This clause has been identified as a **priority clause** because the right to complaint and redress is an important and widely recognised customer right.

This must be the responsibility of one or several staff members. This can be part of one or a group of staff members' job description.

### Clause 1.16



Microcredit providers will, in the course of the loan application process, ensure that customers are informed about their right to complain and how to make a complaint to the appropriate person.

The right to complain and who to contact to make a complaint should be included in information material handed to loan applicants, and should be discussed with the applicant.

## Ethical staff and institutional behaviour

### Clause 1.17



Microcredit providers will not discriminate on the basis of race, ethnicity, gender, political affiliation, disability, religion or sexual orientation in the selection and treatment of customers.

Non-discriminatory treatment is important for providing access to financial services to all clients who can use them and builds their confidence in the fairness of the provider.

### Clause 1.18



Acceptable and unacceptable debt-collection practices will be clearly set out in institutional documentation which will also apply to use of external debt collectors.

Institutional documentation includes staff rules and a debt-collection manual. The debt-collection policies should state that customers should be treated in a professional and respectful manner and that coercion or intimidation techniques, including physical force, humiliation and contacting the customer at inappropriate times, should not be used.

### Clause 1.19



Microcredit providers involved in secured lending will have an explicit policy on acceptable pledges of collateral.

The policy should address the issue of accepting collateral which may deprive borrowers of their basic survival capacity. This may include productive assets without which the borrower may be unable to sustain a basic level of household consumption or fall deeper into poverty. The policy may state that the provider does not accept such collateral, that this should be carefully considered by the loan officer or that stricter underwriting should be applied where this may be the case.

### Clause 1.20



Microcredit providers will conduct staff appraisals regularly to assess performance, ethical behaviour, professional conduct and quality of interaction with customers.



## Customer data protection

### Clause 1.21



Microcredit providers will have a written privacy policy governing the gathering, processing, use and distribution of customer data.

### Clause 1.22



Microcredit providers will ensure they have systems (including IT) in place to protect the confidentiality, security, accuracy and integrity of customers' personal and financial information.

This may include password protection or encryption of customer databases.

### Clause 1.23



Staff will be trained to protect the confidentiality, security, accuracy and integrity of customers' personal and financial information.

This will include explaining the rights of customers, and the processes and procedures in place in the provider to protect customer data. It should be included in the training programme of the provider.

### Clause 1.24



Customers will be informed about how their information will be used and about their right to withdraw their permission for this use.

This should include explaining how the data will be used and presented, and that the customer can withdraw their permission for the particular use. This should be explained to a customer before the customer is requested to submit the information in question.

### Clause 1.25



Written customer consent is required for use of any customer information in promotions, marketing material and other publicly disclosed information.

This means that such use of customer information requires the signature of the customer. The customer may provide the signature electronically via email.

## Investor relations

### Clause 1.26



Microcredit providers have the responsibility not to mislead investors.

For example, they cannot say that financial promotions are subject to regulation by a statutory agency if this is not the case.

### Clause 1.27



Microcredit providers will give relevant information enabling investors to make informed decisions.

The extent and nature of risk must be made explicit, and clear and transparent accounts and reports in accordance with the reporting standards laid out in the Code of Good Conduct will be made available. Microcredit providers will make it clear that any investment in the institution is risk capital and not equivalent to deposits.

### Clause 1.28



Microcredit providers will endeavour to target prospective investors equipped to understand risk (or have access to external, professional advice related to investments).

Microcredit providers offering fixed, low-cost shares as a form of membership, such as credit unions, are exempt from this clause. This applies to individual and not institutional investors.

### Clause 1.29



Microcredit providers should take the necessary steps to verify investors' identity to prevent money laundering.

For individuals investing, this is done by acquiring their name, photo identification, and place of residence and birth. For companies, one would have to check company register details and details of their directors.



A

# 2 – Governance



## Introduction

According to the Handbook for the Analysis of the Governance of Microfinance Institutions, governance “encompasses all the mechanisms by which stakeholders... define and pursue the institution’s mission... and ensure its sustainability by adapting to the environment, preventing and overcoming crises.” Strong and accountable governance structures are of great importance in microcredit institutions, as they ensure that providers are driven by clearly setting out road maps and that they do not deviate from this course. This is particularly important for preventing mission drift. This section covers business planning, the role and responsibilities of the board and management, and external audits.

## Development of a business plan

### Clause 2.1



**The microcredit provider will produce a business plan that is reviewed on a regular basis, at least once a year, and updated if necessary.**

This clause has been identified as a **priority clause** because a business plan may serve as a road map that sets the direction of the organisation and guides its policies and strategies. The components of the business plan are set out in Clause 2.3.

### Clause 2.2



The business plan will cover a minimum of a 3-5 year period.

### Clause 2.3

**The business plan will, at a minimum, cover the following aspects of the business:**

**Clause 2.3.1: Its mission, goals and objectives**

**Clause 2.3.2: Customer and product mix, including piloting and rolling out any new products and reaching out to new customer groups**

**Clause 2.3.3: Delivery model, including current and future staffing requirements, delivery partners**

**Clause 2.3.4: Legal and institutional form, including any proposed changes to the legal and institutional structure of the institution**

**Clause 2.3.5: Detailed budget and forecasting, including income, expenditure, bad debt provisioning, cash flow and balance**

**Clause 2.3.6: Funding, including revenue and capital funding**

**Clause 2.3.7: Identification of key risks and how these will be managed**

This clause has been identified as a **priority clause** because without these elements a business plan may not offer sufficient guidance for the direction of the organisation.

### Clause 2.4



Microcredit providers will commit to measure, disclose and improve their financial and social performance.

Microcredit providers will measure and disclose the financial and social performance indicators stipulated in ‘Reporting Standards’ in the Code of Good Conduct.

**Clause 2.5**

Microcredit providers will use management control and performance tools in business planning.

This will, at a minimum, include budgeting and variance analysis (i.e. calculating difference between budgeted and targeted expenditure and revenue – see glossary). The use of such tools should be evident in the business plan.

**Board****Independence of board****Clause 2.6**

**All microcredit providers will have a supervisory board, board of directors or equivalent body (henceforth, 'the board')**

This clause has been identified as a **priority clause** because having a board is an essential part of ensuring the sustainability of the provider and that it is fulfilling its corporate mission.

The board or equivalent body should have a known membership and a chairperson, have regular meetings covered by written minutes and comply with the clauses set out in the Code.

**Clause 2.7**

The board will have an audit or supervisory committee.

The committee should have a membership named by the board and have regular meetings covered by written minutes.

**Clause 2.8**

The audit or supervisory committee will be independent of management.

Representatives from management should be kept to a minimum and constitute only a minority of members of the audit or supervisory committee.

**Clause 2.9**

The audit or supervisory committee will meet with external auditors on an annual basis.

Minutes for the meetings should be recorded and kept for reference. While management may be present at the meetings with the auditors, the audit or supervisory committee will have the right to meet without the management team if necessary.

**Clause 2.10**

The audit or supervisory committee will have expertise in financial analysis and accounting.

**Clause 2.11**

The board of large microcredit providers will have a minimum of seven board members. Small and medium microcredit providers will have a minimum of five board members.

In its Consensus Statement on corporate governance, the Council of Microfinance Equity Funds suggests that seven to nine members are ideal and common. Fewer than seven is not advisable, as the quorum becomes small, especially if a representative of management is on the board. For very small providers, a board of three members may be sufficient.

### Clause 2.12



**The majority of board members will be independent of the management.**

This means that the majority of a board should not be composed solely of any combination of management, staff, customers or their immediate family.

This clause has been identified as a **priority clause** because having an independent board is crucial to ensuring effective oversight of and the provision of guidance to management on strategic issues.

This clause does not apply to cooperatives in which the board is constituted by customers who are cooperative shareholders. Cooperative and mutual providers should strive to ensure that any combination of management, staff or immediate family does not make up the majority of the board. For very small providers, a board of three members may be sufficient.

### Clause 2.13



The selection of chairperson and board members and any remuneration they receive will be decided by the General Assembly, the Annual General Meeting or the highest body within the organisation.

The election of the chairperson and board members should be included in the minutes of the General Assembly or the Annual General Meeting.

### Clause 2.14



The effectiveness of the board will be reviewed periodically by the General Assembly or the Annual General Meeting or equivalent body.

The performance and effectiveness of the board should be raised as a specific agenda item, and the discussion should be covered in the minutes of the General Assembly or the Annual General Meeting or equivalent body.

## Responsibilities of board

### Clause 2.15



The board will supervise the performance of the executive management.

The performance of the senior management should be raised as a specific agenda item during at least one board meeting annually. This will include discussing the performance of executive management in key management functions, such as planning, organisation, and implementation of plans, human resources, leadership and direction, and control and monitoring.

### Clause 2.16



The board or equivalent body as defined by national legislation is accountable for the compliance of the microcredit provider with relevant laws and regulations.

The board will ensure compliance in liaison with the person responsible for the internal audit function.

### Clause 2.17



The board on a regular basis reviews whether a microcredit provider is fulfilling its mission and business plan.

This should be discussed at board meetings on at least an annual basis. The discussion should include whether the institution is reaching its target group and achieving its financial performance.

### Clause 2.18



The board monitors financial indicators on a regular basis.

As a minimum this will happen on a quarterly basis.

## Influence of board on microcredit provider

### Clause 2.19



The board will be represented on the interview panel when hiring a new chief executive. It will also decide if her/his contract should be renewed.

These rules should be enshrined in the governance documents and any HR manuals of the institution.

### Clause 2.20



The board has the right to veto the appointments of executive management.

This should be enshrined in the governance documents and any HR manuals of the institution. This refers to the Chief Executive Officer, Managing Director, Financial Director or the two most senior posts in the organisation.

### Clause 2.21



The board decides the level of remuneration for the executive management posts.

This should be enshrined in the governance documents and any HR manuals of the institution.

### Clause 2.22



The board has to approve and has the right to veto any significant changes in pricing policies.

Pricing policy does not refer to minor adjustments to interest rates due to changes in base rates, but rather to more fundamental changes, such as the introduction of fees or considerable changes in interest rates. This clause only applies to providers that are allowed to lend and affect pricing levels.

### Clause 2.23



The board members are given monthly or quarterly reporting data regarding portfolio quality, financial performance and customer data.

It is important that customer data refers to global rather than individual customer data.

### Clause 2.24



All members will develop working capacity for financial statement analysis and understanding of banking.

Financial statement analysis refers to the process of identifying the financial strengths and weaknesses of the organisation by establishing relationships between items in the balance sheet and profit and loss account. In small and medium microcredit providers, the finance of the organisation must be explained to board members.

### Clause 2.25



All members will develop an understanding of credit risk in the provision of microcredit.

This will include how microcredit providers monitor and control credit risk, and how to respond to credit risk problems.

## Selection and representation of board members

### Clause 2.26



Improper persons are excluded from becoming board members in accordance with national legislation.

This will, for example, include people with unspent convictions. The exclusions should be clearly set out in any governance documentation.

### Clause 2.27



All microcredit providers will have rules stipulating term limits and rotation for board members.

These rules should be clearly set out in any governance documentation.

### Clause 2.28



All microcredit providers will have rules requiring full disclosure of any conflicts of interest of board members.

Any conflicts of interest should be disclosed in the annual report or other documents available to the public or, at least, to investors and members.

### Clause 2.29



All microcredit providers' boards will have members with qualifications or equivalent experience in the following fields: finance, business, management and law.

## Board practical work organisation

### Clause 2.30



The board will meet a minimum of four times a year.

The meetings should be covered by minutes made available to stakeholders.

### Clause 2.31



The microcredit provider will have rules on quorums, which must ensure that there is never a majority of staff or management at board meetings.

This means that the majority of a board should never be composed of any combination of management, staff or customers for valid transactions. These rules should be clearly set out in any governance documentation.

### Clause 2.32



Microcredit providers will disclose the proportion of related-party (insider) lending in its annual report.

Related-party (insider) lending refers to board members, staff or immediate family receiving loans or investment from microcredit providers.

## Management

### Management expertise and human resource management

### Clause 2.33



Executive managers of microcredit providers will be qualified to undertake key management functions.

This will include planning, organisation, and implementation of plans, human resources, leadership and direction, and control and monitoring. This will be addressed by the board as per Clause 2.15.

### Clause 2.34



Microcredit providers will have a succession plan for executive management.

Microcredit providers will plan for the planned (e.g. retirement) and unplanned departure of their chief executive. This should be an explicit if not written plan known by the board and may include potential candidates, training of potential in-house candidates and temporary arrangements.

### Clause 2.35



Microcredit providers will have clear personnel policies set out in written personnel manuals.

This will cover promotions, disciplinary procedures and salary policy. For small microcredit providers, an explicit policy well known by all relevant staff members is sufficient.

### Clause 2.36



Microcredit providers will have a formal training and induction programme.

For small microcredit providers, an informal training and induction programme may be sufficient.



## Operational manuals

### Clause 2.37



Microcredit providers will have operational manuals detailing financial operations and management.

This will cover aspects such as budget controls, producing accurate financial statements, credit applications, approvals and refinancing, portfolio quality review and provisioning. For small microcredit providers, an explicit policy well known by all relevant staff members is sufficient.

### Clause 2.38



Microcredit providers must have operational manuals detailing procedures for treasury.

This will cover aspects such as how cash is handled, accounting, investments, funding and liquidity management.

## External audit

### Clause 2.39



**Microcredit providers will be audited by an external auditor on an annual basis.**

This clause has been identified as a **priority clause** because having external audits is one of the principal means of assuring the accuracy and meaningfulness of financial reports. This clause refers to a financial audit rather than a procedures audit.

### Clause 2.40



The auditor will have the appropriate qualifications, accreditations and experience in accordance with national or international standards on auditing.

### Clause 2.41



The external audit will adhere to national or international standards on auditing.

### Clause 2.42



The external audit will be accompanied by a letter from the auditor.

The letter must contain an opinion paragraph which renders one of the following types of opinion: unqualified opinion, unqualified opinion with an emphasis of matter, qualified opinion, disclaimer of opinion, or adverse opinion.

### Clause 2.43



If the letter is qualified, then the microcredit provider will address the issues raised in the letter with appropriate action.

The actions taken or proposed to address the issues in the letter should be made explicit to the board and, if appropriate, addressed in the business plan.



# 3 – Risk Management



## Introduction

Microcredit providers face numerous risks that threaten their financial and institutional viability and long-term development. Their portfolio may suffer sudden rises in loan delinquency and arrears. Providers may be subject to fraudulent loans made by their loan officers. Therefore, it is imperative that providers have robust systems and procedures for identifying, assessing and prioritising risks, internal controls for preventing or detecting undesirable outcomes (e.g. credit committees), and an internal audit function for uncovering breaches of internal controls and fraudulent behaviour. This section of the Code sets out common standards for the management of credit, fraud and security risk and for the internal audit function.

## Risk management framework

### Clause 3.1



**Microcredit providers will have formalised and explicit processes and procedures in place to identify, to assess and to prioritise risks.**

This clause has been identified as a **priority clause** because these processes and procedures are essential in reducing the likelihood that a loss occurs and minimise the magnitude of the loss should it occur.

These processes should ensure that risks are examined and assessed regularly (frequency depending on priority assigned to the risk in question). This may involve having regular management meetings to discuss risks using a risk matrix or register.

A risk matrix or register identifies risks, determines the likelihood and the severity of the risks (e.g. low, moderate or high), and produces an aggregate risk profile combining the measures (likelihood and severity).

It may also incorporate the quality of existing risk management in terms of controlling the risk (e.g. strong, acceptable or weak) and the trend of the risks (e.g. stable, increasing or decreasing).

### Clause 3.2



**A senior member of the executive management will be accountable for risk management within the institution.**

This clause has been identified as a **priority clause** because management sets the tone for the approach to risk and internal control in the organisation.

It is important that the staff members responsible are not operational staff, such as loan officers and administrative staff. Instead, it should preferably be the Chief Financial Officer. In larger organisations, the person given overall responsibility for risk management should not be involved in operational activities, but should instead be dedicated to risk management.

### Clause 3.3



Microcredit providers will have a clear and explicit assignment of responsibility for the implementation of risk controls and ensuring that they are respected.

Risk controls are ex-ante mechanisms built into the organisational design, procedures and daily operations to ensure acceptable levels of risk.

Typical risk controls include policies requiring dual signatures on loans to reduce credit risk and risk of fraudulent lending, and safes, vaults or security guards to protect cash and other assets. The responsibility for the implementation of new risk controls and ensuring that these are respected should be assigned to a specific staff member or post. The provider may decide to make different staff members and posts responsible for different risk controls. It is important that the staff members responsible are not operational staff, such as loan officers and administrative staff.

### Clause 3.4



Microcredit providers will have a clear and explicit assignment of responsibility for monitoring and ensuring appropriate senior management receive the information necessary to conduct their tasks.

This may mean that a specific staff member or staff role should be responsible for compiling data and reports on relevant risks for the management on a regular basis.

## Management of credit risk

### Clause 3.5

Microcredit providers take into account credit risk when deciding on the following features of the loan product:

Clause 3.5.1: Eligibility requirements will be based, in part, on criteria known to alleviate credit risks involved in lending to vulnerable groups and individuals 🏠 🏠

These criteria will differ for different countries, but may include producing a viable business plan, relevant business and household documentation (e.g. bank statements, receipts) and having relevant experience (or training).

Clause 3.5.2: Loan amounts will be within a customer's ability to repay 🏠 🏠

The loan amounts should be based on a realistic assessment of disposable income, allowing for fluctuations in income and including an allowance for other debts. Providers operating with automatically increasing loan sizes to entice repeat business should also take into account the customer's ability to repay.

Clause 3.5.3: Loan terms will be sufficiently long to allow for affordable instalments 🏠 🏠

The repayment term of the loan should be adjusted to the underlying useful life of the asset being financed/purpose of the loan.

Clause 3.5.4: Repayment frequencies will be sufficiently frequent to instil repayment discipline in borrowers 🏠 🏠

Greater repayment frequency allows for greater control and oversight of credit risk. At the same time the repayment frequency should take into account transaction costs for the provider and the borrower, and the type of loan.

Clause 3.5.5: Microcredit providers will consider using non-traditional collateral and/or collateral substitutes to reduce credit risk 🏠 🏠

Collateral is an important mechanism for reducing credit risk. The provider should therefore consider whether demanding collateral, on balance, is an appropriate and cost-effective way of limiting credit risk in the circumstances in which it operates.

Clause 3.5.6: Microcredit providers will take into account risk in the pricing of their products 🏠 🏠

The interest rate should, at least in part, reflect the level of risk and costs involved in delivering the loans. This is of course not the only factor in determining, as the level of interest rate may also be influenced by national interest rate caps, funding arrangements and affordability of loans for borrowers.

### Clause 3.6

**Microcredit providers will limit credit risks by requiring that at least two people approve all loans.**

This clause has been identified as a **priority clause** because requiring two people to approve loans is one of the most widely recognised ways of reducing the number of poor or fraudulent lending decisions.

This will include loans that are rescheduled and refinanced. One of the people approving the loan may be a loan officer.

### Clause 3.7

Microcredit providers will limit credit risks by reviewing the aggregate exposure of the provider to any particular concentrations of groups of borrowers whose ability to repay could well be similar.

Relying on a narrow range of borrowers could potentially leave a provider at risk of high default rates triggered by events affecting a particular group, such as geographically concentrated economic downturns, sector-specific changes (e.g. new regulation, increased competition) and natural disasters.

The concentrations of borrowers could include, but not be limited to, sector or geographic location. This review may be conducted by the management and/or the board. The review should consider the impact on the risk exposure of the provider, if the provider should and could take measures to prevent over-reliance on a particular borrower group and what these potential measures could be (e.g. diversification of portfolio, expanding into new geographical markets).

It is recognised that microcredit providers typically target vulnerable groups and that this may lead to concentrations of groups of borrowers with similar repayment abilities. This does of course not mean that providers should avoid lending to these groups.

#### Clause 3.8



Microcredit providers operating with staff incentives should ensure that these are not exclusively linked to loan origination, but also to portfolio quality.

### Planning of portfolio quality

#### Clause 3.9



Microcredit providers will, at a minimum, measure portfolio quality by tracking the indicators set out in the Code of Good Conduct.

The key indicator in question would be Portfolio at Risk, both as a ratio and as a value of loans at various days past due. However, it may also be advisable to track other indicators, such as renegotiated loans and loans written off.

#### Clause 3.10



Microcredit providers will revise both the loan-loss provision expense and the loan-loss provisioning methodology regularly.

The microcredit provider should review the loan-loss provision expense regularly to verify if this accurately reflects the loan losses of the provider. If this is not the case, the provider should consider altering its methodology for provisioning for losses. This should happen once a year at the very least and be conducted by the management and/or the board.

#### Clause 3.11



Microcredit providers will disclose their loan-loss provisioning methodology to their funders and investors.

#### Clause 3.12



Microcredit providers will have an explicit policy on write-offs which is consistently applied.

Typically a write-off policy – the policy guiding the process of recognising a loan as uncollectible – states that a loan past due by a certain number of days is written off. This may be verified by the internal or external auditor.

### Management of fraud and security risk

#### Clause 3.13



Microcredit providers will have a written policy specifying lending limits for various ranks of officers and credit committees.

Providers should specify in their lending policy the maximum loan amount that their loan officers and credit committees can issue. The process for granting loans above this limit should, where applicable, also be specified in the policy document.

#### Clause 3.14



Microcredit providers will have explicit, appropriate and transparent procedures for the rescheduling of loans.

This should cover guidance on the type of re-scheduling allowed and deemed most appropriate, repayment schedules for missed payments, and the circumstances in which rescheduling is permissible and appropriate.

The type of rescheduling refers to if the borrower continues to pay interest rates or if payments of both principal and interest are deferred with or without interest accruing. The repayment schedule of missed payments could involve bulk payments after a specified event or instalments.

Appropriate circumstances for rescheduling include circumstances in which the borrower is temporarily unable to repay due to an unexpected event or emergency (e.g. natural disaster, delayed payment from customers) but where a possibility for recovery exists (through income from business or another source).

This guidance should be in a written policy.

### Clause 3.15



Microcredit providers involved in secured lending will have explicit policies and procedures on dealing with collateral.

Policies and procedures should address such aspects as the type of assets acceptable as a pledge of collateral, the process of valuing and registering the collateral, any inspection of collateral for impairment and clear procedures for returning collateral to the client (if the provider retains collateral during the lending period).

### Clause 3.16



Microcredit providers will have explicit policies classifying restricted and unrestricted fund account activity.

Providers should have a policy ensuring a separation between grants and investments whose use is unrestricted and those that are earmarked. This is standard procedure in internationally and nationally recognised accounting. By adhering to such standards, providers would comply with this clause.

This is important for preventing the misuse of funds. This may include requiring that funds be held in separate accounts, that separate audit trails be kept for different funds and that they be documented separately in audit accounts and other relevant documents.

### Clause 3.17



Microcredit providers will, as far as possible, limit the handling of cash by going through banks or relying on electronic means of transfers.

Dealing with cash and cash transactions poses potential security threats for providers, including in the form of theft and destruction of cash, and requires measures to safeguard cash.

The most effective control for safeguarding cash is to conduct, as far as possible, all financial transactions, including disbursements and repayments, electronically or through banks. Providers may develop their own electronic payment structure or they may work in partnership with banks to make use of existing electronic payments infrastructure. Where there is limited infrastructure to support electronic means of transfers, providers may want to consider alternative means of electronic payments, such as mobile banking, or prepaid or stored value cards. Providers should, on a regular basis, assess whether customers paying by cash could switch to electronic payments.

### Clause 3.18

Microcredit providers handling cash will have the following measures and procedures in place:

Clause 3.18.1: Sufficient security measures in place to protect cash and other assets



This may include safes, vaults, door and window locks, security cameras and security guards.

Clause 3.18.2: Standardised and consistent procedures for cash transactions



These procedures should cover the recording of and the reconciling of cash transactions. For medium and large microcredit providers, this should be covered in the operational manuals concerning treasury functions.

Clause 3.18.3: Segregation of duties for the handling and recording of cash transactions



The staff member that receives a cash payment should not also be the person recording the transaction. For medium and large microcredit providers, this rule should be covered in the operational manuals concerning treasury functions.

### Clause 3.19



Microcredit providers will operate with segregation of duties for the approval and disbursal of loans.

This should be enshrined in the relevant job descriptions, the IT system and/or the lending policies.

## Internal audit function

### Clause 3.20



**Microcredit providers will have an explicit internal audit function adjusted to the size of the organisation.**

This clause has been identified as a **priority clause** because it is important in determining the effectiveness of external controls.

Every microcredit provider will conduct an ex-post evaluation of risk controls, which should test the accuracy of information coming from management reports and investigates specific areas of higher risk to MFIs.

The audit should in particular focus on identifying fraud and portfolio quality problems before they result in significant losses.

The nature and magnitude of the audit will vary, depending on the size, from management spot checks of subordinates' work to a comprehensive audit involving reviews of loan files and customer visits.

One person should be responsible for conducting a regular internal audit. In smaller providers, this may be conducted by a senior manager or outsourced to an external auditor. Medium-sized and large providers may have a dedicated internal auditor or internal audit department.

### Clause 3.21



The internal auditor or the person responsible for the internal audit will report directly to the board of directors.

The person should report to the board of directors directly and regularly.

### Clause 3.22

The internal audit will determine the following:

Clause 3.22.1: The reliability and accuracy of financial and operational information

Clause 3.22.2: Adherence to stated procedures and policies set out in operational manuals

Clause 3.22.3: Any violations of internal controls

Clause 3.22.4: The existence of uncontrolled risks

The internal audit may also involve investigating a number of other risks and internal controls, depending on the size and nature of the organisation, and the nature of the risks it faces.

### Clause 3.23



The functions set out in Clause 3.22 will be conducted on a regular basis, at least on an annual basis.







# 4 – Reporting Standards



## Introduction

Globally, the consensus is increasingly underlining that a greater degree of public disclosure and transparency is the best way of promoting better use of public and private funding and greater market discipline. To facilitate comparisons of the performance of microcredit providers, financial reporting standards have been developed through international consensus. This section of the Code sets out a set of common standards for the reporting and disclosure of social and financial performance indicators. These are largely based on definitions of the Microfinance Information Exchange (MIX), which are based on internationally accepted accounting standards.

## Common financial reporting standards

### Clause 4.1

Microcredit providers across Europe will adhere to the following definitions when measuring and reporting the following indicators:

For organisations where the provision of microcredit is not the main activity – the organisation may provide other forms of credit or non-financial services, or it may form part of a larger parent company – it is recommended that the microcredit activity be separated out.

This is of particular importance for personnel and administrative expenses, but also in terms of assets and liabilities.

#### Clause 4.1.1: Current portfolio

Refers to the outstanding value of all loans that do not have any instalment of principal past due excluding accrued interest.

#### Clause 4.1.2: Gross loan portfolio

Refers to the outstanding principal balance of all outstanding loans, including current, delinquent, and restructured loans, but not loans that have been written off or interest receivable.

#### Clause 4.1.3: Net loan portfolio

Net loan portfolio is calculated by subtracting the impairment loss allowance from the gross loan portfolio.

#### Clause 4.1.4: Active borrowers

Active borrowers refers to individuals who currently have an outstanding loan balance with a microcredit provider or are primarily responsible for repaying any portion of a gross loan portfolio. Individuals with multiple loans with a microcredit provider should be counted as a single borrower.

#### Clause 4.1.5: Financial revenue

Financial revenue includes revenue from a loan portfolio and from investments.

Financial revenue from a loan portfolio refers to revenue from interest earned, fees and commissions (including late fees and penalties) on the gross loan portfolio only. It includes interest paid in cash and interest accrued but not yet paid.

Financial revenue from investments refers to revenue from interest, dividends or other payments generated by financial assets other than the gross loan portfolio, such as interest-bearing deposits, certificates of deposit, and treasury obligations. It includes interest paid in cash and interest accrued but not yet paid.

#### Clause 4.1.6: Operating revenue

Includes all financial revenue and other operating revenue generated from other financial services, such as fees and commissions for non-credit financial services not considered financial revenue.

It may include revenues linked with lending, such as membership fees, ATM card fees, transfer fees, or other financial services, such as payment services or insurance.

It may include net foreign currency gains/losses, but excludes any donations and revenue not generated from provision loans and financial services.

Training may be included if seen as integral to financial service provision.

#### Clause 4.1.7: Personnel expense

Covers wages and salaries, other short-term employee benefits, post-employment benefit expenses, termination benefit expenses, share-based payment transactions, other long-term benefits and other employee benefits.

#### Clause 4.1.8: Administrative expense

Covers non-financial expenses excluding personnel directly related to the provision of financial services or other services that form an integral part of an MFI's financial services relationship with customers.

#### Clause 4.1.9: Financial expense

This includes all interest, fees and commissions incurred on all liabilities, including deposit accounts of customers held by an MFI, commercial and concessional borrowings, mortgages and other liabilities. It may include facility fees for credit lines. It includes accrued and cash interest.

#### **Clause 4.1.10: Portfolio at Risk (PAR)**

This clause has been identified as a **priority clause** because it is the most widely recognised measure of portfolio quality.

This refers to the value of all loans outstanding that have one or more instalments of principal past due more than a certain number of days.

It includes an entire unpaid principal balance, both past-due and future instalments, but not accrued interest.

It does not include loans that have been restructured or rescheduled. Providers should at least measure PAR 30 or 45 days.

It is advisable that providers disclose PAR 30, as this is the internationally recognised measure.

#### Clause 4.1.11: Write-offs

Value of loans recognised as uncollectible for accounting purposes.

A write-off is an accounting procedure that removes the outstanding balance of the loan from the gross loan portfolio and impairment loss allowance, but does not affect the net loan portfolio, total assets or any equity account.

If the impairment loss allowance is insufficient to cover the amount written off, the excess amount will result in additional impairment losses on loans.

#### Clause 4.1.12: Impairment loss allowance and provision expense

Impairment loss or loan loss allowance is the portion of the gross loan portfolio that has been provided for in anticipation of losses due to default.

#### Clause 4.1.13: Assets

Sum of Property, plant and equipment, Investment Property, Goodwill, Intangible assets other than goodwill, Other financial assets, Loans and receivables, Investment accounted for using equity method, Biological assets, Non-Current assets classified as held for sale, Inventories, Current tax assets, Deferred tax assets, Trade and Other Receivables, and Cash and Cash Equivalents.

#### Clause 4.1.14: Liabilities

Sum of Total Trade and other payables, Provisions for employee benefits, Other provisions, Deferred revenue, Other financial liabilities, Other non-financial liabilities, Current tax liabilities, Deferred tax liabilities and Liabilities included in disposal groups classified as held for sale.

**Clause 4.1.15: Operational sustainability ratio** 🏠

This clause has been identified as a **priority clause** because it is a core indicator of performance of a microcredit provider.

It measures the extent to which a provider is covering its costs through operating revenues. This is calculated using the following formula:

$$\frac{\text{Operating revenue}}{\text{(Financial expense + Loan loss provision expense + personnel expense + administrative expense)}}$$

Clause 4.1.16: Financial sustainability ratio 🏠 🏠

The financial sustainability ratio measures how well a provider is covering its costs through operating revenues, taking into account subsidy adjustments. Subsidy adjustments are hypothetical revenues and expenses, which take into account the subsidised cost of funds and in-kind subsidy which better allow for comparisons of performance between organisations. This is calculated using the following formula:

$$\frac{\text{Operating revenue}}{\text{(Financial expense + loan loss provision expense + personnel expense + administrative expense + subsidy adjustments)}}$$

Clause 4.1.17: Adjustments to sustainability ratios taking into account subsidies 🏠 🏠 🏠

There are two types of subsidy adjustments: subsidised costs of funds and in-kind subsidy.

The subsidised cost-of-funds adjustment tries to account for the difference between an MFI's financial expense and financial expense it would pay if all funding were priced at market rates. It is commonly done by multiplying an MFI's average funding liabilities by some shadow price – market interest rate – then subtracting actual financial expense. The difference is the amount of adjustment and is treated as an expense.

The in-kind subsidy adjustment is the difference between what an MFI is actually paying for goods or services and what it would have to pay for the same goods or services on the open market. These adjustments are hypothetical and are not included in the annual accounts of a provider.

## Common social reporting standards

### Clause 4.2

Microcredit providers will, on an annual basis, publicly disclose the following indicators:

**Clause 4.2.1: Social mission** 🏠

This clause has been identified as a **priority clause** because disclosing the social mission is important for enhancing transparency around a key aspect of the provider's business model.

Clause 4.2.2: Average disbursed loan size 🏠

Clause 4.2.3: Median disbursed loan size as percentage of Gross National Income per capita. 🏠

Clause 4.2.4: Percentage of female customers if relevant for target market and mission 🏠

Clause 4.2.5: Percentage of rural customers if relevant for target market and mission 🏠

Clause 4.2.6: Percentage of customers below the poverty line if relevant for target market and mission 🏠 🏠

Clause 4.2.7: Percentage of customers graduating to mainstream finance if relevant for target market and mission 🏠 🏠

Clause 4.2.8: Percentage of ethnic minority or indigenous customers if relevant for target market and mission 🏠

Clause 4.2.9: Percentage of start-up businesses funded if relevant for target market and mission 🏠

Clause 4.2.10: Percentage of customers on welfare benefits if relevant for target market and mission 🏠

## Common disclosure standards

### Clause 4.3

Members of the public will be able to access information, stipulated in the Code of Good Conduct, about individual microcredit providers through an online database.

It is recommended that the providers disclose this information in their annual reports and other relevant forums.

### Clause 4.4

Microcredit providers will, on annual basis, publicly disclose the following indicators:

Clause 4.4.1: Number of active borrowers

This refers to the number of individuals who currently have an outstanding loan balance with the provider or are primarily responsible for repaying any portion of the gross loan portfolio. Individuals who have multiple loans with a provider should be counted as a single borrower.

Clause 4.4.2: Number and value of loans issued and outstanding

Clause 4.4.3: Value of current, gross and net loan portfolio

Clause 4.4.4: Portfolio at Risk

Providers will disclose PAR 30 or 45 days.

It is advisable that providers disclose PAR 30, as this is the internationally recognised measure.

Clause 4.4.5: Total value of assets and liabilities

#### Clause 4.4.6: Operational sustainability ratio

This clause has been identified as a **priority clause** because transparency of performance is an important part of instilling market discipline and enhancing confidence in the sector.

Clause 4.4.7: Financial sustainability ratio

Clause 4.4.8: Percentage of the cost per loan subsidised

Clause 4.4.9: Number of loan officers and (total) personnel

### Clause 4.5

Microcredit providers will record complaints made by applicants, and active and past clients.

All issues that an applicant, or active or past customer, reports through the formal complaint procedures should be recorded as a complaint.

### Clause 4.6

**Microcredit providers will report and disclose data on complaints:**

**Clause 4.6.1: The number of complaints made by applicants, and active and past clients**

**Clause 4.6.2: The number of complaints made by applicants, and active and past clients as a percentage of applicants, and active and past clients respectively**

This clause has been identified as a **priority clause** because the reporting and disclosure are important in instilling market discipline in enhancing customer care.





# 5 – Management Information Systems



## Introduction

According to the 1998 CGAP Handbook on Management Information Systems (MIS), a “management information system is the series of processes and actions involved in capturing raw data, processing the data into usable information, and disseminating the information to users in the form needed.” An effective and appropriate MIS can enable microcredit providers to serve their customers with greater efficiency and reliability.

This section of the Code sets out common standards for the MIS of providers regarding completeness and expandability (in terms of functions), security and staff support.

## Functional completeness and expandability

### Clause 5.1

**Microcredit providers will have a MIS that is capable of producing the data necessary for the following key management, operational and financial reports:**

This clause has been identified as a **priority clause** because the production of such reports is important in underpinning daily operational activities (e.g. delinquency management, etc.) and management of the microcredit provider.

**Clause 5.1.1: Income statement**



**Clause 5.1.2: Balance sheet**



**Clause 5.1.3: Daily loan and delinquency reports, ratios and trends**



### Clause 5.2



Microcredit providers will have a MIS that enables the provider to perform a full range of accounting activities.

This will include loan-loss provisioning and tracking cash flow, revenues and expenses.

### Clause 5.3



Microcredit providers will have a MIS that operates in accordance with generally accepted accounting principles and recognised accounting standards.

### Clause 5.4



**Microcredit providers will have a MIS that is able to monitor and manage loan portfolio quality and functions.**

This clause has been identified as a **priority clause** because having a MIS with such capabilities will aid in the monitoring and management of delinquency, in particular for both lending staff and management.

This will include producing historic data and specific loan officer information, and delinquency-management facilities.

### Clause 5.5



**Microcredit operators will have a MIS that is able to manage and maintain information about clients.**

This will include name, address, historical data, aggregate customer data and relevant social performance indicators.

This clause has been identified as a **priority clause** because effective management of customer data is important in understanding the customer base.

### Clause 5.6



Microcredit providers will have a MIS that is capable of facilitating prompt access to relevant information for management, lending staff and board members.

This does not necessarily mean that the manager, loan staff or board members have to be able to access this information directly through the MIS. Rather it means

that the MIS should be capable of producing relevant information for all these groups.

### Clause 5.7



Microcredit providers will have a MIS that is capable of handling and incorporating new products, multiple offices, services and delivery channels.

This will include separating and aggregating office-level data, new lending methodologies, currencies and various types of interest rates. This applies to providers that operate with or have plans to operate with various products, offices, services and delivery channels.

### Clause 5.8



Microcredit providers will, if applicable and part of the plan of the institution, have a MIS that is able to cope with planned growth.

This will include growth in volume lent and new branches.

## Security and staff support

### Clause 5.9



Microcredit providers will restrict access to the data captured by the MIS through use of appropriate security systems.

This may include pin codes (changed regularly), IP control and equivalent measures.

### Clause 5.10



Microcredit providers will operate with different levels of user access and reporting with functions reserved for specific user levels integrated into the user interface.

A key aspect of this is that one person should not be able to go through a whole process alone.

### Clause 5.11



Microcredit providers will have provisions in place to store completed transactions, balances and statements safely and restore information if necessary.

This may include regular back-ups and built-in recovery mechanisms.

### Clause 5.12



Microcredit providers will have a MIS that is able to perform regular back-ups.

Back-ups refer to making copies of computer programs and files, so that these can be used to restore the originals after a data-loss event.

### Clause 5.13



Microcredit providers will have safeguards to prevent illicit or accidental alteration of data files.

This may include user restrictions to specific activities, user passwords and system violation logs.

### Clause 5.14



Microcredit providers will have a MIS that is able to produce an audit trail on crucial processes and data changes.

The system should identify who has performed or signed off certain key actions, such as disbursing loans, changing loan amounts and rescheduling loans.

### Clause 5.15



Microcredit providers will provide training and/or manuals to support MIS users.

# Glossary

Term	Definition
Annual General Meeting (AGM)	Meeting of directors and shareholders of a company of incorporated firms. Often required by law, the AGM (sometimes called annual meeting) approves annual accounts, elects board members and deals with other matters.
Annual Percentage Rate	The annual rate that is charged for borrowing, expressed as a single percentage number that represents the actual yearly cost of funds over the term of a loan. Includes any fees or additional costs associated with the transaction.
Audit trail	Paper or electronic trail giving step-by-step documented history of a transaction. Enables tracing financial data from general ledger to source document (e.g. invoice, receipt, etc.). The general ledger is a repository of accounting information of an organisation in which summaries of all financial transactions during an accounting period are recorded.
Borrowing rate	Interest rate expressed as a fixed or variable percentage applied on an annual basis to the amount of credit drawn down.
Business plan	A detailed document describing the past, present and future financial and operational objectives of a company or organisation. Serves as a road map that sets out the direction of an organisation within a set time period, usually 3-5 years. Guides the organisation's policies and strategies and is underpinned by financial data.
Collateral	Traditional collateral tends to refer to property deeds, while non-traditional collateral tends to refer to personal guarantees, household assets and forced savings. Collateral substitutes refer to peer-guarantees.
Credit risk	This is the risk to earnings or capital because of a customer's failure to meet the terms of the lending agreement. Principally this is the risk that borrowers will not repay their loan.
External audit	"An external audit is a formal, independent review of an entity's financial statements, records, transactions, and operations, performed by professional accountants to lend credibility to financial statements and other management reports, ensure accountability for donor funds, or identify weaknesses in internal controls and systems. The scope of external audits can differ significantly according to the objectives of each audit" <sup>4</sup> .
Financial statement analysis	Process of identifying financial strengths and weaknesses of an organisation by establishing a relationship between items in the balance sheet and profit and loss account.

4 Source: CGAP (1998). External Audits of Microfinance Institutions – A Handbook, Volume 1. Technical Tool Series No. 3. December 1998

Term	Definition
Portfolio at Risk (PAR)	The value of outstanding loans that have one or more payments past due more than a given number of days. Often displayed as a ratio and divided into categories according to the number of days it is overdue.
Quorum	Minimal number of officers and members of a committee or organisation, usually a majority, who must be present for valid business transactions.
Refinancing of loans	This refers to the disbursement of loans to enable the borrower to repay prior loans they otherwise would have been unable to pay.
Rescheduled loans	The rescheduling of loans is the process of renegotiating or modifying “the originally scheduled payments of principal” <sup>5</sup> .
Restricted funds	Grants, investments or donations that require funds to be used in a specific way or for a specific purpose according to the wishes of the funder, such as providing services. The fund may be for delivering a set of services to a specific target group or it may be earmarked to cover certain costs (e.g. pay, equipment, etc.).
Risk matrix	A risk matrix or register identifies risks, determines the likelihood and the severity of the risks (e.g. low, moderate or high), and produces an aggregate risk profile combining the measures (likelihood and severity). A related tool is a risk management matrix, which incorporates the quality of existing risk management in terms of controlling the risk (e.g. strong, acceptable or weak).
Secured lending	Secured lending is when a loan is made in exchange for a pledge of an asset as collateral. If the loan is unpaid, the lender can repossess the collateral to recoup any losses.
Unrestricted funds	Grants, investments or donations that can be spent at the discretion of the recipient organisation.
Variance analysis	Process aimed at calculating the difference between actual and budgeted or targeted levels of costs or income and identifying causes of difference or variance.







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