Responsible Finance – the perspective of a development finance institution

Stefan W. Hirche
Principal Project Manager
Financial and Private Sector
Sub-Saharan Africa

Making Finance Work For Africa
Open Space on Responsible Finance
8-9 September 2009
Accra, Ghana

Overview

Background on KfW Development Bank

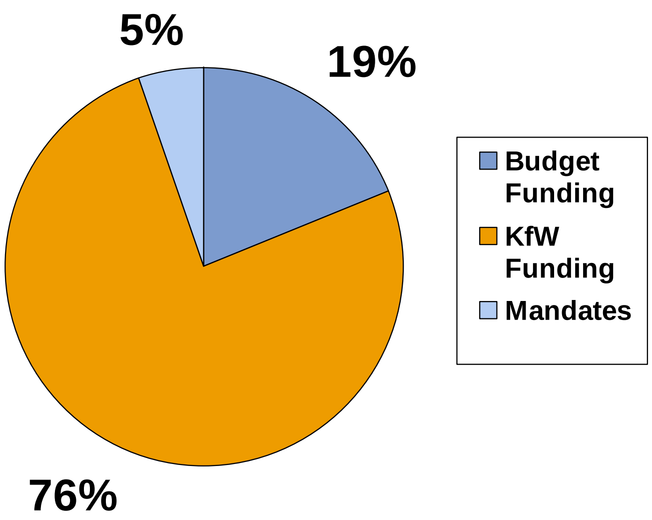
General Issues on Responsible Finance

Implementation and Case Study

Financial sector portfolio worldwide

KfW ENTWICKLUNGSBANK

- Active in more than 60 partner countries
- Outstanding portfolio in financial sector development: EUR 4.4 billion, 483 projects
- KfW has one of the largest microfinance portfolio totaling EUR 1.4 billion, 199 projects
- Systemic approach to financial sector development: Responsible finance is an integral part of sound financial systems development



Overview

Background on KfW Development Bank

General Issues on Responsible Finance

Implementation and Case Study

The rationale for responsible finance

- „Irresponsible finance“ in partner countries
- Biggest „banana skins“ (risks) are linked to responsible finance
- The global financial crisis
  - starts having an impact on developing countries
  - has led to a deteriorating loan portfolio quality
  - shows the need to refocus on fundamentals, i.e. increase credit standards
  - increases demand for high ethical standards

→ Need for action for regulatory bodies, financial institutions and investors

Dimensions of responsible finance

Donors and Investors
- long term involvement
- strengthening of local financial markets
- supporting transformation processes
- Focus on MFI ownership

Supporting financial institutions
- transparent credit selection process
- adequate assessment of clients repayment capabilities
- sound client protection priciples
- measuring social performance

Supporting Regulatory Bodies
- …have a role to play
- banning irresponsible collection practices
- proactive client protection, but
- not with interest rate caps!

Support at Client level
- strengthening financial education
- raising overall confidence in the financial sector
- promoting savings collection
- Access to responsible offers – lack of adequate financial products

Financial institutions – profitability and responsibility

- A strong credit approval process is key:
  - Adequate assessment of repayment capabilities
  - Risk of clients' over-indebtedness linked to credit risk of the bank
  - Clients' over-indebtedness may lead to financial sector instability

- Transparency in client communication and collection practices:
  - Transparent, simple language
  - Information on total costs, especially effective interest rates
  - Refrain from unfair or illegal debt collection
  - Client complaint mechanism

Consumer finance – issues for discussion

- What is/how consumptive is a “consumer loan”?
- Some facts:
  - Consumer lending is a fact, demand exists
  - Consumer loans may go hand in hand with over-indebtedness, intransparent lending and aggressive marketing
  - Indicators: <u>combination</u> of high RoE and interest rates, bad portfolio quality and low loan loss reserves
- Issues for discussion:
  - Consumer loans are not bad per se (e.g. consumption smoothening)
  - High consumer lending indicates increased risk of indebtedness
  - Focus on building assets and choose a reasonable product mix

Regulatory framework

- Promoting responsible finance from a macro perspective:
  - create and strengthen confidence
  - ensure financial sector stability
- Set up and support key institutions:
  - Banking supervision
  - Credit registry
  - Deposit insurance fund
- Consumer protection:
  - Voluntary practices
  - Promote of efficiency through transparency
  - Ban irresponsible debt collection practices
  - Enhance financial literacy
  - **However:** refrain from interest rate caps for the sake of responsible finance

Overview

Background on KfW Development Bank

General Issues on Responsible Finance

Implementation and Case Study

KfW Development Bank as a responsible finance institution

- Going beyond endorsements, mainstream responsible finance
- Named responsible finance focal points within the financial sector teams
- Responsible finance toolkit:
  - Position paper
  - Study on household credit
  - Check list
  - ToR for due diligences
  - Responsible finance clause in loan agreements
- Responsible finance in-house trainings
- Constant input in board meetings/investment committees of investees

Responsible finance at AB Microfinance Bank Nigeria (1)

- KfW equity participation (12.45%); Other shareholders: Access Holding, AfDB, IFC, Incofin
- Responsible finance as an affirmative covenant in the shareholders‘ agreement
- Business plans limits consumer lending to 7% of portfolio volume
- Responsible finance in the Operating Policy:
  - <u>Transparency:</u> Loan costs are indicated … as an effective rate including all cost elements. Clear, simple and equal rules for treating repayment default are communicated and enforced….
  - <u>Graduation principle:</u> …the Bank builds up a relationship of trust with its borrowers ….
  - <u>Quality and quantity:</u> Loan officers and middle loan management are paid performance-based salaries; their compensation is a function of their productivity and the quality of their work

Responsible finance at AB Microfinance Bank Nigeria (2)

- Responsible finance is also linked to refinancing: Competitors…
  - …attract deposits with lotteries
  - …promise loans if clients make deposits, and break those promises
  - …impose forced savings of up to 50% of the loan amount
  - …make use of aggressive deposit collection practices

- AB Microfinance Bank…
  - …does not provide lotteries
  - …does not make false promises
  - …does not make use of aggressive deposit collection practices

- General Manager: „You need more time to build up a good reputation in the market – but it is definitely worth it."

Conclusions

- This period of crisis is a critical moment to review lending standards

- Responsible finance benefits all:
  - Clients become more informed and self-reliant
  - Financial institutions fully tap their business potentials
  - Overall financial sector stability

- KfW remains committed…
  - …to be itself a responsible financier/investor
  - …to promote the relevant framework conditions

Thank you for your attention

<u>Contact:</u>

Stefan W. Hirche
Principal Project Manager
Financial and Private Sector
Sub-Saharan Africa
Tel.: +49 69 7431 - 4743
Fax: +49 69 7431 - 2944
stefan.hirche@kfw.de