KfW Development Bank

»» Perspectives on Development Finance

Responsible Finance
Guiding principle of KfW in the development of financial systems

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Financial systems in emerging and developing countries have developed significantly in recent years. It is crucial that the Responsible Finance principles are adhered to in order to ensure that the positive social and economic effects of improved access to financial services can develop. Responsible Finance (RF) is therefore an important guiding principle of KfW when developing financial systems.

Why Responsible Finance?

In the last fifteen years, developing countries and emerging economies have made important progress in developing financial systems. Many people today have access to a wide range of financial products: savings products, insurance products and increasingly tailored credit products for households and companies. However, financial services are also becoming more complex, requiring an increased level of basic financial knowledge on the part of consumers. Financial institutions also have an obligation to act in this regard. They need to communicate the terms of their products in a transparent and easily understandable way to protect their customers from excess debt and wrong decisions while limiting their own risk. The microfinance crisis identified many gaps in the industry and underscored the importance of actively addressing RF in dialogues relating to the international sector and international policy and supporting project partners in implementing the RF principles.

What is Responsible Finance?

KfW understands RF to be a business policy aimed at a fair balance of interests between financial institutions, their customers, investors and other stakeholders. It follows the definition of RF established in international professional circles. This is based on three complementary pillars[1] that address the tasks and responsibilities of different actors.

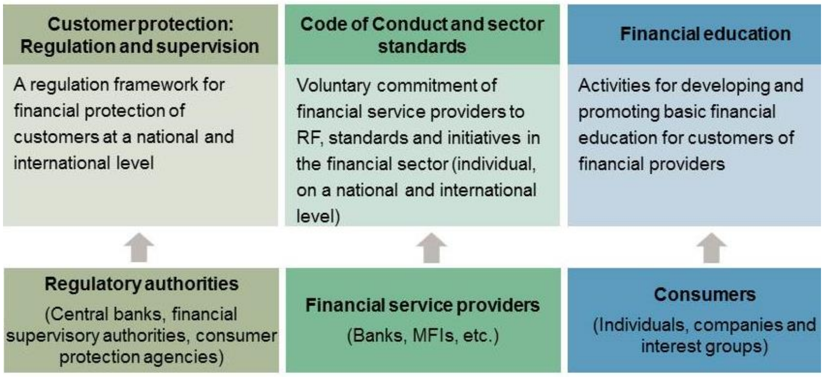
First, **legislators and financial supervisory and regulatory authorities** must establish and effectively monitor customer protection policies to reduce the information imbalance between customers and financial institutions. The customer protection policies of the SMART Campaign[2] have been established as the standard in international development cooperation (DC). **Providers of financial services** are themselves also obliged to treat their customers fairly and to make the conditions of their financial services transparent (**Code of Conduct**). Last but not least, initiatives by partner countries in close cooperation with international development cooperation to improve the **financial literacy of customers** and the use of these services by consumers are essential.

Only through the interplay of activities across these three pillars can the principles of RF be successfully established and improved access to savings, credit and insurance products achieve the desired positive economic and social effects.

[1] Dorasil, S. et al. (2011). *Advancing Responsible Finance for Greater Development Impact*. Washington D.C.: World Bank.

[2] http://smartcampaign.org/

The three pillars of Responsible Finance



Responsible Finance at KfW: firmly anchored in the project cycle

KfW addresses RF on various intervention levels. The focus of their initiatives is at the project or financial institution level.

During **project preparation**, RF aspects are an important part of financial sector analysis. Particular attention is paid to the analysis of developments and competition in the relevant market: are there signs of excess debt, how sustainable is the growth of the financial sector, are there signs of overheating? These questions need to be answered and assessed in the light of the overall level of development of the financial sector in the partner country. For the evaluation, it is also crucial whether, for example, a well-functioning credit information system exists and is used or whether sound customer protection provisions are established and effectively monitored.

In the **conception phase** of a project, the selection of a suitable partner institution is an important contribution to the establishment of RF guidelines. Accordingly, KfW only supports financial intermediaries that have RF anchored in their business model. Therefore, the RF principles are also an integral part of appraising the partner institution.

For the management of its fund investments, KfW selects professional fund managers with extensive knowledge of local financial markets and a strong sense of social responsibility. Many of these fund managers lead international efforts in RF and social performance management.

KfW obliges its fund managers to take RF aspects into account when selecting financial institutions to be financed. In addition, advisory funds are available to many funds, which can also be used for measures to improve the RF performance of financial institutions and for other measures, e.g. in the area of financial education of microfinance clients.

In addition to selecting the right partners, it is crucial to focus on the customer's needs when designing projects and to support the partner institutions in addressing these needs with appropriate products. The passing on of exchange rate risks by financial intermediaries to final borrowers is another critical aspect from an RF perspective. This is particularly problematic if the customer generates most of their income in local currency and is unable to hedge against exchange rate fluctuations. KfW strives to expand refinancing in the local currency. Where this is not possible, it works to ensure that its partner financial institutions hedge against exchange rate risks rather than pass them on to their clients.

When providing equity capital, KfW commits itself to a "buy and hold" strategy. It is thus pursuing a long-term investment perspective to strengthen the financial institution. KfW acts as an investor for the implementation of RF principles in the institution through its representation in the shareholders' meeting and on the supervisory boards.

During the **implementation** of a project, KfW reviews the performance of the partner institution in the area of RF, points out existing weaknesses and, if necessary, supports its partners with appropriate advisory measures. These measures may include, for example, the development of products specifically adapted to the needs of certain customer groups, support in preparing for SMART Campaign certification or the partial financing of financial education information campaigns.

RF is also an integral part of KfW's Sustainability Guideline, which is anchored in KfW Development Bank's processes and forms the basis for the environmental, climate and social impact assessment that every new project must undergo.

Microloan customer in Yemen. Source: KfW photo archive, copyright: photothek.net

Responsible Finance on the sectoral and policy level

As well as on a project level, KfW does not only address the project level with its activities, but the sectoral and policy levels too.

At the **sectoral level**, projects to establish credit information systems and the establishment and capitalisation of deposit guarantee funds are particularly noteworthy.

Credit information systems enable the exchange of credit information between financial institutions and thus lead to an improvement in credit analysis. They also contribute to the protection of customers from excess debt.

The establishment of deposit protection funds is a further important pillar of KfW activities in the area of RF at the sectoral level. Deposit protection funds help to increase the stability of the financial sector in the partner country and strengthen customer confidence in financial institutions. This has a positive effect on savings activities.

Building up savings – even for the poorest population groups – is very important from the RF perspective, because savings deposits can serve as a financial buffer for customers and their families in difficult times and can prevent them from needing to sell what little property they have or making compromises with regard to nutrition and health care.

At the **policy level,** KfW engages in dialogue with regulatory and supervisory authorities, ministries, state institutions in the respective partner countries as well as with the international DC community to address issues regarding RF. This also includes active exchange with central banks on a wide range of sectoral policy topics such as maximum interest rates (see Box 1).

Responsible Finance and beyond

In response to the microfinance crisis, the RF discussion initially mainly focused on customer protection. The aim was to firmly establish minimum standards for customer protection in the (micro)financial sector.

The concept of social performance management (SPM) is now an important further development. While the SMART Campaign focuses on customer protection, i.e. the "do no harm approach", the initiative of the Social Performance Task Force goes a decisive step further. It defines SPM on the basis of six criteria (see chart) and shows financial institutions aiming to achieve social impact as well as financial returns, how SPM can be integrated into business practice. KfW considers SPM to be an important concept and endorses its use by its partners.

But even RF itself is not a static catalogue of criteria. Rather, RF must adapt to new developments in the financial sector. RF will become even more important in the future with the advancing digitalisation of the financial sector and the associated challenges in the area of transparency and data protection.

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Photos / graphics

P. 1, 2: KfW photo archive/photothek.net

P. 2: Based on: Dorasil, S. et al. (2011). *Advancing Responsible Finance for Greater Development Impact.* Washington D.C.: World Bank.

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