CERISE+SPTF

Social Investor Working Group

Detailed Guidelines

for investors to take action on Client Protection in the investment process in the inclusive finance sector

Client Protection Pathway

Suggested approach approved by the Social Investor Working Group of Cerise+SPTF

Version 4 – July 2023

Acknowledgment

These guidelines propose a set of actions investors can take to drive implementation of client protection standards among investees, as well as examples of implementation. Signatories of the Joint Statement (who have committed to reporting what actions they have taken during the investment process to drive client protection uptake) will find these guidelines particularly useful.

These guidelines were developed in close cooperation over many months by asset managers and investors in the financial inclusion industry.

We particularly wish to thank for their active sub-group contributions Christophe Bochatay of Triple Jump, Chiara Pescatori of LMDF, Edouard Sers of Grameen Crédit Agricole Foundation, Frank Streppel and Tatiana Kalinina of Triodos, and Gaëlle Guignard of Incofin,

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Introduction and background

Why a Client Protection Accelerating Action group?

In September 2021, Cerise+SPTF launched a call for action amongst investors and development finance institutions to engage these key stakeholders on client protection risks and management. The aim was to create global, industry-wide uptake on the existing work – to create transparency, comparability and share examples of successful client protection implementation. For investors, this call for action is materialised through the Joint Statement, and counts over 40 signatories representing the industry as MIVs, donors and networks.

At the SPTF Annual Meeting in Paris in October 2022, the Social Investor Working Group gathered around the conviction that it was high time to move to concrete implementation of this call for action, and make client protection a fundamental, systematic and meaningful step of the investment process. The CP Accelerating Action Group (CPAAG) was thus launched with representatives from social investors interested in and committed to operationalising client protection.

Methodology

The first meeting was held on December 15th 2022 with representatives of 9 investment funds and asset managers, and continued with monthly meetings. Based on first concrete examples of implementation by some investors and MIVs, the approach led the group to reflect on **what actions could and should be taken globally by the investor community at each step of the investment process in the inclusive financial sector** to assess client protection, receive information from the prospect / investee and raise awareness around next steps.

We started using the current experience of each participant, moving further to reaching consensus on what was reasonable to require from investment managers and from FSPs. The burden and cost were constantly put in the balance, together with the leverage of other requirements or tools that are already in place.

The following guidelines propose a set of minimum actions to drive implementation of client protection standards among investees, as well as examples of implementation.

For more information on the CP Pathway and the tools mentioned in these guidelines, please refer to the document "Annex – CP Brief for investors", and to the Cerise+SPTF website.

Section 1. Investors' TRANSPARENCY

There are a variety of actions that an investor can take to drive implementation of client protection standards among investees.

The CPAAG believes that it would be useful for the community of responsible investors to understand where each investor/fund stands in this implementation.

In order to **promote transparency** on what investors actually do, the working group suggests that **investors report** on the following categories of action. Cerise+SPTF would send a brief questionnaire to collect this data and could disclose the results within the SIWG.

Categories

The following categories are the different types of initiatives that a debt or equity investor can take to promote client protection amongst their investees. Those marked with ***** are considered minimum requirements for responsible investment.

<u>Assess</u>
Assessment of client protection risks

1. Internal assessment, with in-house tools
2. Assessment in line with Cerise+SPTF CP standards (SPI Online tools)
    a. ESG subset
    b. CP Commit*
    c. ALINUS
    d. CP Full
    e. SPI Full
3. Requirement to provide Social Rating or Certification

<u>Engage</u>
Level of engagement with investees

1. Non-binding improvement suggestions; e.g., during due-diligence, raise awareness on CP Pathway and encourage to sign commitment
2. Binding improvement requests:
    a. Contractual clause to sign-up to CP Pathway within a defined timeframe* (step 1 of the Pathway) or with specific action defined (e.g., yearly ALINUS reporting, and/or specific progress expected)
    b. Condition Precedent (e.g., sign-up to CP Pathway before disbursement)

<u>Support</u>
Support in improvements related to client protection

1. Non-financial support; e.g. conducting the assessment with investee, providing direct TA…
2. Financial support – contribution towards the FSP's capacity building
    a. Co-financing of a CP assessment to design an action plan (step 2 of CP Pathway)
    b. Co-financing of Technical Assistance to address gaps
    c. Co-financing of CP certification (step 3 of CP Pathway)
    d. Price incentive based on binding improvements expected

<u>Other Reporting on CP to existing initiatives</u>
What other type of client protection related reporting is submitted to other stakeholders?

Reporting

On a yearly basis, investors report to Cerise+SPTF on what actions they have taken and the % of FSP's these actions have been applied to *(reporting template to be further developed and discussed with SIWG)*.
This reporting will be publicly available on Cerise+SPTF website and list all the reporting organisations individually (anonymously if requested) with details along the 4 above-mentioned categories.

Section 2. Presentation of the selected MINIMUM requirements for responsible investments & some examples of implementation

We propose a step-by-step approach, along the investment process steps.

A. Before an investment | Screening, Eligibility criteria, Due diligence

*At this step, the investor verifies that the investee/ prospect has the systems and practices in place **to ensure no harm is done to its clients**, and **raises the awareness** around client protection and international standards.*

Training of staff in charge of investment

The investor ensures that all their staff involved in the investment process are trained and regularly updated on client protection and international standards. This is an on-going process.

Screening

When screening the market and identifying potential new investees, the investor first refers to **the list of Committed FSPs** on Cerise+SPTF website.

- ◊ If the FSP is listed and marked as active[1], the investor can directly contact the FSP to request the evaluation that has been submitted.
- ◊ If the FSP is not yet listed, or does not qualify anymore as committed on the CP Pathway, the investor **raises awareness on the CP Pathway**, with the help of the Communication's Kit available on Cerise+SPTF website.

Due Diligence

At the time of conducting the due diligence, whether or not the prospect has already conducted a CP assessment, the investor integrates **key client protection elements and questions in its due diligence**. The investor uses the indicators from CP Commit or ALINUS as a minimum.
Equity investors are advised to use more in-depth tools such as CP Full or SPI Full to assess more comprehensively the alignment of the prospect with international standards.
The completed assessments are handed to the prospect so that they can use it to sign-up to the CP Pathway, and share it with other investors.

In conducting its due diligence, the investor identifies potential CP risks and major gaps against the CP Standards. The investment committee considers this CP assessment in its investment decision.
Each investor defines at its own discretion what it considers minimum CP requirements and major gaps[2], as well next steps (e.g.: to move forward but with contractual conditions, or not to proceed with the investment).

FSPs are encouraged to share their CP Commit or ALINUS due diligence reports with other investors.

Going beyond minimum - best practice

- The FSP is encouraged to sign-up to the CP Pathway as a Condition Precedent for disbursement
- The investor considers the compliance with all Entry indicators of CP Commit as a minimum level

[1] Reminder: The commitment expires (i) if the FSP doesn't provide any proof of assessment within 6 months of joining the CP Pathway, and/or (ii) if the FSP doesn't update its assessment after a period of 2 years.
[2] In some cases, major gaps may be considered eliminatory for investment, which thus triggers no more action from the part of the investor.

- In defining major gaps, the investor considers the Entry (and Progress) indicators as critical.

For current/existing investees, investors actively promote the CP Pathway using any opportunity such as a review/reporting stage. At the moment of renewal, the investor applies these minimum guidelines.

B. At signature | Contract, Disbursement

*At this step, the investor brings the investee to **join the CP Pathway**, and to commit on **improvement**.*

Formal Commitment to implement

If not already done, the investee **formally signs the "commitment to implement"** statement of the CP Pathway, within a defined timeframe. This constitutes a formal requirement from the investor through a **written clause** in the agreement.

Why make it a requirement?

- There is no cost associated to joining the CP Pathway and Cerise+SPTF.
- If a CP Commit or ALINUS due diligence has been conducted, the investee can use it to submit its "proof of commitment".
- Cerise+SPTF ensures the monitoring of keeping up-to-date with documents submission.

Examples Of Binding Agreements

Example of covenant in loan/grant contract

Commitment to implement Client Protection. Within 90 days of the disbursement date [or contract signature], the borrower agrees to formally commit to implement Client Protection Standards by joining the CP Pathway. The borrower commits to keep an active status on the CP Pathway throughout the whole contract term, and, as such, to comply with all requirements as requested by Cerise+SPTF.
[Event of default] Non-compliance with the above will be considered an event of default.
[Not EoD] Non-compliance with the above will not be considered an event of default but shall be discussed between the Borrower and the Lender in order to find a prompt remediation.

Reporting on Client Protection. The Borrower commits to share with the Lender updated reporting through [CP Full/ ALINUS] within 12 months of signature, and on a yearly basis.

Example of covenant for Certified institutions

For companies that are already certified at the time of contract signature
The Borrower commits to maintain the [Bronze/Silver/Gold] certification under the Cerise+SPTF Client Protection framework throughout the duration of the Loan Agreement.

Example of shareholder agreement clause

The shareholders agree that the Company shall formally commit to implement Client Protection Standards by joining the CP Pathway within 90 days of this agreement's signature, and that the Company shall remain at all times committed to delivering fair and safe financial services to its clients. The Board of Directors shall ensure that this commitment is fulfilled through the regular monitoring of client protection risks (over-indebtedness, unfair treatment, lack of transparency, privacy of client data, complaints, fraud, corruption and bribery).

The Board of Directors will make strategic decisions based on annual reporting of client protection risks provided by management and internal audit, and shall take corrective action when it identifies risks to clients.
The Board of Directors shall hold the management accountable for achieving client protection through formal targets included in the CEO's performance evaluation.

Improve practices (if applicable)

If during the CP due diligence assessment any **critical gaps** are found, that have not been considered as eliminatory criteria, the FSP and the investor agree on a formal **action plan** for improvements (e.g.: decrease the interest rate throughout the investment term). The investor sets **milestones** and requires documented evidence of improvement made.

Each investor defines at its own discretion what it considers critical client protection risks and major gaps that need to be addressed.

EXAMPLES OF MAJOR GAPS

- Having a 3-year average Return on Assets above a given threshold
- Calculating and disclosing interest rates to clients on a flat balance
- The FSP encourages its staff to identify the delinquent client's weakness point to use as a pressure element and leverage

Going beyond minimum - best practice

- The contractual undertaking to formally sign-up to the CP Pathway specifies that the FSP should commit within 90 days (3 months) of contract signature or disbursement.
- The action plan is based on a CP Commit/ ALINUS due diligence assessment by the investor
- The CP Commit Entry indicators are considered critical, and need to be fully compliant
- In case of major weaknesses identified in the due diligence, the action plan is a Condition Subsequent (CS) within the first periodic monitoring report (usually 1 - 6 months)

C. During the investment term | Monitoring - By the end of the contract

*At this step, the investor encourages the investee to **improve** its CP practices.*

Monitoring activity on the CP Pathway

- ◊ Within the previously agreed timeframe, the investor checks on the Cerise+SPTF list of committed providers whether the investee has joined or not. If not, the investor follows-up with the investee and provides additional guidance until at least Step 1 of the CP Pathway is completed.
- ◊ Throughout the loan term, the investor regularly consults the list of committed FSP to verify that the FSP is active or expired[3] on the CP Pathway.

Monitor the action plan (if applicable)

When the due diligence or the regular reporting has identified **areas for improvement**, the investor requires documented evidence of implementation of actions, or verifies through monitoring visits.

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[3] Reminder: The commitment expires (i) if the FSP doesn't provide any proof of assessment within 6 months of joining the CP Pathway, and (ii) if the FSP doesn't update its assessment after a period of 2 years.

Going beyond minimum - best practice

- **Certification**. Investors agree that Certification is **not necessarily a minimum requirement**. It can become a requirement in specific contexts such as high-risk markets or reputational risk of a given FSP (taking into account risk, maturity & business model).
- At the frequency of its choice, the investor **requires completing ALINUS**.
- The ALINUS reporting, when completed as a self-assessment by the FSP, is reviewed in-depth by the investment manager who verifies the quality of the assessment and discuss any gaps
- The investor sets internal **thresholds** on scores and/or expected specific improvements to be reported on; if no progress is found, the investor invokes a "breach of social undertaking"

CHALLENGES & LESSONS LEARNT FROM THE REPORTING PROCESS – Testimony by Incofin

At Incofin, an annual update of ALINUS is required for each portfolio company. As per our internal guidelines, ALINUS needs to be completed by the Investment Officer, not by the investee. That said, a self-assessment by the investee can be accepted as long as it is reviewed and adjusted, if necessary, by the Investment Officer. Therefore, from experience, this second option does not necessarily save considerable time. In any case, the annual ALINUS update is used to monitor progress on the CP Pathway.