GOVERNANCE: ORGANIZING, DEVELOPING AND EMPOWERING BOARDS TO OVERSEE MFI OPERATIONS

Written by:
BEATRICE SABANA, MICROFINANCE CONSULTANT AND DIRECTOR
EQUITY BANK, KENYA

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EXECUTIVE SUMMARY:

'The temptation is great among young institutions dominated by founding entrepreneurs for the founder to select board members on the basis of friendship or prior relationship. While this practice may provide support and counsel to the founder and a ready-made group of backers for a new venture, it leads to management-dominated organizations lacking important checks and balances. Board members whose primary loyalty is to the CEO may hesitate to challenge him or her or demand accountability, particularly if such members lack technical knowledge. As the institution transforms, such boards are often reluctant to cede control to a different group of people, particularly if the long time members identify strongly with the shared experience of building the institution. This factor has prevented some NGOs from becoming licensed financial institutions where investors become owners. Evolution into a robust professional organization requires that such tied board members yield over time to more professional board members' [1]

This statement summarizes the challenge of instilling effective governance structures in microfinance institutions in Africa, especially in unregulated NGO MFIs. A review of current trends in the development of the microfinance industry indicates that the issue of governance will be critical to the growth and survival of the MFIs. For example, the wind of regulation that is sweeping across the microfinance landscape in Africa requires microfinance institutions to transform their governance structures. Similarly, MFIs wishing to access commercial sources of funds (through debt and equity instruments) have to convince the lenders and/or investors that they have sound governance structures.

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[1] Consensus Statement of the Council of Microfinance Equity Funds. The Council comprises of 17 private funds that make equity investments in microfinance. ACCION International convened this group in 2003 as a forum for advancing understanding and exchanging views on equity investing in microfinance. CMEF members are Accion International, Accion Investments in microfinance, Africap, Andromeda Fund, Citigroup, Development International Desjardins(DID), Deutsche Bank, Gray Ghot Microfinance Fund, Oiko Credit, Open Society Institute, Opportunity International, Profund International, ShoreBank, ShoreCap International, Societe d'Investment et de Development International (SIDI), Triodos Bank and Unitus.

The mushrooming of 'quack'[2] MFIs and the collapse of many MFIs, often with clients' deposits, has intensified interest and demands for more effective governance of MFIs.

This paper uses the risk management paradigm to emphasize that poor corporate governance is a major risk to the sustainability and viability of microfinance institutions. The paper argues that board systems, and procedures do not guarantee effective governance of MFIs. Boards have to be sufficiently empowered in order to discharge their duties and responsibilities more effectively. This requires MFI boards to evolve from advisory or 'rubber stamp boards' which take a back seat, leaving management to take all strategic decisions to strategic boards which are catalysts, initiating, influencing, evaluating and monitoring strategic decisions and actions of management and holding management responsible and accountable for the performance of the institution.

In order to ensure that these functions are performed effectively, MFIs have to establish internal and external mechanisms that will attract, empower, motivate, retain and renew their boards. The paper explores the what, why, how and who of microfinance governance. The paper proposes that beyond establishing governance systems and structures, there is need for external oversight systems that promote the practice of governance in MFIs**.** Finally the paper asks the all-important question: 'who should empower boards' and suggests that**:**

- The MFI industry should develop an industry wide Code of Corporate Governance to which every MFI should be required to subscribe and comply. Sanctions for non-compliance should be applied (e.g. blacklisting and publishing the names of rogue MFIs). This is best done at a country /regional level

[2] Refers to 'get rich quick' traders who fleece members of the public

- Resources (Financial and technical) should be committed to developing the capacity of boards.
- Donor and investors should encourage and monitor the status of corporate governance in all institutions they support.
- Clients and shareholders should be educated and empowered to monitor and demand sound governance from microfinance institutions.
- There is need for more research into the impact of governance on the performance and sustainability of MFIs and case studies on governance need to be developed and disseminated.

1.0. INTRODUCTION:

'Governance is Governance…………..it is not management and it is surely not volunteering'.

Ken Dayton

Governance is still a relatively new concept in microfinance and its evolution is characteristic of the challenges that industries face as they develop. Typically, emerging industries go through various stages of governance awareness. At start up, businesses are preoccupied with vision setting, setting up systems, mobilizing resources and developing market entry strategies. At this stage, scant attention is paid to governance. At the next stage organizations are concerned with balancing growth with profitability. As the organization matures and new owners enter the business, then governance issues begin to emerge. In many countries, the microfinance industry has evolved through these stages and has now entered the maturity stage where commercialization, regulation, consumer awareness and competition are creating pressure for more transparency and accountability.

Whereas, there is growing awareness about the need for effective governance in microfinance institutions, it has not attracted the same level of concern and scrutiny as other issues that are considered critical to the development of microfinance development (growth capital, outreach, sustainability, impact). Governance is the least discussed, least researched and least funded issue in the microfinance development arena. Funding is available for product development, innovations, commercialization, transformation, regulation, capacity building, but virtually no funding dedicated to strengthening of governance structures and systems in microfinance. There is virtually no research on the impact of governance on microfinance institutions (The last paper on governance was posted on the microfinance gateway in 2004 while the last authoritative publication on governance in MFIs institutions was in

1998[3]. And yet, poor governance is the greatest risk that threatens the sustainability and viability of the microfinance industry. There is compelling evidence that poor governance is perhaps the major cause of the collapse of many MFIs in Africa. The following examples illustrate some of the common governance problems in MFIs.

1.1 COUNTRY CASE STUDIES

EXAMPLE 1: COUNTRY X:

The Savings and Credit Cooperatives (SACCOs) are the largest provider of financial services to urban and rural populations in Country X. By the end of 2005, there were an estimated 4,400 SACCOs, with over 5 million members with savings portfolio of USD 980 million and outstanding loan portfolio of about US$ 20 billion. But poor governance has led to the collapse of many of these SACCOs, leaving many families destitute. And since these SACCOs are unregulated, members have no legal recourse.

EXAMPLE 2: COUNTRY A:

MFI A was established in 1995, by a group of seasoned business people and professionals, led by a leading entrepreneur operating a chain of businesses in the country, with millions of dollars in annual turnover. The entrepreneurs and professionals were social investors who had started the MFI as a vehicle for economic empowerment of their people. The board comprised of a number of astute business people, a lawyer, a commercial banker, a teacher, a local women's leader and even a local pastor. Board meetings were conducted in a professional manner, with the board members bringing the skills and experience to bear on the discussions. This could have been the board of a

[3] Principles of microfinance Governance by authored by Rachel Rock,Maria Otero,Sonia ,Saltzman for ACCION International

commercial bank! Being astute business people, the board commissioned the preparation of a business plan that would provide a roadmap for the growth of the organization. In the process of collecting and verifying information for the business plan, the consultants discovered serious anomalies in the financial information provided by the management. Further investigations revealed serious cases of fraud by both senior management and staff.

EXAMPLE Y:

A leading and highly respected MFI in country Y collapsed under the weight of huge non-performing loans. The CEO was a professional accountant, highly experienced and skilled microfinance operator. He had attended many courses on MFI business planning, governance, risk management etc. He had assembled a diverse board comprising of lawyers, accountants and business people. When the institution collapsed, there were allegations of impropriety, lack of transparency and fraud.

EXAMPLE 4: COUNTRY Z

One of the 'largest' and seemingly fast growing MFIs in the country was salvaged from near collapse by an international investor. On paper the institution was growing and indications were that it was a likely candidate for regulation once the MFI bill was passed. Board concerns about the low profitability of the institution were typically met with the usual myths about the high transaction costs in microfinance, poor repayment culture among clients and competition in the market.

A comprehensive audit of the firm declared the firm technically 'insolvent'! The board comprised of a banker, a lawyer, a businessman and a donor representative.

EXAMPLE 5: COUNTRY P

A newly established and fast growing MFI collapsed with millions of shillings of client's deposits. The MFI had assembled a high caliber board of professional bankers, lawyers, business people and a university professor. Efforts by the Central Bank of Kenya to prosecute the directors for fraud collapsed following a court ruling that the Central Bank has no power to prosecute the directors of the institution.

1.2 PURPOSE AND SCOPE OF CORPORATE GOVERNANCE:

So what is governance and what does it mean to empower boards?

'Governance is the process by which a board of directors, through management, guides an institution in fulfilling its corporate mission and protects the institution's assets over time. A board of directors is established to provide oversight and give direction to the managers of an institution. The board carries out this function on behalf of a third party, referred to as shareholders in the case of for-profit corporations. Because there are no owners in nonprofit corporations, that third party is not as easily identified and has been defined to include the corporation's clients, staff, board, and donors.'[4].

'Governance is a system of checks and balances whereby a board is established to manage the managers.

Governance is sometimes conceived as a virtuous circle that links the shareholder to the board, to the management, to the staff, to the customer, and to the community at large.' [5]

Empowering is defined as 'giving someone more control or authority do something'[6]

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[4] Principles and Practices of Microfinance Governance; by Rachel Rock Maria Otero Sonia Saltzman ACCION International.

[5] CGAP focus note no. 7 1997

For purposes of this discussion, empowering a board mean that the board has the necessary authority to discharge its governance duties more effectively.

Effective governance requires boards to perform the following functions:[7]

- Define and uphold the mission and purpose of the MFI
- Develop and approve strategic directions (with management); monitor achievement of strategic goals
- Oversee management performance, including selection,
- Support and evaluation of CEO, maintaining a healthy balance between management and board.
- Ensure that the MFI manages risks effectively; assuming fiduciary responsibility
- Foster effective organizational planning, including succession planning
- Ensure adequate resources to achieve the mission, including assisting in raising of equity and debt capital
- Represent the MFI to the community and the public;
- Ensure that organization fulfills its responsibilities to the larger community
- Ensure that the organization changes to meet emerging conditions particularly in times of distress,
- Uphold the ethical standards of the organization,
- Maintain transparency and avoid conflicts of interest
- Evaluate (or seek external evaluation of) its own performance and commit to improving that performance

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[6] Macmillan English Dictionary

[7] Adapted from the Consensus Statement of the Council of Microfinance Equity Funds.

2.0. CORPORATE GOVERNANCE AND RISK MANAGEMENT:

'Good Governance for financial Institutions is built around risk management'[8]

Effective governance requires empowered boards, which understand their duties and responsibilities and have the authority to take corrective action. A review of the risks that MFIs face indicates that empowering boards have an important risk management function in microfinance institutions. Ultimately, sound governance is the ultimate risk management strategy!

Boards must take their risk management responsibilities seriously and must establish mechanisms and systems for tracking and managing risks. Reporting on these risks must be integrated into the MIS and the board must demand regular reports on the impact of these risks on the performance of the institution. Internal and external audit systems must be established as independent functions reporting to the board in order to avoid manipulation of the information.

The following discussion highlights the most common risks in MFIs and the role *of the board in controlling these risks*

Common Risks in MFIs[9]:

2.1 Institutional Risks:

a**) Balance between social and commercial mission**

'During at least half of our board meetings we discuss the proper balance between financial and social goals'

Herbert Muller, BancoSol

Mission risk arises from the failure of the board and management to establish an appropriate balance between the social and commercial mission. MFIs originated, in most cases, with a dual mission that combines social and financial objectives.

[8] Adapted from Consensus Statement of the Council of Microfinance Equity Funds
[9] Adapted from the CARE Microfinance Risk Management Handbook

The social mission seeks to provide financial services to as many of the lowest income population as possible while the financial objective drives the organization to achieve financial self-sufficiency, which permits sustained service delivery without dependence on subsidies. Boards play a key role in ensuring that the MFI responds adequately to both objectives. Lack of balance of the two can create a crisis in the MFI. For example where the board has too much social orientation, the organization falls into the trap of setting unsustainable interest rates because of the belief that they would be undergoing a mission drift if they charged commercial interest rates. (This is common among church sponsored microfinance institutions. In one such organization, the CEO was forced out when he insisted on charging sustainable interest rates). Such boards are not able to monitor the institution's financial performance and operational efficiency. Similarly, boards that have a heavy commercial orientation may want faster attainment of sustainability and may therefore force management to move upstream and provide larger loans in order to increase profitability.

An empowered board sets vision and a mission indicator with which it ensures that the right balance is maintained.

b) Excessive Executive Power:

A survey of MFIs and other development projects in Kenya by the Springfield Centre for Enterprise Development reported that in most of the institutions, the Chief Executives wielded a lot of power over the boards. Most of the board members interviewed indicated that they had been invited to the boards by the CEOs and therefore could not question their actions. The report indicated that in some organizations, the board members were intimidated by the CEOs. This situation is very common where founder CEOs are perceived as the visionaries who shape the destiny of the institution. In such cases the CEOs set the board's agenda and determine the outcomes of board meetings. Although literature refers to such boards as rubber stamp boards, in reality these boards

are guilty of professional negligence because they fail to provide the necessary oversight and direction to management.

An empowered board ensures that it has the authority to check the powers of the CEO. Indeed governance "is a system of checks and balances whereby a board is established to manage the managers[10]". So where the reverse is the norm (i.e. the managers manage the boards) then there is a governance failure.

Effective governance demands that responsibility between the board and management should be clearly defined. There must be a clear distinction and understanding by both board and management that the role of the board is at the strategic rather than the operating level. The board must put establish indicators for monitoring the CEOs performance and must be able to take corrective action when performance is consistently below the established benchmarks, including firing the CEO! But how many MFI boards are empowered enough to do so? Unfortunately many MFI boards allow the performance indicators to be established and modified by the management, thus defeating the whole essence of performance measurement.

c). Strategic Inertia:

An institution faces a risk where the board allows the CEO and Management to develop and implement corporate strategy without any input from the board. Unfortunately this is the case in many MFIs, especially those where the directors have little knowledge of microfinance. Such MFIs are likely to suffer from unplanned and/or unmanaged growth. In one MFI, the CEO committed the organization to external borrowing (in foreign currency) thus exposing the organization to foreign exchange fluctuations. The board only became aware when the organization's assets were due to be auctioned after the MFI had defaulted.

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[10] CGAP focus note no.7 1997

FIDUCIARY RESPONSIBILITY:

'Just the consciousness of fiduciary responsibility changes the tone of the MFI board from a board concerned with social mission only'

Bhati Ramola, Basix

An empowered board understands its fiduciary role. A board of directors is entrusted with the fiduciary affairs of the corporation. The term "fiduciary" refers to a person or persons to whom property or power is entrusted for the benefit of another. Treating directors and managers as fiduciaries provides a mechanism for imposing sanctions if they fail to exercise their responsibilities to the corporation, without necessarily requiring that all of those responsibilities be detailed in advance.

As explained by legal scholars Frank H. Ester brook and Daniel R. Fischer, "the fiduciary principle is an alternative to elaborate promises and extra monitoring. It replaces prior supervision with deterrence, much as criminal law uses penalties for bank robbery rather than pat-down searches of everyone entering banks."

As a fiduciary, the board of directors has several legal obligations. First, the board must ensure that the institution complies with its articles of incorporation, bylaws, and internal policies and procedures. Further, the board must ensure that the institution maintains its legal status. The board must also ensure that the institution complies with government rules and regulations, which will vary with the institution's corporate structure. For example, as a institutions institution becomes regulated, it will be subject to a new set of regulatory requirements that the board must understand. A final element of the board's legal obligations is the level of personal liability of individual directors for the institution's activities. Such liability varies by country, yet board members must be keenly aware of the degree of responsibility and immunity provided for them by local law.

In representing the interests of a third party and fulfilling their legal obligations, boards delegate responsibility to management and hold management internally accountable to a set of objectives and performance standards that the board has defined. However, achieving these standards and objectives can be impaired and effective governance diminished when board members are unclear about their role. For example, a director may assume that activities related to operations are part of his or her responsibilities and may hinder management's ability to perform effectively or management's accountability. Similarly, a CEO may depend too much on a board and request its input on decisions outside of the board's domain. A final element of the board's legal obligations is the level of personal liability of individual directors for the institution's activities. Such liability varies by country, yet board members must be keenly aware of the degree of responsibility and immunity provided for them by local law.

2.2. Operational Risks:

Operational risks are the vulnerabilities that emanate from an MFI’s daily operations, which can erode the institution’s capital and erode the institution’s capital. Microfinance business operations are by nature intensive and the common risks arising from these operations are:

- Fraud
- Theft
- Human errors
- Credit Risk
- Inefficiency

Fraud is a common risk facing many MFIs in Africa. The microfinance graveyard is littered with MFIs that collapsed due to fraud. In many cases the MFI funds have been diverted to personal use.

MFIs experience various types of fraud ranging from high-level fraud committed by top managers to petty fraud committed by low-level staff. Any organization that handles large volumes of money is extremely vulnerable to fraud, a vulnerability that tends to increase in poor economic environments. Exposure to fraud is particularly acute where money changes hands. These vulnerabilities in a financial institutions institution can be exacerbated if the organization has a weak information system, if it does not monitor clearly defined policies and procedures, if it has high staff turnover, or if the financial institution experiences rapid growth.

The management of savings, particularly voluntary savings, creates additional vulnerability in that a failure to detect fraud could lead to the loss of clients' very limited cash assets and to the rapid deterioration of the institution's reputation. In the detection of fraud, timeliness is a critical factor to address the problem and send a sharp message to staff before it gets out of hand. Also referred to as integrity risk, fraud risk is the risk of loss of earnings or capital as a result of intentional deception by an employee or client. The most common type of fraud in an financial institution at the branch level is the direct theft of funds. Other forms of fraudulent activity include the creation of misleading financial statements, bribes, kickbacks, and phantom loans. Since line staff handles large amounts of client and financial institution funds, branch level controls are very important. If left uncontrolled, these risks inevitably increase as fraudulent activities have a habit of spreading like a virus from one employee to another.

A 2004 evaluation study conducted among MFIs in East Africa [11]concluded that fraud and outright theft were common in many MFIs and that donors perpetuated these situations because they continued to pump money into organizations that had failed to account for previous funding.

[11] Capacity building study by Swiss Contact- unpublished

In many cases boards are not able to detect the fraud because of the sheer volume of transaction and poor management information systems. In some cases, where management is involved in the fraud, there is tendency to manipulate the financial information presented to boards. The large volume of transactions also introduces a high propensity for human error. Such errors can only be detected if the board has high level of financial literacy and can be able to pick up errors of commission or omission. In one case, an MFI board approved accounts with a typing error indicating a 100% increase in profitability.

"An empowered board sets up a system of checks and balances and a reporting system including traditional methods of oversight such as internal and external audits that can detect and control fraud. 'The board is the ultimate arbiter of accountability'[12]

a). Credit risk:

The biggest risk in financial institutions is lending money and not getting it back. In order to determine an institution's vulnerability to credit risk, it is necessary to review the policies and procedures at every stage in the lending process to determine if they are designed to produce an acceptable level of delinquencies and loan losses. These policies and procedures include the loan eligibility criteria, the application review process and authorization levels, collateral or security requirements, as well as the "carrots and sticks" used to motivate staff and compel borrowers to repay.

Besides analyzing whether these policies and procedures are sound, it is also necessary to determine whether they are actually being implemented. The best policies in the world are meaningless if staff members are not properly trained to implement them or choose not to follow them. For this reason, it is very important that boards monitor its portfolio quality closely and take action

[12] Michael Chu-ACCION INTERNATIONAL

when necessary. In one MFI, an ignorant board member congratulated the CEO for increasing the PAR from 8% to 18%!

b). Liquidity risk

This is the risk to capital or earnings arising from inability to meet its obligations when they come due, usually resulting from poor cash flow planning. Effective liquidity management requires an understanding of the impact of changing market conditions and the ability to liquidate assets quickly to meet increased demand for loans or withdrawals from savings.

c). Interest rate risk

This is the risk of financial loss from changes in market interest rates. Interest rate risk arises from differences in the timing of rate changes and the timing of cash flows (repricing risk), from differences in yield curves (basis risk), from rate variations across the spectrum of maturities (yield curve risk) and from interest related options within financial products (options risk).[13] In Financial institutions, the greatest interest rate risk occurs when the cost of funds goes up faster than the financial institution can adjust its lending rates.

d). Security Risks

As with the vulnerability to fraud, the fact that most MFIs handle money also exposes them to theft. This exposure is compounded by the fact the MFIs tend to operate in environments where crime is prevalent or where, because of poverty, temptation is high. For example, in high volume branches the amount of cash collected on a repayment day can easily exceed the average annual household income in that community.

e). Asset And Liability Risks

The financial vulnerability of an MFI is summarized in asset and liability risks, which include interest rate, liquidity, and foreign exchange risks. Interest rate

risk arises when the terms and interest rates of assets and liabilities (which fund assets) are mismatched. For example, if the rates on short-term liabilities rise before an MFI can adjust its lending rates, the spread between interest earnings and interest payments will narrow, seriously affecting the MFI's profit margin. MFIs operating in inflationary environments are particularly vulnerable to this type of risk. Liquidity risk involves the possibility of borrowing expensive short-term funds to finance immediate needs such as loan disbursement, bill payments, or debt repayment.

MFIs are most vulnerable to foreign exchange risk if they have to repay loans in a foreign currency that they have converted to local currency and therefore are earning revenue in the local currency. Boards must approve and monitor all external loans.

f). Inefficiency Risks

Efficiency remains one of the greatest challenges for MFIs institutions. It reflects an organization's ability to manage costs per unit of output, and thus is directly affected by both cost control and level of outreach. Inefficient MFIs institutions waste resources and ultimately provide clients with poor services and products, as the costs of these inefficiencies are ultimately passed on to clients through higher interest rates and higher client transaction costs.

g). System Integrity Risks

An assessment of this risk involves checking the quality of the information entering the system, verifying that the system is processing the information correctly, and ensuring that it produces useful reports in a timely manner.

2.3 External Risks

Although they have less control over them, boards should also assess the external risks to which they are exposed. MFIs institution could have relatively strong management and staff, and adequate systems and controls, but still be

prone to major problems stemming from the environment in which it operates. External risks are usually outside the control of the MFI, however it is important that these risks are perceived as challenges that the MFI must address, rather than excuses for poor performance. The following are the most common external risks:

a). Regulatory Risk

Policy makers, banking superintendents and other regulatory bodies are becoming increasingly interested in, and concerned about, MFIs institutions. This concern is heightened when MFIs are involved in financial intermediation—taking savings from clients and then lending out those funds. In many countries (e.g. Nigeria, Cameroon, Lesotho, Rwanda etc) policy makers are regulating the activities of MFIs institutions, occasionally with policies that can threaten the institution, such as usury laws. Other regulations that can create vulnerability in an MFI include restrictive labor laws, contract enforcement policies, and political interference.

b). Competition Risk

In some environments, MFIs is becoming increasingly competitive, with new players, such as banks and consumer credit companies, entering the market. Competition risks stem from not being sufficiently familiar with the services of others to position, price, and sell your services. Competition risk can be exacerbated if MFIs do not have access to information about applicants' current and past credit performance with other institutions.

c). Demographic Risk

Since most MFIs target disadvantaged individuals in low-income communities, MFIs managers need to be aware how the characteristics of this target market increase the institution's vulnerability. In assessing demographic risks, consider the trends and consequences of illness and death (including

HIV/AIDS), education levels, entrepreneurial experience, the mobility of the population, the social cohesiveness of the communities, the past experience of loans and repayment, and the local tolerance for corruption.

d). Physical Environment Risk

Some areas are prone to natural calamities (floods, cyclones, or drought) that affect households, enterprises, income streams and MFIs service delivery. In addition, the physical infrastructure—such as transportation, communications, and the availability of banks—in the MFI's area of operations can substantially increase its vulnerability.

e). *Macroeconomic Risk*

MFIs institutions are especially vulnerable to changes in the macroeconomic environment such as devaluation and inflation. This risk has two facets: 1) how these conditions affect the MFI directly and 2) how they affect the MFI's clients, their business operations, and their ability to repay their loans.

3.0 STRATEGIES FOR EMPOWERING BOARDS:

Having analyzed the risks that MFIs face and the role of board members in mitigating these risks, we now examine ways in which boards can be empowered to perform their duties more effectively. There is an extensive body of knowledge on the principles of good governance. This section will propose how to operationalize these principles in order to empower boards to perform their governance function more effectively.

3.1 SELECTION OF DIRECTORS

An effective recruitment and selection process is the first step towards strengthening governance in MFIs. Unfortunately, the recruitment and selection of MFI directors is still shrouded in secrecy and in many cases boards

directors are selected either by CEO or by other board members on the basis of friendships and other affiliations Therein lies the risk for such board members, as they owe their allegiance to the CEO or to the board member who introduced them to the organization. While diversity is essential and should be encouraged, it must be driven by the desire to balance skills and experiences rather than by other subjective considerations.

How can we ensure that boards are selected in an objective manner especially in unregulated MFIs? Firstly, the recruitment and selection of directors should be accorded the same seriousness as that accorded to the recruitment of top management.

The following principles should guide the selection of board directors of MFIs:

a. An independent selection panel should be established. Ideally, it should be an independent committee comprising of some board members and external independent experts.
b. The committee should first conduct a skills audit among existing board members and on the basis of the results; draw up the job specifications for the board director(s). In the case of a new MFI, selection should be done on the basis of required skills. Recommended board member skills should include both technical and management/leadership skills.

Table: Recommended board member skills[14]

Technical Skills	**Management/Leadership Skills**
Banking/Finance/Microfinance experience	Vision/Mission Congruence
Legal	Integrity
Accounting	Demonstrated leadership

[14] Adapted from Guidelines for Effective microfinance Institutions by Anita Campion and Cheryl Frankiewicz.

	success
Human Resource	Communication Skills
Investment	Team Spirit
Marketing/Public relations	Commitment to participation
Sociology/Community Development	Independence
Information Technology	Decision making skills
Business Entrepreneurship	Strategic Planning
Resource mobilization	Willingness to learn

c. The recruitment process should be managed in a transparent and competitive manner, using the same methods that are used in the recruitment of senior staff including headhunting, advertising interviewing. Directors who are selected through this process are likely to take their responsibilities more seriously than those who are selected on the basis of friendship and other considerations.
d. Board members must be given letters of appointment detailing the terms and conditions of appointment. They should also be given job descriptions detailing their duties, responsibilities, rewards and sanctions for performance.
e. Board members should undergo a structured orientation programme in order to build a new director's commitment to the organization and to ensure that he or she understands issues specific to the industry and the institution, it is as necessary to orient new directors as it is to orient new staff. The following should be the minimal requirements for board member orientation:
   - Review of previous board reports and minutes, annual reports, recent technical assessments, and biographies of the other directors;
   - Meeting with managers and key staff; and
   - Visits to the institution's main office and branches and with clients.

3.2. Training of Board Directors:

It is acknowledged that training of directors is important to the performance of MFIs. However, in many MFIs training of directors is often done on an adhoc basis and usually consists of two-day workshops and a few exposure visits Unfortunately, this does not constitute training! Every year, MFIs set aside a training budget for their staff. A very small percentage of the budget is committed to training of the board members! And yet these are the people who must provide direction and oversight to management!

Training of board members should be done with a specific purpose in mind. The whole purpose of the training of board members should be to equip them with the skills and competencies that are necessary for the effective discharge of their duties. So just like any other training the following steps must be observed:

a. Determining the skills, knowledge and competencies expected of board members.
b. Conducting a skills audit among the members to determine the gaps
c. Designing a curriculum for the board members
d. Implementing the training programme.
e. Monitoring the impact of the training on the performance of the board members.

The curriculum for MFI board members must reflect the unique characteristics of the industry and must therefore comprise of both technical and general management and leadership skills.

Table 2. Curriculum for Board Training

Topic	**Objective: to equip directors with knowledge and skills to:**
Technical Skills	
Introduction to microfinance	Understand the general concepts and trends in microfinance to avoid situations where their lack of

	knowledge hinders their effectiveness
Financial Analysis	Understand and interpret financial statements so that they can discharge their fiduciary responsibility
Portfolio Management	Monitor critical indicators of portfolio performance such as the PAR, repayment rates, yield on portfolio interest rates etc.
Risk Management	Know the MFI vulnerabilities so that they can develop strategies to mitigate these risks
Business Planning	To provide direction and monitor the business
General Skills	
Leadership	Demonstrate effective leadership Skills
Communication	Establish clear communication channels and systems in order to obtain relevant and timely information for effective decision-making.
Group Dynamics	Ensure that the board is an effective working group- devoid of the dysfunctional elements of groups (groupthink trap, camps etc)

3.3 Organization of board training:

Most board members have very busy schedules and can barely make time for board meetings let alone training! However this should not deter an organization from organizing full training schedules for the board members. The following tips may make it easier for board members to create time to attend training:

a. Preparing an annual training schedule for board members (the same way it is done for staff)
b. Include training in the board evaluation criteria
c. Combine training with other activities (e.g. exposure to other MFIs)
d. Avoid generic/off the shelf training for board members. Most probably, they have attended such training before. The training should be tailored to the specific needs of the board members.
e. Create opportunities for board members to apply and share the new skills and knowledge.

3.4 Enhancing Board Knowledge:

Boards can only be empowered to perform their duties when they have regular information about the organization as well as information about the general environment**.** Board members whose knowledge is confined to the information on the board agenda are likely to make decisions that are inconsistent with existing realities. It is therefore imperative that board members are kept in the loop about major events in the organization (new products, new branches, staff changes etc). Board members are the public face of the institution and must therefore be equipped with adequate and timely information about the organization.

Mechanisms for updating board members include regular bulletins, regular briefings by the CEO, internal marketing to board members whenever a new product or branch is launched and regular board reports. Board members must also take the initiative to obtain regular information about the organization as well as any other information that may affect the MFI (e.g. from the press).

3.5 Enhancing Board participation:

Board members can only perform their functions if they participate fully and effectively in board functions as well as other organizational events.

> The Duty of Care calls on a director to participate in the decisions of the board and to be informed on the data relevant to such decisions. A common statement of the Duty of Care asks a director (1) to be reasonably informed, (2) to participate in decisions, and (3) to do so in good faith and with the care of an ordinarily prudent person in similar circumstances. To discharge the Duty of Care efficiently and effectively, directors must attend meetings, exercise independent judgment, and ensure that they have an appropriate level of understanding of the issues critical to the institution.

Participation enables boards to discharge their Duty of Care.

Key areas of participation include:

a. Board Meetings

Participation in board meetings entails physical attendance during meetings as well as participation in the discussions. As often happens in groups, board meetings can be dominated by the chairman or by some board members. It is important for all board members to give their opinions, ask for clarifications and generally participate in meetings.

Board participation at board meetings can be enhanced by:

- A skillful chairman who ensures full participation by all members.
- Establishment of board committees
- Embedding participation as a performance indicator in both the board charter and the board performance evaluation.
- Creating an environment that fosters free participation by all members
- Non- victimization of board members on account of their views

b). Participation in key organization events

MFIs organize a variety of events and activities geared towards achieving their corporate objectives (e.g. promotional events, client meetings, press briefings, workshops, sports etc). Typically, such events are considered as part of as management rather than a board responsibility. Whereas board members may not necessarily participate in each and every event, their participation in key strategic events increases their visibility in the organization and enables them to interact with staff, management and other clients. It also promotes a sense of 'ownership' and belonging' to the MFI.

3.6 Enhancing Board Performance:

Board performance is both a function and consequence of empowerment. A board can only perform its duties effectively if it is empowered to do so. In this way, board performance is a function of empowerment. But the board is also empowered if board members realize that their performance is critical to the success of the organization. A rubber stamp boards[15] has no incentive to perform since its performance has no bearing on the organization. Conversely a hand- on-board[16] is well aware that its performance influences the organization. Obviously, the hands- on-board will feel more empowered than the rubber stamp board, thus its performance is likely to be higher.

Board performance can be enhanced in many ways including

- Through training and development
- Establishing performance indicators and evaluating board performance
- Developing a board manual that outlines policies and procedures for conducting board business
- Developing board charters

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[15] A rubber stamp board is one where is generally reactive in its relationship with management and management tends to present strategic thinking as well as plans and decisions to the board merely for its official approval.

[16] A *hands-on* board of directors consists of members who offer strong expertise and are actively involved in defining and monitoring the activities of the institution. Directors are kept informed of the ongoing operations and issues of the institution, are well prepared for meetings, and play a proactive role in overseeing the management of the institution.

- Providing regular feedback on both positive and negative performance
- Recognizing and rewarding effort and good performance and imposing sanctions for poor performance

3.7 Establishing Performance indicators

'What gets measured gets done". As with any other performance requirement, board performance is necessary for board effectiveness. But for it to be effective there must be specific indicators of performance that can be measured and/or recognized. The board must set both individual and board performance indicators. At individual level indicators may include:

- Attendance to meetings and other board events
- Participation
- Ability too work in a team
- Commitment to the organization
- Providing leadership
- Commitment to organizational vision and mission

Board performance indicators should focus on the how effectively the board performs its functions.

3.8 Evaluating board performance

Evaluating board performance should be a meaningful exercise aimed at improving the performance of the board members as well as creating awareness about the board's responsibility and accountability. The board performance appraisal should therefore be institutionalized by creating policies, systems and procedures to support the process:

The appraisal process should be aimed at:

a. Clarifying individual and collective responsibilities board directors.
b. Identifying areas of weakness and identifying opportunities for improving those weaknesses (it should not be perceived as aimed at removing directors!).
c. Improving the board's oversight responsibilities

d. Enhancing team spirit and bonding within the boar by encouraging candor and constructive criticisms of each other.

e. Assessing the board performance against the work plan

Board evaluation should include an assessment of the board's performance in the following areas:

i. Responsibility to shareholders:

- How well do the MFI objectives reflect shareholder expectations?
- Is there full and accurate reporting on MFI affairs to the shareholders?
- What is the state of relationship with the shareholders?
- What are the Board's relationships with monitoring agencies?

ii. Responsibility to stakeholders:

- Has the Board identified key stakeholders?
- Is there a policy determining how the MFI will relate with stakeholders?
- What is the state of the relationship with the key stakeholders?

iii. Oversight

- Is the level of strategic planning of sufficient quality and content?
- How accurately is the strategic plan reflected at an operational level in the business plan?
- Does the Board review the MFI's performance against the business plan?
- How satisfactory is the Board's monitoring of the MFI?
- Are the important issues being identified?
- How well are these analyzed and discussed?
- How well is the CEO's job Description defined?
- Is the CEO satisfactorily supported by counsel from the Board?
- Is the CEO's performance monitored and appraised satisfactorily?

iv. Legal/Ethical Duties

- Are all legal/ethical requirements met satisfactorily?

- Does the MFI have a code of Ethics?
- Is the MFI a good employer?
- Is the MFI complying with the regulatory requirements?

v. Board Meetings

- Is the information supplied to the Board appropriate and relevant?
- Is preparation and planning for Board meetings satisfactory?
- Is the frequency and style of meetings appropriate?
- Is Board attendance and participation working well?
- Is the Board and Committee structure still appropriate?
- Are accurate and timely minutes made and maintained?
- Is there follow up on actions necessary and/or reports to the Board on actions taken

3.9 INDIVIDUAL DIRECTOR EVALUATION

i. Strategic Thought

- Contribution to the strategic planning process
- Ability to contribute at a strategic level in Board debate

ii. Corporate Governance

- Understanding of the role of the Board (governance versus management)
- Acceptance of collective responsibility and Board room confidentiality
- Level of understanding with regard to the legal and ethical responsibilities of the Board

iii. Competence

- Contribution to the Board: strengths, abilities, experience and judgment
- Availability and willingness to attend meetings and actively participate in the work of the collective agency
- Understanding the financial structure of the business
- Understanding of the business as a whole

- Level of understanding of the relevant sector
- Communication with fellow Board members, CEO and shareholders
- Level of understanding of the market, the customer and quality focus

iv. Independence

- Confidence and courage of thinking, speaking and acting
- Ability to constructively debate in a reasoned manner
- Willingness to take an independent viewpoint

v. Preparedness as a Director

- Preparation for meetings
- Contribution to committee work
- Willingness to give extra time with Chairman/CEO on relevant matters between meetings
- Knowledge of MFI's key officers, managers and facilities

vi. Personal Attributes

- Special attributes or skills brought to the Board
- Understanding of socio-economic issues facing the community and the business
- Level of ethical and moral judgment
- Preparedness to keep abreast with latest developments in the sector and in their corporate responsibilities.

vii. Awareness of Stakeholders

- Awareness of shareholders expectations
- Understanding of sectoral reform
- Level of understanding of the Boards obligations to staff, the media and the community with respect to Board policy
- Understanding the relationships between other key players in the sector

3.10 PERFORMANCE FEEDBACK:

Feedback is an essential part of performance appraisal. The board should adopt a policy of open communication about the performance of the individual directors as well as the board as a whole. Effective feedback should focus on specific performance indicators rather than on subjective traits. Good performance should be recognised and appreciated, while poor performance should be highlighted and strategies developed for improving the performance

3.11 TOOLS FOR ENHANCING CORPORATE GOVERNANCE

A: BOARD MANUALS

As with any other operational area in an MFI, board functions should be guided by a set of policies, rules, regulations and procedures. Policies, which can be defined as broad or overarching statements related to conduct, strategy, and operation that guide the activities of an institution, are a matter for board concern and decision-making.

Policy decisions should be recorded in the minutes that are distributed to board and senior management. Policies should be explicit, current, literal, centrally available, brief, and encompassing. Policymaking requires an understanding of where the line between the board and management lies.

B. Board Service Charters

A board charter is a document that articulates the board's commitment to discharging their responsibilities and may focus on the directors' commitment to ensuring that:

- The MFI has clear corporate values which are stated and enacted

- The MFI is governed in a way that is efficient, responsible, accountable, and transparent and with probity.
- Policies defining the governance of relationships with defined key stakeholders are published.
- The rights of members and specifically their right to expect a good return on investment and growth in the medium to long term are recognized.
- The MFI is committed to investing for the long-term and as such developing long-term relationships.
- The board recognizes and differentiates accountability linkages to members and responsibility linkages to other stakeholders.
- The MFI is open in structure, process and disclosure and has open communication and engagement with key stakeholders.
- The MFI practices and encourages social and environmental responsibility.

Others tools include:

- Business and work plans
- Annual budgets
- Performance benchmarks/indicators
- Reporting and accountability structures
- Periodic and annual reports/accounts Operating systems, guidelines and
- Procedures (manuals)
- Good management information systems.
- Constitution and By-laws

4.0 WHO SHOULD EMPOWER BOARDS?

In discussions on MFI governance, there is an underlying assumption that effective governance can be improved through the establishment of systems, policies and procedures. However, board empowerment is more complex and is influenced by many factors within the internal and external environment.

There is need for additional oversight structures that ensure that boards are sufficiently empowered to perform their duties. In regulated institutions, the regulators provide external oversight. However, in unregulated MFIS, the absence of an external oversight system leaves the entire process of governance to internal forces.

In order to enhance the board empowerment process in unregulated MFIs, it is recommended as follows:

- The MFI industry should develop an industry-wide Code of Corporate Governance to which every MFI should be required to subscribe and comply. Sanctions for non-compliance should be applied (e.g. blacklisting and publishing the names of rogue MFIs). This is best done at country /regional level
- Resources (Financial and technical) should be committed to developing the capacity of boards.
- Donor and investors should encourage and monitor the status of corporate governance in all institutions they support.
- Clients and shareholders should be educated and empowered to monitor and demand sound governance from microfinance institutions.
- There is need for more research into the impact of governance on the performance and sustainability of MFIs and case studies on governance developed and disseminated.

5.0 CONCLUSION:

The concept of empowering boards, as a means of improving corporate governance in MFIs is still relatively underdeveloped. Examples of failed institutions reveal that setting up governance systems and processes is not a guarantee for effective governance. Boards have to be empowered to operate within these systems. The process of empowering boards is a complex one and begins with selection, training and evaluating the performance of boards.

Characteristics of empowered boards are:

A. Independence:

Empowered boards exercise their collective and individual independence, free from the influence of the management.

B. Strategic Direction

Empowered boards focus on providing strategic rather than operation direction to the management.

C. Partnership

Empowered boards build strategic partnership within the board, with management and with other stakeholders**.**

D. Leadership: Empowered boards demonstrate both technical and managerial leadership in the MFI. Those board directors who are responsibly fulfilling their role as leaders will be best positioned to shape both the institutions they oversee and the context in which their institutions operate.

E. Proactive

Empowered boards are proactive rather than reactive. They monitor the environment and trigger the appropriate responses.

F. Board Agenda

Empowered boards determine their own agenda in line with its responsibilities.

G. Performance Monitoring

Empowered boards establish systems for evaluating institutional, management and board performance and develops strategies ensure the institution achieves its objectives.

H. Learning

Empowered boards are willing to learn, they invest in systems and processes that develop and improve the knowledge and skills of board members.

I. Renewal

Empowered boards continuously seek to renew the board, bringing in new members of the board and embracing change.

Finally, empowered boards demonstrate**:**

Accountability - {Leadership that must be ready to account]

Efficiency and effectiveness {hence leadership for results}

Probity and integrity {hence leadership that is honest faithful and diligent}

Responsibility {hence leadership that is capable, responsible, representative and conscious of its obligations}

Transparent and open leadership, with accurate and timely disclosure of information relating to all economic and other activities of the corporation.

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