GUIDELINES FOR THE EFFECTIVE GOVERNANCE OF MICROFINANCE INSTITUTIONS

1999

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PREFACE

Governance of microfinance institutions has only recently surfaced as an essential component of long-term institutional success. Its importance is highlighted by the juncture at which we find microfinance—a field poised to become part of national financial systems with links to international financial markets. At no other time has the competence and commitment of governance bodies of microfinance institutions appeared more pressing.

This publication comprises part of a larger Governance Project undertaken jointly by CALMEADOW, ACCION International and the MicroFinance Network. This project began with a review of governance literature, and resulted in a publication that provided a framework for addressing this issue in microfinance institutions. Written by ACCION International in August 1998 and published as part of the USAID’s Microenterprise Best Practices project, Principles and Practices of Microfinance Governance1 analyzes the specific attributes of microfinance institutions that must be taken into account in governing their operations.

This publication, Guidelines for the Effective Governance of Microfinance Institutions, responds to the growing need of microfinance institutions to upgrade and fine-tune their governance structures and functions. It is designed to provide clear, succinct guidance to senior management and boards of directors of microfinance institutions in areas related to governance. As such, it is a companion piece to the literature review, and draws from the current experience of microfinance governance practice. The material for these guidelines was gathered as follows:

- **Governance Survey.** In 1998, executive directors and board members of leading microfinance institutions (MFIs) completed a survey on their current governance procedures and practices. The findings of this survey were published, and comprised the baseline information for the agenda of an international conference on governance.2

- **Governance Conference.** ACCION, Calmeadow and the MicroFinance Network held a conference on Effective Governance of Microfinance Institutions in Washington, DC, October 18-20, 1998 for executive managers and board members of microfinance institutions. The conference convened 152 people from 36 countries; half of these participants represented institutions that participated in the governance survey. The conference had three objectives: 1) to identify and discuss the main issues related to

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the governance of microfinance institutions; 2) to define effective governance practices in microfinance institutions; and 3) to develop guidelines that can be used to improve the accountability and effectiveness of microfinance governance.

This publication assembles the thoughts, anecdotes and recommendations shared during the conference, combines this practice with the principles that emerge from governance literature, and organizes it into guidelines that are recommended for use by all microfinance institutions.

The underlying message of this publication is that effective governance does not just happen. It requires a major commitment from senior management and the board. Additionally, effective governance does not appear to be a prerequisite for initial success. There are enough examples of the opposite – microfinance institutions considered among the best performers that lack strong and effective governance. If a microfinance institution wants to achieve permanence beyond its current stage of development or beyond the leadership of a strong managing director, however, then effective governance is required. It is this permanence in the provision of financial services to low-income populations that the industry seeks, and from this perspective, effective governance of microfinance institutions becomes essential.

Maria Otero
Executive Vice President, ACCION International
Chair, Steering Committee, MicroFinance Network
INTRODUCTION

There is nothing new about corporate governance, but effective corporate governance is only now coming into its own.

Martin Connell
CALMEADOW

As the field of microfinance continues to grow and develop, the issue of governance is receiving increased attention, and the role of effective governance is assuming even greater importance. The following microfinance trends reflect the need for enhanced governance:

• MFIs around the world are expanding their outreach and assuming responsibility for increasingly large sums of money, challenging the capacity of their management to maintain high standards of performance, and necessitating increased input and involvement by the board to ensure effective management.

• An increasing number of MFIs are becoming regulated, assuming the responsibilities and challenges of a regulated entity. Their decision to capture deposits from investors and savers, many of whom are low income persons, demands meticulous oversight to ensure the safety of those deposits.

• MFIs are operating in increasingly competitive markets. Maintaining or expanding market share is becoming an important strategic objective. The achievement of this objective demands a sharper focus and more vigilant monitoring of operational efficiency, profitability, outreach, institutional stability, capital mobilization, and other economic outcomes.

• MFIs often operate in unstable financial environments, which is causing stakeholders (donors, lenders, and owners) to require more transparency and communication of information. Only effective governance can assure the desired level of accountability.

Clearly, the governance context for the microfinance field is complex. This complexity makes the act of effective governance even more difficult and challenging than in traditional non-governmental, financial or corporate institutions. The publication of
Guidelines for Effective Governance of Microfinance Institutions is designed to address this complexity and provide practical guidelines to increase understanding of the role of governance, heighten awareness of poorly understood or controversial issues, and recommend steps that can broaden knowledge in these areas in the future. In recognition of the variety of institutions and environments in which they operate, these guidelines should be viewed less as standards and more as general suggestions applicable to most MFIs.

For the purposes of this publication, governance is defined as the process through which a board of directors guides an institution in fulfilling its corporate mission and protects that institution’s assets over time.\(^3\) There are three elements of this definition worth emphasizing.

First, governance is a process. It is a system of checks and balances between owners and other stakeholders who set the standards and objectives of accountability for a given institution. It is fluid; involves many players; and evolves over time according to the institution’s legal structure and external context.

Second, governance is a process that requires leadership and commitment. It is the process used by an institution to ensure that it fulfills its mission and protects its assets over time.

Third, governance is a process guided by the board of directors. Although the MFI may have many stakeholders, the governance process is under the direction of the board. Therefore, the board needs to be aware of what effective governance requires, in terms of board characteristics, responsibilities and oversight mechanisms.

Keeping in mind these three elements, Chapters 1 through 4 focus on the role of the board: its mandate, composition, structure, procedures, development and appraisal. Chapters 5 and 6 discuss the relationship between the board and management, along with the relationships that the board must foster with other key stakeholders to build an effective oversight strategy. Chapters 7 and 8 address issues of interest to all stakeholders in the effective governance of an MFI: the challenge of balancing social and commercial objectives, the effects of ownership types on governance, and the challenge of governing change and conflict within MFIs.

\(^3\) This definition taken from Rock, Otero and Saltzman, p. 1.
1. MANDATE OF THE BOARD

The board is the ultimate arbiter of accountability.

Michael Chu
ACCION International

The board of directors of a microfinance institution has a dual mandate: a) to guide the institution in fulfilling its corporate mission and b) to protect the institution’s assets over time.

A board of directors must fully comprehend its mandate before it can discuss tactics and strategies for effective governance. A clear articulation of the board’s role is essential for effective governance of a microfinance institution. In defining the board’s role, this chapter provides guidelines for the responsibilities of the whole board and the responsibilities of individual members.

1.1 Responsibilities of the Board as a Whole

The board’s responsibilities comprise five categories: legal obligations, strategic direction, fiduciary, oversight, and self-assessment and renewal.

Legal Obligations

a) The board ensures that the microfinance institution (MFI) fulfills its legal obligations and protects it from unnecessary liability and legal action.

The board monitors the institution’s compliance with its articles of incorporation, bylaws, and internal policies and procedures, as well as pertinent government rules and regulations. Boards of non-profit MFIs may need to pay careful attention to maintaining the institution’s tax-exempt status. Board members (also referred to as directors) should know whether individual members may be held liable for the activities of the institution. Liability varies by country and institutional ownership structure, and directors should know the degree of their responsibility and immunity provided by local law.
Strategic Direction

a) The board ensures that the institution’s mission is well defined, reviewed periodically, and respected over time.

A crucial responsibility of the board is to ensure that the institution has a formal mission statement that clarifies the institution’s purpose. While the mission may be defined by a group other than the board—for example, the founders—the board carries the mission forward to ensure that it is understood and provides management with direction that is conducive to its fulfillment. In addition, the board should recognize that the institution’s mission may evolve over time. They should review it periodically (many MFIs suggest every three to five years) and amend the mission statement if necessary to respond to a changing environment or shifting priorities.

b) The board ensures effective planning.

Although management should assume responsibility for preparing strategic, business, and other action plans, the board oversees this process. The board provides management with guidance and input in three areas: i) charting the institution’s strategic course; ii) setting broad operational policies for the institution; and iii) resolving strategic issues as they arise. The strategic planning process can be an iterative one, with both board and management contributing in several stages to the creation of a final product. Chapter 5 provides more information and guidelines on the planning process.

c) The board works to enhance the image of the institution.

The board plays an important role in shaping the institution’s image. The prestige of directors extends to the MFI, and therefore the institution’s credibility partly rests on the shoulders of its board members. Directors should be aware of the important contribution they can make and should use their personal capital to benefit the institution. Board members can promote the institution’s work in high level forums, participate in public relations events, and create access to potential investors.

Fiduciary

a) The board serves as the institution’s steward.

As the highest authority within the institution, the board of directors is the ultimate repository of the power and property invested in the institution by third parties. These third parties may be shareholders (as in the case of a for-profit institution), members (as in the case of a cooperative or credit union), or donors (as in the case of a non-governmental organization). The board is entrusted to protect their property and ensure that it is managed in a manner that is consistent with agreed-upon values and goals. The board should discuss the fiduciary principle as it applies to its responsibilities and ensure that the full board assumes this role.
a) The board should ensure that the institution has adequate resources to implement the agreed-upon plans.

There are two components of this responsibility:

- Understanding the institution’s short- and long-term financial position in relation to its strategic plan, and
- Taking necessary actions to secure the additional resources needed to implement that plan.

Understanding the institution’s financial position requires regular monitoring of capital adequacy, asset quality, earnings and liquidity. Securing resources might involve the following activities: fundraising; accessing outside capital; recruiting potential investors; and approaching donors. If the institution is unable to raise the necessary funds to implement its strategic plan, the board should make sure that the plan is adapted to meet the institution’s fiscal reality.

b) The board guarantees the long-term viability of the institution.

To varying degrees, MFIs face the pressure of focusing on short-term goals. These pressures may come from shareholders seeking dividends, donors expecting the attainment of outreach or disbursement targets, or managers interested in quick results. The board balances these short-term pressures with an awareness and understanding of what is needed to ensure the institution’s long-term viability.

Oversight

a) The board governs, not manages, the institution.

Governance and management are two distinct roles and should not be confused. The board provides direction to management in the area of strategic planning and oversees that management carries out the strategic plan. Management assumes operational authority and ensures implementation of the institution’s program of activities as agreed upon with the board.

b) The board appoints and oversees the performance of the managing director (also known as executive director or chief executive officer).

Although the board does not manage the institution, it does manage the manager. Effective governance requires the board to assign responsibility for the daily operations to the managing director. The board oversees the managing director to ensure that the institution’s mission is fulfilled and its assets are protected.

c) The board monitors operations and business performance.

To ensure the MFI uses its resources effectively, the board monitors the performance of the institution’s portfolio, operations, and financial indicators. It does this through frequent and transparent reports, regular board and committee meetings, periodic on-
site visits with staff and clients, and internal and external audits. Chapter 6 outlines guidelines for designing an effective oversight strategy.

d) The board evaluates the institution’s performance in relation to other MFIs.

It is critical that board members understand where their institution stands relative to other MFIs and why. The *MicroBanking Bulletin* provides a compilation of industry performance statistics, which provide regional and worldwide peer group comparisons. The board should compare the institution’s performance to that of similar MFIs (based on the age and size of the institution, its target market and the region in which it operates) as well as to benchmarks set by the best performers. The evaluation process yields important information about areas of weakness and enables the board to ensure that management addresses them.

e) The board assesses and responds to internal and external risks.

External risks (e.g., natural disaster, civil strife, financial crisis, and government intervention) and internal risks (e.g., portfolio deterioration, fraud, overexpansion, and client desertion) frequently threaten MFIs and may undermine their performance or even their existence. The board prepares for such problems to the extent they are foreseeable, establishes early warning systems where necessary, and ensures the MFI operates prudently in the face of these challenges.

f) The board protects the institution in times of crisis.

One of the most important roles of the board is to protect the institution in times of crisis. When the institution is in distress, the board intervenes as necessary and develops a plan to address the problem. Members of the board may have to assume an active management role. The board may meet more frequently, take on additional responsibilities, spend increased energy in raising funds, and, if necessary, replace the managing director.

Self-Assessment and Renewal

a) The board should regularly assess its own performance.

In a corporate structure, there is no one to evaluate a board of directors besides the board itself, but this does not mean that an evaluation is not useful. An introspective self-evaluation can benefit the board in a variety of ways. It can clarify individual and collective roles and responsibilities, and remind board members what effective governance requires. An evaluation can define the board’s strengths and weaknesses and identify ways in which the board can become more effective. It can also improve the working relationship between board and management. Chapter 4 provides tools for appraisal of the board and individual members.

b) Board renewal is one of the most important outcomes of the assessment process.

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*The MicroBanking Bulletin* can be downloaded at http://www.colorado.edu/EconomicsInstitute.
Unless the board uses the assessment process to effect change, it will not serve its purpose. The assessment process often identifies shortcomings that cannot be addressed by existing directors, and therefore initiates the process of selecting new board members. The assessment may also encourage inactive board members to resign their positions as it reveals their lack of participation and commitment.

1.2 Individual Director Responsibilities

While the board as a unit works to achieve the functions and responsibilities delineated above, each individual board member also assumes personal responsibilities. The following three duties of a board director highlight these responsibilities.

Duty of Care

The duty of care reflects the board member’s quality of commitment. It requires each member to be informed and to participate in the decisions of a board. A common duty of care statement asks a member to:

- Devote sufficient time to do the job, including meeting preparation and regular attendance at board and committee meetings.
- Ask substantive questions and request more detailed information as required to comprehend the happenings within the institution.
- Participate in the decision-making process in good faith and make informed decisions.

Duty of Loyalty

This duty requires board members to exercise their powers in the interest of the corporation and not their own interest or in the interest of any one entity or person. Duty of loyalty addresses conflicts of interest, corporate opportunity and confidentiality. In accordance with the duty of loyalty, a member should:

- Support the majority view of the board once an issue is decided or a policy adopted.
- Maintain independence, objectivity, ethical standards and confidentiality.
- Reveal any potential conflict of interest situation that could influence the member’s participation in a particular board decision.

Duty of Obedience

The duty of obedience expects a board member to be knowledgeable of and faithful to the institution’s mission. While board members have the authority to determine how the institution can best meet its mission, they are prohibited from behaving in a manner inconsistent with the basic institutional objectives.
2. BOARD COMPOSITION: MEMBER SELECTION AND APPOINTMENT

The knowledge and experience of the board members absolutely must match the strategic demands facing the company.

Jay A. Conger, David Finegold, and Edward Lawler
Harvard Business Review

The composition of the board reflects the complex and unique characteristics of a microfinance institution. No individual director possesses all of the skills needed by an MFI board, nor can anyone hope to understand all the issues that the institution might confront. Microfinance institutions need directors whose skills and backgrounds are diverse and complement one another. The board, through its members and advisors, should collectively possess the necessary knowledge and experience to address the strategic demands facing the MFI.

This chapter presents guidelines for board composition that stress diversity and balance, and provides suggestions to achieve these objectives. It describes the process for effective recruitment and selection of board members and offers recommendations for creating appropriate terms of board member appointment.

2.1 Collective Board Characteristics

The composition of a board will evolve in relation to a) the mission of the institution; b) the stage of the institution’s development; and c) the external context in which it operates. These factors determine what issues and challenges the MFI will face and, therefore, the appropriate size of the board and what specific skills and qualities it should seek in its directors.

Board Size. The capacity of the board to function effectively is partly a function of its size. A microfinance board should be large enough to incorporate key skills and perspectives, yet small enough to allow for the active involvement of all members and the smooth functioning of meetings. The number of members elected to the board will
vary; 5 to 15 directors are common. The total number of directors is usually an odd number to facilitate decision-making by simple majority.

**Director Characteristics.** Effective microfinance boards consist of directors with a range of characteristics along the following spectra: a) social and commercial skills; b) strategic and operational abilities; c) number and people skills and d) level of stature and involvement. The challenge is to balance these characteristics in the board and not concentrate representation at one extreme or the other.

**Director Skills.** When recruiting new members, it is useful to look at the skills of the current board and recruit new directors who provide complementary skills. **Table 1** provides a list of leadership and technical skills that boards should seek in their members. Most members have one or two of the technical skills, but they should possess most of the recommended leadership skills. While it is useful to recruit a board member with specific technical expertise, other directors should have some knowledge of the subject so that information used for decision-making is not concentrated in one director.

**Table 1: Recommended Board Member Skills**

<table>
<thead>
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<th>Leadership Skills</th>
<th>Technical Skills</th>
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<tr>
<td>Commitment to the MFI’s Mission</td>
<td>Banking/Economic Expertise</td>
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<td>Integrity/Trustworthiness</td>
<td>Microfinance Industry Expertise</td>
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<td>Demonstrated Leadership Success</td>
<td>Accounting</td>
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<td>Communication Skills</td>
<td>Legal Skills</td>
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<td>Common Sense/Sound Judgment</td>
<td>Public Relations</td>
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<td>Willingness to Make Time Commitment</td>
<td>Marketing</td>
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<td>Objectivity/Independent Thinking</td>
<td>Human Resources</td>
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<td>Ability to Work with Other Board Members</td>
<td>Entrepreneurship/Business Success</td>
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<td>Consensus Building Skills</td>
<td>Sociology/Community Development</td>
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<td>Willingness to Participate</td>
<td>Information Technology</td>
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<td>Awareness of Personal Contribution</td>
<td>Fundraising</td>
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The following are additional guidelines regarding the composition of the board:

- A relatively new institution can benefit from having “stars” on its board—high-profile, well-respected individuals with strategic connections and stature. As the institution matures, high-profile directors who do not actively participate may “graduate” to another body, such as an advisory council.

- MFIs may use age, gender, and race as selection criteria if the institutional mission deems it necessary. For example, an institution dedicated to the empowerment of women may mandate that the board consists primarily of women board members.
• Since it is logistically difficult and costly for foreign directors to provide sufficient oversight, they should be used primarily as temporary or transitional board members. In countries where there is a shortage of local microfinance expertise, international representatives can play a critical governance role. In addition, an MFI’s equity structure can necessitate the participation of foreign board members. The board can facilitate participation by ensuring attendance of foreign directors at important board meetings, such as for budget approval or strategic planning, and by designating local alternates for other meetings.

2.2 Director Affiliation and Representation

This section discusses governance issues related to board member affiliation with the MFI or representation of another institution. It addresses the relationships that might influence the effectiveness of individual directors.

There are three types of board directors: internal, affiliated, and external. An internal director is either an employee or client of the microfinance institution. Affiliated directors are board members who are not involved in the internal operations of the MFI, but are affiliated with it in some way such as investors, lenders, or legal representatives. External directors, by contrast, are completely unaffiliated with the institution. There is little consensus on the ideal mix of internal, affiliated and external directors. However, having all three types sit at the table can greatly enrich a board’s deliberations.

Internal Directors

MFIs have varying opinions on the role of staff (particularly the managing director) and clients on the board. There is consensus that they should have a voice represented at the board level, but less agreement on what form that should take. While internal directors provide valuable inside information and a strong commitment to and understanding of the institution, in most instances, it is preferred that these members have a voice but no vote on the board.

Participation of Senior Management. In some countries, it is illegal for the managing director to sit on the board, but where permitted, best practice recommends that senior management serve the board with a voice, but no vote. This allows the board to benefit from their knowledge and insight, and increases the quality of communication between the board and management, while maintaining the separation of powers that is vital for effective oversight. If the managing director is the only internal director, the board should ensure that operational information used to make board decisions is backed by reports.

Participation of Staff Representatives. The board should invite staff members to make regular presentations, but not to have a permanent seat on the board.

Participation of Clients. With the exception of credit unions in which client participation is an inherent part of the structure, clients should not have a seat on the
board. The disadvantages of an ownership structure in which clients are shareholders are that client board members tend to lack both the financial literacy required to provide rigorous accountability and the deep pockets to supply additional equity funds when needed. **Box 1** discusses how a couple MFIs address this issue.

**Box 1: Managing Limitations to Client Ownership and Board Representation**

<table>
<thead>
<tr>
<th>SEWA Bank (India) and CARD Bank (Philippines) are two examples of successful MFIs that have chosen to create a regulated financial institution with their clients as the majority owners and as board representatives. They have chosen this structure to empower their primarily female clients and to ensure the institution’s long-term commitment to clients’ needs. In times of financial need, however, these MFIs must identify external sources of funds since their owners’ ability to provide additional equity funds is limited.</th>
</tr>
</thead>
</table>

Regardless of ownership, client directors have difficulty upholding the duty of loyalty. Clients face conflicts of interest on the board if required to choose between the best interests of the institution and their own best interests (e.g., in the setting of interest rate policy). There are alternative methods to represent client interests on the board. For example, a board committee can monitor client feedback on the quality of services and the appropriateness of the products.

**Affiliated Directors**

Affiliated directors are the most common type of board member. Investors, lenders, and legal representatives can offer a strong commitment to the institution, a fresh perspective, and a broad information base. Best practice recommends that boards of for-profit MFIs consist primarily of affiliated directors.

**External Directors**

External directors unaffiliated with the MFI offer additional objectivity. The smaller the number of shareholders and the more similar they are to each other, the greater the need for external directors. However, when inviting the participation of external directors, the board must ensure that they fully assume their roles and responsibilities.

The following guidelines address the recruitment of directors who represent an external institution, government or donor.

**Use Individual Rather than Institutional Representatives.** To maintain continuity and reduce conflicts of interest, board members should serve as individual rather than institutional representatives whenever possible. If the board appoints individuals as a representative of their employer, they may be required to leave the board if they leave their current position, thus jeopardizing the board’s continuity.
Guidelines for the Effective Governance of Microfinance Institutions

Appointing board members as institutional representatives increases the potential for conflicts of interest, since this requires the board director to wear two hats in the boardroom. Appointing directors as individual representatives enables them to remove the hat of their employer and execute more effectively their duty of loyalty to the MFI.

**Avoid Direct Government and Donor Representation.** Except in the case of a government-owned institution, government representatives should not occupy voting seats on an MFI board. The short-term politically motivated pressure and influence wielded by a government representative could have a detrimental impact on the long-term sustainability of the institution. Government involvement also creates the risk that clients will confuse the MFI for a public sector initiative, which can give the impression that the institution's financial services are deferential or temporary, potentially resulting in asset quality problems.

Likewise, donors should not hold direct equity positions or occupy voting seats on the board. Given their political nature, changing agendas and rotating staff, unless donors can assure continuity of support and oversight, donors should not be owners of MFIs. Other mechanisms available to donors are more effective in monitoring the institution's performance and holding it accountable for the use of funds. Examples include the use of multiple disbursement schedules that are linked to achieving performance targets; the provision of loans rather than equity; and the channeling of resources through other institutions such as investment funds, holding companies or other third party institutions. Donors should carefully select an indirect investment channel based on compatible objectives and its ability to add value. Donors should consider the accountability of the local organization and develop clear exit strategies.

Some MFIs have found it useful to invite government and/or donor representatives to participate as observers on their boards. In certain cases, such representation has provided the institution with valuable external perspectives; facilitated opportunities for the MFI to educate representatives about the field of microfinance and its policy needs; and decreased the threat of harmful external intervention.

**2.3 Recruitment and Selection**

The recruitment and selection process provides a significant opportunity to improve governance. Through this process, the existing board selects who will govern the MFI. The process also conveys the character and mission of the institution to prospective directors. Boards should establish a process that will: i) yield the kind of board director the institution requires; and ii) provide potential directors with an accurate and comprehensive picture of what the institution is and strives to be.

The following steps guide board member recruitment and selection:

a) Board recruitment begins with a focus on the institution’s mission and vision. The mission is the MFI’s most powerful tool for attracting candidates dedicated to serving the institution.
b) The board develops a recruitment profile of desired skills and characteristics for nominees, keeping in mind the leadership and technical skills listed in Table 1.

c) The board identifies potential board member candidates. Current members of the board, management, the general assembly, shareholders, and even founders who no longer have an official role with the institution may all recommend nominees for open board positions.

d) A nominating committee, usually composed of affiliated and external directors, evaluates the nominations. Some boards incorporate a screening mechanism that allows directors to acquaint themselves with the nominees and assess their compatibility. For example, some MFIs require candidates to serve as business advisors to clients before they are considered for board membership; others expect nominees to sit on a credit committee for a specified period of time before inviting them to join the board.

e) The nominating committee, not the managing director, should oversee the process of selecting new members to maintain the necessary separation of power between the board and management. The board selects new members based on a comparison between their qualifications and the recruitment profile, giving special attention to the individual’s commitment to the MFI’s mission.

### 2.4 Terms of Board Appointment

This section provides guidelines for creating appropriate terms and conditions for board members.

Clearly communicate requirements and expectations. Leading MFIs strongly recommend that boards create and approve a board manual to share with potential directors before they invite them to join the board. Table 2 details guidelines for the contents of board manuals. At a minimum, each prospective board member should receive a written description of director responsibilities and the expected time commitment before accepting the position. This ensures that the role is clearly defined in written form and the candidate is aware of the expectations.

<table>
<thead>
<tr>
<th>Table 2: Recommended Contents of a Board Manual</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The institution’s bylaws and policy statements</td>
</tr>
<tr>
<td>• A written explanation of the individual, committee and collective responsibilities of the board, detailing the time commitment per area of responsibility</td>
</tr>
<tr>
<td>• A description of the institution’s board appraisal process</td>
</tr>
<tr>
<td>• The terms of board appointment, renewal, and discharge</td>
</tr>
<tr>
<td>• Descriptions of the board and institutional structures</td>
</tr>
<tr>
<td>• The shareholders’ agreement, if a for-profit MFI</td>
</tr>
</tbody>
</table>


Establish terms of service to the board. The board needs to strike a balance between a tenure that is long enough to allow directors to develop expertise and to provide leadership continuity, yet short enough to incorporate regularly fresh perspectives and innovative thinking. The typical term for a board director ranges from 2 to 4 years.

Use renewable terms. Except in credit unions, in which the structure is based upon democratic representation of their members, renewable terms allow boards to retain their most dedicated and skilled directors. Although term limits or mandatory retirement policies can guarantee regular injection of new perspectives to the board, experience has shown that it is more important to have a policy that allows continuation of a winning team.

Stagger terms. Microfinance institutions often renew their boards in a staggered manner to balance continuity and change, and to avoid a situation in which an inexperienced majority governs the MFI. For example, a nine-member board will incorporate three-year terms of service so that only one-third of its members potentially rotates each year.

Establish a dismissal policy. The MFI should have a policy detailing circumstances in which the board may ask a board member to resign. Dismissals could be effected with cause (due to poor attendance, harmful contribution, or an undeclared conflict of interest) or without cause (due to term limits, unmet shareholding requirements, or changes in the constituency represented).

Compensate board directors. MFIs should have a written policy on compensation that takes into account the different status of directors. For example, internal and affiliated directors may profit from their relationship with the institution and have a built-in incentive to serve it well, while external directors may not. If the institution does not offers monetary compensation, the non-monetary benefits should be clear (e.g., the opportunity to be part of a team working toward a social goal or the chance to influence the decision making of the MFI). The MFI board should not underestimate the value of affiliation with an institution providing a social good.
3. **BOARD STRUCTURES AND PROCEDURES**

The board’s authority comes from both law and custom.

*The Director’s Handbook Series: A Practical Guide for Corporate Directors*
National Association of Corporate Directors

This chapter discusses the role that the chair, other officers and board committees play to ensure effective governance. It presents guidelines for bylaws and board procedures, including the preparation, frequency, duration, and scheduling of meetings. It presents a typical meeting agenda and suggestions for board reporting.

### 3.1 Role of the Chair and Other Officers

**The Chair**

The chair, sometimes referred to as the president, plays a critical role in MFI governance and is ultimately responsible for the smooth operation of the board. The chair creates a process for reaching consensus that is in line with the institution's mission and ensures the active participation of all board members.

The chair position requires a visionary who thinks ahead of management, anticipating situations, developments and needed changes. The chair is a key public relations figure for the institution and adds to its stature. Yet, in selecting a chair, professional qualifications and experience are more important than public image. The chair must have the energy and drive to lead the board and should exercise authority without being domineering. An effective chair commands respect and accountability through his/her personality and reputation.

The chair presides over meetings, sets meeting agendas (in cooperation with the managing director and/or other directors), and ensures that the committees are active and well staffed. The following guidelines highlight the responsibilities of the chair:
The chair oversees the preparation of a board meeting. The chair prepares a logical and organized meeting agenda; authorizes participation of staff and outside guests; ensures that proposals are well researched and presented; and makes sure that appropriate information is distributed in advance.

The chair ensures that the meeting is effective. The chair conducts meetings in an unbiased manner, welcoming healthy skepticism and diverse perspectives. It is the chair’s responsibility to manage the various personalities on the board by anticipating the potential effect of the subject on individual board members. The chair encourages directors to avoid taking a position too early on sensitive or contentious issues. The chair keeps meetings on the topic by eliminating irrelevant discussion, asks questions and invites comments to move toward a conclusion.

The chair expends considerable effort building relationships. By meeting regularly with the managing director, the chair serves as a liaison between senior management and other board members. The chair is the board’s external spokesperson, linking the organization with its shareholders and other stakeholders, and setting the tone for this interaction.

The chair oversees the long-term strategy of the institution. The chair is responsible for balancing the two objectives that drive most MFIs: the goals of social impact and profitability/financial self-sufficiency. The chair safeguards the institution’s mission in light of these dual objectives, which Chapter 7 discusses further.

The chair should not be the managing director. This separation is necessary to avoid concentrating power in one person. The separation of the two roles underscores that the managing director reports to the board and highlights the function of the chair as the intermediary between management and the board. This approach strengthens governance by facilitating effective regular performance reviews of the managing director. While the separation of roles provides an opportunity to distinguish responsibility for the strategic and operational activities of the institution, it is important that the managing director and chair have a good working relationship to provide the institution with unified leadership. Chapter 5 discusses the relationship between the chair and the managing director in more detail.

Other Officers

Microfinance institutions usually place more value on the executive committee than the role of the following officers. In fact, such officers are not designated on some MFI boards. For MFIs that engage officers besides the chair, their roles are as follows:

Vice Chair. The vice chair provides support to the chair, filling in or taking on duties that the chair is unable to fulfill on his or her own.

Secretary. The secretary’s main function is to record the minutes of every board meeting. A staff member or other member who has time to perform the role often fills this position. The managing director should not fulfill this role.
Treasurer. Many MFIs do not have board treasurers. Auditors typically report to an audit committee or to the full board and not to one designated individual. Therefore, the role of the treasurer is usually to track direct expenses of the board and board committees.

3.2 Board Committees

Board committees focus on specific issues assigned by the board and develop thoughtful proposals to recommend to the full board. The effective use of committees can improve the quality and efficiency of the board. Board committees can help to engage directors more deeply in oversight activities, increase interaction between board members and staff, and facilitate informed decision making by the board.

One of the greatest challenges for MFI boards is to identify directors who are willing to make the time commitment for committee work. If used effectively, board committees can reduce the amount of time full boards spend in deliberations thereby minimizing the overall time commitment of the board. The absence of a committee structure can result in superficial decision making by the board. Committee members must be careful, however, not to become overly concerned with details to the point of meddling in operations. The following guidelines define the appropriate role and effective use of board committees:

Statement of Purpose. Each committee has a clear statement of its mission, authority, responsibility and duration. This statement, or charter, helps assure that important board functions are not neglected because of misunderstandings or incomplete delegations, and it keeps the committee focused.

Composition. The composition of each committee is small and appropriate, generally between three and five members. Some committees, such as the nominating committee, should not include internal directors to avoid potential conflicts of interest. Boards with low member turnover may consider rotating committee membership to provide directors with a well-rounded understanding of the organization. Some members, however, may have skills that require their presence on a certain committee.

Role of Committee Chair. The board assigns a chair to head each committee and coordinate the group’s work. Committee chairs are preferably affiliated or external directors.

Process of Committee Work. Board committees should convene prior to full board meetings. They present only a synthesis of their work and recommendations to the full board for review and action.

The number and type of committees utilized by a given MFI will depend on the size of its board, the time availability and expertise of board members, and the challenges facing the microfinance institution. In general, there are two types of committees: standing and special (or ad hoc). Standing committees are permanent and specified in the organization’s bylaws. Table 3 lists the most common standing committees.
Table 3: Common Microfinance Standing Committees

### Executive Committee

<table>
<thead>
<tr>
<th><strong>Scope</strong></th>
<th>All major functions of the MFI</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Composition</strong></td>
<td>Chair, managing director, and two to four others; should include chairs of other board committees</td>
</tr>
</tbody>
</table>
| **Responsibilities** | • Discuss issues and agenda in preparation for board meetings, and more often if necessary  
                          • Establish initial level of consensus on difficult issues that the board must address  
                          • Make decisions and address policy issues that the board has delegated to it  
                          • Play a key role in directing the activities, discussions, and decisions of a board  
                          • Act on behalf of the board in its absence |

### Audit and Finance Committee

<table>
<thead>
<tr>
<th><strong>Scope</strong></th>
<th>Ensure the integrity of financial statements and adequacy of internal controls; act as liaison between shareholders and independent auditors; both internal and external auditors report to this committee</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Composition</strong></td>
<td>Two or three affiliated or external directors with strong financial skills, and possibly the finance manager</td>
</tr>
</tbody>
</table>
| **Responsibilities** | • Choose the auditing firm, approve the audit fee, define range of the audit, and consult with auditors on the audit plan  
                          • Review the procedures and results for internal audit and control  
                          • Consult with independent auditors regarding adequacy of internal controls  
                          • Review annual and quarterly financial statements  
                          • Review examination reports of supervisory authorities (if applicable)  
                          • Review reports and recommendations generated by internal and external auditors and ensure that corrective action is implemented by management  
                          • Review budget and make suggestions before budget presentation to the full board  
                          • Make recommendations to board on resolutions related to its activities |

### Nominating Committee

<table>
<thead>
<tr>
<th><strong>Scope</strong></th>
<th>Ensure desired composition of board and adherence to the bylaws regarding board composition, appointment, and renewal</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Composition</strong></td>
<td>Three or four members; no internal directors</td>
</tr>
</tbody>
</table>
| **Responsibilities** | • Identify new skills and characteristics required by the board  
                          • Identify prospective directors and receive nominations from other board members  
                          • Interview director candidates on behalf of the board and present recommendations to the full board |

### Credit Committee
### Asset-Liability Committee

**Scope**
Monitor balance sheet management to ensure appropriate levels of liquidity, maximum earnings on securities, and appropriate management of interest rates and currency exchange risks (In smaller organizations, these responsibilities are often assumed by the Finance Committee)

**Composition**
Managing director, finance director, two or three board members who are not internal directors

**Responsibilities**
- Ensure regulatory requirements on liquidity are met (if applicable)
- Oversee cash flow projection procedures to ensure they are implemented and effective
- Guard against inadequate or excessive liquidity
- Monitor securities portfolio and its activity
- Ensure appropriate diversification and compliance with corporate policy
- Monitor interest rate sensitivity and term matching of balance sheet
- Monitor exchange rate exposure

### Human Resources Committee

**Scope**
Oversee human resource management and develop personnel policies for senior management

**Composition**
Majority should be board members not employed by the MFI

**Responsibilities**
- Recommend compensation for senior management, officers, and directors to the full board, including granting of stock options or similar benefits
- Provide oversight for personnel matters
- Supervise orientation and ongoing development of board members
- Work closely with Human Resources Department
- May be involved in compensation and benefit planning for lower level employees

Of all the committees referenced here, the executive committee is the most valued and widely utilized by MFIs. Boards give the audit committee high priority, followed by the nominating and credit committees. **Box 2** provides examples of the use of committees.
**Box 2: Examples of MFI Board Committees**

BANCOADEMI (Dominican Republic) has a board that meets monthly. Its 8 members participate in different committees of the organization: 3 members sit on the Executive Committee; 2 on the Audit Committee and 3 on the Credit Committee. TSPI (Philippines) has an Executive Committee of 4 members that discusses important matters that arise between board meetings, as well as a Board Development Committee of 3 members responsible for board membership and board skills and relationship development. Compartamos (Mexico), has a special committee of 5 members responsible for the NGO’s transformation into a regulated, for-profit MFI.

**Special Committees**

In contrast to standing committees, the board may create special or *ad hoc* committees for a specific purpose and disband them when they have completed their task. Boards often use special committees for strategic planning or preparing the MFI for a major transition such as the transformation from a non-governmental organization (NGO) to a formal financial institution or the implementation of a new management information system. Special committees may also deal with financial, regulatory, or other problems, such as officer or director misconduct, management deficiencies or litigation.

**Advisory Board**

An advisory board is a useful mechanism for providing an institution with access to a group of well-respected, high-stature, knowledgeable, and usually very busy, individuals. Since an advisory board assumes no legal or moral responsibility for the institution, its members can be recruited based on their ability and willingness to support the institution’s activities. The use of an advisory board is especially recommended for institutions that have only internal directors on their board. MFIs have found advisory boards extremely useful in providing objective information, insight, and strategic connections. MFIs can also use an advisory board as a graduation mechanism, inviting key directors to participate as advisors once they have decided to leave the board.

**3.3 Bylaws**

The bylaws of an institution establish the rules that govern its internal organization and management. They generally include details on the roles and responsibilities of shareholders, board members, committees and officers; specifications on term lengths, board size and meeting frequency; and processes such as voting, nomination of directors and the execution of agreements. The following guidelines apply to board bylaws:

- Bylaws should be in simple, written form. An eloquent legal document with sophisticated language is less useful in assisting stakeholders in their effective governance than a straightforward statement.
• The board should always have the power to amend these bylaws according to a specified procedure.
• The board should review the bylaws on an annual basis to ensure that they continue to be relevant and provide adequate direction.

No standard model currently exists to guide MFIs in drafting their own bylaws. One of the next steps to promoting good governance is to develop model bylaws for microfinance institutions, taking into account different forms of ownership.

3.4 Board Procedures

Most boards make decisions in full board meetings, however, other board procedures, such as board retreats or task auctions, can improve the effectiveness of the board. A discussion of these additional board procedures follows the guidelines for board meetings outlined below.

Board Meetings

**Frequency.** Board meetings are typically held monthly or quarterly. The fewer full board meetings, the greater the need for committees to meet in the interim. As an organization expands and becomes more complex, the need for more frequent board and committee meetings increases. In particular, the rapid growth of the institution demands frequent interaction between the board and management to monitor a potentially volatile loan portfolio and to ensure proactive management so that systems and procedures adequately increase the MFI's capacity.

**Duration.** Meetings typically last two to five hours, but can last as long as two days, if combined with board education or long-term strategic planning.

**Scheduling.** Both regular and special board meetings should be established and communicated to directors well in advance, preferably in the context of a full year’s schedule, with reminders and/or proposed changes sent out in a timely manner.

**Quorum.** The most common quorum requirement is 50 percent plus one for most issues. Boards should use a quorum requirement of 75 percent for important issues such as institutional transformation or amending the bylaws.

**Preparation.** Management should prepare and distribute meeting materials at least a week in advance. These materials include appropriate reports, draft motions and resolutions for consideration at the meeting. It is important to avoid distributing excessive quantities of materials. Management should provide key information in a format that allows directors to analyze it easily.

**Agenda.** Typically, the managing director and the chair jointly prepare the agenda. The agenda should allow sufficient time for the board to analyze and discuss each agenda item fully. **Table 4** provides a list of preparatory materials and a sample board meeting agenda.
Table 4: Key Preparatory Materials and Sample Board Meeting Agenda

<table>
<thead>
<tr>
<th>KEY PREPARATORY MATERIALS:</th>
<th>SAMPLE AGENDA:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Copy of the agenda</td>
<td>• Approval of board minutes</td>
</tr>
<tr>
<td>• Balance sheet</td>
<td>• Chair’s comments</td>
</tr>
<tr>
<td>• Income Statement</td>
<td>• Managing director’s report</td>
</tr>
<tr>
<td>• Portfolio quality reports</td>
<td>• One or two pertinent issues</td>
</tr>
<tr>
<td>• Cash flow statement</td>
<td>• Committee reports</td>
</tr>
<tr>
<td>• Committee report summaries</td>
<td>• Old and new business that need discussion</td>
</tr>
<tr>
<td>• External reports or sources of information</td>
<td>• Corporate resolutions</td>
</tr>
</tbody>
</table>

Minutes. Ideally, two board members review a draft copy of the meeting minutes before distribution. The board amends and approves the minutes at its next meeting.

The following are guidelines for preparing minutes:

- Describe clearly and concisely what action occurred at the meeting, including any limitations placed on the action or any conscious decision not to act.
- Describe matters of discussion and note the authorities relied upon in reaching any decision.
- Note the source of the request for action (board member, staff, branch, client).
- Identify in the minutes all documents incorporated by reference or attached to the minutes.
- Reflect the results of any motion taken and identify directors who voted against an approved transaction or who abstained.
- Highlight pending issues and when and how they will be addressed.

Other Board Procedures

Board Retreats. An additional meeting tool available to boards is an annual retreat. Corporate boards organize retreats to explore substantive issues and plan for the coming year. Retreats create a comfortable atmosphere that can enhance the working relationship between directors and provide a focused environment in which to address serious problems.

Task Auctions. When a new task or project presents itself, the chair can employ a task auction technique in which he/she sends information to all board members and requests that interested participants reply. The chair then assigns the task or forms a committee to address the project.
4. **Board Development and Performance Appraisal**

*Rare is the company that does not periodically review the performance of its key contributors—whether they be individuals, business units, or senior managers. But one contributor usually escapes such review, and that one is arguably the single most important—the corporate board.*

Jay Conger, David Finegold, and Edward Lawler  
*Harvard Business Review*

The rapidly evolving nature of microfinance requires that boards stay abreast of changes in the field to fulfill their oversight responsibilities effectively. This chapter addresses methods for enhancing microfinance governance through improved board development and performance appraisal. It provides guidelines for the implementation of mechanisms to assess the performance of individual directors and the overall board.

### 4.1 Board Development

Boards should develop a process to upgrade the knowledge and skills of its members. This process includes three elements: a) orientation, b) continuing education, and c) periodic evaluation. The process begins with the orientation of new directors, but should support a culture of continuous learning and inquiry.

Few MFIs have formal board development programs, which is an industry-wide weakness. Without a development program, it is a challenge for directors, some with limited knowledge of microfinance, to provide effective oversight and strategic guidance.

Boards should avoid the following development activities: sending board members excessive materials or the same materials year after year; and assigning directors to committees against their will.  

*Table 5* provides some tools that microfinance institutions have found helpful in board development.
Table 5: Board Development Tools

- Self-study/reading packages
- Video tapes
- Trade publications
- Observation visits, both locally and internationally
- Interviews with senior management and advisory board members
- Short presentations to the board by industry experts
- Client visits

An effective board development program encompasses the following:

**New Director Orientation.** The orientation process should enable new directors to achieve three objectives: i) learn about the microfinance industry; ii) become familiar with the institution; and iii) develop commitment to the MFI. In many MFIs, the managing director has the primary responsibility for new director orientation. It is preferable if board members and other employees of the institution take part in this role as well, perhaps through the Human Resources Committee.

**Continuing Education for Directors.** Continuing education focuses on developing the knowledge and skills of board members. The following are natural areas in which board member education can be integrated: organizational review; discussions of peer group performance; market and strategic issues; regulatory and compliance issues; and board consolidation (activities that strengthen relationships between the board and management, as well as among individual board members).

**Periodic Evaluation.** The board development process should incorporate an evaluation of the board's performance at least once per year. Along with the performance appraisal, the board should have a mechanism by which directors annually recommit to the institution's mission.

**Board Development Strategies.** Table 6 summarizes several of the most common approaches to board development. The selected strategy depends on the institution's objective, the type and number of board members being trained, and the available time and resources. Several of the recommendations of activities for new board member orientation also apply to continuing education and vice versa.

### 4.2 Board Performance Appraisal

Performance appraisal is one of the most powerful board development tools. Constructively utilized, it can improve the performance of individual directors, of the board as a whole, and ultimately, of the institution by essentially creating an additional level of accountability.

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Table 6: Suggested Approaches to Board Development

<table>
<thead>
<tr>
<th>Activity</th>
<th>Approach</th>
<th>Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Increase Knowledge</td>
</tr>
<tr>
<td><strong>New Member Orientation</strong></td>
<td>1. Provide an orientation package that includes:</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>• Articles of incorporation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Overview of the institution</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Recent annual and quarterly reports</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Previous board minutes and reports</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Biographies of other directors</td>
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</tr>
<tr>
<td></td>
<td>• Written description of board responsibilities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. Visit the institution’s main office to interview senior management, staff and clients</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>3. Invite new directors to participate on a committee</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>4. Review key financial performance indicators with senior management</td>
<td>X</td>
</tr>
<tr>
<td><strong>Continuing Education</strong></td>
<td>1. Distribute reading materials compiled by staff, consultants or local/regional associations</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>2. Organize seminars or inform directors about relevant externally sponsored events</td>
<td>X</td>
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<tr>
<td></td>
<td>3. Visit local marketplaces and other concentrations of microenterprises to study the institution’s impact</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>4. Visits to branches of the organization</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>5. Incorporate an educational component into each board meeting</td>
<td>X</td>
</tr>
<tr>
<td><strong>Performance Appraisal</strong></td>
<td>1. Use board appraisal mechanisms to review the roles and responsibilities of the board</td>
<td>X</td>
</tr>
</tbody>
</table>

A performance appraisal process should fulfill the following objectives:

- Clarify individual and collective roles and responsibilities of board directors.
- Help the board identify areas of weakness and stimulate ideas about how it might improve in those areas.
- Enhance the working relationship between board and management by encouraging greater candor in dealing with each other.
- Provide a mechanism for regularly reviewing the performance of individual directors, thus making it possible to assess board member strengths and weaknesses, and apply a performance-based policy for replacing directors who are not providing the leadership that the institution requires.
The Appraisal Process

Few MFI boards have an assessment process. The following four steps are recommended to launch an appraisal process.

a) The board establishes objectives for each area of responsibility against which to measure performance. The board should set these objectives annually, usually at the beginning of the fiscal year, and preferably not at the same meeting in which they assess board performance of the previous year.

The board should take care to ensure that all major areas of responsibility are covered periodically, but given the constraints on board members’ time not every responsibility needs to be evaluated each year.

b) The board’s secretary or another appropriate entity prepares a report about the board’s resources and activities in the past year, including an analysis of how the board spent its time and energy. The report should also include an analysis of information collected from outside the institution such as from market analysts, industry networks and rating agencies, which are discussed in more depth in Chapter 6.

c) The board assigns the nominating committee chair or another director to survey the other members regarding the board’s performance relative to the objectives. This survey is usually conducted in a written format although some organizations have found it useful to interview board members one by one.

The survey should use a mixture of open-ended questions and numerically scored multiple choice items to facilitate easy analysis, yet provide an opportunity for board members to share their insights on what is and is not working. For example, the survey might ask members to indicate on a scale of one to five whether they think all board members understand the institution’s mission or whether the board is prepared to deal with unforeseen crises. It might ask open-ended questions about the board’s overall performance or about the effectiveness of the current committee structures.

d) The director conducting the survey compiles the responses into a single report that identifies in which areas the board met its objectives and where it needs improvement. The tone of the report is as important as the content. It must be confidential, balanced, and acknowledge where viewpoints differ. The board should receive a summary of the report followed by a discussion, aimed at improving the board’s effectiveness.

Evaluating the Board as a Whole

A board should periodically evaluate itself, particularly its ability to establish and achieve objectives. The process should:

- Review board skills and experience in comparison with the institution’s strategic direction to determine whether training and/or changes to the board’s composition are needed;
• Compare board accomplishments with the work plan;
• Ensure the MFI has internal control, information and audit systems in place, which can adequately convey to the board whether the institution is achieving its objectives;
• Examine the sources of the data used by the board ensuring the use of information from both internal and external sources;
• Assess the effectiveness of meetings in terms of frequency, time efficiency, and ability to reach important decisions;
• Consider whether board members are receiving, in a timely manner, the type and quality of information they need to prepare for meetings;
• Evaluate the institution's strategic planning process: does one exist, is it being used, is it yielding strategic initiatives that are on schedule, within budget, and producing the desired results?

Evaluating Individual Board Members

The evaluation of individual board members is much more controversial than the evaluation of the board as a whole. There are two main concerns with individual appraisals. First, the focus on individual performance may undermine teamwork and encourage members to focus on their performance rather than their contribution to the board’s overall effectiveness. Second, in an environment in which it is difficult to attract top-notch members, the appraisal requirement might drive away good board members who feel they have proven themselves. They may incorrectly interpret the appraisal process as questioning their experience and expertise.

Acknowledging these concerns, there are benefits to the evaluation of individual board members. Appraisals hold members accountable to clear performance expectations, call attention to under-performance when it occurs, and act to correct it through participation that is more effective or by replacing the member with someone who can do the job.

Should an MFI decide that it wants to appraise individual member performance, three strategies are possible:

Self-evaluation. Self-evaluation is a relatively innocuous but potentially effective strategy. The board develops a short questionnaire that each individual completes in private. The results are confidential, but they can assist members to reflect upon and improve their own performance.

Committee Assessment. The nominating committee could meet to assess each member, the results of which only the evaluated board member receives.

Anonymous Evaluation by Fellow Members. Alternatively, the institution could ask members to evaluate one another anonymously. The evaluations could be distributed in-house (for example, by passing envelopes around the table for each director and placing the evaluation for each individual in the appropriate envelope), or they could be collected by an outsider who would provide each board member with a summary of
their peers’ comments and ratings. The outsider could also provide the full results to the committee charged with nominating directors for term renewal to help identify under-performance.

Boards unaccustomed to individual member appraisal may prefer to begin with self-evaluation, introducing assessment by committee or fellow members only after the board has gained some experience and become comfortable with the concept.
5. MANAGING MANAGEMENT

An effective partnership between board and management is crucial to success.

Mary Houghton
Shorebank Corporation

One of the most important responsibilities of the board is to hire, monitor, and if necessary, replace the institution’s managing director. Determining compensation is an additional important aspect of managing management, and it should be clearly linked to achieving appropriate performance targets. Finally, even if the managing director is doing an excellent job, the board must still have a clear succession plan to deal with unforeseen events.

5.1 Hiring the Managing Director

The process of hiring a new managing director for an existing MFI should follow the format laid out in a prearranged succession plan. While the board must look for the right person at the right time, it must recognize that there is no right person for all time. In general, the recruitment process contains four elements:

Written Job Description. Each MFI should have an organizational manual that provides a job description for each post within the institution including the managing director. It should identify the required and preferred skills, experience, commitment, and other criteria sought in a managing director.

Candidate Identification and Recruitment. The MFI should always be in the process of grooming potential candidates to succeed the managing director. If none of the internal candidates are ready, the board looks outside the organization, making use of advertising, executive search firms, and networking to identify potential candidates. Transparency in this stage is vital. It is also recommended that the board identify a sufficient number of candidates to ensure a good selection.

Interviewing Process. The board usually delegates the responsibility of interviewing potential managing directors to a search committee of the board.
New Managing Director Selection and Hiring. The full board makes the final decision about who should be offered the job and on what terms.

Immediately after hiring, the board and new managing director should begin a series of conversations and activities to build and define their relationship and to familiarize the managing director with the institution, its culture and processes. The board should facilitate any training necessary for the new manager to assume the role effectively. If the managing director has never led a microfinance institution, it is highly recommended that training include exposure to other leading microfinance institutions.

5.2 Defining the Relationship between Board and Management

The board and management should have a relationship defined by partnership, particularly between the board chair and the managing director. Partnership refers to the mutual support, trust, and respect forged between two entities.

The board governs management and must have mechanisms in place to fulfill its oversight function. Oversight alone, however, does not produce effective governance. The MFI needs a process that enables the board and management to combine their skills and efforts to move the institution forward—a process built on a foundation of partnership and supported by an oversight structure. Table 7 defines the relationship between the board and management, and their roles and responsibilities.

<table>
<thead>
<tr>
<th>Board</th>
<th>Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provides guidance to management in the strategic direction of the organization and approves major strategic directives</td>
<td>Manages the day-to-day operations, recommends strategy to the board</td>
</tr>
<tr>
<td>Approves a framework of policies and objectives, which is mutually agreed upon by the board and management</td>
<td>Recommends to the board and implements approved policies and plans to achieve targeted objectives</td>
</tr>
<tr>
<td>Authorizes a performance monitoring and evaluation process to ensure that policies are respected, plans are implemented, and objectives are achieved</td>
<td>Maintains the institution’s financial solvency and manages the institution’s human resources in a manner that encourages high productivity, performance, and staff development</td>
</tr>
<tr>
<td>Ensures that the institution’s operational priorities do not overwhelm its strategic priorities</td>
<td>Ensures that the institution’s board is well informed, and that it considers itself an integral part of the institution</td>
</tr>
<tr>
<td>Maintains a healthy separation from management to ensure that boundaries between the roles and responsibilities remain clear</td>
<td>Develops a strong management team to ensure effective implementation of policies and grooming of a potential successor</td>
</tr>
<tr>
<td>Does not execute authority in the management</td>
<td>Does not serve as a voting member of the board</td>
</tr>
</tbody>
</table>
Given the distinct roles of the board and management, it can be challenging to ensure that the two sides of leadership function harmoniously. The following suggestions help to achieve this:

- Encourage excellent communication and information flow. Effective reporting and regular conversations between the chair and the managing director are key. Although the board should have occasional interactions with other senior managers and staff, most communication between board and staff passes through the managing director.
- Create informal opportunities for discussion between the board and management (for example, through social events and/or retreats).

**5.3 Establishing Policies and Objectives**

One of the main responsibilities of the board-management partnership is to define general institutional policies. In the case of an MFI, this includes policies on lending, branch openings, compensation, mergers and acquisitions, dividends, debt management, debt-to-equity ratios, and the issuing of shares, among others. The procedures for implementing these policies are the responsibility of management, but the setting of policy is an area in which the board must play a strategic role.

In determining strategic direction, the institution's mission serves as a compass. With the mission in mind, the board should review policies periodically to ensure that they are still relevant and make changes as necessary. If the board and management receive many legitimate requests for exceptions to a policy, it is a clear sign that it needs review.

Besides setting general operational policies, the board-management team must develop short, medium, and long term corporate goals and objectives. These objectives include benchmarks against which both parties can measure performance and progress. This annual process consists of four steps:

a) The board first establishes key objectives for the coming year in cooperation with management. Some institutions have found that an annual strategic planning retreat is an effective way to identify these objectives since it brings the key stakeholders together in a focused environment.

b) Next, management prepares the institution's annual business plan and a three to five year strategic plan. These plans include measurable objectives in the following areas: budget (including investment requirements and resources); finance and operations (including delinquency and productivity objectives); mission (target markets and impact); and plans for expansion (client and portfolio growth projections).

c) The board reviews and approves these plans, paying particular attention to the appropriateness of the targets and objectives.
d) Finally, the board monitors the performance of the institution in relation to these targets and objectives at every meeting.

5.4 Management Compensation and Performance Incentives

The board approves annual budgets, which include recommended compensation for staff and management. The boards should compare the salaries of their executives with those in similar organizations, as well as the range of salaries throughout the institution. Management salaries need to be high enough to attract and retain committed and capable managers, but not so high that they undermine the morale of other employees.

Within this framework, the board establishes the compensation package for the managing director. This package should be clearly stated and linked to the achievement of measurable objectives as well as qualitative indicators such as teamwork. It may contain a mix of financial and non-financial benefits such as core salary, health insurance, and shares in the company.

The board may also want to establish performance incentives for the managing director that will complement the base compensation and motivate maximum performance. The following recommendations guide the design of an effective incentive scheme:

- Limit the number of indicators to those that are truly important - choose no more than five indicators, and preferably fewer;
- Reward individuals for issues that are within their control and for behaviors that they can directly affect;
- Keep the incentive scheme simple - set measurable and achievable targets;
- Clearly explain the rationale used in selecting the indicators.

In designing an incentive scheme, the board should take extreme care in selecting and balancing the indicators. Overemphasis on certain indicators can cause the managing director to steer the institution off its desired course. Incentive schemes must also consider the cultural context.

Part of the board's oversight responsibilities is to monitor and review the performance of the managing director. The managing director's performance review should be linked to the achievement of institutional objectives, which Chapter 6 discusses in more detail.

In summary, in managing the position of managing director the board develops the following:

- Written job description

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• Compensation package
• Performance incentives

Institutional objectives change over time, sometimes yielding a formerly effective managing director ineffective due to changing requirements of the position. Given the lack of job alternatives in many developing countries, some managers may not resign even when they are no longer qualified for their position. Although politically difficult, boards occasionally must ask a managing director to resign, fulfilling their duty of loyalty to the interests of the institution.

5.5 Succession Planning

All MFIs should have a written succession plan. Even if the MFI is running smoothly, with no anticipated need for a successor, unforeseen events and tragedies do occur. If the need arises before the plan is in place, the institution may fall into a crisis mode. It would have no time to prepare for the transition and little time to think strategically about how succession should take place. The board would have to seek an acceptable replacement in the shortest time possible and the institution would unnecessarily endure a difficult period of transition due to the lack of adequate foresight and planning.

The following are guidelines for developing a framework for a succession plan:

Write a Succession Plan. The succession plan details a strategy for replacing the managing director and other specified senior management should the need arise, including a job description for each key position and the necessary and desired criteria for replacement of each position.

Groom Internal Successors. The plan involves the current managing director in the preparation and training of potential internal successors. This approach to succession planning offers four benefits: a) it allays the manager’s fear that a successor is being prepared without his or her knowledge; b) it grooms candidates who understand the philosophy, values and experience of the position; c) it creates a replacement for temporary or long-term absences of the managing director; and d) it improves the effectiveness of the senior management team. Transparency in the process creates an institutional environment in which employees feel motivated to strive for promotion, thereby improving individual performance.

Develop Contingency Plans. The succession plan also includes a contingency for a major dislocation (temporary or permanent) of senior staff; for example, if several managers are hired away or leave their positions for personal reasons (e.g., maternity leave, illness, family responsibilities). Each senior manager presents to the managing director his/her recommended successor(s) along with an analysis of the person’s strengths and weaknesses and the training that he/she would require to assume the new position. The managing director consolidates this information for the board, which decides upon appropriate action.
Revised Annually. Management prepares the succession plan and revises it each year. The board reviews the plan and evaluates the recommendations before approving it.

Chapter 6 addresses oversight of microfinance institutions. In preparation for effective oversight, the board with input from management must have the following in written form:

- A three to five year strategic plan
- Annual business plan including budget
- Institutional policies
- Key objectives
6. OVERSIGHT

While day-to-day affairs are typically delegated to bank management, a bank’s board of directors is ultimately responsible for the bank’s actions.

This chapter discusses oversight, a critical element in the effective governance of microfinance institutions. Oversight refers to the methods by which the board and management attempt to establish accountability, control risks, prevent losses, and achieve objectives. By providing effective oversight, the board ensures that the MFI uses its resources in an appropriate and responsible manner and fulfills the institution’s mission.

6.1 Designing an Effective Oversight Strategy

Every stakeholder affiliated with the MFI plays a role in oversight: management, employees, directors, investors, donors, consultants, regulators and clients. The board ensures that all parties are involved in a way that generates effective accountability. The board is intimately involved in designing the oversight strategy and establishing policies, controls and incentives on which the strategy depends. The board monitors the implementation of the strategy and encourages management to take swift and decisive corrective action when necessary.

Effective oversight implies problem identification and resolution, as well as foresight and prevention. The following guidelines affect the design of an oversight strategy:

- **Oversight Strategy Evolves Over Time.** The oversight strategy should be consistent with the institution’s level of maturity and mission, and often changes as the institution grows. The strategy should employ a diverse set of tools, applying both incentives and disincentives to the behavior of staff and management. Transparent channels of communication and information flow must be developed and nurtured.

- **Balance is Key.** Boards should strike the appropriate balance between the thoroughness of oversight and the associated administrative costs, ensuring that the system is reliable yet efficient.
Board Directors Must Have Oversight Skills. Boards should be careful in selecting new board members and training existing ones. New members should have the skills and the microfinance knowledge necessary to pose analytical questions and be incisive in their discussions to fulfill their oversight responsibilities.

An effective oversight strategy contains the six key components outlined below.

a) An Appropriate Institutional Culture

The foundation for an effective oversight strategy lies in the institution’s culture. An organization should strive to have an operational environment based on honesty, accountability and the transparent flow of information. An institution’s strategy cannot rely solely on these things, but their existence greatly enhances its effectiveness. The MFI’s working environment should promote high ethical standards, a team approach, and a learning philosophy. If an institution values innovation and seeks to improve its activities, the remaining components of its oversight strategy are relatively easy to implement.

All financial institutions experience some level of fraud, and MFIs are no exception. While institutional culture can reduce the prevalence of fraud, it can not eliminate it. MFIs should address the possibility of fraud directly, not condoning it, but overcoming the propensity to deny its existence.

b) Objectives, Policies and Procedures

The board establishes objectives and policies, which are critical to the success of any oversight strategy. Without them, there is nothing against which to judge institutional performance. Objectives, guided by the institutional mission, define what the MFI wants to achieve and when. Policies set the rules by which management implements the institution’s activities. They facilitate smooth operations, institutional coherence, consistency and fairness in decision making. Procedures, established by management, are acceptable methods of conducting business in accordance with these policies and objectives.

c) Effective Reporting on Institutional Performance

To exercise effective oversight the board must ensure the following conditions:

- The three parameters (objectives, policies, and procedures) are established to create a reporting framework.
- The board conveys what information it needs to monitor and to analyze the institution’s performance. The board solicits reports that allow it to assess the institution’s current position as well as identify future risks and opportunities.
- Management provides performance indicator reports in a timely and accurate manner, presenting the data in a format that can be easily analyzed.
- Through the internal auditor, the board verifies that the information collected is reliable, accurate and complete.
d) Monitoring

With established parameters and reliable reports, the board can regularly analyze the institution's performance and compare it to the objectives. The board can use committees to facilitate a more in depth or frequent analysis if desired.

The board should analyze performance in comparison with external standards and benchmarks provided by others in the industry. Rating agencies, such as the one developed by the Private Sector Initiatives Corporation, and internal assessment tools like the CAMEL\textsuperscript{7} and PEARLS\textsuperscript{8} instruments, can be very useful in this stage.

e) Evaluation

The board should evaluate whether the institution is achieving its mission. This includes determining if the institution is positioning itself in the right direction for the future and whether it is protecting itself against future risk. The board should consider both short- and long-term trends and examine changes in the external environment such as competition or new government policies that could have an impact on the MFI’s long-term viability.

f) Corrective Action

Oversight does not end with analysis; it ends with action. The board must see that corrective actions are taken to address identified institutional weaknesses. The board can institute new policies, adjust incentives, and have management modify systems and alter procedures. If the source of institutional weakness is the managing director, the board may need to replace him/her.

\textbf{6.2 Performance Indicators}

This section presents guidelines for identifying indicators and ensuring that the data are presented in a format that is useful in decision making.

Choosing Indicators

Effective oversight depends on indicators to measure results. Indicators determine what data are collected and what information is analyzed. The board must take great care in selecting both \textit{qualitative} and \textit{quantitative} indicators for its oversight strategy, keeping in mind the following guidelines:

Within the Framework. Indicators must be linked to the objectives, policies and procedures defined by the institution and used to assess whether the MFI is achieving its mission.

\textsuperscript{7} ACCION International’s CAMEL instrument measures Capital adequacy, Asset structure, Management, Earnings, and Liquidity.

\textsuperscript{8} The PEARLS system, as used by the World Council of Credit Unions (WOCCU), measures Protection, Effective financial structure, Asset quality, Rates of return and costs, Liquidity and, Signs of growth.
Selective, Yet Frequent Monitoring. The board selects key indicators to monitor regularly, and another set to measure periodically. Trying to monitor too many indicators simultaneously can be overwhelming in terms of the time required to complete the task and the cost involved in collecting the information. The finance, credit and asset-liability committees should perform in-depth, frequent monitoring as part of their responsibilities.

Consider Past and Future Performance. The board balances static (historic) and dynamic (predictive) indicators. Static indicators, such as financial reports and audits, provide useful information on the status of the MFI, but they are of limited use in preventing or predicting future risk. Dynamic indicators provide information on

<table>
<thead>
<tr>
<th>Category</th>
<th>Indicators and Frequency of Reporting</th>
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<tbody>
<tr>
<td></td>
<td>Monthly</td>
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<tr>
<td>Capital Adequacy</td>
<td>• Institutional capital/required minimum capital</td>
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<td></td>
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<td></td>
<td></td>
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<tr>
<td>Liquidity</td>
<td>• Cash + deposits + short-term investments as % of deposits/borrowings</td>
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<tr>
<td>Profitability/Financial Self-Sufficiency</td>
<td>• Budgeted versus actual revenues and expenses</td>
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<tr>
<td>Portfolio Quality</td>
<td>• Portfolio at risk</td>
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<td></td>
<td>• Doubtful debts</td>
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<tr>
<td>Client Satisfaction</td>
<td>• Percentage of repeat loans</td>
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<td>• Client desertion rate</td>
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<td>• Loan rejection rate</td>
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<tr>
<td>Operational Efficiency</td>
<td>• Total number of staff by function</td>
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<tr>
<td>Growth/Expansion</td>
<td>Monthly trends in:</td>
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<tr>
<td></td>
<td>• Size of portfolio</td>
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<tr>
<td></td>
<td>• Loan disbursement</td>
</tr>
<tr>
<td></td>
<td>• Number of clients, branches and staff</td>
</tr>
<tr>
<td></td>
<td>• Market share (as percentage of estimated target market)</td>
</tr>
<tr>
<td>Reach/Social</td>
<td>• Monthly: Loan size distribution</td>
</tr>
</tbody>
</table>
Impact

- Annually: Analysis of impact data collected at the time of loan disbursement such as increase in sales, assets, employment, profits, savings

growth, market share and other trends that can serve as early signals of potential risk or opportunity, and assist the institution in its future strategic planning.

The board must choose indicators that make the most sense for its institution. To guide this decision, Table 8 summarizes the indicators that some MFIs have found useful.

Gathering Information

Once the board has selected an appropriate set of indicators, the following guidelines ensure that the information is collected and presented in a manner that will enable it to analyze those indicators effectively:

Reporting Standards. The board communicates to management the indicators it wants reported and the frequency and standards by which it wants reports prepared. Table 9 summarizes characteristics of effective reporting.

<table>
<thead>
<tr>
<th>Table 9: Characteristics of Effective Reports</th>
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<tbody>
<tr>
<td>Timely</td>
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<tr>
<td>Accurate</td>
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<td>Digestible</td>
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<td>Dynamic</td>
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<tr>
<td>Cost effective</td>
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<tr>
<td>Balanced</td>
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<td>Relevant</td>
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<tr>
<td>Contextual</td>
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</table>

Reporting Format. The board should also work with management to develop a standard reporting template for the presentation of information to the board. The format should make it easy for board members to analyze performance on selected indicators and highlight important matters. It should compare current month ratios and statistics to those of previous months and to the same month for previous years. It should also present an analysis of actual versus budgeted figures.

Transparent Reporting. The board expects management to have an information system that provides channels for the upward, downward, and lateral flow of information. This allows staff throughout the organization to have access to relevant information. It also provides staff with an opportunity to review the accuracy and

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content of the information reported to the board, thus incorporating them into the oversight strategy.

**Creative Data Collection.** The board should experiment with additional ways of collecting information that do not rely solely on reports provided by management. For example, board members can speak directly with clients and branch staff or they can invite senior managers besides the managing director to make presentations on institutional performance to provide alternative perspectives.

### 6.3 Ensuring the Accuracy and Reliability of Reports

Besides choosing the best indicators and gathering the right information, the board must also ensure that the information it collects is accurate and undistorted. The board has three tools for ensuring the reliability of the information it uses to oversee the institution: internal controls, internal audits, and external audits.

**Internal Controls**

The board must ensure that management has incorporated a sound system of internal controls into the institution’s daily operating procedures. **Table 10** presents examples of general control activities along with specific applications.

<table>
<thead>
<tr>
<th>Control Activity</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Segregation of Duties</td>
<td>Separate expense authorization from check disbursal duties</td>
</tr>
<tr>
<td>Approvals</td>
<td>Two signatures required on all checks</td>
</tr>
<tr>
<td>Verification and Reconciliation</td>
<td>Daily cash box reconciliation</td>
</tr>
<tr>
<td>Performance Appraisals</td>
<td>Regular board, management and staff appraisals</td>
</tr>
</tbody>
</table>

For effective internal control, the MFI’s information system should encourage the upward, downward, and lateral flow of information. The wide availability and transparency of information increases the number of people that review its accuracy. Institutional policies must be distributed to all staff, including incentives and disincentives for compliance with those policies.

An audit or finance committee of the board is often responsible for conducting risk assessment and safeguarding the institution’s resources. This committee oversees the internal control procedures, reviews the proposed budget, and may recommend changes before the budget is considered by the full board. It also ensures that the institution complies with laws and regulations.
Internal Audit

The purpose of an internal audit is to disclose irregularities and to propose changes to internal procedures to prevent losses. The internal auditor seeks to identify new or previously uncontrolled risks or inefficiencies, which require new control activities. He/she presents findings and makes suggestions to the board on a monthly or quarterly basis. The board considers the recommendations and weighs the potential costs and benefits of their implementation. It then decides whether to proceed with the recommendations, seek more information, or reject the proposed changes with sufficient justification for non-implementation. Table 11 summarizes the characteristics of effective internal audits.

Table 11: Characteristics of Effective Internal Audits

- Objective and independent
- Board provides clear guidance on its information needs
- Auditor understands the norms and intricacies of MFIs
- Provides auditor unrestricted access to information
- Monitors adherence to pre-established policies and procedures
- Includes branch level analysis
- Incorporates client visits as part of process
- Auditor reports directly to the board

The following guidelines are helpful when creating an internal audit unit:

- The board must provide the audit unit with clear direction. It must establish appropriate policies to direct the unit’s work. The board needs to be specific about its information needs so that the unit can ask the right questions in its audits and ultimately deliver useful information.

- Auditors should be encouraged to take note of what is working well within the institution as well as what is not, so that efficient methods can be replicated.

An internal audit includes three elements:

a) Procedural audit. The internal audit reviews whether staff members are properly implementing procedures outlined in the institution’s operations manual. The procedural audit includes spot checks and random sampling to ensure that:

- applications and loan analysis are done correctly;
- loan sizes and terms comply with company policy;
- loans are approved by the proper people;
- legal documents are properly signed and notarized; and
- delinquency management procedures are correctly followed.
These spot checks should include one-on-one conversations with field workers and visits with clients who are excellent performers as well as those at risk.

b) **Portfolio quality verification.** The portfolio data from the main office need to be reconciled with branch data, which then must be reconciled with the clients’ information. Verification should be made of actual amounts outstanding and the accuracy of the portfolio classification. This requires client confirmation and an analysis of the information system. If the information system is computerized, internal controls should include backup and recovery procedures, a review of software development, acquisition policies, maintenance procedures, and security access controls. Auditors need to look very closely at non-performing and restructured loans to ensure that the MFI is not involved in creative accounting or hiding delinquency.

c) **Client sampling.** In microfinance, balance verification must come from the clients themselves. It is not realistic, however, to verify every loan as is common practice in traditional banking institutions. Auditors need to verify information with a statistical sampling of clients. The size of the sample will depend on the total number of active borrowers, an agreed error margin, and the confidence level that the institution wants to achieve. More crucial than the number of clients sampled is the verification process. Given the characteristics of microentrepreneurs, it is necessary to go to the clients’ businesses to verify their existence and have them discuss their account balances. The auditor should present the process to the client as a customer service visit rather than an invasive audit.

**External Audit**

An external audit provides the board with an objective, third-party opinion on the adequacy of the internal control system. The most common type of external audit is the financial statement audit that provides reasonable assurance that the institution’s financial statements are free of material misstatement. The board should not rely on external audits to identify risk exposure, fraud or needed control activities. If the board requires external advice in these areas, it should hire an independent advisor or consultant. External audits are also of limited value because auditors tend to have little understanding of the norms and intricacies of microfinance institutions. In selecting an auditor, the board should ensure that candidates are able to adjust their practices to the fact that loans may not be secured with traditional collateral.

External audits of MFIs should occur on an annual basis, or as frequently as required by local regulatory authorities. Where possible, the board should receive the auditor-approved financial statements within three months after the close of the fiscal year. Both the internal and external auditors report to the audit/finance committee or the board as a whole. It is critical that the board ensure management controls the selection, retention, evaluation, and compensation of internal and external auditors.

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10 Refer to CGAP’s “External Audits of Microfinance Institutions,” which guides boards on how to commission an effective audit and external auditors on audit adaptations for MFIs.
7. OWNERSHIP AND GOVERNANCE

Different types of owners have different objectives when they exercise a governance role; if these are not well understood, the varied perspectives of owners can obstruct rather than facilitate the board’s ability to govern.

Maria Otero
ACCION International

Corporate structure does not define effective governance, but for each type of microfinance institution — non-profit, profit, credit union — factors exist that may strengthen or weaken a board’s ability to fulfill its roles and responsibilities. The characteristics and the perspectives of owners who exercise the governance role are perhaps the most important factors related to effective governance.

These guidelines address the relationship between ownership and effective governance by presenting guidelines by type of institutional structure: for-profits, credit unions, and NGOs. Governance of public institutions is not addressed because, with the notable exception of Bank Rakyat Indonesia, there are no other significant examples of this type of ownership structure. The chapter begins with a discussion of the underlying issue that every board must address: the social and profit objectives of the institution.

7.1 Balancing the Social and Profit Objectives of Microfinance

One of the most challenging tasks facing boards of all institutional types is balancing the dual objectives of social mission and profitability. Particularly in regions where the microfinance industry is underdeveloped, conventional wisdom asserts that these are mutually exclusive objectives. Microfinance best practice has shown, however, that these objectives are complementary. The social and profit objectives reflect the same tradeoffs any business faces when trying to balance short- and long-term goals.

The social and profit objectives are aspects of the same business philosophy, each one reinforcing the other. Social mission, expressed in conventional business terms, is an
MFI's orientation toward a specialized market niche, where actors must be innovative to serve the market efficiently and profitably. The profit objective, expressed in social terms, is an institution's search for permanence. It is tied to the social objective because institutions that do not achieve permanence will fail to achieve their social mission over the long term.

A single MFI is likely to evolve through several phases in its life span, during which its balance of objectives will assume different forms. In its early stage, an MFI may aim to demonstrate that it can provide financial services to a previously unbankable market in a sustainable manner. In a second stage, it might expand its outreach to serve more people in the target market in a permanent, profitable manner. In a third stage, when the institution achieves profitability and attracts competitors, the MFI may develop new products oriented to clients' needs, or restructure its costs to reduce interest rates. At a later stage, it may even return to the first objective, and seek to reach even poorer market segments still considered unprofitable.

Acknowledging the existence and feasibility of these dual objectives, the task of balancing them on a daily basis can still be daunting. In doing so, MFIs should consider the following guidelines:

- The institution must focus on the specialized market niche that defines its social mission. For it to achieve both objectives, it must understand the characteristics of its target market and design its services accordingly. Simultaneously, the board must be aware of the MFI's stage of evolution and set profit objectives accordingly.
- The MFI should embrace the dual objectives in its mission statement and ensure that its institutional policies and procedures follow from that statement.
- The board should seek out additional training and/or temporarily cede to management's discretion if it does not have sufficient experience during certain phases of its existence to implement the balancing process effectively. A solid partnership between board and management is particularly crucial to success in a microfinance institution given the need to provide unified leadership in the face of a challenging balancing act.
- A balance in the composition of the board may enable it to balance the two objectives effectively. However, MFI boards should avoid polarization by avoiding candidates who see the issue from only one perspective. Ideally, board members should consider both objectives important, although they may have a natural bias toward one or the other.

The discussion and guidelines below should help institutions address the following governance issues as these relate to ownership:

- Institutional mission and stakeholders;
- Board composition;
• Board member identification and selection;
• Directors’ motivation for representing the MFI;
• Board member compensation;
• The type of owners which impacts how governance is approached;
• Government rules and regulations that must be followed.

7.2 For-Profit MFIs

The financial goals of for-profit MFIs are oriented toward ensuring a return on investment and preserving capital. For-profit MFIs have boards that are comprised primarily of the owners of the equity invested in the institution.

The following section discusses the governance issues pertinent to two types of for-profit MFIs that predominate today: NGOs converted into regulated financial institutions, and subsidiaries of traditional commercial banks. A third type, a for-profit institution created to specialize in microfinance, is not addressed here because there are only incipient examples of this type of institution.

Transformed NGOs

Several for-profit MFIs are transformed non-profits that are partly owned by the founding NGO. After the initial transformation agreement, it is difficult to control ownership and board composition, because the exchange of shares transfers ownership and often board membership to the highest bidder.

There is usually a mix of investor types in transformed for-profit MFIs, including NGOs, private investors, public entities, and specialized equity funds. Each ownership type brings its own set of motivations, interests and concerns:

• **NGOs as owners:** The non-profit background of an MFI does not provide the tools or framework for the effective governance of a for-profit MFI. For this reason, the individual who represents an NGO on the board of a for-profit must have the expertise to provide the oversight required by the newly entered regulatory environment, and must dedicate the necessary time to the governance function. An NGO representative can also play the important role of addressing the social dimension of the institution’s work in an effective manner.

• **Public entities as owners:** The discussion limits itself to multilateral and bilateral agencies, which play a key role as equity investors in microfinance institutions. The time demand of governance combined with the various additional objectives these institutions address make it difficult for them to play

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an active and effective role on a board. If they do participate as owners, it is imperative that they define clearly their objectives, and the limitations of time, travel and continuity for participation on a board. Recognizing these shortcomings, multilateral and bilateral institutions will often realize the logic in indirect ownership participation, and will instead invest in a third-party institution such as a specialized equity fund or holding company.

- **Private capital in MFIs**: There is very little “pure” private capital invested in microfinance today. Most of the private capital comes from the socially responsible investment community which generally gives priority to the social objectives of the institution.

- **Specialized Equity Funds**: These investment funds focus all their activity on microfinance and have as their primary objective the preservation of capital and an adequate return on investment. As owners, these equity funds play an active role, are technically well prepared, and tend to be long-term investors. Profund, in Latin America, is one example of such a fund.

The following guidelines are specifically for transformed MFIs:

- The board selection process of a transforming NGO must check the motivation of director candidates and their level of understanding of and interest in microfinance;
- Transformed MFIs must implement a stricter set of internal controls into their operational systems.

Subsidiaries of Traditional Financial Institutions

The other type of for-profit microfinance institution is a division or subsidiary of an existing commercial bank. Since these subsidiaries are usually governed by the same body that oversees the rest of the banks’ operations, they are often not given the special attention and treatment necessary for effective microfinance governance. Effective governance can be stifled if investors focus too heavily on the anticipated return relative to alternative investments; if they apply the same performance benchmarks for the bank and the MFI; and if they adopt a short time frame for success.

The following guidelines address the common issues experienced in microfinance subsidiaries of commercial banks:

- Create a separate board to oversee the microfinance division;
- Select board members who believe in and respect the dual objectives of long-term profitability and commitment to the microenterprise sector;
- Develop a mixed institutional culture, maintaining the formality of a traditional bank while supporting the development of close relationships with client entrepreneurs.
7.3 Credit Unions

The owners of credit unions are also their principal clients. Credit union governance rules dictate that voting rights are democratically distributed, rather than proportional to investments or deposits held with the institution. Although members participate in the distribution of profits as owners, their primary incentive for joining the credit union is to receive financial services rather than financial returns. This is an important distinction since, as owners, they simultaneously influence the strategic direction and operational policies of the credit union. These factors, combined with the fact that credit unions are often not regulated or only minimally regulated, highlight the need for an effective internal governance structure. Below are common weaknesses inherent in credit union governance and recommendations to overcome these limitations.

Inadequately Qualified Board Members. In a credit union, the general assembly of members elects the directors who are simultaneously owners and clients. These directors often lack the business acumen or management skills to monitor the credit union's business. Particularly in regions where education levels and literacy rates are low, it is difficult to identify a sufficient number of qualified directors within the credit union membership. Since board members are elected based on a one-person, one-vote principle, those elected are often popular or politically skilled, rather than the most competent. The following guidelines address these concerns:

- Specify minimum qualifications/criteria for board membership in bylaws (e.g., requiring a minimum level of education or professional experience), except in cases in which issues of trust are foremost. Box 3 illustrates this exception.
- Provide training to board members specific to the needs of the credit union, which will vary depending upon its stage of development, the level of competition, the regulatory environment, and the complexity of its products. Before joining the board, training should cover basic cooperative principles and teamwork. Additional training, including financial management, regulatory requirements and managing risk, can be addressed after joining the board.

Box 3: Addressing Issues of Trust and Illiteracy in Kafojiginew

In Mali, West Africa, where the majority of people are illiterate, characteristics such as honesty and personal integrity are more important to the general members of the credit union, Kafojiginew, than educational level. This credit union addresses the issue of low educational levels by providing training to members of its Administrative Council, Credit Committee and Surveillance Committee on their roles and responsibilities. Kafojiginew's bylaws protect institutional memory by using staggered three-year renewable terms with a maximum of one-third of the directors up for reelection each year.

Net Borrowers’ Interests Pervade. The Latin American credit union movement has placed a greater emphasis on the provision of credit than the mobilization of savings.
This has resulted in the interests of net borrowers pervading policy and decision making to the detriment of long-term profitability and sustainability. In these cases, directors have little at risk, and their interests often conflict with the interests of net savers. Net borrowers tend to place downward pressure on interest rates and favor loan terms and policies that may expose the institution to inappropriate credit risks. Low loan interest rates can result in credit rationing, which encourages insider lending, favoritism and poor loan selection, and ultimately leads to asset quality problems.\textsuperscript{12} Net savers, on the other hand, are interested in high deposit rates and strong prudential discipline to secure their deposits.

Since adequate regulation and supervision is often unavailable, the following guidelines help credit unions avoid an overemphasis on the interests of net borrowers:

- Forbid insider lending or limit loan sizes to board members;
- Promote savings products and attract net savers to serve on the board;
- Aim for a balance of net savers and net borrowers on the board.

**Diffuse Ownership.** Since credit unions are owned by their many clients, no owner has a big enough stake to encourage effective and thorough monitoring. Few individuals supervise the performance of the credit union, attend the annual general assembly, and monitor their elected board representatives.\textsuperscript{13} This can result in excess dependence on a few key people, often the managing director or a few board members. The following guidelines address the issue of diffuse ownership:

- Attract net savers to the board as they have natural oversight incentives to participate actively and demand information that is not readily available;
- Communicate the fluctuation of the net asset value of shares at the general assembly meeting or in writing, at least annually;
- Regularly conduct operational audits and disclose findings in a way that informs and protects small savers;
- Enforce the adequate flow and transparency of information through internal and external oversight.

**Need for Board Renewal and Democratic Representation.** Credit union boards must strike a balance between the need for renewal and continuity by rotating their board members. Even in cases where there is a lack of educated candidates for board membership, change is preferable to a stagnant board. Democratic representation is one of the most important principles of a credit union. Term limits of board members are necessary in credit union governance, unlike the other ownership structures in


\textsuperscript{13} Ibid.
which renewable terms are preferable. Guidelines for board renewal and democratic representation include:

- Write board rotation into the bylaws;
- Rotate only one-third of board members at each election to ensure continuity and protect institutional memory;
- Allow members from all trades or market sectors to be eligible for board membership;
- Make special efforts to enlist female directors to represent female members where it is culturally difficult for women and men to serve on the same board.

### 7.4 Non-Governmental Organizations

Many NGOs choose to remain NGOs with the understanding that governance without ownership can still be accountable, transparent and robust. These NGOs recognize, just as commercial or transforming MFIs do, that the legal structure of the organization must facilitate the implementation of the organization’s mission. Because an NGO’s mission is based fundamentally on social objectives, it is consistent with the non-profit ownership structure.

The major difference in governance between an NGO and other legal structures of microfinance institutions ownership is that it lacks real owners. In the case of NGOs, the stakeholders are clients, employees, donors, and suppliers of technical assistance none of whom have traditional equity in the institution. NGO boards are accountable to these stakeholders and to fulfillment of the institutional mission. Yet board members hold no personal stake in the institution and primarily act out of a sense of personal duty and social responsibility. Therefore, it is vital that the NGO mission be clearly defined and communicated to all stakeholders to ensure that decisions and policies are made accordingly. Below are weaknesses inherent in the NGO governance structure and corresponding recommendations.

**Lack of Ownership-Driven Accountability.** The absence of investor-owners poses several issues in the governance of NGOs. The ownership structure makes it difficult for them to establish credibility in the banking community to access commercial sources of funding to fuel their growth. NGOs lack access to deep pockets to provide additional capital in times of financial crisis. The directors of NGO boards serve on a voluntary basis, making it more difficult to ensure a commitment of time and substance at board meetings. The overriding issue is how an NGO can create accountability when the assets are not owned.”

Box 4 describes how the limitations of NGO ownership played a role in the Corposol/Finansol crisis. The following guidelines suggest ways to improve the accountability of NGO boards:

- Select directors who embody both a strong commitment to the organization’s mission and a bottom-line orientation;
• During the board selection process, ensure that individuals are ready and able to make the tough decisions required in the event of high loan losses and operating deficits;
• Provide the necessary tools and training to involve the board in asset quality monitoring;
• Incorporate a transparent system of checks and balances between the managing director, management and the board;
• Improve internal audit capacity and transparency with monthly performance audits;
• Contract annual external audits;
• Ensure that donors play an appropriate role and are not directly involved in board affairs. The board must ensure that donor funds and obligations are consistent with the institutional mission before signing any donor agreement. A separate section on appropriate donor roles appears later in this chapter.

Box 4: Limitations of NGO Ownership –The Corposol/Finansol Example

The NGO parent, Corposol, maintained controlling interest (71 percent) upon creation of the commercial MFI, Finansol. Because Corposol mismanaged its governance role, the regulated financial institution lacked management and structural autonomy. As an NGO, Corposol did not have the level of commitment to fiscal prudence required for effective functioning as a private sector entity. Additionally, its board representation had no personal financial stake in Finansol that encouraged stringent oversight. These were among the factors that led to Finansol’s financial crisis. When the seriousness of this situation came to light, these board members did not have the financial resources or the means to raise funds for Finansol’s recapitalization. Ultimately, Corposol was liquidated and the commercial MFI was restructured with new owners (including the government financial entity, IFI) brought in by Finansol’s minority board members. Today, Finansol is known as FINAMERICA, which in 1998 registered as a solvent financial institution.

Lack of Separation between Board and Management. Lack of owners can result in a board of directors that does not separate governance from management roles, and that depends on the managing director to play both roles. Since NGO board members do not risk a personal financial loss, it is possible for the board to become passive and for decision-making to devolve to the managing director. A strong correlation appears between the success of a non-profit MFI and the existence of a strong managing director. However, dependence on one individual introduces a significant risk to institutional stability. To reduce the concentration of control and responsibility and to improve the governance of microfinance NGOs, boards need to assume an active role. The following special efforts can empower NGO boards and clarify their responsibilities:
- Create a board development and education committee with budgets appropriate to scale of the organization;
- Clearly define and communicate the role of board members *vis-a-vis* the role of management;
- Organize continuing education and training for directors.

**Multi-service NGOs**

There are two main types of microfinance NGOs: specialized and multi-service. Specialized NGOs focus on the provision of financial services to the microenterprise sector. Multi-service NGOs provide financial and non-financial services, sometimes including training, health and education services. The discussion thus far is applicable to both types, however, multi-service organizations pose some additional governance issues.

If one were to start a new microfinance NGO today, it would be preferable to create a specialized MFI as a separate legal entity. The provision of multiple services adds significant complexity to the governance and operational structures. Multi-service NGOs are prone to conflicts of interest inherent in pursuing multiple objectives and agendas. Most multi-service agencies have difficulty separating the expenses associated with their financial and non-financial services, and therefore the boards cannot easily rate their microfinance performance against other MFIs. Revenue from the microfinance operations is often used to support other non-income generating social service activities, rather than for the capitalization and expansion of financial services.

The following are guidelines for pre-existing multi-service NGOs:

- Separate the microfinance operations from other NGO activities, and if possible operate as a separate legal entity;
- Create a special board committee dedicated to oversight of the microfinance activities;
- Operate the microfinance division as a profit center with specialized staff and management qualified to address the issues unique to microfinance;
- Develop separate management information and accounting systems for the microfinance division;
- Hold the microfinance operations to industry performance standards and high levels of transparency.

**Appropriate Donor Role in NGOs**

Donors should not hold direct equity positions or occupy seats on the board of MFIs, regardless of the legal structure of the institution. The general rule for donor involvement is *explicit influence, implicit ownership.* Donors are usually not in a good position to act as effective board members due to their limited time availability, and their many other...
responsibilities. However, donors can and should play an important role in improving NGO governance, as suggested in the following guidelines:

- A full disclosure of donor preferences, intentions, and conditional interventions should be agreed upon in writing at the beginning of the NGO-donor relationship;
- Donor agreements should expect the board of directors to protect donated assets from misuse or misappropriation;
- Donor agreements should clearly describe the appropriate process for the disposition of assets and their future ownership in case the NGO creates a for-profit MFI;
- Donors should only interfere in the organization in the case of poor performance based on specific conditions outlined in the donor agreement;
- The donor community should coordinate its agenda because an uninformed donor can undermine the microfinance environment, for example, by supporting subsidized interest rates;
- Donors should recognize their ability to influence the MFI outside the boardroom and should not attempt to seek control by pushing third-party relationships;
- Donors should be careful when applying conditions (e.g., geographic, gender, size of loans) and should consider the variety of macroeconomic, social and cultural environments in which microfinance institutions operate.
8. GOVERNING CHANGE AND CONFLICT

Crisis is the ultimate test of the board’s understanding of its role.

Jim Boomgard
Development Alternatives, Inc.

In the infant microfinance industry, exponential growth is common, causing MFIs to constantly address issues of change and conflict. Some institutions have embarked on a dramatic transformation by changing their legal status to expand access to capital markets and advance their natural growth cycle. The first part of this chapter addresses the issues presented by institutional transformation and proposes guidelines for boards to oversee MFIs through such phases. The second part of the chapter provides guidelines for dealing with three common challenges: conflicts of interest; difficult situations; and problematic personalities.

8.1 Institutional Transformation

An MFI is likely to experience many transitions in its lifetime, the most radical of which may be transforming from one legal entity to another. Although other types are conceivable, transformation from a non-profit MFI into a for-profit regulated financial institution is the most common.

Governing an institution through the transformation process is a complex and challenging undertaking. It requires an enlightened board, a solid management structure, and a powerful board-management team. Transformation requires many other elements such as a strong asset base and a supportive regulatory environment that allows MFIs to charge adequate interest rates. The purpose of this discussion, however, is to focus specifically on how the governance of an institution can affect and be affected by transformation. Transforming MFIs can benefit from the following guidelines:

Recommitting the Mission. Many MFIs have expressed concern about their ability to maintain their social mission after transformation. It is the board’s responsibility to ensure that the appropriate institutional mission continues during and after the
transformation, acknowledging that the mission may change. To reassure an enduring commitment to the mission, the board should:

- Lead the MFI through a process of reviewing and revising its mission using the board’s post-transition vision as a compass;
- Guide the institution through the transformation process, by including the mission in the institution’s bylaws and shareholder agreements;
- Use the mission to hone the strategic planning process and to select investors.

**Strategic Planning.** The board’s advisory role is particularly critical during a major transformation because of the number of fundamental changes involved such as setting new policies, offering new products, complying with regulators, and managing the expectations and concerns of staff and clients. It is vital that the board and management work together to present unified leadership and design a feasible plan. In developing a transformation strategy, the board-management team should:

- Avoid drawing potential investors into the strategic planning process until the MFI has determined what kind of investors it wants to include.
- Organize board and senior management retreats to discuss issues in depth, to make decisions on complex topics, and to consider the most appropriate strategy for tackling each stage in the transformation process;
- Create committees to channel internal and external expertise toward the completion of certain tasks or the resolution of specific problems;
- Employ independent consultants to advise the board and the institution on specific issues; for example, a consultant with previous experience with the central bank can explain how to present a feasibility study to the authorities.

**Regulatory Relationships.** One of the most critical functions of the board during the transformation process is to forge a strong relationship with regulatory authorities. This will help the board understand the license application process and the new rules that will apply. It also serves the function of educating regulators about microfinance, which is very different from the type of finance activity they know. A strong relationship with board members will increase regulators’ level of comfort with the governance of the institution. This is particularly important if they have any misgivings about regulating microfinance institutions. Guidelines for building regulatory relations are:

- Meet with regulatory officials to discuss the ramifications of a change in legal structure, both for the MFI and for individual board members;
- Consider observation visits by board members and regulators to regulated MFI’s in other countries and opportunities to discuss concerns with other regulators.
Changes in Board Composition. An MFI cannot assume that its current board is prepared to guide the institution through a transformation. The following guidelines can prepare the existing board for a forthcoming transformation:

- Organize an intense training effort, including visits or conversations with board members of other institutions who have already made a similar transition;
- Provide external training opportunities to strengthen skills deemed necessary for the transition, currently lacking among board members.

With the addition of owner investors, restructuring of the board’s composition is often inevitable, in which case:

- The recruitment guidelines in Chapter 2 can inform the process of assembling an appropriate team of directors who represent different types of owners and expertise;
- The selection of board members should explicitly exclude those seeking short-term profits and include special training to educate candidates on the realities of building a microenterprise loan portfolio;
- Microfinance expertise should exist beyond the original NGO shareholder.

Identifying Investors. The board decides when and how to bring in new investors. Before initiating contact with potential partners, the board should:

- Look for strategic partners who will give the MFI leverage and recruit to the negotiation table those local, private investors who are not competitors;
- Oversee the drafting of a shareholder agreement that institutionalizes strategic decisions such as an exit strategy for partners who decide to divest, taking care to provide the MFI with some control over who purchases the shares;
- Draft a resolution on the terms of the transfer or sale, making the transaction transparent;
- Calculate capital requirements to make the desired transition and avoid overcapitalization as excess funds can make it difficult for an MFI to be profitable.

Relationship between the Old and New Institution. There is little consensus on the best way to define the relationship between the original NGO and the new for-profit institution. There is, however, one recommendation that has widespread support. If the original institution continues operating after the transformation, it is critical that there is agreement on what each institution will and will not do. This will define limits to avoid conflicts of interest between the two institutions in the future.

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MFIs that have made the transition often decide that the for-profit institution assumes all financial service functions and the non-profit provides training and/or other social services. If the functions are split there is no problem with directors sitting on both boards. However, they must clearly understand the time commitment and be willing to serve the missions of both institutions. **Box 5** describes how K-Rep separated its financial and non-financial functions to create K-Rep Bank.

**Box 5:** Separation of K-Rep’s Financial and Non-Financial Services Divisions

| K-Rep transferred the assets, liabilities and activities of its Financial Services Division to create K-Rep Bank in 1999. K-Rep’s Non-Financial Services Division remained with the parent NGO, K-Rep Development Agency, which will act as an incubator to pilot new financial services, such as rural savings mobilization and health care financing, to reach poorer segments of the population. The NGO will spin off activities that prove profitable into new for-profit institutions. While K-Rep Bank may benefit from some of the research findings in the future, the NGO’s agenda is not tied to the bank’s long-term objectives. In addition to the distinction of responsibilities, the bank’s ownership and governance structures will further minimize conflicts on interest between the old and new institutions. K-Rep Holdings, the parent entity of K-Rep Development Agency, will hold 25 percent ownership of K-Rep Bank, resulting in only two of the NGO’s board members also on K-Rep Bank’s board. |

### 8.2 Conflicts of Interest

Conflicts of interest are a real and common occurrence in MFI boards. Conflicts of interest are not inherently illegal, nor do they necessarily infer a lack of integrity on the part of the board member involved. Given that individuals frequently serve on a board because of their institutional affiliation, directors will often end up representing two institutions—their employer and the MFI—and this can lead to conflict.

MFIs should not expect to create a board in which no conflicts of interest occur. However, the MFI can demand transparency in the management of these conflicts. **Table 12** lists a number of potential conflicts of interest identified by MFIs along with suggestions for dealing with them.
## Table 12: Managing Conflicts of Interest

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<thead>
<tr>
<th>Conflict</th>
<th>Guidelines for Resolution</th>
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<tr>
<td><strong>Related-party transactions:</strong> Engaging in activities to the detriment of an organization on whose board one serves in order to benefit another related organization or individual</td>
<td>When joining the board, each new director should sign a Code of Conduct agreeing to a primary commitment to the MFI in all board dealings&lt;br&gt;New directors should complete a “conflict of interest form,” which lists all potential conflicts and overlapping affiliations&lt;br&gt;Members with an acknowledged conflict of interest on a given issue should excuse themselves from voting on that issue&lt;br&gt;If a board member has not been transparent about a conflict of interest that has caused harm to the MFI, the board should ask the member to resign</td>
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<tr>
<td><strong>Nepotism:</strong> Hiring family members to fulfill a function within the institution</td>
<td>Allow hiring to take place only if the candidate passes objective hiring criteria determined by non-family members&lt;br&gt;Set policies, such as “no sole reporting to a family member,” to provide checks and balances on such relationships</td>
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<tr>
<td><strong>Insider lending:</strong> Providing loans to board members</td>
<td>Do not allow or apply strict limits for maximum loan amounts and transparent documentation and approval procedures</td>
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<td><strong>Springboard:</strong> Using a board position to advance political aspirations or run for political office</td>
<td>The board member should resign before pursuing such goals or be asked to leave the board</td>
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<tr>
<td><strong>Competition:</strong> Institutions begin to compete that have common board members.</td>
<td>The overlapping board members must resign from one of the boards</td>
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<tr>
<td><strong>Multiple relationships:</strong> International shareholders are also providers of technical assistance or financial services</td>
<td>Consider technical assistance from shareholders only after the consolidation of a transforming MFI, and then on a case by case basis&lt;br&gt;Involve different individuals on the technical assistance teams and the board&lt;br&gt;Set policies for dealing with possible conflicts of interest and include these in the shareholder agreement</td>
</tr>
<tr>
<td><strong>NGO dominance:</strong> Majority NGO shareholder advancing the agenda of its institution</td>
<td>Limit power through principles set in bylaws or shareholders agreement</td>
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</table>
8.3 Dealing with Difficult Situations

In an atmosphere of rapid growth and frequent change, issues become more complex and challenging. Preventive rather than prescriptive measures are usually best for addressing difficult situations. Listed below are ten common situations that present difficulties for boards and recommended guidelines for addressing or preventing them.

a) Low staff morale and high turnover:
   - Sponsor social activities where board members and staff can interact to become acquainted and gain appreciation of each other’s perspectives;
   - Bring in an outside specialist to do an organizational climate evaluation under an ad-hoc board committee;
   - Identify the problem and mandate that the managing director responds quickly.

b) Incomplete or manipulated information:
   - Require third-party diagnosis (CAMEL, rating agency review, special audit) reporting directly to a permanent board committee;
   - Train staff and management so they understand their responsibility for maintaining the integrity of information: they should not alter information or cover up problems;
   - In a crisis, bring the case to the general assembly or larger body of shareholders.

c) Fraud:
   - Institutionalize a regular internal auditing process so that an audit is seen as normal and does not create mistrust;
   - Establish strong system of internal control with regular audits;
   - Form an audit committee that receives and reviews reports, and supports management in taking appropriate actions;
   - Prosecute those who commit fraudulent acts.

d) Manipulation of information by or collusion between managing director and chair:
   - Create an executive committee of the board that meets more frequently than the full board;
   - Ensure that responsibility for decision-making is not concentrated in the chair or managing director;
   - Request the resignation of both parties if guilty of intentional deceit.

e) Staff and board recommendations for microfinance loans:
   - Clearly prohibit in the institution’s policies and procedures;
• In exceptional cases, the board might agree to issue a loan with a 100% written guarantee from the staff/board member who advocated for the client.

f) Board unable to reach consensus:
   • Ensure the existence of policies that clarify the role of the chair in such cases;
   • Maintain an odd number of directors.

g) Differing vision, board versus management:
   • Establish a board committee to work out issues.

h) Institutional culture clash between for-profit and non-profit philosophies during a transformation:
   • Create a committee for transformation consisting of board members and staff that oversees staff training, a key component of transformation;
   • Bring bankers’ onto the board and train other members in the financial and business skills required for commercialization;
   • Make sure bankers’ are aware of the social concerns and non-profit philosophy of other members;
   • Make sure board members share a common vision and mission.

i) Law Suit:
   • Establish a policy on this issue. For example, the MFI could agree to cover legal expenses if behavior was deemed to be in line with the proper fulfillment of institutional responsibilities; if behavior was deemed improper, the board member would be asked to resign and legal expenses would not be covered;
   • All major litigation issues should be reviewed jointly by board and management with an ad hoc committee;
   • The board should have legal counsel, either represented among its membership, or externally contracted.

j) Deteriorating portfolio quality:
   • Board and senior management must address immediately;
   • Utilize early warning systems to detect and react as soon as possible;
   • Ensure that the latest industry advancements and findings are collected and reported on a regular basis;
   • Bring in outside consultant if necessary to resolve problem.
8.4 Dealing with Difficult Personalities

Listed below are five personality types that present difficulties for boards and recommended guidelines for addressing them.

a) Dominant or controlling managing director:
   - Have clear policies to address issues before they arise;
   - Involve other members of the management team in board and committee meetings to avoid hearing only one side of an issue;
   - Remember that dominant is not necessarily bad; it may be needed during difficult situations, but the board must be careful to hear more than one voice and not become complacent;
   - Design mechanisms (internal audit, third party reviews, evaluations, etc.) to obtain information about operations through independent assessments.

b) Dominant board chair:
   - Rotate the position or institute renewable term limits;
   - Create an executive committee that can play a more active advisory role to the chair.

c) Major shareholder:
   - Define roles in shareholder agreement;
   - Separate ownership issue from voting, distinguish between voting shares and non-voting shares;
   - Recruit investors with the same mission/mindset: include right of first refusal for original owners in shareholder agreement.

d) Lack of board participation:
   - Clearly define attendance requirements and responsibilities for board members;
   - Involve members in board committees and support these committees so they function well;
   - Consider the creation of an advisory board to which highly influential individuals could serve with a lower participation requirement.

e) Discordant board member:
   - Engage them in committee or other work that will help them gain appreciation for the complexity of the issues and build commitment to finding reasonable solutions.
• While it is good to have a devil’s advocate on the board, if the member becomes disruptive to board operations, rotate him/her out in the annual elections or through a renewable term limit.
APPENDIX A – GOVERNANCE CONFERENCE SPEAKERS

“Effective Governance of Microfinance Institutions” Conference
October 18-20, 1998 – Washington, D.C.
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