A s microfinance institutions (MFIs) expand their outreach and increase their assets, and as more MFIs become regulated entities that can capture savings deposits, clear articulation of the functions of their boards of directors is essential for effective governance.

Governance is a process by which a board of directors, through management, guides an institution in fulfilling its corporate mission and protects the institution’s assets. Fundamental to good governance is the ability of individual directors to work in partnership to balance strategic and operational responsibilities. Effective governance occurs when a board provides proper guidance to management regarding the strategic direction for the institution, and oversees management’s efforts to move in this direction. The interplay between board and management centers on this relationship between strategy and operation, both of which are essential for the successful evolution of the institution.

In exercising their governance responsibilities, board members must consider the perspectives of numerous external actors. Depending on the legal status of the MFI, these actors can include providers of capital such as donors, governments, depositors or other financial institutions; regulatory bodies such as the superintendent of banks; and other stakeholders, including clients, employees, and shareholders. In its governance role, the board also is accountable to all these stakeholders and must assess continually which of these are the most important for the institution.

All board members must follow basic codes of conduct to carry out their governance roles and responsibilities in good faith. “Duty of loyalty” requires board members place the interest of the institution above all others. “Duty of care” calls for board members to be informed and to participate in decisions prudently. Finally, “duty of obedience” requires that board members be faithful to the institution’s mission.

Not all boards maintain the same level of involvement in the institution. At one end of the continuum of board involvement is a rubber-stamp board, which is generally reactive to management. At the other end is a hands-on board, which provides excessive oversight and engages directly in operations. In the middle are representational boards, made up of highly influential individuals who are not necessarily experts in microfinance. These boards resemble rubber-stamp boards except that board members’ access to sources of power and funds is exercised to the benefit of the institution. Multi-type boards balance representational members with those that have microfinance expertise, and generally are better equipped to make informed decisions on a timely and efficient basis.

The relationship between the board and the executive requires clarity about the roles and responsibilities of each, and about the complementarity of these roles. The board should exercise this responsibility by (1) maintaining distance from daily operations; (2) drawing on the institutional memory of the directors; and (3)
making binding decisions as a group. Application of these factors results in a process of decisionmaking that empowers the board and adds significant value to the management of the institution. Major board responsibilities can be grouped into the following four categories:

- The board has legal obligations that revolve around ensuring compliance with the institutions bylaws, procedures, and other legal requirements. The board may be held liable for the institutions activities.
- The board must ensure management accountability by hiring competent professionals, establishing clear goals for these executives and closely monitoring their performance, and confronting weaknesses when they surface.
- The board is responsible for setting policy and providing strategic direction to the MFI. The board must work closely with management in carrying out this role to ensure congruence between the institution’s strategic thinking and its operations.
- The board must assess its own performance on a regular basis. It is the boards responsibility to maintain continuity or “institutional memory” in its ranks, to renew its membership with new directors, and to evaluate its own processes for decisionmaking.

Diligence in fulfilling these roles and responsibilities does not in itself ensure effective governance. Other essential factors are the commitment of the directors to the institutional mission; directors’ skills and expertise; attributes of the chairperson; the presence, structure, and function of committees; clearly defined board policies and procedures; and a climate that allows for critical self-evaluation.

**Governance Issues in Microfinance**

**The Dual Mission: Balancing Social Impact with Financial Objectives.** In this paper, MFIs are defined as institutions that combine a social mission—provision of financial services to the lowest-income population possible—with a financial objective that drives the institution to achieve self-sufficiency. Some sophisticated MFIs have attracted private sources of capital, including deposits, and have become regulated institutions. The extent to which microfinance institutions seek to maintain the dual focus of profitability and outreach to poor clients is directly shaped by the composition of the boards of directors and by the priorities established by the board. This paper argues that these two objectives are not mutually exclusive, and that boards, through their strategic decisions and policies, can move institutions in the direction of achieving superior profitability and reaching an expanding clientele of low-income entrepreneurs.

**Ownership of Microfinance Institutions.** Traditionally, the board of directors either consists of owners or represents the interest of owners. Aligning the interests of individual directors with the interests of the institution is key to realizing effective governance. Creating this alignment within the microfinance industry depends on understanding the issues associated with each of the four corporate structures of MFIs: public (government), nonprofit (NGO), for-profit, and cooperative (credit unions). The specific corporate structure does not in itself define effective governance. For each, however, factors exist that may strengthen or undermine a board’s ability to fulfill its roles and responsibilities:

- **Public ownership/government corporate structure.** With the exception of Bank Rakyat Indonesia, public ownership models for microfinance from the past three decades have failed because of misguided policies that distorted markets through targeted subsidized credits, political interference, and corruption. In the past three years, however, some governments have taken new approaches to public ownership of MFIs. These approaches range from various mixes of public and private ownership, mechanisms to depoliticize the institutions, and an increased adherence to market principles. Because these efforts are still nascent, it is not possible to draw conclusions about their success.
- **Nonprofit NGO corporate structure.** Because nonprofits have no owners, commitment to the institutional mission is what drives NGO board members to fulfill their duties responsibly. Failed governance in NGOs has occurred where power has been concentrated in the hands of an executive who does not receive proper oversight from the board,
as evidenced by the collapse of Corposol in Colombia. The NGO model has yielded important successes when board members have identified strongly with the institutional mission and been able to guide the MFI strategically and hold management accountable to performance objectives.

### For-profit corporate structure

There are two types of for-profit MFIs. The first includes commercial banks and finance companies that moved down market to serve the microenterprise sector; the second type includes NGO-established regulated financial institutions. While profitability primarily motivates the owners of the former, the motivation of owners in transformed NGO-MFIs varies with the mix of capital. Rather than pure, private capital, four principal sources of social capital typically are provided: NGOs, public entities, specialized equity funds, and limited private investors. Each of these potential investors has its own set of concerns and brings different experiences to the institution. In planning for the participation of various parties on an institution’s board, balance should not be put ahead of individual ability and commitment. The key is to have clarity in the requirements for effective governance, and to determine the willingness and capability of potential investors to perform the duties required.

### Credit union corporate structure

In credit unions, where owners are also the institutions' clients, three critical lapses in governance arise: (1) a misalignment of priorities among elected directors, contracted management, and member-owners; (2) unequal representation of the interests of the two categories of clients—net savers and net borrowers—generally in favor of borrowers; and (3) a lack of regulation and supervision of credit unions. Successful governance of the credit union corporate structure requires a balance between savers and borrowers; this balance can be achieved by reorienting the services of the institution to attract more savers. In addition, specific rules should be in place to guard against excessive risk-taking by the board. These include rules to enforce the fulfillment of board roles and responsibilities, compliance with external auditor requirements, controls on insider operations and loan risk, and the exercise of prudent discipline.

### Fiduciary Responsibility of Microfinance Institutions

In general, the fiduciary responsibility of the board of any financial intermediary is considered greater than that of other corporate entities. Besides maintaining the solvency of a financial institution, boards of MFIs have three additional issues to consider. Low-income microentrepreneurs, as borrowers and savers, lack multiple sources of financing and are at greater risk than middle-income savers if their savings are lost. An insolvent microfinance institution, in most countries, means the end of a client’s access to capital at commercial rates. Additionally, microfinance boards incur a responsibility with donors, in the case of NGOs, but this fiduciary responsibility increases when the MFI intermediates funds by borrowing from a bank, mobilizing deposits, or floating an instrument in the local securities exchange. Finally, the insolvency of any large-scale microfinance institution that is considered a “success” around the world would have an effect on the domestic and international microfinance sector. It is likely that lenders and other investors would become concerned about the viability of this field and withdraw or curtail the financial resources to microfinance. Hence, boards of advanced MFIs must understand that their fiduciary responsibilities extend beyond their governed institution and can affect the wider microfinance industry.

### Risk Assessment Capacity in Microfinance Institutions

In its role as corporate fiduciary, the board must be able to assess risks associated with the provision of financial services. The growth of microfinance institutions, combined with significant increases in competition, and the creation of regulated microfinance institutions require greater ability on the part of boards to assess risk. The paper covers these factors that make risk assessment an essential board responsibility and discusses effective integration of personnel in NGOs that hire private sector (usually banking) staff to strengthen their financial and banking expertise.

### Achieving Best Practices in Microfinance Governance

#### Board Membership

The composition of the board has to be considered from several perspectives: skills and characteristics of microfinance board members; directors’ commitment to the dual mission of microfinance; directors’ ability and willingness to fulfill the duties of
care, loyalty, and obedience; the board’s commitment to develop the knowledge and skills of new and existing members; the size of the board; and finally, board member terms, removal of inactive members, and board performance evaluations.

**Governance Structure.** There are three mechanisms a board establishes to operate effectively: (1) the separation of the role of the board chair and that of the managing director or chief executive officer (CEO); (2) the role of the board chair in relation to other board members; and (3) the use of board committees. The paper calls for the splitting of responsibilities between the CEO and the chair and discusses the important role a chair plays in ensuring ample discussion, debate, and the achievement of consensus among board members. Creating and utilizing board committees to address key issues in preparation for consideration by the full board can be useful. The effectiveness of the committee structure, like that of the full board, depends on the clarity of the committees’ responsibilities.

**Procedures.** Well-defined and clear procedures are essential for effective governance. Even the most committed and highly qualified individuals cannot discharge their roles effectively without following well-documented procedures. Proper documentation—in accurate board minutes, up-to-date articles of incorporation or by-laws, and a board policy manual—is essential.

**Issues for Future Research**

The paper concludes by identifying three areas related to effective governance that require further analysis:

1. Conflicts of interest, such as the ability to fulfill the duty of loyalty and the practice of reciprocal board service;

2. Ownership considerations on microfinance boards, which comprise diverse types of people and are becoming ever more diverse; and

3. The effect of rapid change in microfinance—caused by competition, a movement toward the commercial model of microfinance, and increased participation by governments—on MFIs’ board composition, incentives, function, and leadership.