The Practice of Corporate Governance in Shareholder—Owned Microfinance Institutions

Consensus Statement of the Council of Microfinance Equity Funds

May 2005

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1. Introduction to Governance

Shareholder-owned microfinance institutions (MFIs) are playing an increasing role in the delivery of financial services to the poor. Shareholder-owned MFIs are for-profit, limited liability companies, whose ownership is in the hands of multiple (mainly private) shareholders. Most are licensed financial institutions – finance companies and banks. Many are deposit-takers.

Governance is governance… it is not management and it is surely not volunteering… as a board member you have to see to it that the organization is well-managed rather than managing it yourself.
Ken Dayton

This statement on corporate governance for shareholder-owned MFIs provides practical guidance for stakeholders in governance – investors and prospective investors, board members, and senior MFI managers – to use in and assessing the governance of their own MFIs. The Council of Microfinance Equity Funds (CMEF) developed the guidelines.[1] CMEF consulted with investors from CMEF member funds, MFI board members, MFI executive directors, microfinance experts, and corporate governance experts who exchanged views in order to arrive at a consensus.[2]

Numerous statements on corporate governance and even on microfinance institution governance are available.[3] CMEF developed a new statement for two reasons:

- Lack of guidance tailored specifically for shareholder-owned MFIs. While many of the principles of governance are the same for all types of institution, shareholder-owned MFIs have special characteristics that bear directly on governance.
- While governance is an arduous process requiring diplomacy, insight and even at times courage, it is easy for statements about governance to offer bland bromides.

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[1] CMEF is a group of 17 private funds that make equity investments in MFIs. ACCION International convened this group in 2003 as a forum for advancing understanding and exchanging views on the subject of equity investing in microfinance. Annex 1 lists CMEF members.
[2] These guidelines were drafted by Ira Lieberman and Elisabeth Rhyne based upon this consultative process. See Annex 2 for participants.
[3] Annex 3 lists statements on governance from a variety of sources for further reference.

> CMEF wished to get beyond generalizations to the practical issues that boards actually face. In preparing this statement, people deeply involved with MFI governance provided the wisdom of their experience, which the authors have done their best to convey.

CMEF hopes that this statement will contribute to an active process of improving governance among the institutions CMEF members invest in as well as in the microfinance industry as a whole.

1.1. What is Sound Governance?

Governance broadly defined is the system of people and processes that keep an organization on track and through which it makes major decisions. In the broadest terms, the functions of governance are:

1. *To uphold the organization's goals and mission.*
2. *To guide the organization's major strategic directions.*
3. *To maintain an organization's health over time and to mitigate risks.*
4. *To ensure accountability throughout the organization.*

A broad range of actors have an active role, a direct interest – or both – in MFI governance:

- Entities that oversee the institutions' financial health: regulators and auditors
- Providers of financing: lenders, investors, and depositors
- Stakeholders who depend on the organization: customers and employees
- The larger community

Although governance takes place in this broad context, the board of directors is the pivotal point through which all these players connect to governance. This statement focuses on the composition and operations of the board.

1.2. Responsibilities of the Board

The following major responsibilities of the board of directors reflect the broad purposes of governance:

- Define and uphold the mission and purpose of the MFI
- Develop and approve strategic directions (with management); monitor achievement of strategic goals
- Oversee management performance, including selection, support and evaluation of CEO
- Ensure that the MFI manages risks effectively; assume fiduciary responsibility
- Foster effective organizational planning, including succession planning
- Ensure adequate resources to achieve the mission, including assisting in raising of equity and debt
- Represent the MFI to the community and the public; ensure that organization fulfills its responsibilities to the larger community
- Ensure that the organization changes to meet emerging conditions; particularly in times of distress, temporarily assume management responsibilities

Three further responsibilities address board and board member conduct:

- Uphold the ethical standards of the organization, with transparency and avoidance of conflicts of interest
- Represent the interests of the MFI as a whole and not those of one shareholder or group of shareholders
- Evaluate (or seek external evaluation of) its own performance and commit to improving that performance

2. Special Considerations for Shareholder-Owned MFIs

Shareholder-owned MFIs combine certain characteristics that shape the requirements of their governance. No one feature is unique to microfinance, but taken together, they give the governance of shareholder-owned MFIs a distinctive character.

2.1. The Double Bottom Line. Shareholder-owned MFIs operate commercially while maintaining social aims.

MFIs of all types pursue both social and financial goals, but shareholder-owned MFIs, especially regulated institutions, are required by law to maintain solvency and by structure to produce a return on investment. With these strong forces mandating attention to financial performance, the challenge for shareholder-owned MFIs is how to stay focused on social goals.

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

Herbert Muller, BancoSol

Even if they agree generally on social goals, MFI boards are continually called on to make specific decisions with social implications. In this process what may at first seem like small differences among board members on social goals can generate difficult debates.

Measurement of social goals poses a particular challenge, as reliable indicators are few. Many MFIs use only loan size. Efforts to develop "social scorecards" or "balanced scorecards" are appearing more frequently, but there is frustration about settling once and for all on a stable, reliable set of indicators.

To strengthen oversight of social performance:

- Consensus about social goals should be a factor during board selection.
- Boards must invest time to develop a shared understanding about social goals and how to achieve them.

- All MFI boards should adopt indicators, however imperfect, to monitor social performance. Like financial indicators, social indicators should help set goals and monitor achievement.
- MFI boards should seek in-depth information about social performance from time to time, through market research, impact studies, and personal interaction with clients.

2.2. Financial Institutions. Good governance for financial institutions, especially deposit-takers, is built around risk management.

Because financial institutions manage other people's money, their boards carry special responsibility – fiduciary responsibility – to maintain the value of those resources. The paramount responsibility of the board, often enshrined in law, is to ensure that the organization protects those resources. The board monitors solvency, liquidity and profitability while keeping the organization on mission. The board should expect to devote much of its time to risk issues.

Risk taking must not exceed risk management capabilities.

Paul DiLeo , Gray Ghost Microfinance Fund

- At least some members of a board must be deeply experienced in banking and finance and able to make sound business judgments about financial institutions.
- All members must develop a working capacity for financial statement analysis and understanding of banking: each board member bears fiduciary responsibility individually.
- Extra attention may be needed to educate board members on credit risk in microfinance: how MFIs monitor and control credit risk, and how they respond to credit risk problems.
- Some institutions conduct annual risk assessments and put risk management plans in place.
- An audit committee of the board, which hears from both external and internal auditors, is a given. The audit committee should be independent and not include membership from management. At least once a year the audit committee should

meet with the external auditors, without any management representative present, to discuss any concerns of the auditors with respect to the system of internal controls or any other matter the auditors care to raise.

Expertise in accounting and financial analysis is particularly critical for members of the audit committee. Recent legislation in the U.S., the Sarbanes Oxley Act, requires members of the audit committees of publicly listed companies to have accredited financial expertise and to also be independent directors.

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

Bharti Ramola, BASIX

2.3. Regulated. The boards of licensed MFIs are subject to regulation by banking authorities and held responsible by those authorities.

If an MFI is regulated, its board is the official point of contact between the regulators and the institution. Moreover, regulators often specify how governance is to be carried out. Board member selection is subject to approval by regulators, with candidates screened to be “fit and proper.” Regulator guidance on board composition is intended to enhance governance quality. But as with any regulation, inevitably the institution will perceive some regulatory directives as constraints.

Though day-to-day interaction between the MFI and bank supervisors may be with management, formal interaction is with the board. Basel II rules require a higher level of board involvement with management, and although its requirements are only officially implemented in OECD countries at present, its influence is already spreading to other countries.

2.4. Privately Held. In most shareholder-owned MFIs, the governance structure closely mirrors ownership.

Shareholder-owned MFIs are typically owned by a small group of investors, with no one investor in a controlling position, and most board members directly representing specific shareholders. The

close link between owners and governance creates characteristic strengths and weaknesses among MFI boards. The greatest strength is that investors take governance seriously. Investor representatives tend to show high attendance at board meetings, and they stay informed and engaged. Their own incentives to obtain returns on investment align with prudent risk management.

Directors bearing legal liability must be insured, through Officers and Directors Liability Insurance, to avoid putting their personal assets at risk.

Monica Hernandez, Banco Solidario

Directors have a duty of loyalty to the company. They must act in the interests of the company as a whole, not simply as appointed representatives of a particular shareholder. This duty may not be an issue when all shareholders have a long-term perspective, but it becomes difficult during times of ownership change, when shareholder interests differ. Departing shareholders want the best exit, while continuing shareholders want to retain value in the company. When shareholder representatives begin fashioning their own deals, they may lose focus on the ongoing task of overseeing institution. Differences among board members associated with ownership change can thus be very disruptive for the institution.

When board representation is determined by shareholding percentages, little room is left for independent directors (defined as directors who are neither direct shareholder representatives, nor members of management) who can take an institution-wide perspective, or who bring the perspective of other stakeholders. The use of independent directors should be a priority for improving governance among shareholder-owned MFIs. In a number of countries governance reforms are requiring that at least 25 percent of the board be independent appointees. This practice is particularly important for committees such as the compensation and audit committees.

The investor representatives add value. They attend meetings regularly and are more willing to challenge management.

Bharti Ramola, BASIX

Finally, the close link between board and ownership structure suggests a need to ensure that the boards respect laws and agreements protecting minority rights, through safeguards such as requirements for super-majorities for important company decisions.

2.5. In Transition. Boards must become stronger as MFIs evolve from small operations to larger, more sophisticated institutions.

In some cases, shareholder-owned MFIs have NGO origins, with NGOs still present in governance. They may be in transition from social entrepreneur/founder-dominated institutions into more professional institutions with a wider array of checks, balances and delegation of authority.

Such institutions will not have fully developed governance structures. They will chart a realistic path toward stronger governance. As institutions mature, their boards gradually formalize functions previously done informally. Examples include creating committees of the board which undertake detailed work in support of board decisions, developing a board policy manual, or formalizing the CEO's annual review process. The board may need to add more technical expertise-- e.g. legal, accounting, capital market, human resources. It is difficult to generalize about what acceptable governance looks like at different stages, but organizations can make their own assessments.

For MFIs emerging from NGO origins, transition to a shareholder structure involves giving up of control by the original board, which is always very difficult. The original board members legitimately seek to maintain the mission and some level of control even though they may have to share much of the control with new shareholders.

The question of founders compensation arises in such situations, for both founding institutions and individuals. As the new shareholders benefit from the value created by the founders, it can be legitimate to provide some compensation to founders. Appropriate mechanisms for compensation are complicated by the non-profit structure of the NGO and the presence on the balance sheet of donated funds.

The greatest vulnerability of MFIs created by one or two founders is management capture, when management dominates and the board

serves as a rubber stamp for management. Among emerging MFIs, management capture occurs more frequently than its obverse, where boards get too involved in management. Maintaining the delicate equilibrium between management versus board capture is the difficult art of good governance.

Succession planning becomes a particularly sensitive issue for emerging MFIs. It is important to ensure that the MFI is grooming future management and that there is a plan of succession. Management succession is a clear and important responsibility of the Board.

3. Structuring an Effective Board

3.1. Board Size

Boards should be large enough to complete their work effectively (without overburdening members), to provide continuity, and to ensure quorums for meetings. That said, boards should be small enough for the group to work together to make substantive decisions.

MFI By-Laws should provide for flexibility in the number of Board members to enable changes to occur as needed.

- Seven to nine members appears both a common and ideal board size, though effective boards may have as many as eleven or more. Fewer than seven is not generally advisable, as the quorum becomes very small, especially if management is on the board.

3.2. Composition of the Board

Banking laws and regulations require a “fit and proper” test for financial institution board members, which generally requires that members be of good moral character, an appropriately senior level, and experienced in banking. Unregulated institutions and institutions in countries with weak supervision should certainly apply their own “fit and proper” test to ensure that members have these crucial characteristics. Boards should bring a range of skills useful to the MFI, including audit skills, legal knowledge,

knowledge of the target market, and social perspective. Additional considerations include the following:

- Qualified members willing to make personal commitment are highly prized. The ability and willingness of individual board member to devote time and talent to the MFI is essential. Candidates for board membership should reveal to the company all the other boards on which they sit, so that the company can determine whether the candidate has adequate time and/or any conflict in serving.
- Recognizing that shareholder claims generally dictate overall board composition in privately held organizations, MFIs should nevertheless aim to involve independent board members who can bring skills and objectivity.
- People with influence can assist with political issues, tap funding, and help project a positive public image. However, high-powered prestige counts for little if the person cannot or does not participate.
- Diversity of gender and ethnic or cultural background can ensure that the board has a broad perspective.

Four years ago, the Board's role was largely advisory. Now, the Superintendency expects it to take a more active role, especially in risk control. We need to draw more on the specialized expertise of the members.

Monica Hernandez, Banco Solidaro

In order to ensure that board members will be ready to devote sufficient effort to serving on the board, it can be useful to present new members with a letter of appointment in which expected time commitments are spelled out.

Stakeholder participation: staff and clients. There are a variety of philosophies regarding staff representation on boards. One school of thought (associated with continental Europe) sees employee representation as healthy, while another (more Anglo-American) sees it as blurring lines between governance, management and labor. ESOPs can provide a framework for staff to participate (this refers to staff, not senior management), but may be impractical if the organization is small and the market for its shares illiquid.

The customer perspective is important for effective governance, but having clients on the board has not proved to ensure that voice. Clients lack the requisite financial skills and their participation is

often little more than window-dressing. The board should, however, make it a priority to get ongoing input from clients, from client visits, market research or other means.

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

3.3. Appointment period, rotation

Given that the boards of most shareholder-owned MFIs are tied directly to ownership, term limits and rotation are often ignored, but this is not good practice. At a minimum, the boards of privately owned MFIs should regularly examine the performance of individual members, the size of their board, the skills on the board and potential needs for adding to the board or rotating existing members. This responsibility is normally that of the Chair in consultation with the CEO. A committee of the board, the Nominating Committee, usually handles recruitment of board members. Among publicly listed companies, board members are re-elected every year. Members that do not participate during a specified period – such as one year – should be dropped from the board.

3.4. Board Member Compensation

Compensation is important to help attract skilled people to the board and to ensure that board members take their responsibilities seriously. In should be high enough to bring that result about, without attracting members who wish to make compensation the object of their board service.

BancoSol pays a per meeting fee for both board and committee meetings. It also gives board members a 50 percent additional fee if annual targets are met. The chair is compensated for his additional effort.

One approach is to pay board members for the time they spend in board and committee meetings at a rate commensurate with what senior level professionals would earn during a similar amount of time. Compensation can be benchmarked against fees paid by similar organizations in the same country. Board chairs may be paid an extra amount in view of the additional time they are expected to devote to the organization.

The high travel expenses of international directors are a particular issue because they may exceed the compensation paid to local board members. Many MFIs, especially larger, licensed institutions do cover such expenses. For directors who are representatives of institutional shareholders, board fees are generally paid to the institution rather than the individual.

MFIs with a strong sense of mission may choose not to pay compensation if they feel that voluntary service by directors aligns with the institution's social commitment.

Responsibilities and Standards of Conduct for Board Members

Commitment to accountability, sometimes termed the fiduciary responsibility of Board members, must infuse the performance of individual board members. Board members should:

- Know the mission, purpose and goals of the MFI and its policies and programs
- Understand the organization's strengths and weaknesses (strategic role is to address these strengths and weaknesses)
- Prepare for, attend and participate in board and committee meetings
- Ask substantive questions (key role of board is to probe and to make policy decisions)
- Review and understand the MFIs financial statements and related information
- Avoid making an uninformed judgment / policy decision (if information is inadequate, work with management to get the information needed)
- Represent the interests of the MFI as a whole, not those of any individual investor.
- Support the majority view once a decision is made
- Maintain confidentiality
- Maintain independence, objectivity, personal integrity and ethical standards
- Avoid conflicts of interest, inter-related transactions, insider lending, and nepotism. Meet personal disclosure requirements.

3.5. Conflict of Interest Policy

Hidden or inappropriate relationships between board members (and their friends, relations and business partners) and the institutions they are responsible for are probably the single largest cause of financial institution demise. Although the small size of MFI loans makes them less vulnerable to related party or insider lending than other kinds of institutions, they are not immune. Even less serious

conflicts can damage an institution's public standing or internal trust. Although views on what constitutes an unacceptable conflict of interest vary around the world, the key elements of a workable conflict of interest and related lending policy are:

- *No related lending.* Directors, their relatives, and businesses in which they have a stake should not borrow from the institutions they oversee. (Exception: lending to executives under a formal staff loan program such as a car loan program.)
- *Full disclosure of all conflicts.* Board members should disclose all known conflicts and should withdraw from decision making on matters in which they are conflicted.
- *Arms length business transactions.* Some institutions prohibit any business transactions between an institution and its directors (including relatives and related businesses). However, business transactions that are carried out on an arms length basis, with competition and at market prices can be acceptable, with limits or special approval requirements. In certain cases it can be useful to allow board members to provide consulting services to the institution because they have in-depth knowledge about the institution.

3.6. Structures to Balance Governance and Management

One of the most important and delicate tasks in creating good governance is to achieve the proper balance of functions between the board and management, avoiding either board or management capture. The guiding concept is that a supervisory body holds an executive body accountable for performance. This two-tier system of accountability functions poorly if either management or the board is strongly dominant.

Governance traditions around the world use different structures, but all traditions embody the core accountability principle. Some European traditions involve dual boards – a management board

made-up of senior executives of the MFI, and a supervisory board, exclusively non-management appointed board members. In many (but not all) institutions, management executives hold board positions. But increasingly the trend is to limit management participation to the CEO and 1-2 other senior members of management, depending on the size of the board. If management is not officially represented on the board, the CEO and the chief financial officer (CFO) usually attend board meetings in an ex-officio capacity. Other members of management may also attend meetings, or part of a meeting, especially if subjects being addressed require specific management knowledge.

Some boards create executive committees of the board which occupy a middle ground between board and management. The executive committee usually meets between board meetings, especially if the board meets relatively infrequently, for example, quarterly.

The test for any arrangement is whether there is a body not dominated by management that actively holds management accountable. Danger signals that have been observed in the microfinance industry (as well as in many other industries) include:

- Boards that fail to meet regularly or meet in a pro-forma fashion, a signal of management capture.
- CEO and Chair are the same person. This has been a frequent practice in U.S. corporate governance, though current views on corporate governance are trending away from this practice.
- Management occupies a major share of the seats on a board, either because the board is small or because several members of management participate
- Board is largely composed of friends of CEO, often a problem for young organizations and NGOs.
- Board meets more often than once a month. This is a signal of board capture.

- Executive committees that in effect substitute for the board. Executive committees empowered to make interim decisions should promptly seek full board ratification.
- Boards that must frequently resort to recorded votes with split decisions signal that the board is in disarray. In well-functioning boards, most decisions are reached through consensus and then formalized through a vote.

3.7. Responsibilities of the Board Chair

The Chairperson is expected to play a more active role than other board members. The board chair should interact regularly with the CEO, have an active role in recruiting board members, be responsible for succession oversight, appoint all committee chairs, and be an ex-officio member of all committees. The Chair is the primary representative of the MFI to the external community and should confer prestige to the institution. Some of the most important governance roles of the Chair are as follows:

- Serve as the chief non-executive officer of the organization.
- Partner with the CEO to achieve the MFIs mission
- Provide leadership to the board to set policy and to oversee the MFI
- Chair meetings of the board after developing the agenda with the CEO
- Appoint committee chairs
- Serve ex officio as member of committees and attend their meetings whenever possible
- Discuss key issues confronting the MFI with the CEO
- Help guide and mediate key board actions such as those on organizational priorities and governance
- Evaluate the effectiveness of board members
- Ensure that the board carries out its mandate

3.8. CEO's Role and Governance Responsibilities

The CEO's role in governance is to guide and support the board's activities, and to represent the interests of shareholders as expressed by the board, in managing the company. The CEO has the advantage of knowing the MFI intimately and being aware of what is occurring at any moment. Therefore, the CEO needs to guide the board in framing key policy decisions. The CEO also should ensure that the board has adequate financial and operating information in hand prior to board meetings, so that it can provide oversight. In addition, the CEO has to make sure that the board has adequate information with respect to decisions the CEO, in tandem with the Chair, has presented for the board's consideration. The following are the key responsibilities the CEO has towards the board.

- Help the board to govern more and to manage less (avoid board capture)
- Articulate the MFI's strategy and work with the board whose role is to review, modify as necessary and to approve the strategy
- Structure materials for the board meetings to focus on policy and strategy issues (frame significant questions and complex problems in ways that that facilitate board's action)
- Deliver to the board and to its committees as appropriate standard financial and operational reports to monitor institutional performance and progress (the board is always hungry for information)
- Develop with the board a set of institutional performance indicators. Assist the board in managing the double bottom line
- Get material to the board in time
- Be available to answer questions of individual board members prior to and during committee and board meetings

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- Maintain ongoing contact with the board chair to keep chair informed of and to consult about major developments
- Assist in orienting new board members

4. Effective Board Processes

4.1. Board Meetings

Full board meetings are to exchange information and to make key decisions. The majority of board work takes place between meetings, both through committees and during informal exchanges, especially between Chair and CEO. At meetings, routine reporting should not squeeze out treatment of important open-ended and strategic issues. Therefore board meetings should be structured to quickly deal with routine financial and operating reports and leave adequate discussion time for strategic issues. Boards should regularly meet in executive session without management present to discuss matters that may be particularly sensitive regarding management. The standard board agenda could designate a time for executive session, which can be used as needed. Finally, a board secretary should be appointed to keep detailed minutes of the Board and its committees and to keep other detailed company records as required

Frequency and time commitment:

- Quarterly or monthly (may be mandated by the Banking Law, Central Bank or supervisory agency)
- Typically, board members spend at least one day reading board material and preparing for the board meeting and one or two days at committee meetings.
- Committees meet as necessary and as determined by the board and committee chairs.
- Special purpose meetings may take place to discuss a specific issue that needs timely attention. These may take place by phone, internet or fax as long as a quorum exists.

- Email and telephone can be used to ratify or bring to final closure issues discussed previously.
- For every full meeting a board member can expect to triple his/her time commitment between meetings. If the MFI is experiencing problems, the board member can expect time to increase substantially as the board provides more detailed, prudential, oversight.

An open board culture is critical to effectiveness. The Chairperson should carefully guide the board through the agenda and try to adhere to the timetable for the meeting, but also allow adequate questioning by individual board members and robust discussion of the issues. Chairs and/or CEOs that dominate the agenda do not do a service to the board or the MFI.

Decisions should if at all possible be taken by consensus; boards that need to decide issues by voting are generally in trouble.

An Effective Board Meeting

All board members were present, because the meeting date was fixed well in advance.

Most of the members had joined an informal board dinner the night before, allowing them to exchange information and discuss important issues.

Although it was a scramble to prepare the information on time, the CEO sent the board package five working days before the meeting.

All the members reviewed the package before arriving at the meeting.

The agenda was clear. It balanced routine oversight and treatment of special issues.

Committee chairs gave succinct, substantive reports.

The Chair, though conscious of time management, sought to air all views.

The CEO supplied information as needed to advance the discussion.

Discussions were candid, and most members spoke.

The Chair assisted the group to reach a consensus on decision issues.

4.2. Committees

Committees are the workhorses of the board. Committees should meet before formal board meetings and report their progress, and findings to the board in an oral report at board meetings, supported by minutes of the committee meetings which may follow later. If a committee is seeking a decision from the board, the committee chair should arrange adequate time on the agenda through the board chair and have the necessary information circulated to the board in advance. Committee chairs should generally discuss the issues for consideration with the board Chair and the CEO before taking them to the full board.

Common board committees include:

- *Audit / Finance Committee.* This committee must have strongly qualified members. It meets with external auditors independent of management to understand whether there are problems of control, accounting, or financial statements (increasingly the focus in the U.S. of improved oversight of management by the board). The practice of obtaining management letters from external auditors is important, and the committee must meet with the internal auditor regularly, especially if the internal auditor reports to CEO.
- *Executive Committee.* This committee normally meets between formal board meetings. Its mandate should be clear: not to take authority away from the board but to assist the board in carrying out its role. If the board meets frequently, for example monthly, there may be no need for an executive committee.
- *Compensation/ Personnel Committee.* This committee determines compensation for the CEO and other senior management and provides guidance on overall compensation increases and incentives. It deals with the adequacy of human resources in the MFI and the sensitive issue of management succession.

- *Risk Management/ Investment Committee.* This committee examines issues such as portfolio risks, maturity and foreign exchange mismatches, and the need for financial resources in the form of long-term loans, equity investment, and the like.
- *Temporary Committees.* Ad hoc committees are formed for a limited time period to oversee specific issues (e.g. nominating committee to nominate new board members).

4.3. Information and Disclosure

The quality of board oversight, decision-making and strategy development is closely tied to the quality of information management provides. In turn this is tied to the quality of accounting, MIS and the system of internal controls.

- The board will normally receive monthly or quarterly reports on financial and operating performance.
- At each meeting the board should track a carefully chosen set of indicators aligned with financial goals and social mission – a "scorecard" or "dashboard." These indicators should give a complete and focused picture of the institution, and the presentation should show trends over time. Such a scorecard is an essential tool for the board in fulfilling its mandate to guide strategy.
- A complete board package will include: a) meeting agenda, b) minutes of prior meeting, c) reports/ minutes of board committees, d) management report, e) standard financial and operating reports including key financial and social performance indicators; and f) additional information related to issues for discussion during the meeting
- Independently audited annual financial statements and the auditor's management letter, outlining any weaknesses in controls and other problems found during the audit, will generally be presented by the auditors in draft to the audit committee without the presence of the CFO or the CEO. The audit committee may want to confer with the CEO

We find it very helpful to have a CAMEL-type report to analyze performance.
We also look at these indicators in comparison with competitors.

Herbert Muller, BancoSol

and CFO if any problems arise during discussions with the auditors. After discussion of any salient issues, the annual financial statements will be presented to the board as a whole for approval.

Management should disclose to board members any unusual or adverse events as soon as possible after becoming aware of such an event. External disclosure to shareholders, bankers, regulators, etc. if needed, would generally occur thereafter, and with the agreement of the chair as to the tone and substance of the wording. This kind of issue illustrates the importance of regular communication between the CEO and Chair.

5. Key Board Decisions

The board should reserve certain decisions for itself. Though made in consultation with management, these decisions should not be delegated to management. Examples include, among others:

- Executive selection and compensation
- Capital calls and raising of additional capital
- Borrowing decisions beyond existing inter-bank arrangements to bridge temporary liquidity needs
- Selection of accountants and external legal counsel
- Payment of dividends, distribution of profits

The issues noted above involve 1) essential prerogatives needed for the board to hold management accountable for performance; and 2) decisions directly affecting the financial interests of shareholders.

5.1 Major Strategic Directions: Change and Innovation

The board has a major responsibility to set the strategic direction of the organization. This direction is carried out through strategic planning, and oversight of performance vis a vis the strategic plan. Board retreats every year or two are important vehicles for strategy development. At the same time, the board members need

to stay alert to the overall competitive environment in which the MFI operates. One hallmark of an excellent board is that it is instrumental in identifying the need for innovation and change in strategic direction, and that it assists the organization to make such changes.

5.2 Oversight and Compensation of CEO; Succession Planning

The board has a critical role in overseeing and evaluating the performance of the management team, especially the CEO. That role is reflected in questions raised to management at board meetings and in evaluating management performance and compensation. Preferably the board and management will have agreed on benchmarks as a driver of management compensation, particularly incentives such as bonuses or profit sharing. A variety of forms of compensation can be devised to align the incentives of the CEO with those of the shareholders and with the overall achievement of the MFI's strategic aims. These incentives can include performance bonuses in the form of shares or options to buy shares. It can be easier to structure incentives that focus on short term financial returns, and so care should be taken to ensure that the CEO's compensation encourages focus on social performance and long term institutional health.

Succession planning is another key responsibility of the board. This is an important aspect of evolution from founder-based beginnings, but can be sensitive. The board should develop a pool of prospective replacements. Plans for succession should consider a variety of scenarios, such as a CEO's retirement at an appropriate age, a CEO's decision to leave and give notice, medical or other emergency (illness or temporary absence of CEO) or untimely death. A leadership development plan aimed at employees with strong growth potential can be an important element in the overall approach to succession. With its succession plan the board should convey the message that the MFI is bigger than any single person.

Having a succession plan for emergencies can turn succession into a question of prudent management making it less sensitive for the CEO.

5.3 Board Disputes

Board disputes or a schism over an issue or series of issues may well develop. It is the role of the Chair to try and mediate and resolve such differences, preferably through discussion that ultimately results in consensus.

If consensus is not found, the board must resort to more formal processes. It may need to vote with one vote per director, unless a shareholders agreement and the company charter clearly delineate other voting rights. Board members normally have equal votes, but if an issue reverts to a regular or special shareholders' meeting then the shareholders will vote per the number of common shares (unless agreements or the company charter set out other voting rights).

5.4. Board Role in Crisis

The board has a continual responsibility to look at the institution and its setting with an eye to the future, and thus the board should be prepared to identify times when major changes are needed and help the institution prepare for change.

Its role as a force for change may become particularly important during a crisis that could arise from any aspect of the institution's work: management, operations, finance or external shocks. If the board loses confidence in management, it effectively takes management control. The board will then have the responsibility to steer the MFI through the crisis, including and until a new CEO is recruited. This is often when an executive committee plays an important role. It will meet frequently during a crisis, possibly appoint one board member, for example the chair of the board or a member of management, as acting CEO, and report back regularly to the full board.

6. Evolving Good Governance

Good governance is not automatic. It must be developed over time. Among the processes that boards can and should follow to improve their own functioning are:

- *Board training.* Training sessions to ensure that the board understands how microfinance works and how to evaluate MFI performance. These can involve presentations by experts or members of MFI staff.
- *Board retreats.* Annual (or every two year) retreats of the board are especially helpful in building consensus among board members regarding the balance of social and financial objectives and in considering major advances in strategy. They also enhance the ability of board members to work with each other.
- *Opportunities to observe the business and talk with clients.* Board members should participate in some field-based activities so that they can have a
- *Self-evaluation.* Boards should conduct a self-assessment at regular (one to two year) intervals. During these assessments they gauge how close they are to good practice, identify areas of weakness and make plans to address the weaknesses. Boards very often neglect this important function.

Boards should engage in all of these activities in order to ensure that they grow in their ability to take responsibility for their MFIs and lead them into the future.

Workshops of the board have been very valuable to get everyone well informed and in agreement. Dinner before meetings can be highly valuable.

Monica Hernandez, Banco Solidario

Annex 1. CMEF members

ACCION International
ACCION Investments in Microfinance, SPC
AfriCap
Andromeda Fund
Citigroup
Développement International Desjardins (DID)
Deutsche Bank
Gray Ghost Microfinance Fund
Oikocredit
Open Society Institute
Opportunity International
ProFund International
ShoreBank
ShoreCap International
Société d'Investissement et de Développement International (SIDI)
Triodos Bank
Unitus

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Council of Microfinance Equity Funds

About the Statement

This statement on corporate governance for shareholder-owned MFIs provides practical guidance for stakeholders in governance – investors and prospective investors, board members, and senior MFI managers – to use in and assessing the governance of their own MFIs. Although numerous statements are available on corporate governance and even corporate governance of microfinance institutions, the Council wrote this document to provide guidance tailored to shareholder-owned MFIs and to contribute to an active process of improving governance among its members and the microfinance industry as a whole.

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1. Introduction to Governance
2. Special Considerations for Shareholder-Owned MFIs
3. Structuring an Effective Board
4. Effective Board Procedures
5. Key Board Decisions
6. Evolving Ideas of Good Governance

About the Council

The Council of Microfinance Equity Funds is a membership organization of private entities that make equity investments in microfinance institutions (MFIs) of the developing world. Council members seek both social and financial returns from their investments in these MFIs. The Council's purpose is three-fold: 1) to articulate and disseminate the knowledge and expertise about equity in microfinance of the Council's members among themselves and to other MFI stakeholders; 2) to present guidelines and principles for effective investment in MFIs; and 3) to conceive a future strategy for the role of investment capital in microfinance with a particular emphasis on attracting private investors in microfinance. ACCION International, the Council Coordinator, originally brought together the group to create the Council in 2002, and it was formally launched in 2003.

Members of the Council

ACCION International
ACCION Investments in Microfinance, SPC

AfriCap

Andromeda Fund

Calvert Foundation

Citigroup

Développement International Desjardins (DID)

Deutsche Bank

Gray Ghost

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Opportunity International

ProFund International

ShoreBank
ShoreCap International

Société d'Investissement et de Développement International (SIDI)

Triodos Bank

Unitus

Council Coordinator: ACCION International