Corporate governance in microfinance institutions

Pasquale Di Benedetta,
Ira W. Lieberman,
and Laura Ard

WORLD BANK GROUP

Governance affects the way an organization is directed, administered and/or controlled. Good governance can go a long way in preparing an MFI to better handle the risks that are inherently part of managing an MFI. Risk taking is at the heart of financial intermediation and the Board of Directors is ultimately responsible for the level of risk assumed by the institution.

Corporate Governance
IN MICROFINANCE INSTITUTIONS

Pasquale Di Benedetta,
Ira W. Lieberman Ph.D.,
and Laura Ard

WORLD BANK GROUP

1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

The World Bank
Graphic Design: Miki Fernández, miki@ultradesigns.com

We gratefully acknowledge Calmeadow Foundation for their support in publishing this document.

FOREWORD

As microfinance institutions (MFIs) scale up and commercialize, proper MFI governance becomes increasingly important. Current microfinance literature and forums do not sufficiently address MFI governance. The topic is not as 'sexy' as mobile or branchless banking, new product development or credit crisis. Yet good MFI governance plays a crucial role in product development, technological advancement, and more importantly, crisis management.

Governance affects the way an organization is directed, administered and/or controlled. Good governance can go a long way in preparing an MFI to better handle the risks that are inherently part of managing an MFI. Risk taking is at the heart of financial intermediation and the Board of Directors is ultimately responsible for the level of risk assumed by the institution.

Boards should be making decisions that will result in financial and organizational health, maintain mission focus, and assure institutional reputation and market positioning. Not only does the board appoint and review the performance of the CEO but it should also decide which business opportunities to pursue, which market niches are of interest, which products to introduce, and which policies and procedures best support the organization. And as MFIs' operational and decision making complexity has increased, so has the importance of good MFI governance. Increased MFI complexity is exemplified in:

- As MFIs have scaled up, their management has become more complex due to greater outreach, product diversification, and entry into different markets.
- Many MFIs have transformed into regulated entities and face the regulatory requirements associated with such a transformation.
- Scaling up and transformation requires additional, heterogeneous funding and the financial prudence and guidance that implies.
- Multinational MFI organizations (both global and regional) face different governance standards requiring strong direction to keep the organization focused.
- MFIs are maturing and many institutions are beginning to face succession issues for the first time.
- MFIs often operate in regions prone to natural or socio-political crises (Nicaragua, Bosnia, Morocco and India are popular examples). During a crisis, the board plays a critical role in ensuring the viability of the MFI.

"Weathering the Storm" by Daniel Rozas and "Failures in Microfinance" by Beatriz Marulanda and others have documented institutional failures across the global microfinance industry. The cardinal lesson in all those cases is that good MFI governance could have prevented or mitigated the crises these MFIs faced. In most cases, they could have prevented failure altogether.

MFIs need to learn from the experiences of their peers that struggled before them. Development institutions and private investors are uniquely positioned to encourage MFIs to do so. Holding a substantial equity stake, these investors often play a prominent role on the boards of MFIs. But before investors and stakeholders can push for better governance practices, they must first acknowledge and internalize why good governance is important—particularly for an industry that is rapidly maturing.

This background paper on microfinance governance aims to greatly advance our thinking in the industry on why governance is of such critical importance to MFIs, now more than ever. We hope it will shed some light in areas that previously might have gone unnoticed and prompt MFI stakeholders, DFIs and MIVs, to pay more attention to governance; in turn encouraging MFIs to improve their governance principles.

Alex Silva
Calmeadow Foundation
May 2014

ACRONYMS

BANEX	Banco del Exito, Nicaragua
BRI	Bank Rakyat of Indonesia
BIO	Belgian Investment Bank for Developing Countries
BRAC	Bangladesh Rural Advancement Committee
CEO	Chief Executive Officer
CGAP	Consultative Group to Assist the Poor
CMEF	The Council of Microfinance Equity Funds
DFI	Development Financial Institution
EBL	Equity Bank Limited of Kenya
FINCA	Foundation for International Community Assistance
FMO	Entrepreneurial Development Bank, Netherlands
IIC	Inter-American Investment Corporation at IADB
IMF	International Monetary Fund
KEP	Kosovo Enterprise Program
KfW	Kreditanstalt für Wiederaufbau, German Development Bank
K-Rep Bank	Commercial Kenyan Bank, formerly known as Kenya Rural Enterprise program
MD	Managing Director
MFX	Microfinance Exchange
MFIs	Micro-finance institutions
MIS	Management Information System
MIV	Microfinance Investment Vehicle
MIX	Microfinance Information Exchange
MicroRate	Rating Agency for MFIs
NBFI	Non-Bank Financial Institutions
NGO	Non-Government Organization
OXFAM	Oxford Committee for Famine Relief
PROMIFIN	Regional Central American Program for Enhancing the Financial Services for low-income populations
PROPARCO	Branch of the French Development Agency dedicated to Micro Finance
SIFEM	The Swiss Investment Fund for Emerging Markets
SMART	The SMART Campaign to promote responsible investment
SKS	Microfinance Limited
SME	Small and Medium Enterprises

TABLE OF CONTENTS

INTRODUCTION

Why Should We Be So Concerned about Corporate Governance in Microfinance?

The microfinance market today looks much different from 2007. Despite the worldwide financial crisis, the sector has doubled in size, transformed from mostly an NGO driven market to one increasingly dominated by regulated institutions, experienced a strong expansion of savings services, and held its first public listings and mergers. Microfinance is displaying the signs of a maturing industry. It has also weathered its first global downturn, lived through several major market crises, and is currently living through a crisis of perceptions and confidence on whether microfinance actually helps alleviate poverty in the first place. None of these issues existed in 2007.[1]

—2011 MicroRate, MFI Rating Agency

This paper discusses the corporate governance of microfinance institutions (MFIs). It is not meant to be comprehensive by any means, but it aims to draw lessons on governance from research studies, data analysis, and case studies of the failure or success of individual MFIs.

Governance has been one of the most neglected subjects in the microfinance sector. Relatively little has been written about it, and the efforts of various governance initiatives have been fragmented.[2] Recently, however, attention directed toward governance in the sector has increased significantly.

Why has it suddenly become so urgent to discuss corporate governance in MFIs? In today's expanded and more commercialized environment, several factors give rise to governance concerns:

1. Growth and scale of MFIs

In several poorer countries, such as Mexico, Bolivia, Peru, Cambodia, Bangladesh, and Kenya, MFIs have become systemically important with respect to serving the poor or underserved.

2. Emergence of legal and regulatory gaps

Many MFIs have transformed, becoming microfinance banks that mobilize deposits. Banking supervisors need to understand how best to regulate these institutions to ensure sound governance practices, to safeguard the safety and soundness of these institutions, and to protect depositors.

Recent national crises in Nicaragua, India, Morocco, Nigeria, and Bosnia signal that existing overcrowding and over-lending are beginning to elevate risks for the industry.

3. Increasing industry risks

Foreign exchange risk: Some commercial MFIs are borrowing from international debt funds in dollars or euros at relatively high costs and are bearing the attendant foreign exchange risk in event of a devaluation of their local (national) currency.

Product-diversification risk: MFIs are adding new product lines and are moving away from "plain vanilla" working capital loans with typical maturities of 12 months or less. They are adding small business loans, housing-rehabilitation loans, and agricultural loans that may carry different maturities, different payment terms, and different associated risks. In many cases, insurance, money transfers, remittances, and even mobile banking are becoming part of the mix. MFI boards need to be able to evaluate the strategic fit, investment requirements, potential returns, and risks of such products.

Political and/or operational risk: Political risks, such as state intervention and non-payment movements as seen in India and Nicaragua, have damaged the sector's reputation. In India, this has left several large MFIs barely functioning and financially at risk, resulting in millions of clients temporarily without access to services.

Client Risks: Over-lending, high interest rates, and crises have increased the demand for client protection and transparency in the sector. The SMART campaign is one of the best examples of an effort to improve client protection while raising awareness of social impact. The boards of MFIs are feeling pressure to oversee the performance of their organization more closely with respect to client protection, pricing transparency, and social impact, as well as operating and financial performance.

4. Diversification of MFI structure and type

Several groups or networks have expanded substantially to the point where they are systemically important to the sector. Normally governance should be critically examined at the level of the individual institution, but in several countries, groups have expanded and become transnational institutions. This is the case of non-governmental organization (NGO) networks, such as the Foundation for International Community Assistance (FINCA, today a holding company) and Accion International (USA); bank-holding groups, such as ProCredit Holding (Germany); and previous national banks or NGOs, such as the Bangladesh Rural

[1] "Role Reversal II Learning to Wield the Double Edged Sword," MicroRate, October 2011, p.4.

[2] Kate McKee, "Equity Investors Missing Opportunity to Influence Governance in Microfinance," CGAP Focus Note, May 20, 2012, is the first substantive document that the Consultative Group to Assist the Poor (CGAP) has published on this subject. The Council of Microfinance Equity Funds (CMEF) published governance guidelines for its member funds in 2005 and has updated these guidelines in light of changes in the industry such as increased emphasis on transparency and social protection for microfinance clients.

Advancement Committee (BRAC) (Bangladesh), ACP (the parent holding company for Mi Banco, Peru), and Equity Bank (Kenya);

Social-sector based institutions, such as Care International, Save the Children, and Oxford Committee for Famine Relief (OXFAM), have developed substantial microfinance activities. How they separate social services from financial services and how they manage these distinct lines of business are important. How these diverse groups provide governance support to their large network of affiliates or subsidiaries and how they, in turn, govern themselves is important not only for their clients, but also for the sector as a whole.

5. Entry of new institutional investors

Over the past 10 or so years, some 70 debt funds and 30 equity funds, primarily with a mix of public development finance institutions (DFIs) and private investors, have emerged and are requiring that more attention be paid to the quality of governance in MFIs.

6. The double bottom line

Microfinance is viewed as having an important social purpose, providing the resources for the working poor to pursue self-employment opportunities or to build a microenterprise that provides basic support to the family. Regulated microfinance banks also allow clients to have a safe place to save. As such, the performance of MFIs should not be judged only on a financial or operational basis but also with respect to social impact on poverty alleviation and creation of employment opportunities. MFIs thus have a double bottom line, and boards of directors need to have oversight of an MFI's performance with respect to its social impact.

This paper is organized as follows: This introduction is followed by a primer on the industry and on the evolution of the microfinance sector. We then examine the structure of the microfinance industry—(a) NGOs, cooperatives and credit unions, and commercialized vehicles; how they differ and why corporate governance differs according to the nature of the MFI; and (b) large networks, investment and bank-holding groups, and social services/faith-based groups. We then consider how corporate governance evolves and develops in MFIs as their structure and ownership changes. This is followed by an examination of the recurring issues and growing risks in the microfinance industry. We conclude with a look at the responses of governments, investors, and the industry itself to these issues and risks and propose some next steps. ■

The evolution of the microfinance sector

A. Historical Evolution

In 1995, when the Consultative Group to Assist the Poor (CGAP) was founded,[3] if people knew anything about the sector they knew of Grameen Bank (Bangladesh). At that time, with the exception of Bank Rakyat Indonesia and Banco Sol (Bolivia), most MFIs were small NGOs, regionally focused and operating within a given country. They primarily provided working capital loans to the working poor, and almost none of these institutions mobilized deposits. The exceptions were Bank Rykat Indonesia (BRI) which mobilized savings through its Uni Desa system (village units) and Grameen Bank, which required that a percentage of the loan be kept on deposit as a form of collateral, so-called "forced deposits," representing 10 to15 percent of the loan principal.

By 2006, there were close to 199 commercialized MFIs with portfolio holdings of US$8.7 billion and 11 million clients. Twenty or so institutions had over 100,000 borrowers and 20 more had assets over $100 million. NGOs still far outnumbered commercialized institutions, but the tide was turning towards commercialized, fully sustainable institutions. By 2008, some 619 MFIs were commercialized of which 310 held 98 percent of commercialized assets in the industry.[4]

From 2000 to 2011, the number of microfinance borrowers, based on institutions reporting to the Microfinance Information Exchange (MIX), increased from 10.8 million

[3] CGAP is a microfinance secretariat housed within the World Bank, representing some 29 donor institutions and foundations. Initially it provided capacity-building grants to MFIs. It also developed best-practice notes for the sector. Since 2000, it has been primarily a knowledge-based institution. CGAP has an affiliated institution, the MIX Market, which houses a database that is an open source of information for industry analysts and for research on the sector.

[4] Preetesh Kantak, "Growth in Commercial Microfinance: 2005-2008," Council of Microfinance Equity Funds, Winter 2011.

Figure 1: MFI Count (1998-2011)

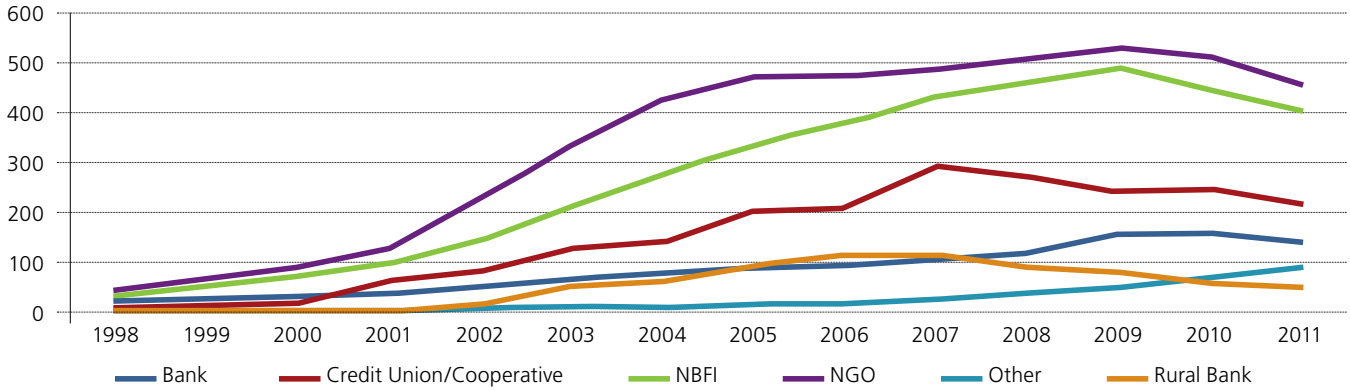
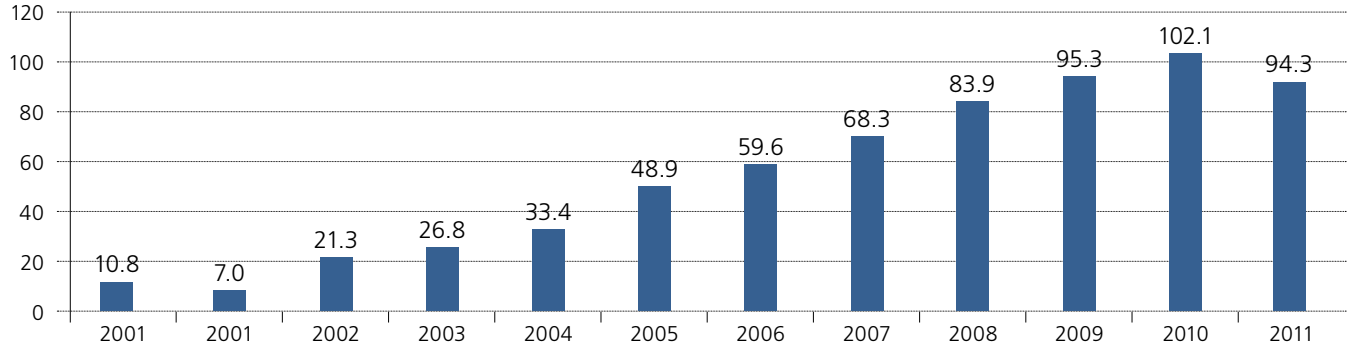


Figure 2: Microfinance Borrowers (millions)



Source: Mix Market 2012

Figure 3: Percentage Increase Between 1998-2006

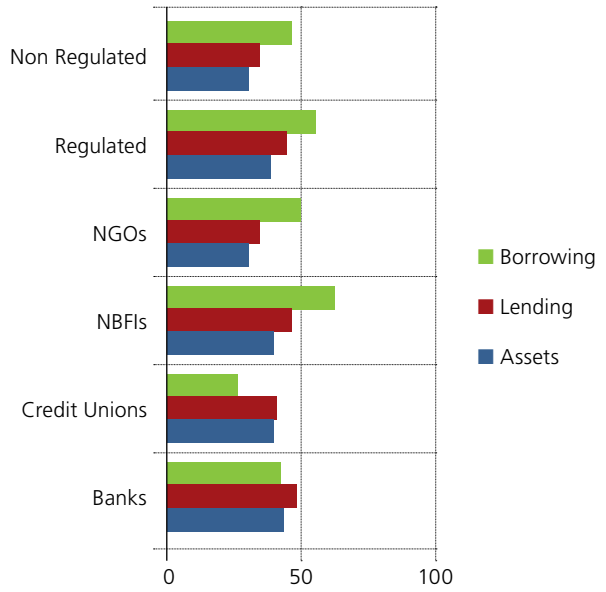


Figure 4: Percentage Increase Between 1998-2006

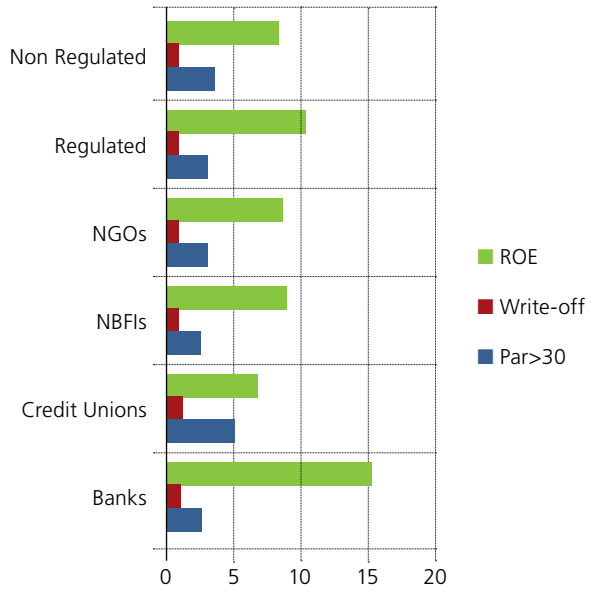


Figure 5: Percentage Increase Between 2007-2009

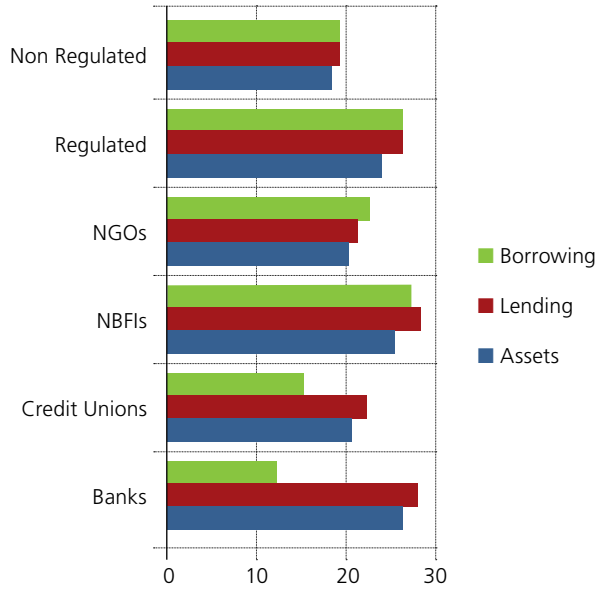
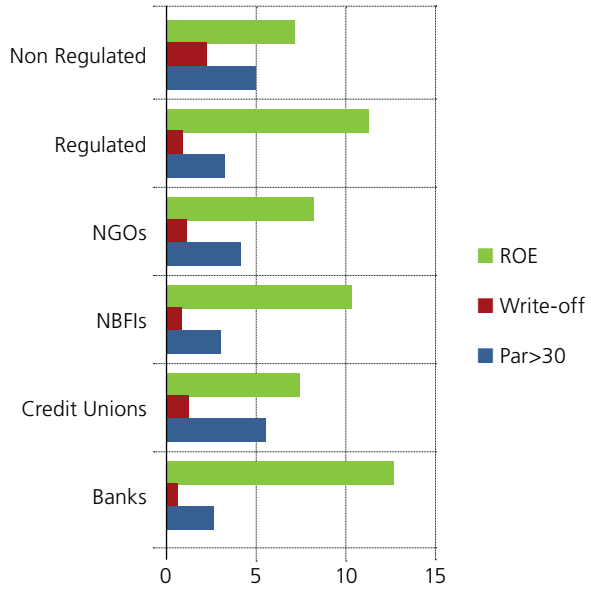


Figure 6: Percentage Increase Between 2007-2009



to 94.3 million (Figure 2)—an indication of the ability of MFIs to scale up and of overall growth in the sector.[5]

Indeed, the microfinance market has broadened and deepened its operations across the different types of institutions in the past 15 years. The MFI industry weathered the 2007 global financial crisis well: lending, borrowing, and return on assets continued to increase, and write-offs kept the same pre-2007 pace. Figures 3 to 6 illustrate industry performance over the decade 1998 to 2009 and are broken down in two periods, 1998 to 2006, and 2007 to 2009.[6]

[5] Information obtained from MIX, which is a centralized information organization to which MFIs choose to report financial and statistical data.

[6] Gabriel Di Bella, "The Impact of the Global Financial Crisis on Microfinance and Policy Implications," (International Monetary Fund (IMF) Working Paper WP/11/175, July 2011, p. 13.

Table 1: MFI Performance by Region from 1998 to 2009[7]

1998-2006	All	Sub-Saharan Africa	Asian Pacific	Central America	South America	Eastern Europe	Middle East & Central Asia
Assets %	36.0	34.8	36.1	31.7	33.5	43.9	36.8
Lending %	39.9	40.8	38.4	33.1	34.5	49.0	52.1
Borrowing %	51.7	40.9	49.2	51.0	43.6	52.0	76.8
PAR> 30	3.3	4.3	3.6	4.2	4.1	1.2	1.7
Write-offs %	1.0	1.4	0.9	1.4	1.2	0.6	0.6
ROE	9.8	4.5	11.8	13.6	12.0	9.1	6.0
2007-2009							
Assets %	21.9	22.2	28.0	10.2	29.2	17.3	19.7
Lending %	23.7	24.1	28.6	9.7	27.8	16.2	25.4
Borrowing %	23.3	21.7	34.9	10.8	22.6	18.4	25.9
Par> 30	3.9	5.7	3.7	6.7	3.5	3.4	2.2
Write-offs %	1.2	1.8	0.5	2.3	1.2	1.3	0.7
ROE	9.7	6.4	14.0	7.3	11.7	4.8	12.5

Source: Gabriel Di Bella, IMF, and MIX Market data

The sector has also deepened at the regional level. All regions have experienced growth in MFI assets, lending, and borrowing and write-offs have remained stable (Table 1).

Investment funds specializing in microfinance have also begun to emerge. Starting in 1995 with one investment fund, Pro Fund, by 2008 there were at least 30 equity funds and 70 debt funds, and some groups are currently managing over US$1 billion in assets. Initially, these investors considered only 100 MFIs to be of investible quality. The number is now closer to 200.[8] MicroRate has estimated the total assets (debt and equity funds) of microfinance investment vehicles (MIVs) at US$7.0 billion as of December 31, 2010. During 2010, MIV assets grew 12 percent, significantly slower than 22 percent for 2009, and far below the annualized growth rate of 50 percent from 2005 to 2009. Of microfinance assets held by MIVs, debt represents 82 percent and equity 18 percent. MIVs have played an important role in funding the sector, particularly commercial MIVs. They also play an important role in the governance of these MFIs by taking board seats in the MFI to which they extend equity.

But this is not without risks. First, MIV loans have traditionally been in dollars, presenting the MFI with a foreign exchange risk. The industry has developed some hedging capacity through the MFX, an institution owned by private and public investors in the sector. A number of MIVs are also lending in local currency, generally hedging their risk through exchange rate diversification, through the MFX or a large wholesale facility managed by the Entrepreneurial Development Bank, Netherlands (FMO), a DFI owned by the Dutch Government.

A second risk, stemming from the financial crisis, has been the result of a flight to quality by investors and has led to a crowding-in effect in select markets (e.g., Peru, Kyrgyzstan, and Cambodia), as well as in a relatively few MFIs around the world, leading to concentrated investments/ lending. MIVs are aggressively competing with development agencies, DFIs, and domestic and international commercial banks. In each of the past five years, large MIVs with assets of US$200 million or more have increased their market share. By year-end 2010, these agents held 52 percent of the microfinance assets invested in by MIVs.[9] An analysis of over-indebtedness and investment in microfinance by MIVs found that, "Local concentration can be aggravated by credit considerations of funders that limit their lending to a limited number of institutions."[10] Their analysis found that 50 percent of

[7] Ibid., 13.

[8] MicroRate Incorporated, *The State of Microfinance Investment 2011, MicroRate's 6th Annual Survey and Analysis of MIVs*

[9] *Ibid.*, p.4–8

[10] *Ibid*

total MIV funding, some US$5 billion, was concentrated in 33 MFIs. The top 100 MFIs received 75 percent of funding, while 90 percent of funding went to the top 200 MFIs. The remaining 10 percent was allocated to an additional 400 MFIs around the world.[11]

B. Characteristics of Microfinance

Microfinance operates in developing and transition economies. It aims to provide financial services for that segment of the population that does not generally have access to formal financial services. Often called the *underserved*, this population is composed mainly of the working poor, many of whom live on US$ 2 a day and are either self-employed or are micro-entrepreneurs, operating a micro-business (defined as having 10 or less employees). Most of these people work in the informal sector, which in poorer countries may constitute up to 80 percent or more of the employed. The underserved have various ways to secure financing: from family and friends, from money lenders, and from traditional financing schemes, such as rotating savings and credit associations (ROSCAs).[12] However, they do not usually have access to banks, either for borrowing or, perhaps more importantly, for a safe place to save.[13]

Microfinance refers not only to a range of credit products for business purposes, for consumption/income smoothing, and to fund social obligations, but also to transactional services, such as savings, money transfers, remittances, and insurance.[14] Microfinance is provided by MFIs, which are generally thought to have originated between the 1980s and mid-1990s as not-for-profit institutions or NGOs, offering financial services to the developing world and later to the transition economies of Eastern and Central Europe, the former Soviet Union and Southeast Europe (the Balkans).

Increasingly, MFIs are changing to become commercial institutions: non-bank financial institutions (NBFIs) or microfinance banks (MF banks). Many of these institutions are regulated by national banking supervisors. Microfinance banks mobilize deposits, often on a large scale, but generally in small amounts. Commercial MFIs represent the majority of assets, loans, and savings in the sector. Commercial MFIs meet the following criteria:

- They are structured as shareholder-owned institutions, joint stock, or limited-liability companies.
- They seek to operate sustainably, covering all of their costs, including financing costs, and, in time, to operate profitably, providing an adequate return on assets and equity.
- They raise their funds in commercial markets through various means.
- They operate as regulated non-bank financial institutions or commercial banks, the latter able to mobilize deposits.
- They increasingly expand their services to include products such as insurance, money transfers, housing-improvement loans, education loans, and small business loans, as well as a variety of savings products.
- They strive to serve the double bottom line: to serve the poor while also operating in a sustainable manner.

The cost of delivering microfinance services is not necessarily intuitive to those outside the industry: microfinance services are expensive to deliver on a sustainable basis. Overhead costs are very high since, to be sound, MFIs need to operate directly in the communities they serve, which are sometimes located in remote rural areas of the country or in urban slums. Adequate management information systems (MIS) are essential to capture, record, and monitor the characteristic high volume of small, short-term loans that typically have no or limited collateral. Likewise, savings accounts are numerous but incrementally small. High-volume transactions require efficient systems and substantial human intervention to process, which raises the expense base of the operation. Furthermore, MFIs that access funds from commercial banks or other institutions face funding costs that are typically elevated because of risk perceptions. Together,

[11] Luis A. Viada, and Scott Gaul, "The Tipping Point: over-indebtedness and investment in microfinance," MicroBankng Bulletin, February 2012

[12] ROSCAS are traditional, informal, rotating, financing schemes with different names found in many developing countries. See David Roodman, *Due Diligence: An Impertinent Inquiry into Microfinance* (Washington DC: Center for Global Development, 2012), 39–40.

[13] Daryl Collins, Jonathan Murdoch, Stuart Rutherford, and Orlanda Ruthven, Portfolios of the Poor: How the World's Poor Live on $2 a Day (New Jersey: Princeton University Press, 2009) spells out in some detail the diverse sources of financing for the poor and how they manage their cash flow on $2 a day or less. In fact, $2 dollars a day, on average, may mean no cash flow some days and more on other days, so managing cash flow, including safe savings through MFIs, may, in fact, be more important to these individuals than loans.

[14] This definition borrows from Robert Christen, Kate Lauer, Timothy Lyman, and Richard Rosenberg, "A Guide to Regulation and Supervision of Microfinance, Microfinance Consensus Guidelines," CGAP, Public Comment Version, April 1, 2011, 10.

these factors increase the ultimate cost to the MFI borrower through higher interest rates.

Product diversification has increased. MFIs are also providing other financial services, such as insurance, remittances or money transfers, and education and home-improvement loans. Although these diverse products are still a relatively small part of the product mix of most MFIs, the demand for them is growing. Once an MFI scales up and has a substantial client base, perhaps 30,000–50,000 clients and mobilizes sufficient savings, it has a base from which to offer its clients life and health insurance (usually as an agent for an insurance carrier), to deal with remittances and money transfers, and to provide other diverse products. This new array of products may require different terms, maturities, and repayment conditions compared with short-term working capital loans, the bread and butter of microfinance.

Rural microfinance differs from urban microfinance. Rural clients require agricultural loans or credit to raise cash crops or to purchase animals that can be raised and sold for cash. Such loans differ from traditional microfinance credit in terms of tenor and risk. Rural microfinance is often provided by rural cooperatives such as the large, savings oriented cooperatives, in West Africa or the Saccos in East Africa.

Microfinance has traditionally been based on low-tech methods as developed initially in Bangladesh at Grameen Bank,[15] at Bank Rakyat in Indonesia, and Banco Sol in Bolivia. It has often involved peer-group or solidarity-group lending, with borrowers in a group cross-collateralizing each other. Loans were working capital loans of short maturity—12 months or less—and there was an understanding that loan repayment of loans led to new loans, usually larger than the initial loans.

Technology has increasingly become a powerful driver of access to finance, especially for reaching rural populations. In a number of developing countries, mobile phone providers are working with commercial banks or large MFIs to bring *mobile phone banking* to the underserved. In Kenya, for example, M-PESA has approximately 14 million clients and has recently signed a joint-venture deal with the largest microfinance and small business bank in the country, Equity Bank, which has branches throughout the country to further extend the penetration of mobile banking in Kenya.[16] As Marguerite Robinson has noted:

> *"The microfinance revolution is a commercial revolution based on new financial technology and greatly accelerated by the information revolution that developed concurrently. It began in the 1970s, developed in the 1980s, and took off in the 1990s….These combinations enabled institutional profitability and long-term viability, making possible large-scale formal-sector financial outreach to low income segments of the population."*[17]

Increasingly, the industry talks not just about microfinance, but about access to finance or financial inclusion, which would also include small business loans as MFIs increasingly reach up to service small versus micro-business owners. Some MFIs, particularly those in transition economies, such as the ProCredit Banks, have offered small business loans from the beginning and have succeeded very well with them. BRAC, as an alternative example, has started and publicly listed a small and medium-sized business enterprise (SME) bank. But SME lending is quite a bit different than microfinance and requires real underwriting capacity, for example, the ability to perfect liens on moving collateral such as accounts receivable, inventory, and equipment. Most countries lack collateral registers. MFIs in a number of countries have encountered difficulty when moving upstream to SME lending without understanding the attendant risks. ■

[15] Muhammed Yunnus is viewed as the father of the industry. He developed a specific methodology of lending at Grameen Bank that has been emulated around the world by hundreds of Grameen replicas. Other important MFIs, such as Bank Rakyat in Indonesia and Banco Sol in Bolivia, developed at roughly the same time. Each institution had different variations of this methodology, but in fact, it was a unique way of providing loans to the poor who had little collateral.

[16] Elisabeth Rhyne, *Microfinance for Bankers and Investors* (McGraw Hill, 2009) "Vodafone: A Bold Move Into Financial Services for Kenya's Poor," 204–8.

[17] Marguerite S. Robinson, *The Microfinance Revolution: Sustainable Finance for the Poor*, World Bank and the Open Society Institute, 2001, 28-29.

Institutional typologies in the microfinance industry

Good governance practices should not vary greatly across different MFI structures. However, a major question, not easily answered, is who should provide oversight for those institutions with no explicit ownership structure or those with highly diversified, non-strategic ownership? This is a particularly relevant question for NGOs that may be very large and of systemic importance.

Non-Governmental Organizations: Most MFIs throughout the world are NGOs. NGOs are distinguished by the fact that they are not-for-profit institutions and have no owners that plow back their earnings, if any, into servicing their clients. Most NGOs have received donor funding, but most donors have little capacity or incentive to provide systematic oversight for what may be thousands of NGOs. Most NGOs are required to register with a social ministry in their respective country. These ministries generally have oversight of NGOs in various sectors, such as health, education, and community development. For the most part, these ministries also lack the capacity to oversee the relevant MFI. Finally, banking regulators/supervisors are unlikely to be willing to take on this task unless the NGO represents a risk to the financial sector at large or is somehow allowed to mobilize deposits.

CGAP's Microfinance Consensus Guidelines, "A Guide to Regulation and Supervision of Microfinance", tackles this issue under non-prudential regulatory issues. Given that NGO MFIs are typically not licensed to take deposits (most regulatory frameworks require licensed deposit takers to have identifiable owners whom the regulator can hold accountable for safe operation and protection of the greater financial system), the Guidelines address the oversight of such institutions from the angle of "permission to lend", whereby the registering authority or the financial regulator provides limited or restricted rights.

> "The regulatory framework should, absent local factors such as extreme corruption in the NGO sector, permit both NGOs and commercial companies to engage in micro-lending; issuance of a permit to engage in micro-lending should be straightforward involving a public registry and a simple process. . . . If regular reporting is required of lending-only MFIs, then the requirements should be tailored—both in terms of content and frequency—to the regulatory purpose and should be much lighter than prudential reporting by deposit takers. The reporting requirements should be harmonized as much as possible with reporting requirements imposed by other regulatory authorities (e. g., the regulator of NGOs)."[18]

Cooperatives and Credit Unions: There are also cooperative institutions and credit unions that operate as MFIs. Some are large cooperative institutions such as the predominantly savings-focused institutions in West Africa and the rural cooperatives in East Africa and Peru. The Central Bank of West African States supervises several of the large cooperatives in that region with priority given to large institutions. Cooperatives and credit unions are member governed, and credit unions normally have their

[18] Christen et al., "A Guide to Regulation and Supervision of Microfinance," 46–47.

own unique regulatory regime throughout the world. This paper will not examine the unique governance issues of cooperatives and credit unions.

Commercialized Institutions: Finally, there are commercialized institutions that have evolved into commercial banks able to mobilize deposits or non-bank financial institutions (NBFIs) generally restricted from taking deposits. Many MFIs have moved through the process of transformation from NGO to NBFI and have then become commercialized microfinance banks. Such institutions have become critically important to the microfinance clients they serve in their country and, in some cases, have become systemically important to the country's financial sector as a whole. The quality of governance in these MFIs is very important. Therefore, banking regulators/supervisors should establish good governance standards for the sector, especially with respect to institutions that are systemically important.

MFIs in transformation: The transformation process is a seminal point in the life of an MFI and usually involves significant changes in governance. Transformation is often perceived as a temporary status but can, in fact, extend over several years. One of the unique features of MFI transformation to a commercialized, shareholding vehicle, most often regulated, is that the NGO often retains a substantial ownership stake in the NBFI or microfinance bank by transferring its portfolio, liabilities, and staff into the new company. This leads to potential issues between the NGO and the transformed MFI regarding their respective roles. In the case of Banco Sol (Bolivia) and PRODEM—its original NGO—it was agreed that PRODEM would pursue rural clients. PRODEM eventually became a very successful and regulated MFI and broke away from Banco Sol. In the case of Commercial Kenyan Bank, formerly known as Kenya Rural Enterprise program (K-Rep Bank) in Kenya—the first NGO in Africa to convert to a microfinance bank—the NGO was also to work with rural clients and be used to reach further down the poverty scale. The dual roles of the Bank and the NGO remained in place under a holding-company structure. Transformation of MFIs also gives rise to regulatory issues when the MFI has an overconcentration of ownership and a lack of qualified senior management to operate a bank. In some cases, banking regulations prohibit the transfer of a loan portfolio in exchange for an equity stake.[19]

Large Networks: A number of institutions have grown very large and operate transnationally. These institutions are significant to the sector. How they are governed at the parent level and how they, in turn, govern down at the subsidiary MFI level is important to sector performance. These institutions include international networks such as Accion International, FINCA, today a holding company, Women's World Banking, and Opportunities International. All of these institutions are NGOs that have MFIs as subsidiaries or affiliates that may be NGOs or, increasingly, commercialized vehicles. They operate globally with 20 to 30 subsidiary or affiliated operations or more, and they play an important role in the microfinance sector.

Bank or Investment Holding Companies: Institutions such as ProCredit Holdings, based in Germany, which, together with a consortium of investors, owns and operates 20 micro and small business banks located in Eastern and Central Europe, the Balkans and the former Soviet Union, Africa, and Latin America, is an example of this type of MFI. ACP, the parent holding for Mi Banco in Peru, has investments in other MFIs in Latin America, such as Bolivia and Paraguay. Compartamos is a large MFI operating as a commercial bank in Mexico that recently invested in an MFI in Guatemala and has banking interests in Peru. BRAC is one of the best and largest national NGOs in Bangladesh, and it operates a very large MFI, among many other social interventions in that country. BRAC has recently branched out to manage MFIs in other parts of Asia, Afghanistan, and Africa. Grameen Bank has a network of non-affiliated Grameen "replicas" throughout the world, as well as Grameen America, an NGO, operating in svereal locations in the United States and a Grameen Credit Agricole joint venture.

Social-Impact Institutions: A variety of major social-action and faith-based institutions have extensive involvement in microfinance. Among them are Care International, Save the Children, OXFAM, Mercy Corps, the Calmeadow Foundation, Habitat International (a new entrant), the Aga Khan Foundation, and Catholic Relief Services. The key for these institutions is the segregation of microfinance operations from their other social endeavors which usually involve grants to meet the needs of poor or distressed communities. Virtually all of these institutions are themselves NGOs, although they might manage a mix of NGOs and commercial institutions as part of their portfolio. ■

[19] See Christen et al., "A Guide to Regulation and Supervision of Microfinance," 35, where the authors note as follows: "to facilitate transformation of NGO MFIs into for-profit companies licensed to accept retail deposits, regulators may want temporary or permanent adjustments of certain prudential requirements: ownership diversification rules, requirements that managers have prior banking experience, and prohibitions against use of a transferred loan portfolio to satisfy initial capital requirements."

Corporate governance: How it evolves in MFIs as their structure and ownership change

Governance focuses primarily on the relationship between a board and management. This is what most people refer to when they discuss governance. Overall, the maturity of the board within an organization should be reflected in its capacity for self-renewal, but there are governance dynamics to consider. Inherent in the dynamics of boards is a tendency to follow a charismatic company executive and to be largely subservient to his/her wishes. This is known as management capture. Alternatively, boards can be strong willed—often led by a powerful chairman—with a tendency for the board to manage. This is known as board capture. This dynamic of board versus management capture is always present in governance. To the extent that a board can achieve equilibrium between board capture and management capture, one normally observes good governance.

Most MFIs were started by a social entrepreneur, and members of the board were generally close associates of the founder who normally assumed the position of managing director and often chairman of the board as well. As MFIs have scaled up and transformed, their governance structures have had to evolve. Boards have had to become more sophisticated with more skills to assist management and to maintain oversight of the MFI. As boards have evolved, they have started to increase the scope of their governance structure, often through board committees which are the "workhorses" of the board. Below we describe the evolution of the governance process within MFIs.

A. The Board

Little work has been done in the sector to benchmark MFIs with respect to governance practices. However, in a recent survey by the MIX Market, 162 MFIs (initial scope was 1,000) from 57 countries responded to a limited set of questions on governance.[20] The responses indicate that both NGOs and commercial MFIs appear to have well-structured boards that meet regularly. Some have begun to separate the role of board chair from that of CEO, have recruited board members with diverse skills and experience, and have established board committees. Some have board oversight of the social performance (impact) of the MFI, even if most have not formed separate board committees to monitor social performance. MFIs do appear to address important strategic and policy issues at the board level. This is encouraging with respect to good practice, but this is just the basics. There is room for improvement.

MFI boards are likely to go through several stages as they evolve and as the MFI matures:

Stage 1: The Founding Board. At inception, a founding board is normally selected by the social entrepreneur who is establishing the MFI. Such a board is likely to be small, reflect deep commitment to the founder's vision, local (from the community or region in which the MFI initially operates), homogenous in terms of background with the founder, and operate informally. These boards are sometimes known as "boards of convenience." The MFI is likely to be an NGO and operate in a single city or region with few branches. The board is likely to be chaired and directed by the NGO's founder, operating as chairperson and CEO (managing director).

Stage 2: The Governing Board. As the MFI, still an NGO, grows and perhaps expands rapidly into new regions and adds a significant new client base, financing needs increase substantially. The board is likely to change and evolve for some, if not all, of the following reasons:

- Board members are overwhelmed by the demands placed on them by rapid expansion.
- Financial pressure requires the board to commit to substantial fundraising which absorbs a great deal of time.
- New board members are recruited who may have wider experience, diverse skills, and less personal identification with the founder and his mission.

Given the changing business and risk profile, the founding board is likely to become more formal and to assume a more responsible role in the direction and oversight of the institution. The characteristics of a governing board, as per good practice, can be summarized as follows:

[20] Micol Pistelli, Stephanie Geake, and Adrian Gonzalez, "Measuring Governance in Microfinance: Initial Findings from a Pilot Project," MicroBanking Bulletin, The MIX, April 2012.

- Size increases
- Homogeneity decreases
- Board manages less and governs more
- Board assumes more responsibility for oversight, accountability, and organizational performance
- Responsibilities become more balanced between the board and the managing director; a chair is likely to be appointed separate from the managing director
- The board begins to organize and function increasingly through committees

Stage 3: The Institutional Board. This further evolution is prompted by transformation to a shareholding MFI with external investors and a decision to become a licensed/regulated institution. There is now greater dependence on the board to raise funds or to approve fundraising. There is an increased need to elevate participation and representation in the community. Board size may expand, and board committees may become more formal to provide adequate expertise and focus for the board's oversight and monitoring function. Characteristics of an institutional board are as follows:

- Larger and more diverse
- Formal prestige attached to membership
- More diverse skills among board members
- Board members sought who can assist with funding and are able to work with local or regional government, even federal government, as the need arises
- Committee chairs play an important role in the life of the board
- Greater focus by the board on risks to the institution through such functions/committees as a Risk Department and a Risk Committee at board level, an Internal Audit Department reporting to the Audit Committee and a Compliance Officer reporting to a Compliance Committee

B. Social Responsibility: The Role of the Board and Management

As institutions with a double bottom line, MFIs should be able to assess their social performance. This has perhaps been one of the weakest areas of MFI performance and, thus, of board oversight. Owing to recent country crises in Nicaragua, Morocco, Bosnia, Pakistan, and India, as well as concerns expressed by various analysts about the over-indebtedness of clients, a consensus has emerged in the sector, led by Accion International and the Center for Financial Inclusion and supported by CGAP among others, on the need for increased transparency in pricing practices and for improved client protection. This is best reflected in the SMART Campaign which has been widely adopted in the industry. Many MFIs have implemented a set of Client Protection Principles (CPPs) including:

- Appropriate product design and delivery
- Prevention of over-indebtedness
- Transparency
- Responsible pricing
- Fair and respected treatment of clients
- Privacy of client data
- Mechanisms for complaint resolution

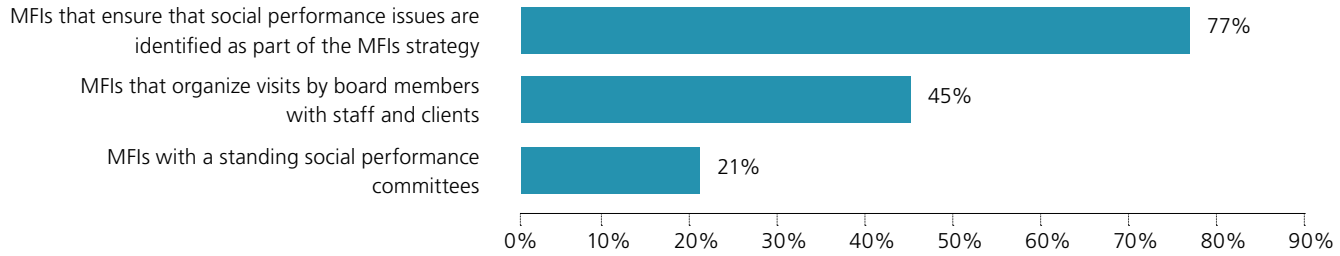
Although senior management and the board should take responsibility for ensuring that these principles are adopted and implemented by the MFI, the SMART Campaign has increasingly pushed for external certification to allow MFIs worldwide to differentiate themselves as pro-consumer and to allow potential investors to verify compliance with the CPPs. The campaign has enlisted microfinance rating agencies to assist in this process which is still in early stages of implementation.[21] In addition to the SMART Campaign, there is a strong push in the industry to ensure that MFIs are able to measure their social performance—i.e., that the MFI's products and services are reaching low-income clients.

Between January 2009 and June 2010, Triple Jump conducted 81 Social Performance Assessments (primarily through an in-depth questionnaire) of its investees under its Social Performance Evaluation Program. The database created with this information, together with MFI-specific financial information on investees, now allows Triple Jump to report both the financial and social performance of its investees to its investors.[22]A survey by the MIX on the "State of Practice in Social Performance Reporting

[21] The SMART Campaign Client Protection and Certification Program, 2011, available at http://www.smartcampaign.org/certification

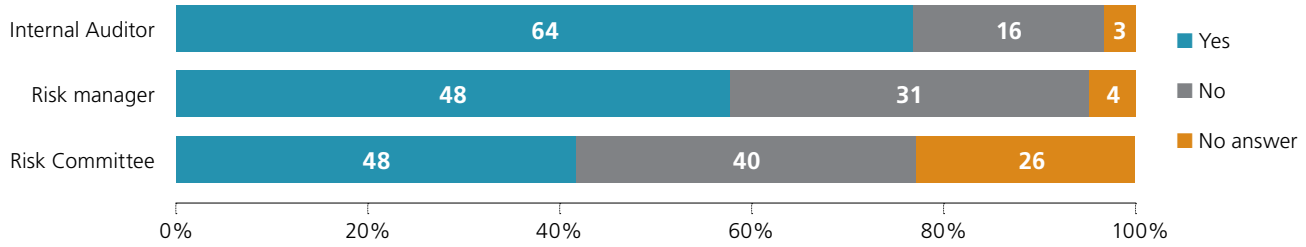
[22] Located in Amsterdam, Triple Jump manages and advises investment funds focused on microfinance. As of November 2010, Triple Jump had invested US$270 million in 152 MFIs in 52 countries. See "Social Performance Assessment, 2010" available at http://www.triplejump.eu/page/Social+Performance/1939/

Figure 7: Governance Indicators



Source: MIX Market Survey

Figure 8: Results of MIX Market Survey



and Management"[23] found that of 405 reporting MFIs during the period 2009–2010, the preponderance do, in fact, consider their social performance (Figure 7).

C. Succession Planning: The Role of Board and Management

A major responsibility of all boards is to plan for succession in senior management, in particular, the managing director (MD) or CEO. Many MFIs were founded by social entrepreneurs who have remained with the MFI for many years as the MD or MD/executive chairman of the board.[24] A critical issue in the sector is how to develop, train, or recruit qualified successors. Newly constituted boards frequently replace the MD, following the period of transformation, in order to ensure that adequate skills are in place to manage and oversee the institution which often has a new and different set of objectives, responsibilities, and accountabilities. This has led a number of MDs, supported by the original boards, to resist transformation and the overtures of new investors. (See the case of KEP in Kosovo) It has also led to a demand for incentives in the form of equity ownership, terminal bonuses or termination pay in recognition of the years of service and "sweat equity" by the MD and his senior management team.[25] At the time of transformation, some institutions have developed comprehensive share-incentive schemes for directors, management, and staff, while others have limited incentives to the CEO and a few senior managers to ensure that the transformation and the closing of the investment occurs smoothly. The case of Kosovo Enterprise Program (KEP) during transformation speaks clearly to the need for careful succession planning and control by the board over the process.

D. Risk Management of MFIs: Six Recurrent Challenges

Strengthening risk-management systems has become critical to the long-term success of the microfinance industry. The MIX Market's survey sheds light on the current status of the practices in the sector and shows how little attention has been focused on this topic. The survey's findings highlight the critical need to strengthen control and risk oversight (Figure 8).

[23] Micol Pistelli, Anton Simanowitz, and Veronika Thiel, "A Survey of 405 MFIs Reporting to the MIX in 2009-2010." MicroBanking Bulletin, July 2011.

[24] Muhammad Yunus, Grameen Bank; Faizal Abed, BRAC; Kimanthi Mutua, K-Rep Bank; and Rupert Scofield, Finca International are all CEOs and, in some cases Chairman as well, that have managed their institutions for over 20 years.

[25] See Ira W. Lieberman, Elisabeth Rhyne, Brian Busch, and Stephanie Dolan, "Aligning Interests: Addressing Management and Stakeholder Incentives during Microfinance Institution Transformations," Calmeadow and Center for Financial Inclusion at Accion International, 2009.

ABOUT THE PHOTO Downtown Prishtina, Kosovo.

The Case of KEP

BACKGROUND: Kosovo Enterprise Program (KEP) was established by the International Catholic Migration Committee (ICMC) in 1999 and is the largest MFI operating in Kosovo. The loan portfolio totaled over €37 million, representing 42 percent of the sector, 33 percent in terms of loan number, with over 20,000 clients. With 8 main branches located throughout the country, it has the broadest outreach in the sector. Loan amounts begin at €300 and range to €80,000 with loan rates averaging 15%.

ATTEMPT TO TRANSFORM: Operating issues began when, unlike other MFIs, the organizer, ICMC, conveyed management of the capital to the local office and board. Thereafter, KEP was managed by its board, which was composed of individuals with diverse backgrounds and expertise. In 2010, KEP management declared its intention to transform into a bank, and in doing so, it initiated a number of changes and steps: prepared a transformation plan; positioned a new management structure; enhanced infrastructure; installed security in branches as well as renovated into bank-like offices; changed the logo; and trained staff. The relevant application was filed with the central bank, the plan being to transform into a bank with 100 percent ownership as KEP NGO. The central bank rejected the application because of unclear ownership structure and recommended that reputable shareholders be solicited, such as the European Bank for Reconstruction and Development (EBRD), and other banks, with a lesser stake held by the NGO itself. The delays in the implementation of regulation contributed to an increased legal vacuum which was used by KEP management in absence of a proper board oversight.

During this period, the transformation regulation was still, de facto, on hold with no other transformations occurring. At the same time, the NGO office conducted an inspection and filed a complaint with the Kosovo Tax Administration regarding the compensation package of the MD and recommended his removal. Further investigation by the board met with resistance from the MD in addition to discovering non-compliance with the founding documents of KEP which required the board to be elected on an annual basis. Based on a lack of information and on subsequent events, the board acted to dismiss the MD. However, since the board appointment(s) had lapsed, the decision was non-binding and the MD remained.

In addition to the internal tensions, further investigation disclosed that management had established offshore vehicles with which KEP had been transacting. In 2011, an administrator was appointed to disentangle the issues and transactions, as well as to evaluate the viability of the existing loan portfolio. Given the regulatory gaps at the time, no direction was given to close the institution, and its future business prospects remained a work in progress.

GOVERNANCE ISSUES

1. Governance matters: to enable prudent decision making and responsible oversight.
2. Boards must be engaged, understand the terms of their appointments, and require sufficient information and communication from management and organizers to be fully informed. Internal review/control functions are critical, and boards should ensure access to and communication with relevant personnel apart from executive management.
3. The MFI lost its "double bottom line" focus and was not fulfilling its original mandate of lending to specified segments, meeting a social need, and achieving prudent commercial viability.

Table 2: Financing Structures of MFIs in Ten Countries, 2010[26]

Country	# of Loans (Thousands)	% of Borrowing	Financing Deposits	Equity
Morocco*	919	81	0	19
India*	26,629	76	4	19
Bosnia*	375	64	18	18
Nicaragua*	391	64	21	16
Pakistan*	1,112	49	26	25
Mexico	4,508	29	47	24
Bolivia	873	17	70	13
Peru	3,089	25	59	16
Indonesia	3,597	5	89	5
Kenya	1,458	13	65	18

Table 3: Characteristics of MFIs by Size[27]

No. of Borrowers[28]	# of MFIs	Share of Total Institutions (%)	Share of Borrowers (millions)	Share of Total (%)	Assets/MFI (US$ millions)	Profit % of Revenues
<100,000	982	89	17.1	21.0	57.2	+1.0
1.000-10,000	401	36	1.8	2.0	7.0	-14.0
10,000-100,000	439	40	15.2	18.0	48	+3.0
>100,000	122	11	67.5	79.0	1,271	+20.0
100,000-1 million	109	10	26.8	32.0	193	+15
>1 million	13	1	40.7	48.0	1,078	+23

Source: Roodman's calculations based on MIX data.

Based on their financing structure, risk-management systems in the MFI industry face a number of challenges. Thus far, the most common relate to the scale of the client base, collection resulting from over-lending and over-borrowing, product diversification, and operational and reputational risk caused by political interference. Table 2 illustrates the mix of financing in microfinance, including the dependence of many MFIs in recent crises on borrowing, much of it external, in order to scale their institutions.

E. Risk-Management Challenges

Challenge #1: Scale of the client base

Many MFIs now have more than 100,000 clients and a portfolio of US$ 100million. A number of MFIs have more than a million clients. These MFIs are increasingly important systemically, within their country/market and some to the industry as a whole. This type of scale requires systems in place that can process client information and a board that can assist management in developing a long-term strategy. It also requires management that can execute strategies to build an organization (human capital) and to expand and develop risk-management systems and controls that keep pace with lending as the institution scales up. Above all, the board will need to assist the MFI in managing risks. Table 3 illustrates the importance of scale in MFI operations and the increasing concentration of assets and loans in very large MFIs. The scale of these MFIs makes good governance practices increasingly important.

The case of EBL in Kenya illustrates the rapid growth of a number of commercialized MFIs. Equity Bank has continued to grow rapidly as a full commercial bank in Kenya. It is listed on the Nairobi Stock Exchange, has a large branch structure to mobilize savings, and partners with M-PESA to provide mobile banking.

[26] Roodman, *Due Diligence,* 265.

[27] Roodman, *Due Diligence,* 112.

[28] Note that two categories of MFIs with few borrowers have been dropped from the table, and therefore the numbers of institutions will not total correctly.

ABOUT THE PHOTO Maasai women make, sell and display their bead work in Kajiado, Kenya. Photo: © Georgina Goodwin/World Bank.

Equity Bank Limited: restructuring growth and scaling-up of an excellent institution

BACKGROUND: Equity Bank Limited (EBL) was founded as the Equity Building Society (EBS) in Nairobi in 1984 and initially focused on providing term loans and in mobilizing deposits. The high risk of term loans, a stagnant deposit base, under capitalization, poor management, and a difficult macroeconomic and political environment led the bank to the brink of collapse. In 1993, the Central Bank of Kenya declared EBS insolvent with more than 50 percent of its loan portfolio at risk of default.

RESTRUCTURING THE BANK: Under the leadership of James Mwangi, the current CEO, EBS began a major restructuring effort that focused on the economically active poor. The bank also began a marketing campaign aimed at mobilizing savings deposits. The vision was to become the leading retail bank in East Africa by providing the full range of financial services to the economically active poor. Loyal savers were progressively converted into borrowers on the basis of their savings patterns. As a result, the company incurred little additional marketing cost while building its loan portfolio.[29] The company invested significant funds and effort in MIS software and systems to manage credit risk, to comply with changing banking regulations in Kenya and, perhaps more importantly, to tighten its control over its portfolio performance.

MANAGING EXPLOSIVE GROWTH: The organization's new strategy, new management team, external technical assistance, and investors paid off. In 2004, EBS was given a full banking license, and following its turnaround and initial takeoff phase, the bank began to grow dramatically. By 2006, when the bank decided to list on the Nairobi Stock Exchange, Equity Bank Limited, as the bank was renamed, was benchmarked versus other Kenyan banks. From 2003 to 2006, the number of borrowers increased from 59,000 to 240,000 at an annual average of 66 percent. The portfolio grew from US$15 million in 2002 to US$158 million at year-end 2006—an annual average growth rate of 82 percent. At the same time, the number of savings accounts increased from 156,000 to just over a million, an average growth rate of 61 percent, while deposit balances grew from US$28 million to US$236 million—an annual average growth rate of 72 percent. Portfolio at risk remained a problem throughout this period, at 12.2 percent at end 2006. EBL sought to address the problem with a significant investment in MIS and with technical assistance on credit-risk management, supported by CGAP. At the end of 2006, the bank's return on assets (ROA) was 4.85 percent, its return on equity (ROE) 40.36 percent, its profit margin 31.53 percent, its capital adequacy was at 11 percent, and its debt to equity ratio was 8.10 percent. Throughout this period of explosive growth, the bank continued to reach down scale, with an average loan balance of US$444, or 65.64 percent of GNI per capita. The bank also continued to offer savings to the working poor which reached US$165 on average, or 36.73 percent of GNI per capita, as of 2006.[30]

LISTING ON THE NAIROBI EXCHANGE: The bank went from being traded over-the-counter (OTC) to being listed on the Nairobi Stock Exchange on August 7, 2006. The purpose of the listing was "to offer shareholders and the Bank the benefits of the stock market liquidity and price discovery."[31]

ATTRACTING A MAJOR INVESTOR: On November 14, 2007, EBL and Helios EB Investors, LP ("Helios") subscribed for 90.5 million new ordinary shares in the bank at KES 122 (US$1.94 per share, with 63 KES equal to US$1). The investment substantially increased EBL's capital, and Helios became the largest shareholder in EBL at 24.99 percent.[32] EBL has subsequently purchased a transformed MF bank in Uganda. It has also entered in a joint venture with M-PESA/Safaricom to extend mobile banking to its client base for both loans and savings products.

GOVERNANCE ISSUES

1. Managing explosive growth.
2. The need to continue to reduce portfolio at risk.
3. The strengthening of risk-management systems and controls, and continued investment in MIS and technology.
4. A need to reduce expenses while maintaining production efficiency, and the possible expansion into East Africa beyond Uganda.

---

[29] AfriCap Investment Report, Opus Cited, p. 10.

[30] The MIX Market.

[31] See Bloomberg.com.

[32] Equity Bank Limited, Press Release, 14 November 2007.

Table 4: Anatomy of Four Microcredit Crises

Country	Annual Growth Rate of Loan Stock 2004-08	Share of Borrowers with Loans from Multiple Lenders	Par>30 days 12/07	12/08	6/09
Bosnia	43 %	40 %	2 %	3 %	7 %
Morocco	59 %	29 %	2	5	10
Nicaragua	33 %	40 %	3	5	12
Pakistan	67 %	30 %	2	2	13

Source: Chen, Rasmussen and Reille

Challenge #2: Collection due to over-lending and over-borrowing

Recent analysis has demonstrated that in selected markets there has been a tendency for MFIs to over-lend or for borrowers to be able to over-borrow. Few markets have adequate credit bureaus, and clients have been able to borrow from multiple MFIs. Portfolio at risk over 30 days (PAR>30), which has long been assumed to be a critical indicator in evaluating an MFI's soundness, may in fact be a lagging indicator. An analysis by Chen , Rasmussen, and Reille notes that collection problems suddenly arose in four major markets—Bosnia, Morocco, Nicaragua, and Pakistan. In 2009, delinquent loans that averaged 2 percent in 2004 suddenly rose to 7 percent in Bosnia-Herzegovina, to 10 percent in Morocco, to 12 percent in Nicaragua, and to 13 percent in Pakistan. The reported delinquencies jumped by multiples, particularly during the first 6 months of 2009 which corresponded to the global financial crisis and slowdown.[33]

The analysis by Chen, et al. concludes that in each case three vulnerabilities went to the heart of the problem: (i) concentrated market competition and extremely high rates of loan growth, (ii) inadequate risk systems and controls, and (iii) erosion of underwriting standards.[34]

Schick and Rosenberg indicate that multiple causes of over-indebtedness often occur in competitive markets approaching saturation and accompanied by MFIs lowering their underwriting standards. These causes are reported as (i) overaggressive marketing; (ii) non- transparency of lenders on pricing and terms; (iii) common methodology approaches to automatically and gradually increase loan sizes that puts clients at risk if there has not been due diligence on the client's ability to pay; (iv) loan products that are too inflexible, and repayment terms that are out of step with borrowers' cash flow; and (v) overaggressive collection practices that can worsen the problem of borrowers already in trouble.[35]

This issue has been described as follows:

> Under these circumstances (intense competition and excess liquidity, authors' insertion), MFIs may be encouraged to increase loan portfolios to meet ambitious outreach goals or shareholder demands. Boards may expect the MFI to increase or at least maintain market share when facing increased competition. These competitive pressures can foster aggressive loan origination policies and staff incentives based on loan volume. These will simultaneously contribute to declining portfolio quality and hastening of the market saturation process.[36]

The MFI needs a board of directors that understands the underlying economic, competitive environment and tempers growth in line with market conditions.

The case of SKS Microfinance Limited (SKS) in India illustrates the rapid growth of a commercialized MFI. In this case, SKS was at the epicenter of the crisis in the state of Andhra Pradesh in India.

Challenge #3: Product diversification

As MFIs grow to become non-bank financial intermediaries or commercial banks, they increasingly seek to diversify their product offerings. MFIs are now offering such products as housing-rehabilitation loans, agricul-

[33] Greg Chen, Stephen Rasmussen, and Xavier Reille, "Growth and Vulnerabilities in Microfinance," CGAP Focus Note, February 1, 2010.

[34] *Ibid*.

[35] Jessica Schick and Richard Rosenberg, Too Much Microcredit? A Survey of the Evidence on Over Indebtedness, Occasional Paper 19, CGAP, September 2011, 3.

[36] Adrian Gonzalez and Emmanuelle Javoy, "Microfinance and the Role of Policies and Procedures in Saturated Markets and During Periods of Fast Growth," Microbanking Bulletin, September 2011.

QUICK FACTS – SINCE 1988 **3.9 million members ■ 7.8 million life insurance policies ■ US$451 million (Rs 2,284 crore) outstanding ■ US$1.3 billion (Rs 6,640 crore) disbursed ■ 1.8 million health insurance ■ 1.5 million retail insurance members ■ 99% repayment rate ■ 13,038 employees ■ 1,354 branches ■ Over 60,000 villages, 18 states ■ 200% Annual Growth**

SKS Capital, a Bank at the Epicenter of the Indian Crisis

BACKGROUND: Launched in India 1998 as a non-profit organization, SKS Microfinance was one of the fastest-growing microfinance organizations in the world through 2010, reaching an estimated 25 percent share of the total microfinance market in India. In January 2005, SKS was converted to a for-profit non-banking financial company (NBFC). NBFCs are regulated by the Reserve Bank of India (India's central bank) and are unable to accept deposits. SKS delivered microfinance through a Grameen (village) banking program using the joint-liability model developed by the Grameen Bank. SKS also offered its members interest-free loans for emergencies, as well as life insurance. Its NGO affiliate, SKS Foundation, runs the Ultra Poor Program, one of the first programs in the country focused on bringing extreme poor populations into the realm of mainstream microfinance.

SKS's philosophy has been focused on aggressive growth and scale. They achieve this through a combination of activities, including entering a state or market where another MFI already exists in order to ensure that there is demand, and then expanding in that market using technology to automate/lower costs. The strategy is to go deep within the districts to increase the efficiency and productivity of the branches and reduce operating costs. As a start-up, SKS identified three main constraints to growth: capital, capacity, and costs. SKS therefore developed a plan to scale microfinance based on three inter-linked principles that would overcome those barriers. These were (i) applying a for-profit methodology so that an MFI did not have to depend on limited donor funding; (ii) using best practices from the business world to speed growth; and (iii) deploying technology to overcome high delivery costs.

TECHNOLOGY FOCUS: A key strength in SKS's aggressive growth was its ability to deploy technology to overcome high delivery costs. For example, SKS brought Adrenalin e-Systems Ltd. on board to put together a technology-based solution for the management of its human capital.

GOING PUBLIC AND THE CRISIS IN ANDHRA PRADESH: In August 2010, SKS went public through an IPO raising some US$350 million and valuing SKS at US$1.5 billion.[37] Vikram Akula, the founder of SKS, and his investors were sharply criticized in the Indian press for making large profits on the backs of India's poor. The State Administration of Andhra Pradesh, in a running dispute with the large and aggressive MFIs in the state (5 of India's 10 largest MFIs had headquarters in Andhra Pradesh), chose this moment to intervene in the sector and effectively bring payments to a standstill.[38] The State Bank of India, the regulator for the sector, sought to diffuse the crisis through a commission that recommended comprehensive regulation of the sector. These regulations languished in the Indian Parliament, and the sector was left in limbo with many of the largest MFIs in India, including SKS, in some difficulty.

GOVERNANCE ISSUES

1. Board's role in managing excessive growth.
2. Board capture by a dynamic founder.
4. Capital market financing of rapid expansion.
5. Development of MIS and other technologies to control growth.
6. Human resources management—contracting out the process.
7. Making the decision to issue an IPO.
8. Failure to foresee and manage political risks, board/shareholders role in a crisis.

[37] Raghuram Rajan, "Doing Poorly by Doing Good," December 8, 2010, available at www.project-syndicate.org/commentary/doing-poorly-by-doing-good.

[38] On 15 October 2010 the State of Andhra Pradesh promulgated an ordinance seeking to regulate the microfinance sector. "Indian Microfinance Crisis of 2010: Finding the Silver Lining," Intellecap, October 25, 2010.

ALCEDA Bank Plc., Cambodia[39]

"ACLEDA Bank's vision is to be Cambodia's leading commercial bank, providing superior financial services to all segments of the community."[40]

ACLEDA originated from the tragedy that befell Cambodia with the assumption of power by the Khmer Rouge in 1975. The International Labour Organization (ILO) and Care International recruited the company's management from refugee camps on the Thai-Cambodian border. The program's initial aim was to develop LEDAs (Local Economic Development Agencies). ACLEDA was the association of these independent regional agencies. In 1996, because of a liquidity crisis, ACLEDA had to decide between providing business development services and financial services—microfinance—to its constituency. The General Assembly of the Association decided to merge ACLEDA's agencies into a single unified institution. ACLEDA began the transformation process to a bank in the mid-1990s and finalized the legal transformation into a bank in 2000. Since then, both the loan portfolio and savings have grown at an incredible pace: savings at a cumulative growth rate of 137 percent and loans at a cumulative growth rate of over 50 percent a year. The Bank has expanded its base to almost all provinces of Cambodia. Based on the institution's growth and progress, it is widely considered a very successful case. The transformation was driven largely by growth and by the need to secure funding to do so. As an NGO, the MFI would have quickly outpaced its ability to secure donations and even subordinated debt; savings deposits offered an attractive source of leverage that also provided an important service to clients. As an NGO, the governance of the organization included a "General Assembly" that included (or was perhaps exclusively) the employees; thus, a strong sense of employee ownership existed. When managers and directors began considering the transformation, they took time to explain the process

[39] The original case was prepared by Lieberman et al. "Aligning Interests".

[40] *Ibid.*

(continued)

tural loans, educational loans, insurance, money transfers, and remittances. In addition, many MFIs have moved upstream to small business lending in order to increase average loan size and enhance profitability. Money transfers, remittances, and insurance are most often fee-based product lines and generally do not represent the same risk considerations as other new product lines. Commercial banks will also invariably seek to mobilize deposits which requires important considerations as to product design, capacity of the branches to absorb long lines of savers, and the economics of handling the accounts of small savers. Finally, as MFIs gain in sophistication, they are seeking to add branchless and remote banking capability and, increasingly, to participate in mobile banking. New products require MFI management to raise capital and recruit and train staff to develop these new offerings. Capital and staff are needed to launch and market the product, to manage its growth prudently, and to improve risk-management systems to avoid losses. Loan maturities are likely to increase as the MFI moves away from plain vanilla working capital loans, and maturity mismatches may arise between loans and sources of capital, such as short-term deposits, interbank loans, and loans from investment funds. In this case, the role of the board in evaluating investment decisions, raising the capital, and controlling the pace of growth is critical.

Commercialization requires transformation. That is transformation to a shareholding corporation, such as a joint stock company, non-bank financial intermediary, or commercial bank. The process of transformation may take time and considerable investment. It includes:

- Raising sufficient capital to meet the minimum capital requirements to obtain a license.
- Investment in the MFI to bring physical facilities, such as branches, up to banking/security standards. Branches will need safes, counting rooms, and security systems.
- Investments in MIS software and related equipment such as servers and computers for branch staff. These investments are expensive. They normally involve an annual licensing fee and substantial consulting fees to install the systems and train MFI staff. An IT manager capable of working with IT systems suitable for banks must also be recruited. The IT manager must also be able to evaluate emerging technologies in MFIs, such

ABOUT THE PHOTOS Providing superior financial services to all segments of the community: Handicraft – silk weaving, small enterprise and (inset) Footwear enterprise in Takeo province. / Micro entrepreneur in Phom Pehn.

and motives to all employees. Part of this explanation included the creation of an investment company, owned by the employees, which would hold shares in the bank—making the employees real owners. The MFI then "handpicked" the future external investors to ensure that mission was not an issue. ACLEDA Bank purchased the NGO's portfolio, and NGO received both shares (a 45 percent stake in the bank) and a subordinated loan for the value of the portfolio. The institution invested heavily in the training of the current management team and ultimately kept most of the key managers.

GOVERNANCE ISSUES

1. **Strong values and a shared vision of ACLEDA, which emerged from shared experience of the tragedy which befell the country.**
2. **Inclusive process by management, involving all employees in the process.**
3. **Employee incentives and intensive management training.**
4. **Strong representation of the NGO and the staff association on the board.**

as branchless banking. This represents a significant upgrade for many MFIs as they move from NGO status.

- Recruiting risk-management and internal-audit specialists and training staff to create their respective departments. Bank staff will also require extensive training to deal with new MIS systems and new products, and to handle the mobilization of deposits.
- Frequently providing incentives to the senior management team to align their interests with those of the ownership.[41]

In all these areas senior management of the MFI and the board must carefully plan the transformation process, which invariably requires bringing on board external equity investors and perhaps new commercial lenders.

The cases of ACLEDA Bank (Cambodia) and K-Rep Bank (Kenya) are examples of the most successful transformation cases in the sector.

[41] See Lieberman et al., "Aligning Interests."

Challenge #4: Political Risk/Operational Risk[42]

Political risk has played a role in several crises—Nicaragua, Pakistan and India among others. But none has matched the Indian crisis with respect to reputation risk to the sector as a whole. In 2010, a major crisis hit the sector that continued for some time. MFIs in Andhra Pradesh were badly affected by political interference from the state government and by charges of over-lending to the poor. Very rapid growth by major MFIs in India and cannibalization of a state government poverty program supporting self-help groups (small borrowing cooperatives) led to political backlash. Populist politicians supported a debtor's

[42] There is a substantial literature on MF in India and the crisis. A select list includes M-Cril Microfinance Review 2010 (M-Cril is a rating agency in India.); MS Sriram, "Commercialisation of MF in India: A Discussion of the Emperor's Apparel," W.P. 2010-03-04, Indian Institute of Management; Intellecap report, "Indian Microfinance in Crisis: Turf War or a Battle of Intentions?" October 2010; Intellecap, "Indian Microfinance Crisis of 2010: Finding the Silver Lining," October 25, 2010; "Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector," Reserve Bank of India, January 2011; "Response to the Malegam Committee Report 24th March 2011"; CGAP, "Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance."

The Kenya Rural Enterprise Program's (K-Rep) Transformation Experience[43]

BACKGROUND: K-Rep was founded in 1984 by a U.S. NGO and was subsequently funded by USAID that provided funding to existing NGOs involved in microfinance and small business development. In 1990, K-Rep established its own MFI and introduced peer-group lending to micro-entrepreneurs. By 1994, K-Rep decided to transform into a microfinance bank and focus on its own operations. This was the first NGO-to-bank conversion in Africa. It took K-Rep several years to transform, partly because of the unfamiliarity of Kenya's central bank with microfinance and how best to supervise such an entity.[44]

OWNERSHIP STRUCTURE: After careful consideration of its options, the board of K-Rep decided to establish a holding company to manage its various activities, which included the bank—K-Rep Bank Ltd.—the NGO, K-Rep Development Agency, and a consulting company, K-Rep Consulting Services. Initially, K-Rep Holdings sought to own 51 percent of the bank, but the central bank limited ownership concentration to 25 percent. K-Rep attracted several like-minded investors that would allow the bank to retain its mission.[45]

MANAGEMENT/EMPLOYEE INCENTIVES: With the support of CGAP, K-Rep set up a form of ESOP as a cooperative, the KWA, so that existing and future directors, managers, and employees could purchase shares in the bank with a view that the bank would eventually undertake an IPO on the Nairobi Stock Exchange. CGAP funding allowed the KWA to retain liquidity so that shares could be sold and purchased by employees, including future employees. The KWA retained a 10 percent interest in the bank but was not allocated a board seat.

MANAGEMENT CAPABILITY: Senior management of the NGO remained with the bank; in particular, the long-serving CEO, Kimanthi Mutua, who was well known and highly respected in the microfinance sector. In time, employees with specialized knowledge were recruited from the banking sector.

ABOUT THE PHOTO A honey producer in Kenya. Photo: © Dana Smillie / World Bank.

GROWTH AND PERFORMANCE: K-Rep Bank grew steadily and strongly as a bank: between 2000 and 2007, clients grew from 15,000 to 153,961, savers from 2,724 to 16,701, gross loan portfolio from US$4.6 million to US$ 110 million, ROE from 13.4 percent to 22.3 percent. In 2007, the bank began to experience delinquency problems with portfolio at risk moving from 3.6 percent to 12.6 percent. K-Rep's problems increased partly because of the bank's diversification into small business loans and a failed effort at succession. Investors provided the bank with more liquidity in the form of a rights offering. In time, a new managing director was brought in as Kimanthi Mutua retired after some 25 years of service. He remained as chair of the holding company, and the bank was restored to health.

GOVERNANCE ISSUES

1. Planning and implementing transformation, attracting investors/raising capital.
2. Management succession.
3. Board role in managing losses.

[43] Original case was prepared by A2F Consulting for Lieberman et al., "Aligning Interests."

[44] Subsequent transformations in Kenya have benefitted from the K-Rep case. See Frankfurt School of Finance and Management, Bankakademie, HFB, "Transforming Microfinance in Kenya: The Experience of Falu Kenya and Kenya Women Finance Trust," February 2012, for a detailed discussion of the transformation of two other MFIs in Kenya.

[45] As of 1999, ownership distribution/board seats were as follows: IFC 16.7 percent, 1 board seat; FMO and Triodos/Doen 5percent and 8.6 percent 1 board seat; Shore Bank, 13.2 percent, 1 Board seat; the African Development Bank, 14percent, 1 Board seat, and K-Rep group 32.5 percent, 2 board seats, as equity investors. In addition two Independent board seats were created.

"strike," as in Nicaragua, that left a number of major MFIs barely functioning. The IPO of SKS, the largest MFI in India, raised perceptions that the MFIs and their investors were enriching themselves on the backs of the poor. The Malagrem Report, commissioned by the State Bank of India, proposed a strict regulatory regime for commercial MFIs in India, but its recommendations were delayed by the Indian Parliament, leaving the sector in limbo with spillover effects in other states.

Challenge #5: The Risk Response of a Board and Investors During an Internal or External Crisis

Crises require strong intervention by the MFI board and sometimes by the shareholders**.** During times of internal institutional crisis or a crisis provoked by external events, the board's role often moves from governance to active management. For example, at a time of previously undisclosed fraud or large losses to the institution, the board will need to step in, potentially appoint a new MD temporarily from among the board members or remaining senior managers, and work closely together to recruit a new MD. The board will also need to work hard to assure and retain staff, inform investors, and also assure lenders and the banking supervisor. In the case of an external shock, such as the type of political interference experienced in Nicaragua and India, the board will need to work closely with the MD to take many of the steps previously noted. At times of crisis, the board will meet more frequently and will take on a role that is closer to management than governance. At times, the shareholders may need to step in and replace the board and key members of management.

The BANEX case is an example of both political risk—interference by the government in the sector, fueling a nonpayment crisis—mismanagement, and a slow governance response by the board and shareholders to a crisis, as well as the failure of investors and creditors to agree on timely and appropriate debt restructuring. These failures resulted in an intervention by the banking supervisor and the liquidation of the bank. ■

ABOUT THE PHOTO Community meeting. Aurangabad, India. Photo: © Simone D. McCourtie / World Bank.

BANEX and the No Payment Movement in Nicaragua[46]

BACKGROUND: BANEX began as FINDE, a very successful, rapidly growing NGO in Nicaragua. In 2002, it converted to a NBFC, FINDESA, and in October 2008, it changed its name to BANEX (Banco del Exito, success bank) when it received its full banking license. Starting with a loan portfolio of US$7 million in 2002, FINDESA grew rapidly, had 30 branches throughout the country, and also began to mobilize deposits. By 2008, the bank had 68,000 clients and a loan portfolio of US$125 million. BANEX began to move upstream to offer small business loans, cattle-raising loans and agricultural loans, all of which had distinctly different risk profiles than the plain vanilla working capital loans that were the staple of MFIs. BANEX's success allowed it to attract both domestic and international equity investors, including a large bloc owned and controlled by the bank's chairman and managing director. International equity investors were primarily microfinance investment vehicles (MIVs). BANEX also attracted a number of MIVs as lenders, as well as Development Finance Institutions (DFIs)—the Inter-American Investment Corporation at IADB (IIC)—and a local and regional development bank, which provided lines of credit to the bank. As of year-end 2008, the bank had mobilized some US$100 million in loans and over US$30 million in deposits and was profitable. Local investors owned 57.8 percent of shares and foreign investors 42.2 percent. Of the eight board members, four represented local investors, three international investors, and one board member was independent.

THE NO PAYMENT MOVEMENT: In response to aggressive legal action by one MFI (against its clients for non-payment of loans), a local protest movement began in the summer of 2009 against all the MFIs, accusing them of usurious interest rates. This soon evolved into a non-payment movement, supported by the populist President of Nicaragua, Daniel Ortega, a former Sandinista.

BANEX IN CRISIS: Initial reaction by BANEX was to assure its investors and creditors that the non-payment movement would slow and that BANEX had ample liquidity and capital to withstand the crisis. By May 2009, BANEX's board had grown increasingly concerned. Performance had begun to deteriorate, and the board asked management to consider a US$3 million recapitalization plan. Management resisted, expressing confidence that beef prices had bottomed out and that cattle loans, perhaps the riskiest segment of the portfolio, would be safe. In September 2009, the shareholders met in Managua. Performance had continued to deteriorate. Lack of agreement between international investors on the size of the investment needed, resistance by local investors who lacked the resources to participate in the rights movement, and a legal agreement with a lender that required majority local ownership, all made the recapitalization process difficult and less timely than it needed to be. In addition, creditors, who had to be part of the solution, had not yet been approached.

A large number of loans were maturing in the first quarter of 2010, and it was clear that BANEX would face difficulty replacing those loans with new loans or having the creditors roll over their loans. Not only did BANEX need more equity, but perhaps more important, there needed to be a debt restructuring as well, with creditors converting a percentage of their loans to subordinated loans which would serve as tier two capital and equity. In September 2009, MicroRate was retained to do a special portfolio audit. Its audit showed clearly that provisions for bad loans were significantly understated.

At the time of the MicroRate audit, the company was reporting PAR > 30 days at 19 percent, while MicroRate projected PAR>30 days at 30 percent. A financial advisory team (the Advisor) was hired just before the MicroRate report was finalized. It soon became clear to the Advisor that the capitalization plan was in trouble. There was no agreement between international and local shareholders. Local shareholders severely resisted the dilution that a large equity investment would mean. They also objected to the valuation of the bank by international investors which would further dilute their holdings. In addition, the bank lacked any form of forward projections as a basis for negotiating with creditors. A meeting of the investors, the creditors, and the Advisor in Geneva seemed to offer some hope for a debt restructuring, but this was conditional on the equity investors recapitalizing the bank in the interim to prevent intervention by the banking supervisor who was now pushing the company hard to recapitalize to maintain capital adequacy. Under Nicaraguan Banking Law, if capital adequacy fell below 10 percent, the supervisor was obliged to intervene the bank. With a very

[46] The information for this case is largely derived from publicly available information contained in Cole et al., "Banex and the 'No Pago' Movement." Also, an author of this paper, Ira W. Lieberman led an advisory team that tried to assist Banex's international shareholders in reaching agreement with its creditors on a debt restructuring. The author is therefore intimately aware of the details of this case.

diverse group of some 30 creditors and investors spread over three different continents, getting agreement was not going to be easy under any circumstances. Following a meeting between the investors, creditors, management, and the banking supervisor in Managua on December 1, 2009, negotiations between the creditors and the investors went on for an extended period as the bank deteriorated. A restructuring plan was agreed to, in principle, with the creditors agreeing to restructure 13.6 percent of their senior debts to sub-debt and equity and the equity investors agreeing to inject some US$8 million in new funds into equity, a package of some US$20 million.[47] Unfortunately, the debt restructuring was too little too late. The restructuring called for an 18-month agreement, rather than an intermediate-term agreement of 5-6 years as recommended by the Advisor. The major creditors, who controlled the creditors committee, were hoping that the market would turn around and that they would be able to get paid since their loans were among the first due in the original maturity schedule. Creditors also indicated that the nature of their debt funds, special purpose vehicles (SPVs), made it very difficult for them to get agreement on a restructuring. As part of the recapitalization agreement the managing director was replaced, and the board composition was changed. Nevertheless, losses continued in 2010, and the bank was eventually intervened to protect the depositors. Its portfolio was allocated to Nicaraguan banks.

GOVERNANCE ISSUES

1. Risks of rapid and diversified expansion.
2. Problems of inadequate controls, MIS, and reporting systems.
3. Oversaturation of MF markets.
4. Role of the board and shareholders in a crisis. Need for international equity investors and creditors to come together in a crisis to reach a realistic and timely agreement on restructuring, with little to no prior experience previously in the sector in cooperating on workouts. International investors needed to reach agreements with local investors, particularly with the managing director who controlled a significant bloc of shares.
5. The role of the Board and shareholders in a crisis.

[47] See Cole et al., "Banex and the 'No Pago' Movement," 10 recap schedule.

ABOUT THE PHOTO Agricultural loans: pile of beans at coffee farm in Nicaragua.

External Factors Influencing Governance

While we have focused mainly on the board of directors and its role in governance, we should not discount the important role that external factors play in influencing MFIs. When an MFI transforms and becomes both a shareholding company and a regulated non-bank financial institution or a commercial bank, its shareholders assume the responsibility to formalize and ensure effective corporate governance.

Investors Due Diligence/Post Closing of the Investment Governance Requirements. During their due diligence investors will examine the governance capacity of the MFI. After investing, the investor will generally want to have a position on the board of directors and also have a say in the number of directors, the role of independent directors, appointment of a board chair, issues requiring super-majority votes of the board versus simple majorities, and the creation of board committees among other governance issues.

The role of rating agencies. A rating services industry has developed in the MFI sector. They are increasingly focusing on governance as one aspect of their overall rating of the MFI, and many investors/lenders require an MFI to be rated before they will invest or lend. Rating agencies are also increasingly providing social-performance ratings.

Equity and debt investors require stronger governance and direct board participation. During the transformation process, the existing board of directors will need to carefully evaluate the entry of equity investors. This will be critical to the future development of the MFI as it moves from NGO status to a share-holding company and a regulated, commercialized institution. Options may be the direct participation of DFIs such as the IFC (World Bank Group) or the IFC's bilateral equivalents.[48] In addition, there are at least 30 private equity funds that have DFIs as investors, some are global in nature, some have a regional orientation, and some are country funds (e.g., funds focused solely on the Indian market).[49] The DFIs, as well as development institutions such as the European Investment Bank (EIB) and the Commonwealth Development Corporation (CDC), are substantial investors in these funds. Therefore most of the funds are, in fact, private-public partnerships. Each of these investors will require board seats as part of their commitment to invest in a transformed MFI. They will also require that governance be strengthened. They will want to see adherence to social responsibility and environmental policies, anti-money-laundering policies and, increasingly, consumer protection through the SMART Campaign. As a result of their entry, the existing board will invariably be reshaped. In some cases, where multiple investors take a stake in the transformed MFI, an entirely new board will be appointed.

Banking regulation and the role of the banking supervisor.[50] Most regulated MFIs fall under the regulatory and supervisory auspices of the banking regulator in their country. This control and oversight generates more stringent adoption of good governance practices, especially in the nomination of "fit and proper" management and board members[51] and in approving individual board appointments. Regulatory issues may arise if the primary experience of management and board members is with MFIs and not with banks or other depository institutions.

Financial reporting to the MIX Market. This requirement exerts a discipline on the MFI to report key financial and operational numbers in a consistent way. The MIX and the MicroBanking Bulletin (its affiliated reporting vehicle) allow the MFI to be benchmarked against its peers. It is also the basis for most investor review and analysis of institutions in the sector.

External audit. The quality of the audit firm, the scope of the audit, and the standard governance requirement that the auditors report their findings to the audit committee of the board all play an important part in external

[48] Some of the DFIs most active in equity investments in the sector are Kreditanstalt für Wiederaufbau, German Development Bank (KfW), (Germany); FMO (Netherlands); Swiss Investment Fund for Emerging Markets (SIFEM), (Switzerland); Branch of the French Development Agency dedicated to Micro Finance (PROPARCO), (France); Belgian Investment Bank for Developing Countries (BIO), (Belgium); and the Nordic Investors—Swedfund, Norfund, and Finnfund.

[49] See the Council of Microfinance Equity Funds.org for a list of member equity funds such as Blue Orchard, responsAbility Social Investment Services, Gray Ghost, Grass Roots/Caspian Capital Partners, Triple Jump, Incofin, Developing World Markets, MicroVest and Accion International, all of which have played a prominent role in injecting equity into the sector.

[50] See "Principles for Enhancing Corporate Governance," Basel Committee on Banking Supervision, BIS, October 2010, for a more complete discussion of good governance principles and the role of banking supervisors in this process.

[51] See CGAP "Consensus Guidelines on Prudential Regulation of Deposit Taking Microfinance," 36.

governance, especially since investors and lenders will look to a clean audit opinion prior to committing resources to the MFI.

External stakeholders. To the extent that the MFI provides timely and efficient service to its clients, MFIs are able to build a loyal client base—both borrowers and depositors—that will make every effort to pay on time, to secure the next round of loans, and to retain their savings within the institution. To the extent that the MFI does not provide such service, clients have been known to dissert the institution. High levels of client desertion are a signal of poorly managed and poorly governed MFIs.

Exogenous Shocks. The recent financial/economic crisis (perhaps we should say the ongoing crisis) has focused attention on several problems with microfinance. Although growth rates in the industry slowed overall, there were other unique problems in several countries/markets, not necessarily directly related to the crisis but exacerbated by it. An IMF working paper by Gabriel Di Bella,[54] analyzes the impact of the crisis on MFIs and concludes,

> *This paper revisits the issue of systemic risks of mfis and finds that contrary to the evidence before the crisis, MFI performance is correlated not only to domestic economic conditions but also to changes in international capital markets. (Abstract)*

Complementary papers on the crisis and problems in the sector (one focused on Latin America, the other on the global outlook)[55] analyze individual problem cases around the world, throughout Latin America, and in such diverse countries as Ghana, Nigeria, Morocco, Europe and Central Asia, Southeast Europe (particularly Bosnia), and Indonesia. These papers have developed a typology of problems or risks, many of which were highlighted or came to the surface during the crisis:

- Poor governance practices, particularly noteworthy as MFIs transformed from NGOs to regulated MFIs (commercial MFIs)—either non-bank financial intermediaries or microfinance banks
- Systemic fraud
- Methodological flaws
- Uncontrolled growth
- Mission drift—loss of focus, especially trying to do SME lending
- Financial vulnerability
- Macroeconomic shocks
- State intervention—political risks
- Uncontrolled market growth and over-lending, leading to over-indebtedness

Despite this long list of problems primarily associated with the rapid scaling up of the sector and the introduction of commercially focused microfinance, there were no systemic crises in the sector. Individual markets and individual MFIs experienced crises; for example, there were serious problems in Bosnia, Nicaragua, Morocco, Nigeria, and India. One estimate is that from 2002 to 2008 some 93 percent of MFIs experienced no crisis while 7 percent of MFIs had some form of crisis. Of those that experienced crisis, 5.3 percent recovered, 1 percent failed, 0.6 percent possibly failed (status undetermined), and 1.3 percent stopped reporting but show no sign of failure.[56] This is certainly far from the type of systemic failure seen in the banking sector in individual crisis countries such as Mexico and Argentina (1995 and 2001, respectively), Turkey (2001), East Asia (1997 to1999), the United States (2008), or, in euro zone countires—Greece, Ireland, and Portugal as examples. ■

[52] Gabriel Di Bella, "The Impact of the Global Financial Crisis on Microfinance and Policy Implications," IMF Working Paper No. WP/11/175. 2011.

[53] Beatriz Marulanda, Lizbeth Fajury, Mariana Paredes, and Franz Gomez, "*Lo Bueno de Lo Malo en Microfinanzas: Lecciones Apprendido de Experincias Falladas en America L atina*," (Take the Good from the Bad in Microfinance: Lessons Learned from Failed Experiences in Latin America) Calmeadow, June 2010; Daniel Rozas, "Weathering the Storm: Hazards, Beacons, and Life Rafts," Center for Financial Inclusion at Accion International, Publication 11, 2011.

[54] See Rozas, "Weathering the Storm," 8.

Conclusions: Industry Responses to Governance Challenges

In the past couple of years, there has been clear recognition that the microfinance industry needs to improve governance standards: MFIs have scaled up, some markets have become more competitive/crowded, and crises—institutional, country, and macro crises—have affected the sector. As transformations from NGOs to commercialized institutions have occurred, there has been a heightened awareness of governance, based on investors' due diligence and investors' demands for board representation and stronger governance practices. In addition, concerns related to potential client abuses with respect to excessive interest rates and lack of transparency on the effective costs of fees and interest rates have led to an industry-wide campaign on client protection—the SMART Campaign—and improved monitoring of the social performance of MFIs.

This increased attention to governance in the sector has led to a variety of independent initiatives. A steering committee of various industry representatives, with overall coordination through the Center for Financial Inclusion at Accion International, is trying to organize these various initiatives. But resources dedicated to this effort, both human and financial capital, are inadequate, and all of the individual activities, as noted below, are somehow insufficient relative to the need. With a few exceptions there is little direct involvement with MFIs which should be the subject or focus of all this effort. There is a need to do more to convene the industry as a whole and to do more on the ground with peer-to-peer (P2P) efforts with the senior management and board members of MFIs engaged.

A. Governance Activities in the Sector

- CGAP is has completed an extensive technical paper on the supervision and regulation of MFIs. This is important for the sector but is not heavilly focused on governance and on the necessary role of regulators in overseeing good governance in MFIs.
- The CMEF revised its governance guidelines in 2012, first published in 2005, and continues to call attention to the concerns of equity investors about improved governance in the sector.
- A recent CGAP note on governance seeks to address investor issues in the sector and will surely raise awareness of governance.
- 167 MFIs responded to a MIX Market survey of 1,000 MFIs, answering a limited set of governance questions as well as a survey of their social performance. These efforts are enlightening but need to be followed up with a much deeper analysis in order to benchmark what is happening with respect to governance in the sector. An in depth survey, supported by case studies of good practices and peer-to-peer education in the sector, could do a lot to improve governance standards.
- There has been a strong push to create governance dialogue in Latin America. This has been the strongest, most effective, effort in the industry but is small relative the need. It has reflected a highly dedicated effort at Regional Central American Program for Enhancing the Financial Services for low-income populations (PROMIFIN), a Central America program based in Nicaragua with the Swiss Government as its donor, and from Calmeadow, the later an active foundation in the sector. PROMIFIN has developed a series of pilot programs with MFIs, workshops, and working guides.
- The Multilateral Investment Fund (MIF) of the Inter-American Development Bank in a joint effort with the Swiss Agency for Development and Cooperation (SDC) will launch by late 2014 a project to support the adoption of good governance principles and practices in MFIs, cooperatives, and credit unions in the LAC region. This technical cooperation initiative is designed to deal exclusively with the governance issues of these financial institutions.
- There has been a push by a select group of MFIs to increase governance efforts with respect to social performance above and beyond the SMART Campaign. The SMART Campaign has been widely adopted by the sector at the MFI level. It is not yet clear where this push at social responsibility is headed.

In total, this effort at improved governance in the sector remains fairly fragmented and its outreach is insufficient for the scope of the issues now facing the sector. Governance remains one of the least-addressed concerns in the sector and requires an important institutional player to fill the gap.

Governance remains one of the least-addressed concerns in the sector and requires an important institutional player to fill the gap.

B. Proposed Next Steps

The proposed governance package being prepared by the World Bank consists of this background paper on governance, an in-depth survey on governance, and governance guidelines in line with the Basel Committe's Governance Principles for Banks and CMEF Governance Consensus Guidelines. But this package needs to be integrated with the already existing initiatives of the World Bank Group (IBRD and IFC) in coordination with other industry players (CGAP and the MIX, Center for Financial Inclusion, CMEF, Calmeadow, the Boulder Institute at the ILO Training Center in Turin) as examples. This would enable the World Bank Group to extend its outreach to the industry relatively quickly and effectively.

A number of other steps could also be taken to deepen our knowledge of what is happening on the ground with MFIs and to extend the information available in this World Bank MF Governance Package:

- A series of cases should be prepared, using the survey prepared by the World Bank and based on face-to-face interviews with management and board representatives of MFIs.
- Based on the survey instrument, the MIX could undertake another more extensive and in-depth survey, totally focused on governance.
- Large microfinance networks, such as FINCA, Accion International, Opportunities International, Woman's World Banking and social networks, should be brought into this effort because of their own needs, their interest in improving governance standards in their captive networks, and their ability to reach out to a large number of MFIs.
- The World Bank Group should work closely with the four rating agencies in the sector to have the rating process do more to evaluate the standard of governance in the sector.
- This material should be packaged such that it would be easy for MFIs to adapt it to their own needs. The CGAP Microfinance Gateway would be an important vehicle for disseminating this information.
- A Directors Institute should be organized at the Boulder Institute or another training institute, such as the Bank Akadameie in Germany, to train directors and senior management with respect to good governance practices

The World Bank Governance Practice Group and the IFC Governance Group have the appropriate expertise and convening power in the industry to lead an industry effort in this area with support from CGAP and institutions such as the CMEF, the Center for Financial Inclusion at Accion, and Calmeadow. ■

Appendix: What Makes Excellent Institutions in Microfinance

The objective of good governance is to create well-managed, efficient, and sustainable MFIs that also meet their social responsibilities to their clients. Between 2003 and 2006, four MFIs had initial public offerings (IPOs) or were listed on their local stock exchange. These institutions are Banco *Compartamos* (Mexico), Bank Rakyat (Indonesia), BRAC Bank (an SME bank belonging to the BRAC Group, while its microfinance operations remain within the structure of an NGO), and Equity Bank (Kenya). Detailed information provided to the MIX, their information memorandums/prospectuses for the IPO listing, and various press offerings allowed us to analyze these institutions in some depth. In addition, each of the institutions carries an important brand or image in the sector. From our analysis and firsthand knowledge of the institutions, we produced a detailed research report on the institutions and their IPOs.[55] We also sought to answer a few critical questions.

What is it about these four institutions that has qualified them for capital market listings and IPOs? What makes these institutions excellent?

Management Excellence

Each of the institutions in question had long-serving senior management who were outstanding social entrepreneurs and managers. Their respective institutions have consistently generated profits. The exception is Bank Rakyat (BRI), which had very dedicated heads of the unit *desa* program and the bank, including former managing director of the unit *desa* system, Sugianto; former president of BRI, Kamardy Arief; and former Indonesian Minister of Finance (1968–1983), Ali Wardhana, whose leadership was concentrated in the larger banks and who was less known in the microfinance industry.[56] Also, when BRAC Bank, the subject of the IPO, was established, BRAC's senior management hired highly experienced bankers to run the bank rather than using the NGO management who were directing the microfinance operations.

Good Governance

A second condition required for an IPO is the existence of a serious board, together with well-instituted good-governance practices. For international institutional investors financing under U.S. SEC Rule 144A, that would include practices that comply closely with the U.S. Sarbanes–Oxley Act guidelines respecting such matters as independent and qualified audit committees and MIS and accounting systems that provide high standards of internal controls. They will also look to the independence and qualifications of directors. The four institutions examined all made a serious effort to recruit serious boards of directors and to implement good-governance practices. Becoming regulated financial institutions has certainly been an important factor in these institutions' improving their governance and going public.

Ownership Incentives

In two of the institutions that listed—Equity Bank and *Compartamos*—management and director ownership has become an important issue. It stands to reason that long-serving management and directors should have incentives tied closely to the long-range success of their institution. The fact that these individuals have been rewarded for their success is a good signal to the industry in general and should also enable the industry to attract first-class talent as the very critical issue of management succession is addressed in a number of MFIs.[57] In both of these cases, management acquired their shares through investment. However, as public entities they will be able to use incentives, such as options or stock grants, as incentives for ex-

[55] Ira W. Lieberman, Anne Anderson, Zach Graffe, Bruce Campbell and Daniel Kopf, "Microfinance and Capital Markets: The Initial Listing/Public Offering of Four Leading Institutions" Council of Microfinance Equity Funds, May 2008.

[56] Ali Wardhana became Coordinating Minister of Economics, Finance and Industry and continues to serve as an economic advisor to the government. Although he remained in the background, Wardhana has been a vital supporter to the unit *desa* system. See also Marguerite Robinson, *The Microfinance Revolution Volume 2* (Washington DC: International Bank for Reconstruction and Development/The World Bank, 2001), xxxi.

[57] The management and directors of *Compartamos* were severely criticized by some factions in the MF industry for generating a substantial personal profit on their investment in shares of the company. *Compartamos* was also seen as charging excessive interest rates. Having known the management for many years, author Ira Liberman felt that the criticisms were misplaced.

isting management and employees and, as appropriate, to attract new management into the company.

Many MFIs have operated with the same senior management team over the past 15–20 years or more, from the early emergence of microfinance in the developing world. Incentive compensation could play an important role in an orderly succession both out of and into these institutions. That is the normal case in for-profit institutions, both financial and industrial. BRI, with majority ownership by the Indonesian government, could presumably not offer such incentives. In the case of BRAC Bank, the very small ownership stake of the senior management in the SME Bank speaks highly of their individual commitments to the Bangladeshi poor.

Despite these two examples, incentives have an important role to play as MFIs structure themselves on commercial terms and become shareholder-owned institutions. We would expect to see stock options as an important form of incentive compensation for management recruitment, as well as employee stock plans, as more MFIs go public in the future.

Scale

Each of these institutions has achieved massive scale within its respective market, translating into a strong capital base and profits. As banks by any international measure, the four are quite small, but within their markets BRI and Equity Bank are important. BRAC has also reached substantial scale, especially if we look at the combined microfinance and SME operations (the latter within BRAC Bank). *Compartamos* is a niche bank in Mexico, but it is among the largest MFIs in the country and in Latin America. The profitability, return on assets, return on equity, and low loan-loss ratios of these institutions rank them among the best-performing banks and financial institutions in their respective markets. Clearly, these four institutions are among the best of the MFIs. As such, they were able to list and issue their shares to both domestic and international investors.

Brand Image and Market Recognition

When an investment advisor looks towards taking these institutions public, a convincing story can be told. Simply, the four institutions have performed exceptionally well, and they benchmark well within the industry and within their respective financial sectors. In marketing terms, they carry a very strong brand image that is recognized favorably by the investing public in their countries and increasingly by knowledgeable investors in international markets.

Quality of Products and Services[58]

It seems clear that each of the institutions has figured out what it takes to meet and anticipate client needs. Microfinance institutions operating within a bank are better able to offer their clients a full range of products and services, including a diversity of savings products, insurance, money transfers, remittances, e-banking, and mobile banking as circumstances warrant. To date, the four institutions have not expanded to offer a full suite of financial products and services. However, BRI does offer a range of savings products, and Equity Bank offers products for both savings and loans. Equity Bank has also been an innovator in financing private education in Kenya. *Compartamos* serves as an agent for insurance products.

Moreover, as these banks add small-business finance on a sound basis, they are able to improve their economics— for example, through larger average size of loans and deposits— without abandoning their social mission. For the moment, BRAC has chosen to keep the microfinance and SME operations separate. *Compartamos* is strictly a microfinance bank and has yet to mobilize savings in a meaningful way. However, BRI and Equity Bank combine these offerings.

In contrast to these four institutions, the ProCredit Banks, a holding of some twenty Greenfield Micro and Small Business banks around the world have been very successful in difficult markets, keeping their microfinance and small-business lending at the core of their financial services and then adding a full array of financial services as client demand requires.[59]

The quality of services and products is reflected not only in high profits, low loan-loss ratios, and low portfolio at risk (Equity Bank was something of an outlier with respect to portfolio at risk when it listed). In the cases of BRI and

[58] For an interesting discussion of this issue see Elisabeth Rhyne and María Otero, "Microfinance Through the Next Decade," Accion International, November 2006, 14 (See "Quality Gap") and 21–28 (See "Who Will Deliver Microfinance").

[59] Ira W. Lieberman, "Appraisal of ProCredit Bank Serbia, Microfinance Program for the Bor Region, World Bank Bor Regional Development Project," June 6, 2007 (mimeo).

Equity Bank, their ability to develop savings products and mobilize savings efficiently also provides a reliable and acceptable cost of funds to these institutions. BRAC Bank, Equity Bank, and ProCredit Banks have seen the advantage of serving the "missing middle"—small business in addition to micro-entrepreneurs—but BRAC does this by separating the two sets of target clients between its NGO, offering microfinance, and its bank, offering financing to small and medium-sized enterprises, while the other two offer a range of financial services through their commercial banks. Again, these actions serve to add to the quality and branding of each bank.

Technology and Infrastructure

Each of the four institutions discussed have had to build an extensive infrastructure of branches or service offices to reach their clients. For example, in its prospectus, Equity Bank discusses moving from 31 branches in 2005 to 61 branches by 2009. Since its founding in 2001, BRAC Bank (SME bank) has grown to 18 branches and 313 regional marketing/field offices. BRI has an extensive village network that exceeded 3,900 unit *desas* at its peak, and *Compartamos* faced the task of converting a very extensive service-office network to full bank branches, especially if they were going to intermediate savings (which, to date, they have moved very slowly to do). Along with this growth, however, comes a need to continuously invest in technology, such as ATMs, credit and debit cards, and MIS systems. BRI and Equity Bank have discussed the extensive investments required in MIS systems, the former as a use of proceeds and the latter before listing. It seems clear that MFIs that want to scale and diversify their products need to be up-to-date technologically and demonstrate their ability to compete in the banking sector with the latest in technological products and systems.

The Social Bottom Line

Microfinance has received a great deal of positive publicity in the past few years. There seems to be an important market segment of individual investors and organizations that will invest a portion of their funds in institutions that support a double bottom line. Initially, debt funds that could guarantee their investors a minimum social return were uniquely placed to tap into this market segment. We have seen this in the development of microfinance funds such as Blue Orchard, the respons Ability Fund, Deutsche Bank's Microfinance Fund, and the Calvert Foundation, which all make loans to and invest in MFIs. Sound MFIs with the qualifications to go public are perfectly placed to tap into this positive market sentiment and growing segment of investors keen to invest in socially responsible institutions.

Outside Strategic Investors

With the exception of BRI, these institutions had participating, internationally recognized external investors take equity stakes prior to the IPO. In addition to the capital they provided, strategic investors brought an important measure of confidence to the market prior to the IPO/listing. In addition, each of these institutions, with the possible exception of BRAC, has received significant technical assistance from the donor community and microfinance experts in order to ensure that their product lines, lending methodologies, credit management systems, MIS, management structures, and governance processes, among other areas, meet or exceed industry standards.

Benchmarking

Each of these institutions is being benchmarked or measured in terms of performance against regulated financial institutions. They are all supervised by the banking regulation and supervisory authority in their respective countries and are increasingly being rated by international rating agencies such as Fitch and Moody.[62] Also, market research on these institutions from investment banks and brokerage firms will rate them against banks rather than other microfinance institutions.

Accounting and Management Information Systems

Each of the institutions was audited by internationally recognized accountants. Without adequate investment in software, accounting systems, and MIS, it is difficult to prepare the years of audited financial statements, disclose financial information, and reconcile the documents with U.S. GAAP or international accounting standards. Each of the institutions that listed and/or went through the IPO, was able to meet disclosure requirements. ■

Annex II: Consolidated Survey for Regulated Microfinance Institutions and NBIF

Name of Institution	
Address of Institution	
Contact Person	
Office Phone Number	
Cell Phone Number	
Email	
Institution website	

WORLD BANK GROUP

A. Institution

A.1. What is the legal status of the institution? (Please tick one answer)

- NGO ☐
- NBFII ☐
- Commercial MFI ☐
- Cooperatives ☐
- Credit Unions ☐
- Other: _____ ☐

A.2. Are you primarily an urban or a rural institution? (Please tick)

- Rural ☐
- Urban ☐

A.3. Is your institution is supervised by the banking supervisory agency? If not, please specify by whom or none (please tick one answer)

- Regulator for the Banking Sector ☐
- Social Ministry and Government Agency ☐
- Other (please specify : _____) ☐

A.4. What information do you report to MIX? (Please tick one answer)

- No information ☐
- Financial Information ☐
- Social Performance Information ☐
- Financial and Social Performance Information ☐

A.5. Please indicate the primary (holding 10% or more) shareholders of the institution (please tick all that apply and give names)

Primary Shareholders	Name
☐ Investment Funds	_____
☐ DFIs (IFC, KfW, FMO, etc.)	_____
☐ Original NGO (as a result of NGO transformation)	_____
☐ International non-fund private shareholders	_____
☐ Domestic non-fund private shareholders	_____
☐ Network Holding such as Accion, Finca, Grameen, Opportunities, Brac	_____
☐ Government	_____
☐ Other (please specify: _____)	_____

A.6. Please specify the institutions

Number of Clients as of latest fiscal year (for example fiscal year December 31, XXX) _____

Portfolio size (amount in millions of USD $) as of latest fiscal year (for example fiscal year ending December 31, XXX) _____

Percentage (%) women clients _____

Number of deposit accounts as of latest fiscal year (for example fiscal year December 31, XXX) _____

Total deposit holdings (US$mn) _____

Number of branches _____

Product lines (please tick all that apply) Credit and Saving Methodology (Group Lending)

Product lines (please tick all that apply) and revenue percentage

- Individual Loans ☐
- Village Banking ☐
- Deposit-taking as collateral ☐
- Deposit-taking as product ☐
- Educational Loans ☐
- Life Insurance ☐
- Health Insurance ☐
- Other Insurance (please specify) _____ ☐
- Remittances ☐
- House Rehabilitation ☐
- Agricultural Loans ☐
- Other (please specify) _____ ☐

B. Board

B.1. Where can details on board structure and composition be found? Board composition and Board voting requirements (majorities, super majorities)

☐ By-Laws

☐ Shareholders Agreements

☐ Other (please specify) _____

B.2. Please provide the (other please specify)

B.3. Number of Board members _____

B.4. Number of non-resident Board members _____

B.5. Titles of the management team who are on the Board

☐ CEO _____

☐ CFO _____

☐ Other (please specify) _____

B.6. Number of Board members who represent individual investors _____

B.7. Number of independent, representing neither management nor investors, Board members _____

B.8. Who nominates and appoints Board members? (Please tick all that apply)

Chairman ☐

CEO ☐

Board as a whole ☐

Majority Shareholder ☐

Shareholders through shareholder meeting ☐

Governance or Nominating Committee ☐

Other (please specify) _____ ☐

B.9. Identify Board member expertise:

In your opinion, what main criteria do shareholders use when they elect members of the board? (Please tick all that apply)

- Work experience in the financial sector ☐
- Work experience in the institution ☐
- Special knowledge ☐
- Loyalty to major shareholders ☐
- Useful contacts ☐
- Availability to fulfill Board member duties ☐
- Reputation ☐
- Community Involvement ☐
- Other (please specify)_____ ☐

B.10. Is the position of chairman of the board and chief executive officer combined in one person?

- Yes ☐
- No ☐

If NO, is the Board Chair an Executive Chair
(does he or she work as a full-time, salaried executive for your institution?)

- Yes ☐
- No ☐

B.11. Which committees does the institution have?

- Executive ☐
- Audit (please specify number of executive directors: _____
- and number of non-executive directors:) _____
- Compensation ☐
- Risk Management ☐
- Credit ☐
- Corporate Governance and Nominating ☐
- Social Performance ☐
- Other (please specify)_____ ☐

B.12. Indicate the number of board members who have formal qualifications in

- Banking _____
- Finance and Accounting _____
- Law _____
- Risk and Control _____

B.13. Indicate the number of board members who have professional experience in

Public Service _____

Finance Sector _____

Marketing _____

Consulting _____

Finance and Accounting _____

Law _____

Risk, Audit and/or Control _____

Social Sector _____

IT _____

Academia _____

Microfinance _____

Other (please specify)_____ _____

B.14. Has your institution formalized board self-evaluation processes?

Yes ☐

No ☐

B.15. On average

How many times does the board meet per year? _____

B.16. On average

What is the percentage of board members that usually attend a board meeting? _____

B.17. Does the Board meet by teleconference?

Yes ☐

No ☐

B.18. If YES: How frequently? _____

B.19. Do committees have their written charters?

Yes ☐

No ☐

B.20. How often do committees meet in person (on average)? _____

B.21. How often do committees meet by teleconference (on average)? _____

B.22. What is the length of board member term?

Please indicate the number of years _____

B.23. How are decisions made by the Board?

- By the Board Chair ☐
- By the CEO ☐
- Through Board consensus (after which there is a formal vote) ☐
- By formal vote ☐
- By Executive Committee ☐

B.24. Does the institution have a formalized strategic plan?

- Yes ☐
- No ☐

B.25. Is Board approval required for the formalized strategic plan?

- Yes ☐
- No ☐

B.26. How does the board measure performance of the institution?

- Financial performance compared to budget ☐
- Performance compared to strategic plan ☐
- Social impact ☐
- Return on equity ☐
- Return on assets ☐
- PAR30 ☐
- Loan Loss Ratio ☐
- Profitability of each line of business ☐
- Profitability by branch ☐
- Growth of revenues ☐
- Growth of assets ☐
- Expense control ☐
- Growth of clients ☐
- Other ☐

B.27. What are the key policy issues and other matters that require Board involvement/approval

- Borrowing ☐
- Equity investment ☐
- Hiring management ☐
- Succession ☐

Adoption of a new Strategy?	Yes	No
Adoption of annual goals and objectives?	☐	☐
If yes, are these documented?	☐	☐
Succession of the CEO	☐	☐
Is there a formal succession plan?	☐	☐
Raising debt and/or equity?		
Approval of consulting and other contracts above a certain amount?	☐	☐
Branch expansion?	☐	☐
Other expansion plans	☐	☐
Transformation from an NGO to a licensed/regulated non-institution financial institution or microfinance institution?		
Product Diversification?	☐	☐
Hiring/firing of senior executives?	☐	☐
On a decision to restructure/re-organize the MFI?	☐	☐
Dividend Policy	☐	☐

B28. Please indicate which risk related policies your institution has formalized: (Please tick all that apply):

- Credit Policies ☐
- Asset/Liability Management Policies ☐
- Trading Policies ☐
- Market Risk ☐
- Interest Rate Risk (Profit Rate Risk) ☐
- Liquidity Management Policies ☐
- Accounting and Financial Control Policy ☐
- Business Continuity ☐
- IT Risk Policies and Contingency Planning ☐
- Compliance Policies ☐
- Anti Money-Laundering Policies ☐
- Disclosure Policies ☐
- Related Party Policy ☐
- Client Protection principles (SMART Campaign principles or other) ☐
- Other (please specify) _____ ☐

B29. How frequently are the risk policies above reviewed and updated?

Once a year ☐

Once every two years ☐

Other (please specify)_____ ☐

B30. Who in your institution is responsible for the following activities?

Operational and financial soundness of the institution

Board ☐

CEO ☐

Other (please specify) _____ ☐

Defining the institution's strategy

Board ☐

CEO ☐

Other (please specify) _____ ☐

Evaluating the success of business strategies

Board ☐

CEO ☐

Other (please specify) _____ ☐

Evaluating institution performance

Board ☐

CEO ☐

Other (please specify) _____ ☐

Managerial oversight

Board ☐

CEO ☐

Other (please specify) _____ ☐

Hiring and firing the CEO ☐

Board

CEO ☐

Other (please specify) _____ ☐

Hiring and firing senior management

Board ☐

CEO ☐

Other (please specify) _____ ☐

Establishing and reviewing, on a periodic basis, the institutions' policies for qualitative and quantitative thresholds for credit transactions

Board ☐

CEO ☐

Other (please specify) _____ ☐

Monitoring the institution's operations for compliance

Board ☐

CEO ☐

Other (please specify) _____ ☐

Evaluating risk profile

Board ☐

CEO ☐

Other (please specify) _____ ☐

Evaluating return on risk

Board ☐

CEO ☐

Other (please specify) _____ ☐

Evaluating return on capital

Board ☐

CEO ☐

Other (please specify) _____ ☐

B.31. Does the board review and approve compensation policies and incentive structures related to management, loan officers, and overall staff of the institution?

Yes ☐

No ☐

B.32. Do the CEO and top executives have a formal contract?

Yes ☐

No ☐

B.33. Do managers of the institution have shares and/or share incentives in the institution? If yes, how much of the institution do they own? (Please tick one answer and give percentage ownership)

Yes (please give percentage _____ %) ☐

No ☐

Do Board members of the institution have shares and/or share incentives in the institution? If yes, what % of the institution do they own?

Yes (please give percentage _____ %) ☐

No ☐

Do employees (non-management) of the institution own shares and/or share incentives in the institution? If yes, what % of the institution do they own?

Yes (please give percentage _____ %) ☐

No ☐

B.34. Does senior management, including the CEO, have formal job descriptions that outline their main roles, responsibilities, and reporting lines?

Yes ☐

No ☐

B.35. Do the CEO and other senior managers have performance benchmarks they are required to meet that are tied to compensation?

Yes ☐

No ☐

B.36. Does Board approve CEO compensation?

Yes ☐

No ☐

B.37. What is the proportion of the CEO's income from the following sources (please indicate percentage)

Fixed Salary (_____ %)

Bonus (_____ %)

Stock Options (_____ %)

Indirect, non-monetary form of remuneration (eg. company car, expense account) (_____ %)

Other (please specify percentage) _____ (_____ %)

B.38. Does the board get compensated?

Yes ☐

No ☐

B.39. If yes, how?

Annual ☐

Per Meeting ☐

Both ☐

Reporting and Information

B.40. In general, how far in advance are board members notified for meetings?

- At least 2 weeks before ☐
- 2-3 weeks before ☐
- All meetings dates for a year are provided at the beginning of the year ☐
- Other (please specify) _____ ☐

B.41. How far in advance do board members receive board information materials for board meetings?

- 1 week ☐
- 2 weeks ☐
- Other (please specify) _____ ☐

B.42. Does the board package contain the following?

- Financial information such as balance and income statement ☐
- Updates on performance against budget ☐
- Updates on performance against the strategic plan ☐
- Key operating and performance statistics ☐
- Results and issues from the internal audit review ☐
- Results and issues from the compliance review ☐
- Information regarding composition, size and quality of banking exposures ☐
- Material exceptions to policy, procedure, and limits ☐
- Performance by product ☐
- Information on risk exposure ☐
- Other _____ ☐
- Board agenda ☐
- Minutes of prior meeting for approval ☐
- Information on each of the policy issues to be addressed during the meeting ☐
- Information on the MFI's activities and performance ☐
- Other (please specify) _____ ☐

Related Party Transactions

B.43. Does the institution have a formalized policy on related party transactions and conflict of interest?

Yes ☐

No ☐

B.44. Does the institution allow related party transactions?

Yes ☐

No ☐

B.45. Is it prohibited for Board Members to borrow from the MFI?

Yes ☐

No ☐

B.46. Is it prohibited for Board members to do consulting, accounting or legal services for a fee for the MFI?

Yes ☐

No ☐

B.47. Is there a conflict committee to review potential business conflicts between Board members?

Yes ☐

No ☐

B.48. Does the institution have identification, monitoring, and compliance systems specifically dedicated to related party transactions?

Yes ☐

No ☐

B.49. Are board members who have a conflict of interest required to abstain from voting on the relevant issue during the board meeting?

Yes ☐

No ☐

C. Internal Review and Risk Monitoring Functions

C.1. Which internal review functions exist in the institution?

- Internal Audit ☐
- Compliance Officer or Department ☐
- Risk Management ☐
- Internal Control ☐
- Other (please specify) _____ ☐

C.2. To whom is each of the above internal review functions report to?

- Board ☐
- Chairman ☐
- Audit Committee ☐
- Other Committee (please specify) _____ ☐
- CEO ☐
- Senior Management ☐
- Other (please specify) _____ ☐

C.3. If a separate risk management function exists, to whom it report?

- Board ☐
- Chairman ☐
- Audit Committee ☐
- Other Committee (please specify) _____ ☐
- CEO
- Senior Management ☐
- Other (please specify) _____ ☐

C.4. Who is responsible for taking actions based on the findings of each of the review functions?

- Board ☐
- Chairman ☐
- Audit Committee ☐
- Other Committee (please specify) _____ ☐
- CEO ☐
- Senior Management ☐
- Other (please specify) _____ ☐

C.5. By whom is the performance of each of the heads of the review functions evaluated?

- Board ☐
- Chairman ☐
- Audit Committee ☐
- Other Committee (please specify) _____ ☐
- CEO ☐
- Senior Management ☐
- Other (please specify) _____ ☐

C.6. What is the scope of risk addressed by the risk management function?

- Credit ☐
- Liquidity ☐
- Interest Rate ☐
- Exchange Rate ☐
- Market ☐
- Operational ☐
- Other (please specify) _____ ☐

C.7. Does a separate credit risk function exist?

- Yes ☐
- No ☐

C.8. Does the institution employ an internal credit risk rating system?

- Yes ☐
- No ☐

C.9. Is an overall credit portfolio analysis periodically performed?

- Yes ☐
- No ☐

C.10. Who manages the day-to-day liquidity function of the institution?

- CEO ☐
- CFO ☐
- Treasury department ☐
- Other (please specify) ☐

C.11. Is liquidity risk management guided by institution policy, procedures and limits?

- Yes ☐
- No ☐

C.12. Is there a written document on management's responsibilities for liquidity management?

- Yes ☐
- No ☐

C.13. What are the functions of the Internal Audit department?

- Verification of internal control ☐
- Compliance with laws and regulations ☐
- Compliance with the institution's policies and regulations ☐
- Verification of internal accounting records ☐
- Verification of financial information and MIS provided to Board ☐
- Identify, review and assess conflicts of interest ☐
- Ensure asset protection ☐
- Verify segregation of duties ☐
- Evaluate related party transactions ☐
- Review limit monitoring, position and reporting process ☐
- Review new products ☐
- Other (please specify) _____ ☐

C.14. Does internal audit review the risk management and compliance functions?

- Yes ☐
- No ☐

D. External Audit

D1. Does the institution have an external audit?

- Yes ☐
- No ☐

D2. Who is responsible for approving the external auditor?

- Board ☐
- Audit Committee ☐
- CEO ☐
- CFO ☐
- Other (please specify) _____ ☐

D3. Who is responsible for reacting to the external auditor recommendations for action?

- Board ☐
- Audit Committee ☐
- CEO ☐
- CFO ☐
- Other (please specify) _____ ☐

D4. Who is required to approve the institution's financial statements?

- Board ☐
- Chairman ☐
- Senior Management ☐
- CEO ☐
- CFO ☐
- No formal approval required ☐
- Other (please specify) _____ ☐

D5. Does the external auditor provide non-audit services?

	Yes	No
Board	☐	☐
Chairman	☐	☐

E. Commitment to CG

E1. What measures have been taken in your institution to improve corporate governance (past 3 years)? (Please tick all that apply)

- Establishment of Board ☐
- Establishment of Board committees ☐
- Changes to Board memberships ☐
- Formalization of functions and responsibilities or Board and senior management ☐
- Improvements to MIS package ☐
- Other (please specify) _____ ☐

E2. Why were these measures taken? (Please tick all that apply)

- Legal or regulatory requirements ☐
- Change of legal status ☐
- Change of ownership or shareholder base ☐
- Need to attract external investments ☐
- Need to improve efficiency of internal operations ☐
- Need to improve coordination between stakeholders ☐
- Other (please specify) _____ ☐

E3. What hampers the development of Corporate Governance in the institution today? (Please tick all that apply)

- Lack of experience and knowledge ☐
- Insufficient motivation ☐
- Lack of support from shareholders ☐
- Lack of support from Board ☐
- Lack of accountability by management ☐
- Over-exertion of control by managers ☐
- Conflicts of interests ☐
- Internal resistance ☐
- Other (please specify) _____ ☐

E4. Which goals should Corporate Governance in the institution achieve?
(Please tick all that apply)

To enhance public image

To improve strategic decision-making

To attract external investments

To improve efficiency of internal operations

To improve efficiency of coordination between shareholders, Board and senior management

To improve capitalization ☐

To contribute to overall risk management practices ☐

To improve the internal control system ☐

To comply with laws and regulations ☐

Other (please specify) _____ ☐

The objective of good governance is to create well-managed, efficient, and sustainable MFIs that also meet their social responsibilities to their clients.

WORLD BANK GROUP

The World Bank
1818 H Street, N.W.
Washington, DC 20433, USA