GUIDE FOR THE ADOPTION OF GOOD GOVERNANCE PRINCIPLES IN MICROFINANCE INSTITUTIONS

FUNDACIÓN MICROFINANZAS BBVA

GUIDE FOR THE ADOPTION OF GOOD GOVERNANCE PRINCIPLES IN MICROFINANCE INSTITUTIONS

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PRESENTATION

The BBVA Microfinance Foundation contributes to sustainable economic and social development of disadvantaged people in society through productive microfinance. The Foundation works to strengthen the microfinance sector in order to extend financial products and services to more people, under better conditions. With this in mind, the Foundation has several lines of work underway, including strengthening corporate governance in the microfinance sector.

The lack of good corporate governance is one of the main challenges facing the sector in Latin America and the Caribbean. Corporate governance is related to an institution's internal operating and control procedures. It plays a key role in creating transparency and trust for investors and in attracting capital. Good corporate governance contributes to efficient management and to considering stakeholder interests, boosting the microfinance institution's reputation and integrity and fostering customer trust.

The BBVA Microfinance Foundation has written two reference corporate governance documents for the microfinance sector, which are available for any microfinance institution interested in applying them:

- The **"Universal Code of Corporate Governance for Microfinance Institutions"** contains a series of good practices, standards and principles that, in accordance with generally-accepted accepted international standards and good practices, the BBVA Microfinance Foundation considers suitable for the good governance of any microfinance institution and for the proper governance of each institution, regardless of its legal structure (regulated or non-regulated financial institution, NGO, cooperative, etc.).
- And the **"Guide to adopting good governance principles in microfinance institutions"**, which is included in this publication and supplements the Universal Code. This Guide was written by the Foundation in conjunction with the BID/FOMIN and covers the essentials that microfinance institutions must consider when preparing a corporate governance code and implementing it in their Boards of Directors.

Experts in corporate governance in the microfinance sector were consulted while writing this guide. The BBVA Microfinance Foundation would like to thank the following for their contribution to the project: Reyes Calderón, Dean of the Faculty of Business Studies at Universidad de Navarra, Marian Ortega, Training Manager at Fundación Lealtad, Augusto Acosta, Former Superintendent of Finance of Colombia, Rudy Araujo, General Secretary for the Asociación de Supervisores Bancarios de las Américas, Alex Silva, Chairman and Founder of OMTRIX and Xavier Martín, expert microfinance consultant.

INTRODUCTION

The purpose of this paper is to explain good corporate governance principles and how they are put into practice in the microfinance sector. The paper is targeted at members of governing bodies in microfinance institutions (MFI) interested in improving their institution's corporate governance practices. Based on examples and real situations in the microfinance sector, this practical tool will encourage MFIs to become more aware of the importance of implementing specific policies and programs to improve corporate governance practices.

The lack of suitable corporate governance policies is one of the main obstacles for the sector's growth. Microfinance Banana Skins 2008, a benchmark publication to measure opinions and risks affecting the growth and viability of MFIs, ranked the lack of corporate governance policies as the second major risk for MFIs[1]. To solve this, MFI directors need to be aware of the challenge and adopt measures to implement specific initiatives aimed at improving their institution’s corporate governance policy. The OECD’s Corporate Governance Policies provide a framework that can be applied everywhere to any kind or organization. This is a good starting point for Directors interested in introducing improvements to their MFI’s governance system[2]. The OECD’s principles do not, however, give specific recommendations adapted to the situation in MFIs. Therefore, special principles need to be developed for the sector.

Based on past work in the field of disseminating corporate governance policies and good practices in the microfinance sector, this paper sets out the main guidelines to adopt good governance principles in MFIs. The paper highlights the mechanisms available to MFIs to implement a good corporate governance system and describes practical cases in order to help MFI directors to achieve their strategic goals and fulfill their job successfully. The paper is divided into three sections. The first section gives a short introduction to the concept of corporate governance and highlights the dual nature of an MFI’s social and financial goals. The second section describes MFI governing bodies (Assembly, Board of Directors and Management) and their main duties. The third section explains the mechanisms that must be considered to create and maintain an efficient Board of Directors committed to the institution’s good governance.

There are also three appendices to reinforce the concepts described throughout the paper. Appendix A includes a self-analysis tool to help MFIs to become aware of how governance systems work in their institutions. Appendix B contains the Code of Conduct and Ethics that Bancamía recently adopted in Colombia which can be used as an example for other MFIs interested in adopting their own code. Appendix C gives a useful resources guide for Directors who want to expand their knowledge in this field.

1 CSFI, (2008) “Microfinance Banana Skins 2008”.

2 OECD, (2004) “OECD Principles of Corporate Governance”.

The concept of corporate governance through the lenses of economic theory

In most microfinance institutions, like in many other organizations, there is a clear distinction between owners and managers. This distinction between ownership and management is useful because it allows investors and contributors to join and leave without necessarily affecting the MFI's activity. This separation of duties allows contributors or investors interested in extending access to financial services to disadvantaged people to hire Directors with the necessary professional skills to take on the MFI's management.

Although this separation of ownership and management duties is useful, it can also cause problems when the owners' interests are not aligned with the directors' interests. This problem is analyzed in economic theory and the theory of organizations and is known as the agency problem. It analyzes formal and informal contracts through which one (or more people) called "the principal" hires another person called "the agent" to defend their interests, delegating that person a certain amount of decision-making power. The problem arises when managers act in their own interests, losing sight of the objectives agreed with the shareholders or contributors. This problem is worse the more exaggerated the information asymmetry. In the general finance system, and in the microfinance sector in particular, information asymmetry problems are bigger than in other sectors, which is why good corporate governance rules are of special importance for MFIs.

Information asymmetry occurs when one of the parties in a relationship or contract has incomplete information compared to the other party. Due to the very nature of microfinance activity, there may be situations in which the interests of an MFI's stakeholders –contributors, investors, customers, employees, government– vary among them. For instance, managers may want to increase the MFI's profitability by investing in high-risk projects and/or projects that do not seek the corporate goal pursued by the institution's owners. This could result in excessive risks and/or distancing from the MFI's corporate purpose. There are many situations of conflicting interests among an organization's stakeholders.

Economic literature uses the concept of moral risk to refer to this situation, in which a financial institution decides to assume a bigger risk to increase profitability at the expense of placing the contributors' and owners' money at risk. If the proper incentives are not offered, an IMF might take excessive risks and jeopardize not just the institution but also the microfinance sector's prestige. This could limit the role of this type of institution in expanding access to financial services to disadvantaged people. In order to bring the incentives of each party into line, minimum regulations to control the sector are required. MFIs also need to be self-regulated by implementing good corporate governance programs.

From a theoretical point of view, the analysis of best corporate governance practices has been traditionally centered around analyzing the contractual relationship between donors and the institution's managers. The idea underlying this approach is that through different governance mechanisms management can be better supervised and controlled, reducing agency costs and increasing the institution's value. Therefore, the challenge involved in establishing a good corporate governance policy is related to aspects such as the influence the owners have over the management and the Board of Directors' role in supervising the institution.

An important aspect when defining a corporate governance structure is that it must be efficient. A good corporate governance structure is efficient if it generates maximum reward for all of the parties involved, including shareholders, creditors, employees, customers, authorities and other third parties affected by the institution's activities. The structure must also be Pareto efficient, in other words, there is better structure that improves a group without harming another.

A good corporate governance policy therefore requires a structure of incentives and controls to bring the organization's interests into line with the managers' interests, thereby reducing agency costs incurred in the distinction between ownership and management and consequently improving the organization's performance. In many MFIs in which the owners often lack the economic incentive to control their investments, the Board of Directors plays the key role in guaranteeing that the institution's mission and goals are fulfilled.

So in case an MFI wants to be succesful in the implementation of a good corporate governance program, it will need a strong and independent Board of Directors to lead the process. The Board of Directors must develop policies that reinforce transparency, supervision, assignment of responsibilities and adaptation to change. The Board of Directors is the key player in an institution's governance structure because it is responsible for strategic management, control and monitoring regarding the institution's achievement of its objectives. Any corporate governance improvement policy depends on how the Board of Directors fulfils its duties.

Good corporate governance boosts investors' and general society's confidence in the institution. There is an increasing number of corporate governance regulations and more legislation in this field. It is important that MFIs adopt good governance principles and develop codes in this area in order to step up their role in improving access to financial services to people who have been traditionally excluded from the banking sector, and, more importantly, this access must be sustainable.

Definition of corporate governance

Corporate governance in the broadest sense refers to principles and rules regulating an organization's operations to ensure that it achieves it goals. It is therefore intrinsically linked to an organization's management and control system. Good governance means that an organization has a system of processes and rules that guarantee fulfillment of its mission and the efficient use of resources.

In the case of MFIs, corporate governance is closely related to how the governing body (Board of Directors) and the management body (Management) manage the institution, in particular how:

- The strategy and goals are set.
- Risk tolerance is determined.
- Everyday activities are managed.
- Investors' interests are protected.
- Obligations with shareholders or contributors are fulfilled.
- Stakeholders' interests are defended.
- Compliance with corporate goals is guaranteed.
- Conduct and activities are aligned so that the institution operates with solvency and integrity, in fulfillment of laws and regulations in force.

A good corporate governance policy plays an essential part in generating transparency and keeping up society's confidence in the institution. Poor corporate governance practice can lead to an MFI's downfall, with costs and consequences that do not only affect the institution. The lack of a good corporate governance policy may also result in the market's loss of confidence in the institution's ability to manage its assets and liabilities properly, including the money deposited by many small investors. This could in turn cause a cash flow crisis or even the institution's disappearance, like the case of Corposol. This Colombian institution lacked many of the controls and balances of power that any MFI governing body should have[3].

Table 1 - Why is good governance important?

Good governance is important because it can help an institution to:

- Fulfill its mission.
- Transmit a positive image to society.
- Foster efficient decision-making processes.
- Boost confidence to attract and hold on to customers and investors.

3 Steege, Jean (1998) "The Rise and Fall of Corposol: Lessons Learned from the Challenges of Managing Growth", USAID Microenterprise Best Practice Series, 128 pp.

Fortunately, in the field of microfinance success stories are more frequent than failures. It is important to remember, though, that may MFIs have been forced to stop their activities, in many cases leaving thousands of customers in major difficulties. Often these situations are mainly related to poor corporate governance. Unfortunately, the case of Corposol is not unique. These days many institutions are facing problems due to the absence of good corporate governance policies. It is worth noting that a recent study[4] revealed that the corporate governance structure has been a decisive factor in the survival of Latin American MFIs in the recent economic crisis. Based on this evidence, the authors have identified an MFI's main corporate governance flaws (table 2).

Table 2 – Main corporate governance flaws

1. Detrimental concentration of responsibilities in one person (Board of Directors Member and General Manager).

    - If too many responsibilities are assigned to one person in the institution, that person is usually unable to detect problems and to react early enough to solve them.

2. Flaws in Board of Directors:

    - In several of the cases analyzed, the Board of Directors' work was almost non-existent and in some cases the members were manipulated by the institution's leader and did not have the necessary information to be able to act wisely.
    - The authors suggest that, just like minimum training and suitability requirements are required in financial institutions to hold the position of Board member, the same requirements should be established in an MFI.
    - They also suggest that the Board must be independent from the Management.

3. Lack of control bodies:

    - The authors note that in institutions in which there were cases of fraud involving directors, this fraud was made easier by a lack of independent control structures.
    - It was noticed that in the institutions that engaged in fraud, the Internal Auditor did not report directly to the Board, he reported to the General Manager, making it easier for him to manipulate information.

4 Marulanda, Fajury, Paredes and Gómez (2010) "Lo bueno de lo malo en Microfinanzas: Lecciones aprendidas de experiencias fallidas en América Latina"

The MFI's twofold mission

Since the microfinance sector came into creation, it has had a twofold mission. First, MFIs seek to improve the lives of low-income people by providing financial services and second, they are responsible for managing their resources in the best way possible to ensure financial sustainability. This dual nature of social and financial goals is ever present in an MFI's daily operations and is evident in its vision, mission and goals. The members of any MFI's governing bodies must have the right experience and knowledge to guide the institution towards achieving this twofold mission.

One of the most important challenges that any MFI must face when designing its corporate governance policy is how to strike this balance between social and financial goals. Just as it is important to measure financial performance indicators, the same amount of effort must be put into measuring the fulfillment of social goals. Until recently, the measurement of social impact had not carried much importance. These days more initiatives are being developed to evaluate the success of institutions in turning their social mission into evident and measurable results (see Table 3). Setting up systems and processes that allow the fulfillment of social goals to be monitored and evaluated is the first important step towards implementing good corporate governance practices.

Table 3.- The SPTF and its role in fostering measurement of social impact

The Social Performance Task Force (SPTF) was set up in 2005 to discuss and define the concept of social performance in the microfinance sector. More than 650 leaders from all around the world, including contributors, investors, networks, rating agencies, academics and other partners, have agreed on a set of principles and indicators to measure and manage social performance.

The indicators were distributed in February 2009 to the more than 1,300 MFIs that periodically report to the Microfinance Information Exchange (MIX). The final indicators were established on the basis of the work in this initial stage and the feedback received from MFIs. These included measurement of impact on customers, on service costs and the degree of the institution's alignment with its mission. Out of the 22 groups of indicators there is one that measures aspects related to good governance in MFIs. This group of indicators evaluates the Board of Directors' responsibilities and duties, the structure of members and their experience, and the institution's commitment to social performance.

Since early 2009, when the MIX started to collect information on social performance, more than 200 MFIs have sent information on the results of these indicators. Measuring social impact and publishing the results in a transparent way is the first important step for any MFI that wants to improve its corporate governance practices.

Source: SPTF, www.sptf.info. The MIX, www.themix.org/standards/social-performance

MFI's governing bodies

These days, in the microfinance world there is a wide variety of institutions that provide financial services to poverty-stricken or low-income people. They range from large conventional financial institutions to small, non-profit organizations. The legal status that each MFI adopts varies depending on institutional strategy and the legal framework in each country. The BBVA Microfinance Foundation advocates corporate legal structures and regulated institutions. However, whatever the legal status adopted, any MFI can implement good corporate governance practices.

Regardless of each institution's special nature, the governance structure that an MFI usually adopts for decision making is formed by three decision-making bodies or levels (Table 3). The first level includes the members who have contributed financial recourses individually or collectively to start up the company. In commercial institutions, this body is usually known as the General Assembly and is formed by the institution's owners. In associations and foundations there are no owners, just members or trustees, although in the same way they form a maximum decision-making body.

In addition to the General Assembly, in any institution there must be a Board of Directors that assumes responsibility for supervising and guiding the institution on behalf of all of the Assembly members. The Board of Directors is also responsible for choosing the General Manager, who will ultimately choose the team that will manage the institution's daily operations.

Table 4 .- An MFI´s gobering bodies

Assembly

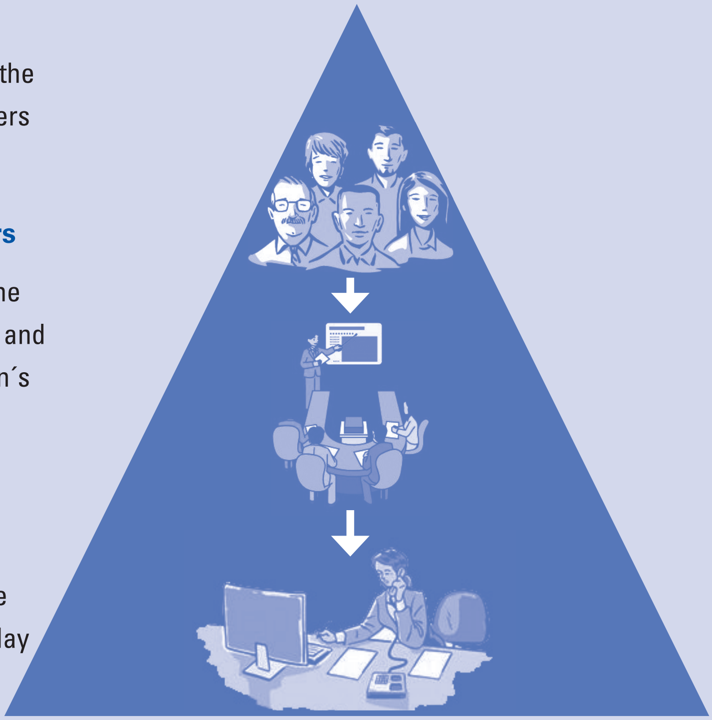
Body formed by all of the organization´s members

Board of Directors

Body appointed by the Assembly to supervise and guide the organization´s activities

Management

Responsable for the organization´s everyday activities



The responsibility for an MFI's governance falls on the Board of Directors, which is the governing body in charge of setting policies and supervising the institution's performance, and on Management, which takes the institution's everyday decisions. As mentioned, the governance structure can vary depending on the type of institution, but there must be a body formed by the institution's members or owners (the Assembly) to which the Board must report. The names of these bodies can vary from country to country or even in each institution, but the most important thing is that there is a structure that guarantees balance of power within the institution to ensure a proper decision-making and control system.

The role that each of these three governing bodies plays in an MFI's governance structure is described in more detail below.

Assembly

The Assembly is the body in which all of an MFI's member/shareholders or owners are represented. It is the maximum level of authority and responsible for making the organization's most strategic decisions. Usually legislation requires that the Assembly meets at least once a year. The Assembly members' basic rights include the right to receive regular and proper information about the institution and the right to participate and vote at the Assembly meetings.

There must also be systems in place that protect the Assembly members' rights. In each country, the Assembly will have certain rights depending on the institution's legal status. In any case, the Assembly members must be able to participate directly or indirectly in decision-making processes when these are of great significance for the institution. The Assembly's rights and responsibilities include participating in decisions relating to the following areas:

- Amendment of articles of association.
- Acquisitions, mergers or spin-offs.
- Winding up of the company.
- Capital reductions and increases.
- Transformation or changes in legal status.
- Issue of bonds and debentures.
- Selection of Board of Directors.
- Approval of annual financial statements.
- Approval of strategic plans.
- Approval of external auditor reports.

So that the Assembly can take efficient decisions, the participants must receive clear and accurate information with sufficient notice to be able to review it. Some years ago, sending all of the relevant information to the Assembly members was difficult and costly. These days, though, any MFI can send large amounts of information via Internet and other electronic communication means at a very low cost.

In order to encourage maximum participation of Assembly members, each Assembly meeting should be planned and organized with sufficient notice. Assembly meeting announcements must be given as much coverage as possible, publishing the date and venue on the institution's website and important media. The institution must also have systems in place to guarantee that the Assembly members can ask questions about the agenda or even suggest new topics for debate, if a large number of members request this.

Likewise, MFIs must strive to ensure that as many members as possible vote. Many MFIs still have few members of shareholders, in the case of commercial institutions, but as the sector is developing it is increasingly common to find larger institutions with more complex ownership structures and more members. Institutions must therefore seek innovate ways to encourage the right to vote as far as possible and avoid establishing minimum participation levels for an Assembly member to attend meetings.

The main responsibility of Assembly members consists of safeguarding the institution's interests by exercising their right to vote. In the case of MFIs in which there are majority members who can exercise absolute control over the institution's decisions, the rights of other more minority members must also be guaranteed. In the microfinance world, where foreign institutional investors are not uncommon, institutions should be aware of the corporate governance policies that this type of investor uses and there must be transparency in the use of voting rights and the management of conflicts of interest that could occur when these investors also participate in other MFIs.

One message that must be stressed to donors who work in the microfinance sector is their supervision and control role in the institutions that they subsidize or in which they invest. Donors often avoid sitting on the Board of Directors and prefer to give their seat to others. It is important to remember that MFIs are financial brokerage institutions and therefore, good governance requires control and supervision of their operations by people or organizations who contribute resources to them. Domestic or foreign donors must assume an active role in supervising the activities of the MFIs in which they invest and they must participate in their governing body meetings.

Board of Directors

The Board of Directors supervises and guides the institution. It liaises between the institution's owners or partners (Assembly) and the people responsible for managing its everyday activities (Management). Boards of Directors are a standard governance system that reduce agency costs due to the distinction between ownership and management. The Board of Directors acts on behalf of the owners or donors, from whom it receives the authorization and legitimacy to act as guarantor of the institution's values and guide it in its strategic decision making. In the case of many MFIs in which the owners often lack the economic incentive to control their investments, the Board of Directors plays an even more important role ensuring that the institution's mission and goals are fulfilled.

Not all institutions have a Board of Directors with the same level of involvement in the institution's operations. Often, younger institutions are led by a group of entrepreneurs who play a highly active role in operational aspects. As the institution grows and becomes more complex, there is usually a tendency to decentralize management tasks. A Board of Directors committed to the institution's future is important, but the Board must be able to delegate responsibilities to the Management, avoiding to get involved in more operational aspects.

Management

The Board of Directors appoints the General Manager. This person is responsible for ensuring that the institution's activities are in tune with the strategy, risk level and policies that the Board has approved. The Management has the usual executive duties, including legally representing the institution, signing contracts, hiring staff and managing the institution's general activities.

To ensure a good governance structure, the Management's duties must be properly defined and there must be a clear distinction between these duties and the Board of Directors' powers. Often problems in institutions arise due to a lack of definition of duties for the Board of Directors and the Management. In some cases, the Management receives no or little support from the Board of Directors and does not therefore receive any supervision or guidance to manage the institution. This increases the possibility of poor management or even fraud situations. At the other extreme, a Board of Directors that leaves the Management no freedom to manage the institution can be just as detrimental for good governance. A balanced and clear distinction of duties between the Board of Directors and the Management is the key to an MFI's success.

BOARD OF DIRECTORS RESPONSIBILITIES, STRUCTURE AND OPERATION

Board of Directors Responsibilities

As mentioned earlier, the Board of Directors plays a central role in Corporate Governance. Depending on each institution's particular situation, its specific duties might vary, but, generally speaking, to ensure good governance the Board of Directors of any MFI assumes the following responsibilities:

1. Strategic management.
2. Monitoring and supervision.
3. Overseeing compliance with ethics, regulations and legislation.
4. Representing the institution.

The duties that these responsibilities entail are detailed below.

1.- Strategic management

One of the Board of Directors' main duties is guiding the institution towards achieving its mission. The Board of Directors must therefore regularly check that the institution has a clearly-defined mission to set its goals. The mission must be taken into consideration when the Board defines goals and develops the strategic plan, which must cover social and financial aspects. The mission must therefore be defined in specific terms in order to allow a medium and long-term planning process that guides the institution towards achieving the set goals. A good approach to planning strategy is regularly organizing strategic planning sessions at which the Board can properly define the MFI's priorities (Table 5).

The Board of Directors must manage the institution's strategy, but it must work closely alongside the Management and other groups to ensure coherence at all times between the planned strategy and operational reality. The Board of Directors must therefore involve the Management and its team in the strategic planning process, because they are ultimately the people in charge of developing and implementing the set strategy. The Board of Directors must take decisions on the direction in which the institution must move, goals that need to be met and the strategy to achieve them. It is important, however, that the Manager and its team define the most suitable operational plan to implement the set strategy.

Because the Board must work closely with the Management on developing and implementing the organization's strategy, both bodies must be completely in tune with each other. The Board's duties therefore include hiring the General Manager and setting his goals and remuneration. The Board will also be responsible for replacing the General Manager when he considers he does

Table 5 - Strategic Planning Sessions

A good system to develop the institution's strategy is regularly organizing strategic planning sessions at which the Board and the Management can meet over two or three days to discuss the MFI's strategic plan. By holding back-to-back meetings over a long period of time, the Board and the Management can discuss the mission, values, trend and risks in the market, and define the institution's strategy and management.

The Board Chairman plays an important role in the planning process. However, a single person would have difficulty leading the group and running the brainstorming process at the same time during the sessions. Sometimes a facilitator can be useful to help the group with managing the discussion and recording the meeting. A facilitator can help the Board with:

- Establishing the agenda.
- Presenting the information.
- Stimulating the discussion.
- Keeping the group focused.
- Recording the process and conclusions.

When the main objective is for the Board and the Management to have up-to-date information on the trends and leaders trading in the microfinance sector, an external expert should be present to set out the main challenges for the sector in the region and to facilitate the discussion. When the sessions are designed for the Board and Management to be able to rethink the MFI's vision, a facilitator experienced in methods to round up the group's ideas and visions should be present.

not fulfill the necessary requirements to meet the institution's challenges. Because replacing a Manager is a complicated decision, the Board should have a transition plan in place so that Management takeovers take place smoothly.

2.- Monitoring and financial supervision

The Board is also responsible for monitoring and evaluating the institution's performance in order to meet any risk and be able to protect the institution in times of crisis. The Board must regularly assess the institution's performance, look at how improvements can be made to risk areas, identify the risks related to its activity and define preventive management policies. The Board must make sure that it has all of the necessary information to take decisions. Clearly-defined indicators are therefore important to evaluate the institution's performance and compare this to other similar organizations. This allows weak areas to be identified.

Table 3 describes the Social Performance Task Force's role in developing indicators that measure social impact. Just as the Board must monitor and establish social impact targets, it should also have indicators and targets that evaluate financial performance. To ensure good governance, one of the Board's priorities must be having the necessary, reliable information on the institution's financial situation and comparing its performance with similar MFIs. Each Board must determine which information it needs and how often it needs it. Financial, operational and risk reports are also important to regularly monitor the institution (see Table 6).

Table 6 – Standards and indicators (SEEP Frame)

In recent years, the Small Enterprise Education and Promotion Network (SEEP) has made a considerable effort to develop and implement report and indicator standards for the microfinance sector which comply with international accounting rules. In 2005 the SEEP published the document entitled "Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring". This consensus text was written by hundreds of professionals, contributors, investors and other partners in the microfinance world. It is a useful tool for MFIs to prepare standard financial statements and measure performance four areas using 18 indicators: i) sustainability and profitability; ii) asset and liability management; iii) portfolio quality; and iv) efficiency and productivity.

The document comes with free Excel software that is simple to use and can help MFIs to develop performance monitoring systems in accordance with international standards. At the moment, SEEP, in conjunction with more than 100 organizations, is in the middle of updating the standards presented in 2005 which will include the new International Accounting Standards Board (IASB), Basel II and the International Financial Reporting Standards (IFR). The document and software can be downloaded without charge at www.seepnetwork.org/section/frame/. Updated information on the standard updating process is available from www.reportingstandards.org.

Microfinance institutions like Bancamía include a section in their Good Governance Codes on internal control procedures that cover the system's general parameters, structure, effectiveness and monitoring and set a good example to define a governance evaluation and control mechanism[5].

5 Bancamía, (2010) "Código de Buen Gobierno Corporativo" http://www.bancamia.com.co/pdf/PC-CGC-Codigo-de-Gobierno-Corporativo_03032010_1.pdf

3.- Overseeing compliance with ethics, regulations and legislation

The Board of Directors is also responsible for guaranteeing compliance with the institution's ethics standards and legal obligations. Like in many other areas, the Board can delegate the General Manager the necessary authority to guarantee compliance with the institution's regulations and ethics. Even so, the Board should establish control mechanisms to ensure compliance with standards, laws and regulations to which the institution is subject. A good practice recommended in MFIs is to count with a **Code of Ethics and Conduct**, approved by the Board. This code establishes, inter alia, the policy for preventing conflicts of interest, the ethic principles to which the organization must adhere and all of the regulations that apply to any financial institution.

The Code of Ethics and Conduct establishes the right attitude and behavior in order to boost the MFI's growth and strength, and sets the guidelines for decision-making in contractual good faith to guarantee corporate integrity. The institution's maintenance and growth is based on managing its members' reputation. All of the MFI's employees must therefore be aware of and accept the Code through training and dissemination programs that teach the values and principles contained therein (Table 7).

As part of personal integrity, employees belonging to the Foundation and institutions in the Network must show outstanding dedication and a professional attitude in both processes and result management, as well as in their relationship with customers, suppliers and institutions, and markets.

All employees must therefore be familiar with, respect and assume the Code contents, which must be stressed during MFI employee training activities and incorporated into the shared culture.

To follow up the Code, the BBVA Microfinance Foundation will promote the setting up of Compliance Committees in each institution in the Network, ensuring that they are formed by executives who specialize in the areas that are more affected by standards and criteria (legal services, compliance, internal audit and human resources). Regular input from these committees will help the MFI to continue to foster the most suitable guidelines and criteria that benefit all of the institutions in the Network.

MFIs must be aware that one of the core pillars on which the Network's sustainability and growth heavily based is managing its members' reputation. Therefore, in accordance with universally-accepted values and the need to maintain professional objectivity in decision making, the Code of Conduct must first and foremost be an instrument that sets the necessary criteria to make sure the decisions taken are in keeping with the MFI's and the BBVA Microfinance Foundation's mission and vision. The Board must foster a culture of excellence in two directions: anticipating anything that goes against ethics and could therefore end up being prohibited, and promoting the strictest standards of conduct on the market.

Cuadro 7 - Código de Gobierno Corporativo y Código de Conducta y Ética de la Fundación Microfinanzas BBVA

The BBVA Microfinance Foundation (http://mfbbva.org/) attaches a great deal of importance to developing ethical values in the institutions that belong to its Network. The Foundation proposes a common Corporate Governance Code and Code of Conduct to the MFIs that belong to its Network. The Network's Corporate Governance Code contains a series of good practices, standards and principles that, in accordance with generally-accepted international standards and good practices, the Foundation considers applicable for the good governance of the Network and each of its institutions. The Code contains the following sections:

- Scope of application.
- Ethical values.
- Personal attitudes and behavior.
- MFI´s support to employees.
- Attitudes and behavior in relation to customers, other employees, suppliers, the MFI, institutions and markets.
- Mechanisms to guarantee compliance with the Code.

The Code of Conduct represents the MFIs's explicit commitment to integrity and professional ethics, encouraging the right attitude and behavior in order to make the institution stronger. Bancamía, a Colombian institution and member of the BBVA Microfinance Foundation's MFI Network was one of the first institutions to adopt and develop its own Code of Conduct. The complete document with the Code of Conduct that Bancamía adopted can be found at: http://www.bancamia.com.co/pdf/nuevos_pdf/codigo_de_conducta_y_etica.pdf

Finally, this Code must be adopted formally by the MFI's Board, which must also ensure that the necessary channels are in place to disseminate it.

The Board of Directors must be strict regarding compliance with the ethics standards and internal policies established in the MFI's code of ethics. The level of strictness must start with the Board of Directors itself, which must rigorously respect the procedures established in areas like hiring new staff or granting loans. The MFI must identify circumstances that could lead to conflicts of interest and the Board must establish clearly-defined policies on how these situations should be managed (Table 8).

Cuadro 8 - Conflictos de interés

Conflicts of interest might arise when a member of the Board or the MFI's workforce has the opportunity to influence the business or decision-making process for their own person benefit or gain. Conflicts of interest do not always result in illegal situations. In fact, it is normal for the Board to often face situations in which conflicts of interest could arise. The challenge is to identify those situations so that they do not affect or jeopardize the institution's integrity. Some common situations in which conflicts of interest might arise are:

- Loans granted by institution to Directors or family members.
- Directors sitting on Boards for several institutions whose interests might clash at any given time.
- Trade transactions of any kind with Directors or family members (purchases of supplies, assets, consultancies, etc.).

Conflicts of interests are common in any organization's future. The challenge is to ensure transparency when these situations occur and mitigate potential negative impacts that they might generate. Each new Director must reveal any possible conflict of interest when he joins the institution's Board of Directors. If a Board member has a conflict of interest regarding a specific matter, he must refrain from participating in discussions or decisions relating to that matter and inform the other Board members about the situation.

4.- Representation/leadership

Finally, the Board must play an important role in developing and maintaining relationships with stakeholders, including regulatory authorities, donors, investors and networks. The Board must play a decisive role in upholding the institution's reputation and achieving a diversified lending fund that allows the institution to fulfill its goals. The Board must therefore play a leading role to foster a cordial relationship with the parties involved in the microfinance sector and help the MFI to carry out its mission.

The Board must have managerial and leadership skills. Although there are still few programs to promote leadership in the microfinance sector, there are some initiatives that can help the Board to develop its managerial skills (see Table 9).

Table 9 – Leadership Training

For a few years, Harvard University and ACCION International have provided a six-day program for leaders in the microfinance sector. The Harvard Business School-ACCION Program on Strategic Leadership in Microfinance seeks to promote leadership roles and can be a good opportunity for some MFIs interested in boosting the skills and abilities of their Boards of Directors. (www.accion.org/hbs).

Similarly, the Center for Microfinance Leadership of the Women´s World Banking with the support of Wharton School at Pennsylvania University arranges workshops and initiatives aimed at developing managerial and leadership skills in the microfinance sector. (http://leadership.swwb.org/).

Board Structure

The Board is structured in such a way as to make the decision-making and Management supervision process as efficient as possible. In accordance with each institution's particular needs, a Board needs to be set up to fulfill the specific requirements in the sector in which it operates. An institution's needs can also vary depending on its stage of development. The institution should consider two factors when setting up its Board of Directors. First, it needs sufficient flexibility to adapt the Board to its needs and, second, it must consider the requirements established by regulatory authorities regarding its structure. In addition, the Board structure must take the following factors into consideration:

- Board of Directors size.
- Directors' profile.
- Types of Directors.
- Directors' term of office.

1.- Board of Directors size

The right number of Directors must be established to allow productive discussions and proper decisions. In larger MFIs, the Board's size must allow the work of the different committees to be managed properly. There is no rule as to the right size for a Board of Directors because it depends to a large extent on each institution's situation. The Board needs to be large enough to cover all of the skills necessary to efficiently guide and supervise the institution. The number of Directors also needs to be small enough to ensure a high level of participation and involvement for a streamlined and effective decision-making process.

The Board's decisions should be based on consensus, but in case a vote needs to be taken the number of Directors should be odd. As mentioned above, there is no ideal number, but a Board with between 5 and 9 members is usually sufficient for most MFIs to run smoothly[6]. Boards with less than 5 members pose problems because the necessary diversity and skills are not usually found in such a small group and a group of less than 5 will have difficulties finding the quorum required to take decisions. Boards with more than 9 members, unless they are very large institutions with lots of committees, are usually difficult to manage and do not have the right level of cohesion for the Board to reach a consensus. In exceptional, complex situations that require a special level of involvement from the Board of Directors, such as transformation for regulation or a merger process, the number of members might need to be increased temporarily to ensure that the Board has the necessary capacity to successfully guide the institution during the process.

2.- Directors' profile

The Board must be formed by people with enough experience to guide the institution towards fulfilling its goals. Because the Board acts as a group in decision making, the skills and types not currently represented in the group should be considered when choosing the right profiles. The Board of Directors must be balanced and have all of the necessary qualities to guide the institution properly. More specifically, when MFIs set up or change their Boards of Directors, they should take the following points into cosideration:

- Professional abilities and skills. The Board must have members with the necessary technical knowledge to fulfill the institution's strategic priorities. In an MFI, usually the Board is formed by people with broad financial knowledge, social awareness, good public relations, ability to liaise with investors and contributors, legal knowledge and familiar with the microfinance sector. Not everyone who sits on the Board has to have knowledge in all of these areas, but it does as a group.
- Level of diversification. In addition to the necessary technical training, the Board members should contribute with different points of view, experiences and values. Promoting diversity in terms of gender, ethnicity and country of origin is considered a good practice because it encourages policies that consider different points of view and enriches the decision-making process. However, the aim of diversity on the Board should not be sought at the cost of reducing the level of required qualifications and professional skills.

6 Mersland and Strøm, in a recent study in which they analyzed a sample of 226 MFIs in 57 countries, found that the average Board of Directors size was 7.45 members and the average number of meetings was 7.32 a year. Mersland, Roy and R. Øystein Strøm (2007), "Performance and corporate governance in microfinance institutions", Agder University, Norway. MPRA paper no. 3888. Available for download at: http://mpra.ub.uni-muenchen.de/3888

- Levels of motivation and leadership. The Board should be formed by people strongly committed to the institution's mission. Directors must also have enough time and energy to actively participate at meetings. Enthusiastic Directors who are able to motivate and play a leading role are important for any institution. A good Board is formed by members with communication skills, previous leadership experience and consensus building abilities.

3.- Types of Directors

As well as the Board's size and Directors' profile, the relationship between the Board members and the institution is an important aspect to be considered. There are three types of Directors:

- Internal Directors who are also MFI's employees.
- Affiliate Directors who are investors or members related to specific stakeholders.
- External Directors who are completely independent members.

Internal Directors, usually the General Manager, can provide valuable information because they have in-depth knowledge of the institution. However, as mentioned earlier, the Manager must report to the Board. The fact that the Manager is also a member of this body with full rights could be a problem because it could cause a conflict of interest. For that reason, the Manager should sit on the Board with the right to speak but not vote. This facilitates the flow of information between the Management and the Board and keeps a clear distinction between both bodies. Regardless of the capacity in which the General Manager participates, time slots should be reserved at the Board meetings at which the General Manager is present for the Board to feel free to discuss any topic. Some institutions even reserve a time slot in every meeting at which the General Manager does not participate.

Affiliate Directors, who are related to or somehow represent investors or other stakeholders, ensure a high level of commitment to the institution. Although these Directors have been appointed due to their link to a specific group, each Director must take his decisions exclusively in the institution's interests and not just as a representative of a specific investor or stakeholder. Affiliate Directors are usually the most common members in a Board. The level of commitment from this type of Director must also be balanced with the presence of completely independent members on the Board.

Finally, External Directors play an essential role in providing objectivity. They must therefore be completely independent and not be linked to any specific stakeholder. The inclusion of External Directors is considered a good governance practice because it increases the Board's independence and objectivity.

4.- Directors' term of office

Establishing a limit on the term of office for Directors contributes to the institution's good governance. Limiting the term of office encourages rotation and allows Directors who do not show the expected level of participation or performance to be replaced more easily. To preserve institutional memory and accumulated experience and to ensure that member rotation does not affect the Board's cohesion as a group, renewable terms of office of three or four years should be established and a rotation system put in place that allows just a small part of the Board to be substituted each year. The Board members should also accept that their posts are not renewed automatically. Instead it will depend on the institution's needs at any given moment and on the person's performance.

Selection, appointment and remuneration of Directors

As mentioned earlier, ensuring the right Board structure means taking many factors into consideration. Recruiting and selecting Directors is a complex process that should be approached with care and ensuring transparency. A properly planned process must be established for recruiting new members. Given the importance of this task, MFIs often set up an Appointments Committee, formed by a group of Directors, often with support from an external member. Generally speaking, the process for recruiting new Board members should include the following steps:

1. **Establishing the skills and abilities that the MFI requires at that given moment.** When looking for new members, the first thing an MFI must consider is what it is looking for. The right choice will be difficult if the institution does not know what qualifications and skills it needs to strengthen. Criteria must be established and the necessary skills selected to help the Board to operate more efficiently. The list of criteria will vary depending on the institution and its evolution. When looking for a very specific profile, such as a new Director with a lot of financial experience to join the Risk Committee, the other general qualities that any Board member must have must not be forgotten.

2. **Selecting a group of candidates for each of the Board vacancies.** If several new members need to be recruited, a specific process for each profile must be undertaken. The process must be as competitive as possible to attract the best candidates. Having a description of the skills and profile sought helps the selection process. The Board members, or even the General Manager, can suggest names but it is also useful if the institution specifies that it is looking for a certain profile. Through speeches to the public, the institution's publications or the Board members' contacts the institution can announce that it is looking for a specific profile and invite people who meet the requirements to present themselves as candidates. In this case an updated list of potential candidates is useful, including the specific skills that the person can contribute to the institution.

3. **<u>Meeting the candidates and teaching them about the institution.</u>** It is important that the Board members meet potential candidates for the post of Director and that they know about the MFI and the level of responsibility involved in the post. A document that sets out some basic points such as the average number of meetings that a Director usually attends each year, their duration and information usually analyzed at each meeting is useful for candidates to know what is expected from them in advance. An orientation program could also be designed before a new member joins the Board, which also includes participation in some of the Board meetings so that the candidate can see whether he really wants to become a member. It is important that all Directors are closely involved in the institution's governance, which is why enough time needs to be taken to make sure the right person is chose.

4. **<u>Recording the new member joining process.</u>** Once the AGM has approved the joining of a new member, the process needs to be recorded. Many MFIs require that Board

Table 10 – Commitment letter for new Board members

I, __________ understand that as a new member of the Board of Directors of ________ I am assuming a legal and moral responsibility under which I am obliged to do my best to achieve the institution's goals. I share the organization's goal and mission and I undertake to fulfill my duties responsibility and prudently.

In fulfillment of my responsibilities as a Board member, I am committed to:

1. Participate at all of the Board meetings, the Committees of which I am a member, and other special events where my presence is required.
2. Stay informed about everything that happens in the organization, participating actively in the decision making process on policies and matters specifically related to the Board of Directors.
3. Accept the conflict of interest policy and report any possible conflict of interest as a Board member.
4. Represent the MFI positively, always defending the institution's interests.
5. Participate in the MFI's strategic plan and monitor its implementation.
6. Support all of the Board's actions, even regarding matters in which I hold a minority position in the group.

If for any reason I do not fulfill the abovementioned obligations, I promise to resign as a Board member.

Date: Signed:

Board of Directors Member

members sign a letter or contract in which they formally accept their new responsibilities (Table 10). When a new member joins the Board, he must reveal any possible conflict of interest and accept the institution's conflict of interest policy. Once the new member has joined, older members should make the orientation process as easy as possible so that the new member can contribute to the institution's governance as soon as possible.

Selecting the right people is one of the most important aspects to ensure a strong and participative Board of Directors that guides the MFI towards fulfilling its goals. Not selecting the right people could bring serious consequences for the MFI's good governance, which is why the Board must devote the necessary time and effort to this process (Table 11).

Table 11 – Big names on the Board

Since the microfinance sector became popular, many celebrities have become involved in it, joining microfinance institutions as Board of Directors members. Some institutions think that including important people on their Board of Directors will increase their prestige and credibility, based on the belief that this can facilitate access to lending and build a smoother relationship with regulatory authorities. However this is not always the case, and the inclusion of celebrities on the Board could end up being detrimental to the institution. One reason is that often these people do not attend the Board's meetings because they cannot fit it in their busy schedule, and in short they do not have enough time to participate in the institution's management. All of this apparent prestige gained initially by including big names on the Board can be lost if the institution performs poorly due to lack of management.

Similarly, institutions commonly invite donors to sit on the Board, on the belief that this way they will be more likely to increase their financial contribution to the institution. In practice though, often donors or investors – especially if they are international – do not want to or cannot attend meetings, which means that discussions and decision-making processes do not have the minimum level of analysis required for the institution's good governance.

All organizations should have active members on their Boards of Directors. Instead of just looking for famous, wealthy people to join the Board, institutions should place the same or more emphasis on selecting members with professional abilities and a passion for the institution's mission who also have enough time and energy to actively participate at meetings.

If an institution has access to famous people whose prestige or connections can contribute positively to the institution, then they are right to try to attract them to the institution. However, it is better to look for other ways of including them in the institution without them sitting on the Board of Directors if the institution senses that they do not have the skills and time to actively participate at meetings. An Advisory Committee or more honorary figure, such as an Honorary Board, could be set up to use their connections without needing to jeopardize the institution's good governance.

As regards the remuneration policy, the Assembly is responsible for designing it and the Appointments and Remuneration Committee is in charge of setting the extent and amount of the remuneration, rights and economic compensation in accordance with the policy. It is worth noting that there are MFIs in which the Directors are so committed that no economic incentive is required.

Although in many MFIs the Board members do not receive remuneration for their work, it is important to remember that often a symbolic remuneration could help to increase the Board's level of commitment, which is essential for good governance. If there is economic compensation, it is considered good practice for this to include a variable part in accordance with target fulfillment. In some institutions it is common practice to pay a fixed part for the Directors' participation at Board and Committee meetings based on a similar amount that people with the same level of experience usually receive in similar organizations in the same country. If an institution decides not to give Board members economic remuneration, there should at least non-monetary benefits to strengthen the relationship between the Directors and the institution, because Board members must be motivated to devote their time and contribute their experience to the institution.

Evaluating and Training the Board of Directors

The Board must regularly evaluate its own performance to ensure that it is properly fulfilling its obligations and identify possible areas for improvement. This is a good practice that contributes towards the institution's good governance because it allows greater control and helps develop the Directors' skills. To guarantee a proper evaluation, responsibilities and specific goals should have been established previously, for the Board as a group as well as for each Director individually. Setting up a system so that performance can be checked regularly allows the Board's and its members' weaknesses to be detected, which is a basic step for any subsequent training plan. Appendix A includes a self-diagnosis questionnaire to help an MFI to evaluate its Board's weaknesses and the suitability of the institution's corporate governance practices.

Introducing certain customs at meetings, such as keeping an open and public record of Director attendance at meetings, allows Board performance and commitment to be evaluated on a regular basis. On a more formal level, at least once a year the Board should perform internal evaluations of its performance. The Board could also create a Corporate Governance Committee in charge of annually evaluating the Board (as described below).

The Board must also check results against initially-established targets, and review areas that could be improved, such as: the type of information received before meetings, or the frequency and efficiency of meetings. To foster transparency in the institution and the Board's ongoing improvement, a short report on the Board's activities could be useful to show the effort and time that Board members have devoted to the institution.

Sometimes the Board could use external consultants to perform a more in-depth evaluation that incorporates new outlooks on how to improve performance. Again, the evaluation must be for the Board as a group and for each Director individually. Evaluating each Director individually can be a delicate issue that might create tension in the Board. The Director evaluation process must be managed properly to try to minimize risks of it becoming a source of conflict in the Board. Self-diagnosis by each member or an anonymous cross-evaluation model between the members are options to allow an individual evaluation of each member.

Once weaknesses have been identified for the Board as a group and each of its members individually, a training plan should be prepared to reinforce the areas detected. The Board's training can be based on training sessions focusing on specific topics conducted by internal or external experts, or through external training programs aimed at developing more general managerial skills.

Often field visits by Board members to the institution's clients or accompanying a credit official on his job are useful ways of keeping Board members in tune with real life in the institution. Also, when possible, Directors are recommended to visit other institutions to analyze different work models and learn from them.

Roles within the Board

To facilitate the distribution of tasks and duties within the Board, the Directors should elect a Chairman, Deputy Chairman and Secretary. The role of Board Chairman is of particular importance because it is institution's public face and, along with the General Manager, is the person who most represents the institution. The Chairman is also responsible for establishing the agenda for Board meetings and making sure that they run efficiently. For that reason, it is important that a person with communication skills and consensus-building abilities is selected. The Chairman must also encourage participation from Board members and choose the Chairmen for the different Committees. The Board Chairman must always maintain a broad overview and leave everyday problems that arise for the General Manager to solve.

An efficient Chairman must play the role of leader in the Board, which is why a person who is forward-looking and is able to adapt to change needs to be selected. As well as communication skills, the Chairman should have good public relations and strategic planning skills.

As mentioned earlier, in some MFIs the General Manager sits on the Board of Directors. In this case, it is not advisable for the General Manager to hold the position of Board Chairmen because this makes it difficult to distinguish between the Management and Board's powers and therefore affects the institution's good governance. The General Manager should play the role of facilitator at Board meetings and participate in the discussions with the right to speak but not vote. In institutions where the General Manager is a Board member will full rights, it is not recommended that he/she holds the position of Board Chairman.

As well as a Chairman, the Board members should elect a Deputy Chairman and a Secretary. The Deputy Chairman's main duty is to stand in for the Chairman if he is absent. In some cases, the Board can assign other specific duties to the Deputy Chairman. The main reason for this figure, though, is to avoid the Board's activities being affected by the Chairman's absence. The Secretary's main duty is to keep the Board's minutes and records and ensure that the decisions taken fulfill legal and statutory regulations. The Secretary's work means that there is a record of what has been deliberated at meetings. The person elected to the post of Secretary should ideally have legal knowledge.

Board operation

For the Board to run efficiently, the meetings must be properly planned and organized. The meetings must be participative and held in a climate of trust to allow the Board to act as a decision-making body. To ensure productive meetings, an agenda must be prepared for each of the meetings, specifying the topics to be discussed and the time set aside for each item. The documentation to be sent to the Directors, so that they can prepare properly for the meeting, must be compiled sufficiently in advance.

The Chairman plays an important role as facilitator during the meetings. As mentioned earlier, a broad consensus as possible should ideally be reached on the decisions of the Board. Consensus building is often a laborious process and involves widely-differing opinions. The Chairman again plays a vital role in reconciling different points of view and building bridges that foster dialog and consequently lead to consensus. If an agreement is not reached, decisions must be made by vote.

The Board usually meets once a month or once every two months, with the committees undertaking extra work between each meeting, although the frequency of these meetings will normally be established in each MFI's articles of association. The Boards of many MFIs only meet every three months. In this case, often the Board has trouble monitoring closely the institution's activities. Depending on the institution's stage of development and the specific moment in time, fewer or more meetings may be necessary. In any case, it is important that the Board establishes regular meetings to be able to monitor the institution properly.

Sometimes the Board might consider necessary to invite one of the institution's employees to a meeting to provide further information on a specific matter. In these cases, the Board must still bear the weight of the meeting, and must never allow employees to make decisions.

The meetings must also be recorded properly. Therefore, after each meeting the Secretary should send Minutes to all of the Board members, including the matters discussed and the resolutions made (Table 12). This should not be left too long and the Board members should receive a draft copy of the meeting Minutes a week after it is held in order to approve them. The Minutes must include:

- Names of attendees (which allows each member's attendance to be monitored and their commitment to be evaluated in the annual corporate governance report).

- Copy of the agenda and any other material sent to the Directors.
- Points of view during the meeting.
- Agreements reached.
- If a vote has been held, each member's vote.
- Meeting date, start and end time.

Table 12 – Example of Board Meeting Minutes

MFI name

(Date, time and venue)

Board of Directors Members:

Present: AAA, BBB, CCC, DDD, EEE

Absent: FFF, GGG

Other people present:

General Manager: HHH

Other: XXX, Internal Auditor

- The meeting starts at 4pm with the reading and unanimous approval of the Minutes from the previous meetings and the reading of the agenda.
- The Manager presents the report with the MFI's financial performance for the last few months which was previously sent to all of the Members of the Board.
- To understand the reasons for the continuous rise in default rates, the Risks Committee is assigned a specific report to analyze the situation and prepare recommendations for the next meeting.
- It is agreed to open two new branches.
- The Internal Auditor presents results from its last audit in which an irregular situation is detected regarding the credits granted by the Director of one of the agencies.
- The Chairman of the Performance Committee presents his recommendations on how to improve social impact measurement to the other members.
- The General Manager presents the logistic details for the next meetings on strategic planning scheduled for February 20 and 21.

Board Committees

In order to fulfill all of the Board's duties and responsibilities, committees are recommended to deal with specific areas in more depth. Committees are particularly useful to deal with complicated or specific matters that can be solved more efficiently without all of the Board members being present. For complicated matters that frequently arise, such as determining the acceptable risk level, a permanent committee should be set up and hold regular meetings. For one-off matters, a temporary ad hoc committee is usually set up until the matter is resolved.

Working in committees means that the specific experience and availability of each of the Board's members can be used to the maximum. The Board delegates the in-depth analysis of certain matters to the committees, but the Board as a whole still must ultimately approve each decision.

Each institution must choose the suitable number of committees for the Board's work. Too many committees can result in too many meetings and excessive distribution of work. At the other extreme, too few committees can turn the Board meetings into long, tedious sessions with too little time to deal with issues sufficiently in depth in order to fulfill the assigned responsibilities efficiently. Regardless of the number, each Committee must be assigned clearly-defined tasks.

Each Committee must be formed by at least two Directors and, if necessary, specialist external staff can be used to support the specific work carried out in each Committee. The Board Chairman should also appoint a Director in each Committee to act as Chairman of that Committee. The Directors' term of office is not unlimited, so a same Director should not usually sit on more than two committees.

The most common Board Committees in an MFI are[*]:

- **Risk Committee.** One of the Board's most important duties in an MFI is establishing the exposure limits for the risk to which the institution will be subject. Due to the complex nature of this task, a specific committee is recommended to design the policies, systems, models and procedures for efficient management of the risks that the institution faces. A Risk Committee can help to determine the frequency and type of reports that need to be checked in the Board in relation to risks. It is important that the Directors who sit on the Risk Committee have enough training and experience to properly evaluate the institution's exposure to risks. A Risk Committee's specific duties include:
    a) Proposing the goals, policies and procedures for comprehensive and preventive risk management to the Board.
    b) Proposing the exposure limits for each risk type to the Board.
    c) Reporting regularly to the Board on exposure to the risk that the institution assumes at any given moment.
- **Audit Committee** This committee's main duty is supervising the internal control systems and establishing the necessary procedures to ensure compliance with the standards that apply to the institution. The Internal Auditor and, at least once a year, the institution's External Auditor, can participate at the meetings. An Audit

Committee's specific duties include:

a) Checking the suitability of the accounting standards applied.

b) Evaluating the external and internal auditors' activities.

c) Checking the integrity of the financial statements.

- **Appointments and Remuneration Committee.** This committee's main duty consists of assisting the Board with matters relating to appointment, end of term of office and remuneration of members of the institution's Board of Directors and Senior Management An Appointments and Remuneration Committee's specific duties include:

  a) Evaluating the qualifications and suitability of potential candidates.

  b) Setting evaluation criteria and indicators to measure the performance of Board members.

  c) If the Assembly decides to pay remuneration to Directors, proposing a remuneration plan for the Board.

  d) Proposing a target-based incentive plan for the Management.

- **Social Performance Committee.** It is recommended that MFI Boards of Directors attach more importance to everything related to measuring impact. Establishing specific committees to deal with these matters is still not a common practice, but Board of Directors are recommended to create impact measurement committees to tackle everything relating to the fulfillment of social targets. More specifically, a Social Performance Committee's duties should include:

  a) Setting up systems to control and check the institution's social work.

  b) Monitoring trends regarding social performance evaluation, measurement and monitoring in the sector and in the region

  c) Establishing policies to guarantee that the products and services offered are in line with the MFI's social targets

- **Corporate Governance Committee.** This committee's main duty is enforcing legislation and every aspect regarding corporate governance the Board's operation. Other responsibilities include:

  a) Checking and regularly evaluating the Board's fulfillment of its duties.

  b) Knowing and analyzing possible conflict of interest situations involving Board members, establishing criteria to solve them.

  c) Monitoring negotiations by Board members with actions taken by the institution.

  d) Dealing and responding to shareholders, investors and other stakeholder claims. Regarding the institution’s corporate governance policies and practices.

Information transparency and protection of customers

Any initiative aimed at improving corporate governance must consider the MFI's relationship with its customers and the current level of information transparency. Information transparency is essential for an institution's good governance. Providing financial and social impact information to specialized institutions in the sector, for example, the Microfinance Information Exchange, or other local self-regulatory organizations is a vital sign of the institution's commitment to transparency and good governance. Publishing up-to-date information and making it accessible also generates trust among customers, investors and the institution's other stakeholders. This also helps create standards in the microfinance sector, allowing institutions to compare their own performance with similar institutions.

The Board of Directors should go beyond what is established in law regarding providing information about its activities. One good practice involves including other information apart from the financial statements in the annual and semi-annual reports, such as strategic goals pursued, detailed information on the institution's ownership and on Director and Manager remuneration. Keeping information permanently accessible through the institution's website or other media is also considered a good corporate governance practice, because it shows the institution's commitment to transparency.

Information transparency must also be aimed at protecting the customer. The MFI should therefore do everything possible to clearly state its interest rates and fees. Providing financial education, avoiding over-indebtedness, using non-abusive charging practices, guaranteeing customer data privacy and establishing complaint systems are also practices that the MFI must promote as part of its good governance commitment. There are currently several initiatives to foster transparency and protect customers in the microfinance sector which interested MFIs can easily join (Table 13).

Table 13 – Some initiatives to foster information transparency and customer protection in microfinance institutions

In October 2009 the Center for Financial Inclusion at ACCION International launched "The Smart Campaign" (www.smartcampaign.org) to improve customer protection policies in the microfinance sector by promoting a series of principles aimed at fostering transparency and improving the service provided by MFIs.

The MFTransparency organization has also recently launched an initiative to foster price transparency in the microfinance industry which consists of collecting information about interest and fees charged on each loan product to, based on this information, calculate and publish the actual interest rate applied (www.mftransparency.org).

The Microfinance Information Exchange is another important organization playing a pioneering role in fostering transparency in microfinance institutions. It keeps the largest database in the sector to be able to monitor financial and social performance in more than 1,400 MFIs around the world. (www.mixmarket.org).

APPENDIX

APPENDIX A – SELF-DIAGNOSIS QUESTIONNAIRE

The following list of questions can help any MFI to detect areas for improvement in relation to the institution's good governance. Analyzing which of these statements holds true for the institution can help your MFI to identify which areas require closer attention.

Governing body:

Size and structure:

1. All of the Board members are strongly committed to the institution's mission.
2. The Board is structured so that all of the owners' interests are fairly represented.
3. The size of the Board of Directors means that all of the necessary skills and abilities are covered to guide the institution properly and streamline the decision-making process.
4. The MFI has independent members on its Board of Directors who act as external directors.
5. The MFI's Board of Directors is formed by different members who, as well as having the necessary technical microfinance training, contribute different points of view, experiences and values.
6. The Board members have the necessary financial, legal and social knowledge to fulfill the institution's strategic priorities.
7. Two different people hold the positions of Chairman and General Manager.
8. The Manager sits on the Board with the right to speak but not vote.
9. The Management's duties are properly defined and there is a clear distinction between these duties and the Board of Directors' powers.
10. The Board establishes clearly-defined targets for the General Manager and sets his/her performance-based remuneration.

Meetings and attendance:

11. The Board's meetings are properly planned and organized. An agenda for the meeting is always sent to the Directors, specifying the matters that will be discussed, the time set aside for each item and the necessary documentation to prepare the discussions.
12. The processes and procedures used to convene the Assembly encourage participation and guarantee that members have all of the sufficient information to prepare meetings.

13. The Board holds regular meetings to monitor the institution properly.
14. The Board's meetings are recorded properly in Minutes which include the matters discussed and the agreements reached, and is sent to all of the Board members a few days after each mee
15. The Board has all of the necessary information to take decisions and compare its performance to other similar organizations. This allows weak areas to be identified.
16. All of the Board members devote the necessary time and effort to actively participate at meetings. The minimum attendance required for meetings is established in the MFI's bylaws.
17. The MFI's Board of Directors is able to guide the institution on strategic matters and assigns operational matters to the Management.
18. The Board of Directors acts as a group because each Director takes his decisions exclusively in the institution's interests and not just as a representative of a specific investor or stakeholder.

Renewal and joining of new members:

19. There are limits on the term of office for Directors to encourage rotation and allow Directors who do not show the expected level of participation or performance to be replaced more easily.
20. The MFI has a well-planned process to recruit new members, which the Appointments and Remuneration Committee checks regularly.
21. A professional selection process is carried out for new Directors in accordance with the required skills and profile.
22. The process of joining the Board is formalized by new Directors signing a commitment letter that sets out their new responsibilities.
23. The MFI has a specific orientation program to help the process of joining the Board easier for new members.
24. The Board has a transition plan in place so that Management takeovers take place smoothly.

Performance assessment:

25. The Board regularly monitors and evaluates the institution's performance and looks at how improvements can be made to risk areas.

26. There is a performance assessment system to regularly identify the Board's and each of its members' weaknesses.
27. The Board actively participates in developing and maintaining relationships with stakeholders, including regulatory authorities, contributors, investors and networks.
28. The MFI's Board of Directors is formed by different members who, have the necessary technical training and contribute with different points of view, experiences and values.

Board structure:

29. There is a balance of power between the institution's governing bodies which ensures a suitable decision-making and control system.
30. The MFI has a Risk Committee that establishes the exposure limits for each risk type.
31. The Board has set up an Audit Committee to supervise the internal control systems and establish the necessary procedures to ensure compliance with the standards that apply to the institution.
32. The Board has an Appointments and Remuneration Committee which assists the Board with matters relating to appointment, end of term of office and remuneration of members of the institution's Board of Directors and Senior Management.
33. The Board has a Corporate Governance Committee that ensures compliance with the MFI's corporate governance code and code of conduct.
34. The MFI attaches a great deal of importance to assessing social impact and has a specific Social Performance Committee to supervise the fulfillment of social targets.

Ethics, conduct and conflict of interest:

35. The MFI has a Code of Ethics and Conduct, which the Board has approved and all of the employees know and accept. This code establishes the policy for preventing conflicts of interest and the ethics principles to which the organization must adhere.
36. The MFI has a Good Governance Code which the governing body has approved.
37. The MFI has identified circumstances that could lead to conflicts of interest and the Board has established clearly-defined policies on how these situations can be managed.
38. There have been no conflicts of interest in the MFI in the past year.
39. The MFI respects legislation, accounting regulations, human rights and safety in the workplace.

Planning and evaluation:

40. There are systems and processes in place to monitor and evaluate compliance with the MFI's social targets.
41. The strategic definition of the MFI's targets, to which the Board regularly devotes the necessary time, is a well-planned process and covers both social and financial aspects.
42. There are systems in place to permanently evaluate and monitor the MFI's main risks.

Transparency:

43. The institution has a clearly-defined mission to set its specific goals.
44. There is sufficient and clear public information on the MFI's ownerships structure.
45. There is sufficient and reliable information on the institution's social and financial performance to be able to compare it with other similar MFIs.
46. The MFI provides financial information and information on social impact systematically via its website and specialist institutions in the sector.
47. The MFI uses non-abusive charging practices and avoids over-indebtedness for its customers.
48. The MFI has established internal policies, which the governing body has approved, that ensure a transparent relationship with its suppliers, customers and institutions.
49. The MFI has customer complaint systems.

APPENDIX B – FURTHER RESOURCES

Bruett, Tillman (2005) “Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring”. Published by The SEEP Network. Available from www.seepnetwork.org

Campion, Anita and Cheryl Frankiewicz (1999) “Guidelines for the Effective Governance of Microfinance Institutions”. Published by the Microfinance Network. Available from www.accion.org

Campion, Anita and Chris Linder (2010) “Putting the 'Social' into Performance Management: A Practice-Based Guide for Microfinance”. Published by the University of Sussex - Institute of Development Studies. Available from www.ids.ac.uk

Lieberman, Ira and Elizabeth Rhyne (2005) “The Practice of Corporate Governance in Shareholder-Owned. Microfinance Institutions”. Published by the CMEF. Available from www.cmef.com

Hattel, Kelly; José Henríquez and Jenny Morgan (2010) “Ensuring Good Governance: A Guide for Microfinance Associations ” published by The SEEP Network. Available from http://networks.seepnetwork.org/en/node/2302

Jacobs, Ruth; Ruth Dueck Mbeba and Bill Harrington (2007) “Board Governance Training for Microfinance Institutions Toolkit” published by MicroSave and MEDA. Available from www.microsave.org

Lapenu, Cécile and Dorothée Pierret (2006) “Handbook for the analysis of the governance of microfinance institutions” published by the IFAD. Available from www.ifad.org/ruralfinance/pub/handbook.pdf

OECD (2004) “OECD Principles of Corporate Governance” Available from www.ocde.org/dataocde/47/25/37191543.pdf

Pugliese, Maria Giovanna (2010) “Same game, different league? What microfinance institutions can learn from the large banks corporate governance debate”. Geneva Papers on Inclusiveness No. 11.

Rock, Rachel; Maria Otero and Sonia Saltzman (1998) “Principles and Practices of Microfinance Governance”. Published by Accion International backed by USAID. Available from www.gdrc.org/icm/govern/govern.pdf

The ***Guide for the adoption of good governance principles in microfinance institutions*** covers the essentials that microfinance institutions must consider when preparing a corporate governance code and implementing it in their Boards of Directors. Based on examples and real situations in the microfinance sector, this practical tool will encourage MFIs to become more aware of the importance of implementing specific policies and programs to improve corporate governance practices.

This ***Guide supplements the Universal Corporate Governance Code for Microfinance Institutions***, which contains a series of good practices, standards and principles that, in accordance with generally-accepted international standards and good practices, the BBVA Microfinance Foundation considers suitable for the good governance of any microfinance institution and for the proper governance of each institution, regardless of its legal structure (regulated or non-regulated financial institution, NGO, cooperative, etc.).