



Same game, different league?

What microfinance institutions can
learn from the large banks corporate
governance debate

Geneva Papers on Inclusiveness No. 11
October 2010

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Editor: Pete Sparreboom

Geneva Papers on Inclusiveness

(commissioned papers)

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Foreword

The microfinance landscape is rapidly changing. Microfinance Institutions (MFIs) across the world are transforming themselves into privately held, investable entities ready for public market access. However, with increasingly aggressive growth strategies supporting attractive IPO valuations, MFIs might stretch themselves too far. In the worst case, widespread defaults could cause a regulatory backlash and a withdrawal of investors from the MFI market. Indeed, we are already seeing the beginnings of higher default rates and perhaps the start of an MFI bankruptcy trend.

We believe that a robust corporate governance structure with proper checks and balances will allow MFIs to better weather adverse financial conditions. Good governance starts at the top of an institution and permeates every level. It aligns management and shareholder interests, enables better risk governance and encourages intelligent transparency. During the mainstream financial crisis we can see, with the benefit of hindsight, how corporate governance failures led to a build-up of unmanageable risk. It is with this thought that the World Microfinance Forum Geneva has produced this paper. In it, we examine parallels between mainstream banking and microfinance institutions and highlight corporate governance best practices and challenges.

In producing this paper, the World Microfinance Forum Geneva gratefully acknowledges the services of Maria Giovanna Pugliese. Her experience working at a national authority for financial sector regulation dealing with, among other things, executive remuneration guidelines positions her to bring the mainstream perspective to microfinance. However, any errors contained in this work are solely the responsibility of the World Microfinance Forum Geneva.

I would also like to acknowledge Stephanie Geake, a recent addition to the World Microfinance Forum Geneva team for diligently reviewing the drafts and producing a summary version of this paper. Pete Sparreboom has, as usual, edited a full length version to produce a format that is rigorous, digestible, informative and actionable. Last, but not least, I would like to thank Melchior de Muralt, our Chairman who has persistently pursued the need to place Corporate Governance at the centre of the global microfinance debate. We hope that this paper and subsequent work we do in this field contribute a little to achieve this objective.

A handwritten signature in black ink, reading "Vidhi Tambiah". The signature is written in a cursive style with a large, sweeping initial "V" that loops around the first part of the name. A horizontal line is drawn under the name.

Vidhi Tambiah
CEO
The World Microfinance Forum Geneva
October 2010



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Executive Summary

The MFI sector is currently undergoing a profound transformation. From small, non-profit, donor-funded social enterprises mainly focused on the provision of “simple” credit products to a relatively homogenous set of clients, many organisations are transitioning towards rapidly growing for-profit corporations, offering a multitude of products to a rapidly changing and increasingly diverse constituency.

In the course of transformation, new stakeholders are brought on board, including professional investors, equity partners and capital markets lenders. Each of these stakeholders brings his or her own objectives and expectations. As a result, new operational challenges and conflicts of interest emerge.

Corporate governance can be defined as a set of relationships between a company’s management, Board, shareholders and other stakeholders. It encompasses the processes through which a company’s objectives are set and achieved, and the structure through which stakeholders’ interests are managed.

The financial crisis has given rise to a heated debate about the corporate governance of large banks, and has emphasized its fundamental role in the management of change, the resolution of conflicts of interest and the prevention of crises. Through good governance, institutions can uphold and reinforce ethics in their operations and business models, while at the same time enshrining professionalism in their organisational structure.

The debate has resulted in concrete recommendations on the corporate governance of large banks. When allowances are made for size and complexity, many of these can be interpreted as directional good practice for any financial institution. Thus, microfinance institutions would be wise to focus on the following key areas:

- The Board of Directors
 - Role and Responsibilities of the Board of Directors
 - Board Size, Composition and Qualifications
 - Practices and Structure
- The Role of Institutional Shareholders
- The Governance of Risk
- Executive Remuneration
- Other Corporate Governance Issues:
 - Transparency and Disclosure
 - The Role of External Service Providers
 - Complex Group Structures

In microfinance, much of the discussion on corporate governance has focused on principles arising from the sector’s non-profit origins and social orientation. However, enshrining social goals into governance only becomes relevant once an institution adheres to the fundamental principles of good governance necessary for success.

Introduction

The microfinance landscape is rapidly changing: portfolio growth, product diversification and institutional transformation are increasing the sector's complexity and risks. Microfinance institutions (MFIs) must adapt their governance structures to manage these risks effectively.

This paper presents the main lessons that have emerged from the recent corporate governance debate in the banking sector, and points out parallels, as well as differences, with the microfinance industry. This publication will be of interest to both microfinance practitioners and their investors.¹

The structure of the paper is as follows: After defining corporate governance and explaining its importance for both banks and microfinance institutions, it will focus on the main topics in the large banks corporate governance debate, namely:

1. The Board of Directors
2. The Role of Institutional Shareholders
3. The Governance of Risk
4. Executive Remuneration
5. Other Corporate Governance Issues:
 - Transparency and Disclosure
 - The Role of External Service Providers
 - Complex Group Structures

The conclusions contain suggestions for further work and research.

1. The analysis in this paper is necessarily conceptual and high level in nature, and as such does not address the important differences in corporate governance rules and practice among different jurisdictions, which are highly relevant for individual institutions.

What Is Corporate Governance?

There is a large body of literature, both academic- and practitioner-led, on the topic of corporate governance. Although most of this literature focuses on publicly listed institutions, governance is relevant for all corporate entities in all sectors of economic activity.

The OECD currently defines corporate governance as “a set of relationships between a company’s management, its Board, its shareholders and other stakeholders. Corporate governance provides the structure through which the company sets its objectives, and determines the means of attaining those objectives and monitoring performance.”²

In the microfinance literature, the analysis of corporate governance has evolved from a principal-agent theory definition to a more complex, multi-stakeholder one. Thus, in 1998, ACCION still defined governance as “a process by which a Board of Directors, through management, guides an institution in fulfilling its corporate mission and protects the institution’s assets.” By 2006, Cerise/IRAM/IFAD recognised that “governance encompasses all the mechanisms by which stakeholders define and pursue the institution’s mission and ensure its sustainability by adapting to the environment, preventing and overcoming crises.”

Why does corporate governance matter?

Good corporate governance provides incentives for the Board and management to pursue objectives that are in the interests of the company and its shareholders, and facilitates effective monitoring. The presence of an effective corporate governance system, within an individual company or group and across an economy as a whole, helps to provide a degree of confidence that is necessary for the correct functioning of a market economy.

OECD 2010

Why Is Corporate Governance Important for Banks and MFIs?

Despite their fundamental differences, important similarities exist between banks and MFIs: not only do they both operate in the financial sector, but they both have large numbers of stakeholders, each with their own, potentially diverging, objectives and expectations.

Institutions with large numbers of stakeholders have a high likelihood of conflicts of interest. Corporate governance offers a framework and a set of processes to preempt and manage these conflicts of interest. It plays an important role in setting individual incentives and managing risks.

Like the banking sector in the run-up to the crisis, the microfinance industry is currently experiencing rapid growth and transformation, albeit of a different nature. MFIs are changing from small, non-profit, donor-funded social enterprises focused on providing credit to a relatively homogenous set of clients to large, for-profit corporations, funded and owned by professional investors, offering a multitude of products to an increasingly diverse constituency.

2. OECD, “Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles.” February 2010.

Multiple stakeholders

By virtue of their diverse client base and the multiplicity of products they offer, banks have a larger and more varied stakeholder base than many other companies. The fact that banks take retail deposits and are highly interdependent implies a threat of contagion and systemic crises in the event of their failure. Therefore, these stakeholders typically include the government.

Transformation of MFIs from NGOs into for-profit entities and increased access to the capital markets are bringing more interested parties on board. Thus, MFI stakeholders increasingly include professional investors, equity partners and commercial lenders.

Transitions are by definition moments of crisis for an organisation. Only well-governed organisations can steer successfully through such times of turmoil.

Corporate Governance Policy Recommendations

The financial crisis has highlighted serious shortcomings in the corporate governance framework among many large international banks, particular around risk and remuneration. This happened despite the widespread existence of detailed Governance Codes and elaborate governance processes in place at most institutions.

A number of international policy-making bodies (including the OECD, the Basel Committee for Banking Supervision, the Financial Stability Board and the European Commission) have published detailed analyses of the main perceived governance failings and recommendations of good practice on this topic.

Most of the recommendations focus on large, complex financial institutions, banks in particular. Thus, many of the more detailed recommendations are not directly applicable to smaller players. However, when allowances are made for size and complexity, these principles can be interpreted as directional good practice, and are therefore useful to other financial institutions, including those, typically much smaller, engaged in the business of microfinance.

Similarly, while much of this paper focuses on institutions that are about to or have just transformed into for-profits, most of the discussion is relevant to the sector as a whole and can be applied, with the necessary modification, also to well-established and relatively “stationary” MFI entities, whatever their ownership or legal status.³

3. For example, see Coady International Institute, “Savings and Spider Plants: What is Good Governance for Member-Owned Institutions in Remote Areas?” 2008 for a discussion of governance in member-owned MFIs.

1 The Board of Directors

The Board of Directors forms a key governance organ within an institution. It is therefore unsurprising that much of the recent debate has focused on defining, and, in some cases, redefining its role and structure, as well as its operating processes and review mechanisms.

In particular, a lot of thought has been devoted to analysing why Boards of large financial institutions have been unable or unwilling to recognise and challenge the increase in their institutions' risk profile. Thus, the main objective of Board reform recommendations is to facilitate the creation of competent Boards capable of objective and independent judgement, and thus likely to exhibit the expected authoritative and challenging behaviour.

The main recommendations for Board reform fall under the following categories:

- The role and responsibilities of the Board
- Board size, composition and qualifications
- Board practices and structure

1.1 Role and Responsibilities of the Board

The Large Banks Debate⁴

The large banks debate has reiterated the crucial responsibility of the Board for setting strategy, risk profile and risk appetite. It has also emphasized its responsibility for setting corporate values and a code of conduct, and for ensuring that these are communicated and embedded throughout the organisation.

The Board is accountable to the owners, i.e., to shareholders; this is consistent with the classic principal-agent framework. However, some commentators have suggested that for financial institutions a wider accountability might be appropriate, through an explicit "duty of care." This reflects the systemic importance of most large deposit-taking banks, but could also be viewed as a mechanism to limit their risk profile.

Duty of care

The European Commission, in its Green Paper, raised the possibility of introducing an explicit duty for bank directors to take into account the interests of other stakeholders, notably those of creditors and in particular depositors.

The Microfinance Perspective

The importance of the Board of Directors in a company's governance is well understood in the microfinance literature.⁵ The crucial responsibility of the Board in defining and monitoring the execution of a company's strategy, vision, and culture is a particularly important lesson for MFIs embarking on a transition to a deposit-taking, for-profit entity.

A particular challenge for shareholder-owned MFI Boards is how to articulate a vision and an accompanying strategy to ensure their institution continues to discharge its social mission, and thus prevent "mission drift." Respecting stakeholder multiplicity can be a way to maintain an institution's initial strategic orientations.

In addition, MFIs might wish to consider the introduction of specific "duty of care" requirements for some or all of its Directors, and/or for Boards as a whole, to ensure that the interests of all stakeholders are taken into account in their decision-making process. This is particularly relevant for MFIs that start taking deposits, and thus undergo significant cultural and operational change.

Mission drift

Mission drift occurs when the vision of an institution changes involuntarily or uncontrolled by the institution. In some cases, diverse interests can be preserved by making sure each stakeholder (including clients) has Board representation.

Lapenu, C. & Pierret D. 2006

Cultural change I

In an MFI that starts to take deposits, the fiduciary relationship with clients effectively reverses. While a lending institution is above all concerned with its clients' financial viability, upon taking customers' deposits, it attains a duty to customers to remain solvent. It is the Board's role to oversee the necessary change in corporate culture.

Cultural change II

In many cases, the Boards of non-profit institutions have mostly representational roles. It can be a significant cultural (and in the case of newly-listed institution, legal) shock to step up to more assertive leadership. MFIs embarking on a transition would do well to consider the role and responsibility of their Board early on, to ensure that its structure and composition are fit for purpose and effective.

4. For an in-depth discussion of the role and responsibilities of the Board, as well as more detailed recommendations on size, composition, practices and structures in large banks, please refer to the OECD, BCBS and European Commission papers, as well as to the UK Walker review (see Appendix for references).

5. See, for example, CGAP 1997, Rhyne, E. e.a. 1998 and Lapenu, C. & Pierret D. 2006.

1.2 Board Size, Composition and Qualifications

The Large Banks Debate

Banks have always been aware of the trade-off between appropriate representation of all relevant stakeholders and a manageable size of the Board. The financial crisis has reiterated the importance of diversity in Board composition.

Diversity

In the run-up to the financial crisis, large banks' Boards have at times exhibited "herd mentality." Diversity in Board composition helps to counteract this phenomenon.

In Board member selection, banks traditionally emphasise an independence and integrity test. Regulated financial institutions commonly use "fit and proper" tests to address trustworthiness (primarily the absence of a criminal record and of prior involvement in failed institutions). The financial crisis has raised expectations of what constitutes independence. For example, several commentators have questioned the suitability for large and complex institutions of having part-time Directors, often sitting on several Boards.

The recent crisis has highlighted the need to balance integrity and independence with skills and competence. Particular emphasis has been placed on the role of the Chairman of the Board as the person responsible for overall leadership, setting the agenda and ensuring the effectiveness of its operations. In selecting a Chairman, institutions should seek to identify the right combination of skills, experience and proven leadership competencies.

Another phenomenon that has come to the fore during the crisis is the risk of "management capture." Boards should put in place policies and procedures to prevent this.

Independence

Banks should expect Board members to:

- Be able to make a significant time commitment
- Sit on Boards of fewer institutions (cross-Board representation)

Management capture

Banks should:

- Separate the roles of Chairman and CEO
- Set clear time and age limits on Directorships

The Microfinance Perspective⁶

Several studies exist on the appropriate size and composition of MFI Boards.⁷ Some commentators suggest that a size of 7 to 9 members is optimal.

The question of raising the professionalism and aggregated competence of the Board is highly relevant to MFI institutions as they transform into more complex organisations. An institution's risk profile changes as it transitions from relatively simple, microcredit-focused institutions with undiversified funding structures to multi-product, multi-channel organisations interfacing with capital markets.

This change must be accompanied, or even preceded, by an upgrading of the skill set of the overseeing body.

Dedicated training sessions should be organised to bring Board members up to date with the evolution in their organisation's complexity and risk profile. In recruiting additional Directors, particular care should be given to ensuring that their professional and technical background fills any skills gap of the existing Board.

In raising skills and competence of Boards, the need to preserve and enhance integrity and independence of judgement should not be neglected. In particular, during the transformation of an NGO into a for-profit company, MFI Directors will need to make a much higher time commitment. Growing MFIs may have to revisit the desirability of Directors sitting on Boards of other institutions (e.g., potential/actual donors or investors, competing MFIs).

Many MFIs have their origins in NGOs with religious or political affiliations, and that would be naturally reflected in their Board composition. As they transition to a for-profit entity with a wider set of stakeholders, such affiliations are more likely to give rise to conflicts of interest, a risk that should be recognised, and, if appropriate, addressed by specific policies and processes.

Board balance

MFIs not only need to balance size with representation of all relevant stakeholders, they also need to ensure they achieve a balanced representation of Directors with financial and social objectives.

Board training

Training for the Boards of transforming MFIs may need to cover knowledge and skills in the area of:

- New products and delivery mechanisms
- Capital markets operations and funding
- Additional legal/regulatory responsibilities

Skills and competence

Banks should:

- Select Board members who are well equipped to understand and challenge the complexity of their operations and business model
- Maintain Board member competence through training and awareness support

Ethics versus professionalism

While large banks typically struggle with how to uphold and reinforce ethics in their operations and business models, MFIs often struggle with the challenge of enshrining professionalism in their organisational structure. Corporate governance is a way to address both issues.

6. A good discussion of Board practices in relation to microfinance can be found in CMEF 2005, "The Practice of Corporate Governance in Shareholder-owned Microfinance Institutions." Consensus Statement of the Council of Microfinance Equity Funds.

7. See, for example, Mora and Munisi 2009, "Strategic Decision Making in Microfinance Organizations: Stakeholder perspective."

1.3 Board Practices and Structure

The Large Banks Debate

As organisations grow in complexity, it is important that Boards structure their governance practices appropriately. They should periodically review and update these practices in response to changes in risk profile and strategic priorities.

The recent literature re-emphasises the practice of establishing a number of Board subcommittees to address specific issues.

In addition, it reiterates the Board's responsibility to identify conflicts of interest of and between stakeholders, and to establish specific policies and processes for dealing with them.

It is considered good practice to have a regular and formalised Board evaluation process, based on a set of pre-determined performance metrics. This may be facilitated by external parties such as the company's external auditors or independent consultants. The results should be made available to shareholders.

Board subcommittees

Most large financial institutions have the following subcommittees:

- Risk Committee
- Audit Committee
- HR Committee
- Remuneration Committee
- Ethics/Complaints Committee

The Microfinance Perspective

Typically, most MFIs, even transformed ones, are not large and complex enough to warrant sophisticated subcommittee structures. However, an increased risk profile and tensions concerning the remuneration of top management and key employees are often quoted as the most challenging issues facing MFIs as they transform. It would therefore seem appropriate that Boards structure their workload and processes to be able to address these issues effectively.

Equally important, particularly for an institution that aims to serve a dual objective of financial success and social improvement, is the issue of conflicts of interest. Boards should spend time thinking about a framework to pre-empt and address these likely issues.

Finally, MFI Boards should establish appropriate accountability frameworks, including regular performance evaluation, liaising, where necessary, with external parties such as the company's external auditors.

MFI conflicts of interest—examples

- Interest rate setting (high for shareholders vs. low for clients)
- Growth strategies (more clients vs. poorer ones)
- Products strategy (credit only vs. deposit taking)

Policies for dealing with conflicts of interest—examples

- Loyalty: Obligation of serving the organisation overseen as opposed to the organisation represented
- Related lending: Ban on requesting and approving loans for family and friends

Procedures for dealing with conflicts of interest—examples

- Guidelines to address typical scenarios (e.g., introduction of new product)
- Process for ex-post evaluation of decisions (e.g., growth strategy)

2 The Role of Institutional Shareholders: Rights and Engagement

The Large Banks Debate⁸

Key among the issues debated in the aftermath of the financial crisis has been the role that shareholders have played in guiding and monitoring the institutions they own, and the perceived shortcomings in the current model of their engagement. The debate has focused on institutional shareholders, for example pension funds, large asset managers, private equity funds and hedge funds. It has revolved around two questions:

- To what extent are institutional shareholders' interests genuinely aligned with those of the company, and in particular with its long-term viability?
- How can the effective exercise of institutional shareholders' rights (including voting and engagement) be encouraged and strengthened?

Commentators point out that the widespread increase of institutional shareholders acting in a fiduciary capacity tends to lead to a "separation of ownership from ownership." In this situation, the interests of the asset managers are not aligned with those of the asset owners.

At the same time, there are often legal obstacles in place that prevent the exercise of shareholders' rights, e.g., "concert party"⁹ rules that prevent investor cooperation, or impediments to effective cross-border shareholder engagement.

Among the solutions advocated to strengthen the governance role of institutional shareholders are:

- Regular **disclosure** by institutional shareholders of voting records, potential conflicts of interest and remuneration practices;
- The adherence of institutional shareholders to "**stewardship codes**" of best practice addressing the rights and responsibilities of institutional shareholders acting in a fiduciary capacity;¹⁰ such codes give directional recommendations for the alignment of interests;
- The **removal of legal impediments** to dialogue between investors and companies, cooperation between shareholders, and the exercise of cross-border voting rights.

Stewardship codes

By virtue of their remuneration and incentive structure, institutional investors may be more short-term oriented and passive than their clients would be. Short-term and passive investor behaviour also hurts the investee company. Stewardship codes can help overcome this problem.

8. The role of institutional shareholders is discussed in detail in the OECD and European Commission papers, as well as in the UK Walker review. See Appendix for a list of references.

9. A "concert party" happens when ostensibly unconnected investors work in concert to make discreet purchases of a firm's share: each investor buys just enough shares to remain below the statutory level (which can vary by jurisdiction) above which he or she must declare his or her interest. Their usual objective is to jointly accumulate enough voting shares to manipulate share prices, influence a firm's management, or initiate a takeover bid. This practice is officially disapproved by securities watchdog organisations.

10. Globally, the ICGN statement of Principles on Institutional Shareholders Responsibilities on [www.icgn.org] provides useful guidance on internal governance, management of conflicts of interest, engagement with companies, and voting.

The Microfinance Perspective

This analysis is highly relevant for MFIs. NGOs transforming into for-profit companies acquire owners for the first time. This transition can lead to tensions, conflicts of interest and impairment in the institution's ability to discharge its social mission. The situation becomes even more complex for MFIs that decide to become listed on the stock exchange and thus become publicly owned.

The challenges to the role of institutional investors identified in the large banks debate can be even greater in microfinance:

- Institutional investors that invest in MFIs typically do so through specialised professional funds, known as Microfinance Investment Vehicles (MIVs). This worsens the problem of "separation of ownership from ownership," by increasing the distance between asset managers and ultimate asset owners.
- Microfinance investors are usually located in developed countries whereas MFIs are based in the developing world. This further increases the challenges to active shareholder engagement.

To strengthen the governance role of institutional investors:

- Asset managers should clearly communicate to investee companies as well as asset owners the assumptions and guidelines on the basis of which they operate, so that any conflicts of interest can be avoided. This includes the expected timeline of the investment: for example, if an investor intends to lead an institution up to an IPO and then exit the investment at that time, that should be made clear at the outset.
- Asset managers should perform due diligence on all corporate governance aspects of an investee company, and actively exercise their shareholder rights. However, in light of the importance of corporate governance issues, it might be desirable for asset owners to have a more active involvement in this due diligence process, and to engage more actively with investees. MFIs should set in place appropriate policies and processes to facilitate and govern shareholder engagement.

The Principles for Responsible Investment¹¹ have been developed by institutional investors, under the coordination of the United Nations Environment Programme Finance Initiative (UNEP FI) and the UN Global Compact. These principles provide a framework to incorporate environmental, social and corporate governance (ESG) issues in investor practice and decision-making progress. It is desirable that all asset owners and asset managers acting in a fiduciary capacity that engage in the business of microfinance sign up and embrace these principles.

Shareholder pacts

A shareholder pact enables some or all of the shareholders to organise their relationships within the company (such as exit conditions, protection clauses or capacity to intervene in the company's management). This type of pact goes beyond the legal statutes by defining the conditions required for the good management of the business, the mutual commitments of the various shareholders and a common vision. It is a useful tool in institutions with a diversity of actors.
CERISE/IRAM/IFAD (2006)

11. <http://www.unpri.org>

3 The Governance of Risk

The Large Banks Debate

Risk management is central to corporate governance. An already vast literature exists on the shortcomings of risk management in the lead-up to the banking crisis, but, from a corporate governance perspective, the main lessons of recent years can be summarised as follows:

- a. Risk management at large institutions had become divorced from corporate strategy and its implementation;
- b. Risk management functions, the Boards in charge of overseeing them and the infrastructure needed to support them, did not keep pace with the development in the risk profile of the business, including rapid growth and increased complexity, and in the external landscape;
- c. Risk management functions lacked authority vis-à-vis revenue-generating functions, and at times lacked the instruments to oversee and challenge their decisions.

Risk management system

The Boards of large banks should:

- Appoint a Board risk subcommittee
- Implement a pervasive risk culture
- Establish a risk management function

In response to these perceived shortcomings, several international bodies (e.g., the OECD and the Basel Committee for Banking Supervision) have reiterated the central responsibility of Boards of Directors in “establishing and overseeing the company’s enterprise-wide risk management system and ensuring that it is compatible with its strategy and risk appetite.”¹²

In large institutions, it is considered good practice to appoint a risk committee of the Board, with a dedicated Chairman, who should advise the Board on all issues relating to risk. Boards should also take responsibility for implementing a pervasive “risk culture” throughout the organisation, by setting up policies and processes aimed at embedding it at all levels.

In addition, it is considered good practice to establish a separate risk management function, working alongside other internal control functions such as internal audit, and, where relevant, compliance. A Chief Risk Officer or equivalent should lead it. The risk management function should have:

- Full independence from profit-generating business units
- Enough authority within the organisation to exercise effective control
- Direct access to the Board of Directors
- Sufficient resources, including appropriate information systems and training
- Incentives aligned with their oversight responsibility

In order to ensure that risk management remains appropriate to the evolving risk profile of the organisation, banks should:

- Put in place clear and effective processes to evaluate the risk profile of all key decisions. These include strategic initiatives such as new business lines, new products and mergers and acquisitions.
- Make use of external sources for risk assessment (e.g. rating agencies), particularly concerning the operating environment.
- Ensure effective horizontal and vertical communication of risks throughout an organisation. It is important to achieve the right balance between comprehensive information that doesn’t “hide bad news,” and a manageable volume of management information.

Risk report

Some commentators (e.g., Sir David Walker in the UK), suggest that the (risk committee of the) Board should produce a risk report, to be included and published in the annual report. This report should give shareholders and other interested stakeholders an overview of the organisation’s strategy in a risk management context, alongside more detailed information about the methodologies used to measure and manage risks, e.g., stress tests.

Risk management policies—example

Even in relatively simple organisations it is generally considered good practice to apply the ‘four eyes principles’, i.e., to always involve at least two people in taking key decisions.

12. See OECD 2010.

The Microfinance Perspective

Traditionally, microfinance institutions have been characterised by extremely tight risk management, as witnessed by loan repayment rates of nearly 100%. The mono-line credit provider model many MFIs operated facilitated this. Liquidity came in the form of grants and long-term, fixed-rate loans and was relatively simple to manage. Market risk was virtually non-existent, and operational risk was constrained by the simple operational model and relatively small scale of operations.

More recently, MFIs are moving towards multiple products and their scale of operations is growing significantly. Their funding profile is becoming more complicated, often relying more on retail savings and capital markets. These developments lead to a step change in liquidity, asset liability management and market risk. Even the credit risk profile is changing as a result of more tailored products and the fact that customers are now more likely to have multiple credit relationships.

In addition, MFIs have expanded significantly, and rapidly growing institutions are inherently risky. Finally, the environment in which MFIs are operating is becoming more challenging as a result of increased competition and macroeconomic instability.

All recommendations that have arisen from the large banks debate are relevant for the microfinance industry. It is particularly important that institutions embarking in capital markets activities (e.g., securitisations, debt issuances, listings) be alert to the new types and levels of risks that are likely to emerge as a result of new ownership or funding mechanisms. They should structure appropriate controls around these risks, including, where necessary, the creation of new functions and roles within the organisation.

Reputational risk (which often arises as a result of other forms of risk crystallising) can be extremely damaging to institutions that have a fiduciary responsibility to their clients, and can lead to a tarnished reputation for the industry as a whole. This has been true of large banks during the recent crisis, and is particularly relevant for MFIs who strive to continue to achieve their social objectives. Even MFIs that are owned, or part-owned, by professional investors should bear in mind that they also have a social responsibility towards their clients. Boards should therefore ensure that they keep reputational risk high on their agenda.

Risks of entering capital markets—example

Capital market operations such as securitisation and debt issuance can give rise to conflicts of interest. Debt holders have clear expectations, e.g., around regular interest payments or the satisfaction of other conditions in contracts or covenants. These may translate into financial pressures on the underlying business. They also have specific rights, which may contrast with those of shareholders. For example, in distressed scenarios, debt holders in many jurisdictions have the right to put a company into insolvency, thus wiping shareholders' assets. Boards should have a comprehensive view of the risks involved in capital market operations before they approve them.

4 Executive Remuneration¹³

The Large Banks Debate

Few topics in the corporate governance debate have elicited as much interest as executive remuneration. Remuneration is not just a market wage, but acts as an incentive: it should thus be structured in such a way that it aligns the staff's personal objectives with the institution's long-term interests, and especially its risk appetite.

Based on the assessment that shortcomings in large banks' remuneration practices were among the key causes of the financial crisis, there has been a flurry of regulatory and public policy initiatives in this area. Most recommendations have been modelled on the nine Financial Stability Forum's¹⁴ Principles for Sound Compensation Practices.¹⁵ Although these have been developed with large, complex institutions in mind, a careful application to other types of institutions is possible.

The FSF Principles are as follows:

a. Effective Governance of Compensation:

- **The firm's Board of Directors must actively oversee the compensation system's design and operation.** The Board must identify how key stakeholders' personal objectives may differ from those of the institution and design mechanisms to align these objectives. It must also approve senior management's compensation package and the general compensation structure for the rest of the staff.
- **The firm's Board of Directors must monitor and review the compensation system to ensure it operates as intended.**
- **Staff engaged in financial and risk control must be independent and have appropriate authority.** They must be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

b. Effective alignment of compensation with prudent risk taking:

- **Compensation must be adjusted for all types of risk.** Performance objectives and measurement should be based on a combination of quantitative and qualitative factors, as well as on multi-year performance where risk is likely to materialise in the long run. Guaranteed bonuses (i.e., variable compensation paid regardless of performance) and practices such as "golden hellos" and "golden parachutes" clearly contravene this principle.

- **Compensation outcomes must be symmetric with risk outcomes.** Variable compensation such as bonuses should not be paid if the performance on which they are based (be it of the firm, the division, or the individual) is poor or negative. "Claw back" provisions on variable compensation are one of the ways in which this can be achieved.
 - **Compensation payout schedules must be sensitive to the time horizon of risks.** Variable compensation should be paid over a period commensurate to the time horizon of the activities on whose results it is based. Mechanisms such as bonus deferral¹⁶ and multi-year vesting¹⁷ periods are typically used to ensure this. They also reinforce employee loyalty towards the organisation.
 - **The mix of cash, equity and other forms of compensation must be consistent with risk alignment.** Paying a portion of variable compensation in shares forms a strong incentive to align individual performance with that of the company, and is generally considered good practice. However, the incentive link gets diluted further down in the hierarchy. Moreover, share performance can be influenced by external factors and so should not be solely relied on as an incentive alignment mechanism.
- ### c. Effective supervisory oversight and engagement by stakeholders:
- **Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.**
 - **Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.** More and better disclosure on remuneration practices is necessary to ensure that stakeholders can assess its structure and its effectiveness in aligning incentives. "Say on pay" initiatives are gaining foot in several jurisdictions, and shareholders' expectations on remuneration disclosure as well as their engagement in approval have been increasing significantly.

Financial Stability Forum's Principles for Sound Compensation Practices

- Effective governance of compensation
- Effective alignment of compensation with prudent risk taking
- Effective supervisory oversight and engagement by stakeholders

13. In what follows, the words "remuneration" and "compensation" are used interchangeably.

14. Now the Financial Stability Board.

15. http://www.financialstabilityboard.org/publications/r_0904b.pdf

16. "Bonus deferral" means that a combination of cash, options and shares awarded in recognition of performance for a given time period is only to be disbursed over a certain period. This can be unconditional (e.g., 1/3 of the bonus immediately, 1/3 after one year, 1/3 after two years) or conditional on the satisfaction of certain financial or non-financial performance conditions.

17. "Vesting" refers to the period in which the employee earns a stock grant or during which share options become available to the employee for conversion.

The Microfinance Perspective¹⁸

In microfinance, a growing body of literature exists on remuneration as a key mechanism for aligning incentives. The issue is often mentioned in the context of the transformation from non-profit to for-profit status. While the remuneration practices that have characterised large banks over recent years clearly have no parallel in the microfinance world,¹⁹ the FSF framework summarised above can still be useful in structuring recommendations for microfinance remuneration.

a. Effective Governance of Compensation:

MFI Boards must oversee the design and operation of compensation systems for management and staff, bearing in mind the institution's financial and social objectives.

Besides, Boards of MFIs transitioning from NGO to for-profit status often need to set up policies and practices for their own remuneration. They need to pay particular attention to any possible conflicts of interest arising (e.g., from share-based compensation) and any legal and cultural obstacles in transitioning from an unpaid to a paid Board.

b. Effective alignment of compensation with prudent risk taking:

In the case of MFIs, "risk" should be interpreted in a broad sense that encompasses the risk of compromising the institution's social mandate.

Awarding shares in the new entity to the original NGOs' founders has attracted some controversy. The notion of "sweat equity" can be used to retain existing managers or to "ease out" managers who are no longer considered suitable to lead the institution. However, this raises a number of ethical and organisational issues, chiefly that the benefiting individuals are engaged first-hand in the

Sweat equity

MFIs seeking to award shares to the original NGOs' founders should consider the following questions:

- Is the equity participation financed from the grants received by the NGO for a non-profit cause, or from future earnings of the for-profit?
- Are the shares granted unconditionally, or are they attached to previously agreed performance metrics?
- Are the shares awarded immediately, or are they accrued over a multi-year horizon?

Transition from NGO to for-profit—remuneration risks

MFI Boards should be particularly sensitive to:

- Possible disparities in compensation between long-standing employees from the original NGOs and new hires;
- Appropriate communication to all stakeholders, and particularly staff, of any new compensation practices and how they relate to the institution's mission;
- Any reputational risk that might arise from the remuneration structure.

transformation, and conflicts of interests almost always arise in this scenario.

Issues of share remuneration tend to attract high levels of publicity during a transformation.²⁰ Boards and senior management should be sensitive to the reputational risk arising in these circumstances, and seek to mitigate them by promoting full transparency. They should not only disclose the actual schemes and structures adopted, but also the decision-making process behind them. Where conflicts of interest are deemed too material, they should consider hiring independent third parties to assist with elements of these transactions.

Institutions might consider introducing elements of share-based compensation for a wider group of employees under an Employee Share Ownership Plan ("ESOPs"). Before rolling out such schemes, though, they should consider whether this is something MFI employees would understand.

Newly transformed institutions should also consider the cultural impact of bringing new personnel into the organisation. Specialised personnel to manage capital markets transactions and treasury operations will typically come from private sector backgrounds, and will have limited experience of the microfinance business. It is crucial that they understand the organisation's mission and culture and do not gain undue freedom or influence. Institutions should look at remuneration not only as a means to attract personnel, but also as a way to ensure alignment of objectives.

c. Effective supervisory oversight and engagement by stakeholders:

As with the banking sector, clear and effective disclosure of MFI remuneration policies and processes is key. This needs to be done bearing in mind the potentially conflicting expectations of various stakeholders, including investors, lenders, regulators, employees and clients.

ESOPs

MFIs that wish to introduce an Employee Share Ownership Programme should consider the following:

- Share ownership and profit sharing are not widespread in the NGO sector.
- If schemes are unclear, the link with incentive alignment is compromised.
- Where shares are illiquid or tax implications are unfavourable, employees might resist the introduction of such a programme.

Performance metrics

In general, share ownership schemes link individual compensation to financial performance. In MFIs it is crucial that variable compensation is based on a balanced combination of financial and social performance metrics.

18. An excellent overview of remuneration issues arising during an MFI transformation can be found in Rhyne, E., Lieberman, I., Busch, B. & Dolan, S., "Aligning Interests: Addressing Management and Stakeholder Incentives During Microfinance Institution Transformations." Center for Financial Inclusion at ACCION International, 2009.

19. Indeed, many commentators have argued that they have no parallel even in the rest of the financial sector in developed countries, having been confined to a relatively small number of individuals in a relatively small number of institutions.

20. See, for example, Université Libre de Bruxelles 2009. "To Whom Should We Be Fair? Ethical Issues in Balancing Stakeholder Interests from Banco Compartamos Case Study" and, more recently, The New York Times 29 July 2010, "Rich I.P.O. Brings Controversy to SKS Microfinance."

5 Other Corporate Governance Issues

5.1 Transparency and Disclosure

The Large Banks Debate

Disclosure is a running theme throughout the corporate governance debate. In its absence it is difficult for stakeholders to hold Boards and senior management accountable. Transparency complements the establishment of appropriate governance structures and processes within a company.

“Disclosure should be accurate, clear and presented in an understandable manner in such a way that shareholders, depositors and other relevant stakeholders and market participants can consult it easily.”

Basel Committee for Banking Supervision 2010

Listed companies are usually subjected to stringent regulations about what they should disclose and how, and international bodies have taken numerous initiatives to ensure standardisation of financial reporting for large financial institutions. Guidelines for the disclosure of non-financial information have also been developed. This includes information on all of the governance issues mentioned in this paper, including Board policies and processes, shareholder engagement, risk governance and executive remuneration.

The financial crisis has highlighted shortcomings in international transparency guidelines, as well as large differences in the quantity and quality of disclosure among jurisdictions and different types of banks. Institutions should focus on quality rather than sheer quantity of reporting. Greater transparency should not be achieved by means of lengthier reports.

Transparency

Banks should:

- Provide broader and more detailed reporting
- Report more extensively on non-financial issues
- Apply international guidelines more consistently

The Microfinance Perspective

In microfinance, several initiatives are currently underway to create a universal standard for reporting. They include the Microfinance Information Exchange, the SEEP Microfinance Reporting Standards Initiative and the Social Performance Task Force. These initiatives should consider incorporating the recommendations arising from the large banks debate.

The above initiatives serve as useful reference frameworks for MFIs. However, given the huge diversity in the microfinance universe and in the legal and operating frameworks where they exist, it is important that individual institutions use them as a basis to develop their own disclosure and communications policy.

As the industry matures, institutional investors and MIVs should demand greater and better disclosure from institutions so they can exercise effective oversight.

Social performance

Microfinance institutions should recognise the diversity of stakeholders interested in their reports. These should therefore encompass not only financial and operational aspects of the company, but also its social and poverty-alleviation activities and performance.

5.2 The Role of External Service Providers

The Large Banks Debate

Large banks, like all large institutions, make use of a wide range of external service providers. This is a normal and efficient evolution of the business, as no institution can expect to have all necessary expertise in-house. However, the recent literature has pointed to conflicts of interest that can arise from relationships with these providers. In particular:

- a. **External Auditors:** These play a key role in banks' corporate governance systems, as they provide assurance to the market that their financial statements present a true and fair view. However, conflicts of interest could arise, as audit firms are remunerated by the same companies that provide their mandate and/or are engaged in the provision of a wider array of services to the institution.

Moreover, external auditors typically can gain access to a wide range of risk-related information on the company. Some commentators have suggested that auditors should have a "duty of alert."

It has also been suggested that external auditors might play a broader role with respect to risk-related information, e.g., by validating a greater range of information relevant to shareholders.

Duty of alert for internal and external auditors

It might be necessary to "examine ways of extending the reporting scheme by which external auditors alert the Board and supervisory authorities of any substantial risks they discover in the performance of their duties ("duty of alert")"

*European Commission
Green Paper 2010*

- b. **Remuneration consultants:** Similarly, remuneration consultants are widely used by large financial companies for benchmarking of compensation structures and levels. Conflicts of interest sometimes arise when the institution engages them in other capacities, or several competitors engage the same consultants.

Code of conduct for remuneration consultants

Some commentators (such as the *UK Walker Review*) advocate the remuneration consultants profession's adoption of a code of conduct, which Boards can use as a guide in hiring and using their services.

- c. **Rating agencies:** the "issuer pays" model, whereby the agency providing the rating is remunerated by the company it is assessing or by the issuer of the instrument it is evaluating, leads to obvious conflicts of interest. This is particularly the case with complex, opaque securities. Conflicts of interest are also inherent in circumstances where the underlying company or instrument is experiencing difficulties.

Careful stakeholder review of rating reports

Considering the conflict of interest inherent in the "issuer pays" model, it is important that investors do not simply "rubber stamp" rating reports, but subject them to a critical, in-house review.

The Microfinance Perspective

While much of the service providers' debate is not directly applicable to the majority of MFIs, an important message can be extrapolated from the brief discussion above. With the transformation of MFIs and their increasing complexity comes the need to rely on a growing number of external service providers. For many MFIs the systematic engagement of third-party service providers is a new experience.

Clean audits, good ratings and positive consultancy reports increase an institution's apparent investibility, but may provide a distorted picture of risk. MFIs should put in place appropriate policies and processes to avoid and manage potential conflicts of interest. This includes, if necessary, Board oversight on certain key relationships.

Specialised service providers

Investors should be especially careful when MFIs engage service providers that are not specialised in microfinance. This is particularly true of external auditors, who might not have a sound understanding of the microfinance business model and might therefore "miss" crucial risk indicators.

5.3 Complex Group Structures

The Large Banks Debate

As institutions grow, they typically structure themselves as groups of sister or subsidiary companies. Particular structures are usually chosen for a combination of reasons, including corporate history, tax efficiency, business lines and legal considerations.

As recent bank crises have demonstrated, complex group structures increase the challenge of managing the strategy and risk profile of an organisation as a whole. For example, groups can run operational risks introduced by interconnected funding structures, intra-group exposures, trapped collateral and opaque counterparty risk. Complex group structures can also result in a lack of transparency and therefore clarity of action in the event of a crisis.

It is imperative that the Board and senior management should know and understand the bank's operational structure and the risks that it poses. The Board of Directors must ensure that adequate governance extends to the whole group.

Review of group structures

It is important that a group structure does not, in itself, impair adequate governance. Boards should continuously review it to ensure that there are clear lines of accountability for management throughout the organisation, including subsidiaries and partnerships.

The Microfinance Perspective

MFI transformation is also starting to give rise to increasingly complex groups. In some jurisdictions microfinance NGOs transfer all assets and activities to a new for-profit entity, or continue their existence either as co-owner of the for-profit or alongside the new for-profit entity in a holding or other group structure. In other jurisdictions NGOs are not permitted to be sole or majority owners of financial institutions, and it is necessary to create additional entities.

Events in the banking sector show the importance of institutions developing clear lines of responsibility, and of policies and procedures to identify and manage the increased risks and conflicts of interest associated to more complex structures.

Complexity should be an important variable in the decision-making process concerning corporate structure; in other words, MFIs should not pursue regulatory and fiscal optimisation at the cost of structuring a governable organisation that is capable of discharging both its social and financial mission in the long run.

Client protection

Some MFIs encourage clients to become shareholders, either directly or through intermediaries such as the Indian Mutual Benefit Trusts. Boards should establish appropriate processes and maintain transparency so that these shareholders can exercise their rights in an informed manner. They should also ensure that any intermediary or proxy acting on behalf of the ultimate owners is done according to the interests of the beneficiaries.

Conclusions and Suggestions for Future Research

A growing body of literature, both academic- and practitioner-led, discusses corporate governance in microfinance. This paper provides a fresh approach by taking the main themes of the corporate governance debate in the banking sector and drawing out potential lessons for the microfinance sector.

We believe some of the themes raised in this paper warrant further exploration and discussion. Below, we offer some suggestions for future work and research for policy makers, practitioners and investors.

The Board of Directors

The Board of Directors forms a key governance organ within an institution. Its role, composition and practices are fundamental in providing the necessary leadership and oversight to the institution.

1. What should be the appropriate structure of an MFI Board of Directors?
2. How should the balance between integrity, independence and competence be achieved?
3. How important is MFI Board leadership as compared to the representation of all stakeholders?
4. How can typical conflicts of interest that arise in the course of an MFI's business be prevented, managed and resolved, particularly at a time of transformation?
5. What would be an appropriate set of metrics to evaluate MFI Boards performance?

The Role of Institutional Shareholders

Typically, institutional investors place their assets in MFIs through Microfinance Investment Vehicles ("MIVs"). MIVs assess MFIs' corporate governance in the course of their due diligence process.

1. Should the end investors be more actively involved in this due diligence process, as well as in continued monitoring, particularly on the governance matters described above? If so, what topics should they focus on? What form should their involvement take?
2. Is there a need for a new Code of Good Practice for Microfinance Investors that gives guidelines on how they should approach and conduct their ownership relationship with their investee companies?

The Governance of Risk

MFIs, long characterised by a relatively simple business model, are becoming more complex, riskier institutions. Risk governance is a key challenge for the sector.

1. What is the best way to shore up risk management within rapidly changing MFIs, both in terms of measurement and awareness, and in terms of oversight and governance processes?
2. How can a more managerial risk culture be promoted within MFIs?
3. What role should Boards and senior management play within the risk governance architecture?

Executive Remuneration

Bearing in mind the sensitivity of executive remuneration in microfinance, and the reputational risk if institutions "get it wrong," more discussion of a number of compensation issues would be beneficial.

1. Is there a need to develop benchmarking surveys of remuneration structures and levels in microfinance?
2. What is the best way to incorporate social objectives into variable remuneration plans?
3. What does good practice in remuneration look like? What is good practice in remuneration disclosure?
4. Do the remuneration structures of investors and MIVs matter with respect to the ultimate goal of achieving alignment between individual incentives and financial and social objectives?

Other Corporate Governance Issues

Other areas of corporate governance that are important to consider are transparency and disclosure, the role of external service providers, and complex group structures.

1. Should stakeholders, in particular investors, demand better disclosure from MFIs? What are the areas in which MFIs should improve their disclosure practices?
2. Is there a need to introduce an explicit "duty of alert" of MFI external auditors with respect to the institutions they oversee?
3. Should MFIs pay more attention to governability when determining their corporate structure, possibly at the expense of fiscal or regulatory optimisation?

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