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Voting the Double Bottom Line: Active Governance by Microfinance Equity Investors

Socially oriented equity investors—particularly those that take formal roles in the governance of microfinance service providers and funds—face challenging situations and decisions.[1] Equity investing requires active governance—and this is particularly true for value-based investing because value-based investors seek to guide the company so that it behaves responsibly and creates both financial and social returns. Again and again in the course of research, those involved in microfinance institution (MFI) governance have said that most microfinance investors are not taking an active enough role.[2] One experienced microfinance professional spoke for many when she observed: "Foreign investors must be engaged owners, not just sleeping partners." This paper offers evidence from interviews that took the pulse of more than 100 industry insiders to provide a self-assessment of microfinance governance today.

Corporate governance serves to mediate interests of diverse stakeholders including shareholders, management, and employees, as the basis for decisions on a company's strategy and goals. It provides the framework within which shareholders oversee operational performance and manage risk to ensure the company's long-term health.[3] In the case of MFIs, those diverse interests also include protecting vulnerable clients and pursuing a social as well as a financial bottom line. Equity is of growing importance to the microfinance sector, and social investors that provide equity have expanding opportunities to play governance roles. This Focus Note explores the extent to which investors are currently capitalizing on this opportunity for active and effective governance. It offers practical insights, emerging good practices, and reflections on how to address reported gaps.

In this paper, we use an intentionally broad concept of governance. This assumes that while traditional corporate governance activities, such as voting one's shares or taking a board seat, are important, microfinance investors can and should go further by exerting influence throughout the investment cycle, from initial due diligence through to their exit from the MFI. Although the focus is mainly on international development finance institutions (DFIs) and microfinance investment vehicles (MIVs)[4] that provide equity, where relevant this paper also considers cross-border lenders and local investors. Interviews with current and former staff of investment organizations, investor-appointed and independent directors of MFIs and funds, chief executive officers (CEOs) and senior managers of MFIs and funds, researchers, and others inform this "self-assessment" of governance in the sector and ideas on how to strengthen social investors' performance in this regard.[5] Together, they represented at least seven DFIs, 32 MIVs, and 19 MFIs. The analysis also uses CGAP investment data, desk research, and preliminary data from a field test of new MIX governance indicators.[6]

Few of those interviewed question that stronger MFI governance is needed and could help improve individual retail providers and the sector as a whole. While existing guidance and how-to tools describe the ideal of effective MFI governance, practices on the ground are still nascent.[7] Our research highlights areas for further improvement and reveals promising practices. Raising the performance bar across the MFI sector will require strategy, resources, and staying power. Equity investors can play a key role. See Box 1 for a summary of key findings.

1 This paper uses the terms "social," "socially oriented," and "double bottom line" investor interchangeably.
2 This paper uses "MFI" in its broader sense to refer to specialized providers of financial services to lower income customers.
3 See, for example, OECD (2004). Traditional corporate governance focuses mainly on the "principal–agent" problem, i.e., how owners can oversee and protect their interests after delegating operational roles to management.
4 DFIs are bilateral (e.g., the Netherlands Development Finance Company [FMO]) or multilateral (e.g., the International Finance Corporation [IFC]) entities that fund development activities and have majority or full public ownership. MIVs include microfinance funds, networks, holding companies, and other entities that fund MFIs directly or through funds/structures.
5 See Annex A for a complete listing of those interviewed.
6 The survey with draft governance indicators received 162 responses from the MFIs that reported to MIX in 2010.
7 See, for example, Council of Microfinance Equity Funds (2005), Cerise-IRAM (2006), BBVA Microfinance Foundation (2011), Promifin (2011), and Goldberg et al. (2011).

Section I summarizes findings and brief analysis of factors contributing to increased attention to governance across the industry. Section II describes the growing influence of microfinance equity investors and their opportunity to strengthen MFI governance. Section III describes the most common "hot button" issues in the board room. Section IV outlines key findings on the reported behavior and effectiveness of equity investors; it also explores implications of an investor marketplace that is increasingly segmented and has attracted some more purely commercial investors. Section V provides a thumbnail sketch of current governance-related initiatives and closes with an analysis of challenges and recommended next steps.

I. Findings and Drivers

A recent study described the mainstream corporate governance ideal as "creation of competent boards capable of objective and independent judgment and thus likely to exhibit the expected authoritative and

Box 1. Key Findings

Further progress on financial inclusion will demand strong, adequately capitalized, and responsible providers. This self-assessment by industry insiders found a mixed governance picture, with bright spots and many weaknesses. Respondents reported that the norm is still far from the ideal: that is, boards are well-informed, guide strategy, and challenge management as needed without micromanaging. While other sectors also suffer from governance deficiencies, the microfinance industry is lagging in applying accepted good practices. Many respondents noted recent improvements, however, as a result of increased awareness, specific reform efforts, MFI growth, and regulation.

The most important findings from the research are as follows:

1. Social investors that provide equity to MFIs, funds, and other MIVs have ample opportunities to contribute to improved governance, including the right to fill at least 325 board seats. They can help encourage MFIs to adopt good practices and model active ownership themselves.

2. The standard roles of corporate governance—addressing the principal-agent problem that is created when owners delegate day-to-day operations to management, setting mission and strategy, overseeing operations and management, and ensuring the company's long-term survival—are relevant for MFI governance. The vulnerability of clients and trade-offs that may arise between the financial and social bottom lines are additional common concerns.

3. Currently, the reported hot button issues in MFI governance are growth, product/segment diversification, client protection, pricing and profits, executive remuneration, and major changes in financing and ownership structures. MFI crises and failures have strained governance and exposed weaknesses, as well as underscored how strong boards help MFIs survive tough times.

4. The research found that equity investors are not fully capitalizing on the opportunity to strengthen MFI governance. The specific areas for improvement include the following:
   - Actively engaging in and beyond the board room
   - Ensuring adequate qualifications, time commitment, and continuity of investors' nominees
   - Addressing director passivity and reticence to question management proposals
   - Aligning shareholder interests

   It also found important progress on tools to strengthen social performance that could be applied more effectively in governance.

5. The MFI sector is relatively young, and many institutions are still led by charismatic founders. Managers are often reluctant to accept the need to give up some control in the interest of achieving more balanced governance and a stronger double bottom line. Reportedly too few investors have the intention or focus to take on cases of management capture, where the CEO or management team dominates the board and the board's oversight of the MFI is weak.

6. MFI governance practices overall exhibit some common weaknesses. These include the following:
   - Clarity on the respective roles of management, the board, and shareholders.
   - Policies on conflict of interest and what information must be disclosed to the board
   - Establishment and use of board committees
   - MFI-specific dimensions of social governance, risk, and human resources management

7. As the microfinance investment market gets more diverse and segmented, including a rise in more purely commercial financing, governance structures and processes will need to adapt to ensure adequate alignment of shareholders' preferences and time horizons.

challenging behavior" (Geneva World Microfinance Forum 2010). The global financial crisis revealed the gap between this ideal and reality. Large financial firms suffered obvious governance failures, including lapses in ethics, poor risk management, and misalignment of executive remuneration with long-term shareholder value. Current reform efforts seek to solve the problems observed, such as management capture, conflicts of interest, board passivity, and inadequate disclosure of information from management to board, regulators, and the public.[8] Most experts agree that if these good governance measures succeed, they should improve firm performance.[9]

Adding to this general attention to governance of financial institutions, microcredit crises and high-profile MFI failures in several countries—largely attributed to unsustainable growth—have heightened concerns about MFI governance. Analyses of these cases revealed that ineffective governance was an important contributing factor, with one study concluding that ". . . an institution's governance structure proved to be the primary differentiating factor between those entities that overcame a crisis and those that did not" (Marulanda 2010). Most of the MFIs that survived a crisis did so because of a timely and well-honed response by their board chair and directors, including mobilizing fresh capital from lenders and shareholders, overhauling the mission and strategy, strengthening or changing management, and rebuilding the confidence of clients, staff, and regulators. Sometimes the board moved out of the traditional oversight role, temporarily stepping in to take on key management responsibilities.

Building a successful MFI in any young, dynamic market is challenging, as the provider seeks to scale up and boost efficiency while managing new operating risks. With MFI business models becoming more complex and product lines diversifying, MFI governing bodies will need to strengthen their skills and oversight capacity. The sector's need for capital also brings MFI governance into sharper relief. Fast-growing providers in some markets have tapped capital markets, including through bond issues or initial public offers (IPOs). This can bring in investor types that are new to the sector, such as private equity (PE) firms and traditional institutional investors. New financing can trigger changes in governance, such as renegotiated legal agreements, board seats, or targets. These changes are sources of governance stress in themselves. Current owners and MFI managers would do well to assess prospective owners carefully for compatibility of the different parties' overall goals, targets, and time horizons.

Recent responsible finance initiatives also focus on governance as the main process that ensures adherence to good practice and aligns MFI strategy and operations with mission.[10] Hundreds of MFIs have joined the Smart Campaign, often with strong encouragement from funders. Fifty-five investors have endorsed the UN-backed Principles for Investment in Inclusive Finance (PIIF).[11] Translating these commitments into practice will require active governance; indeed, the codes and standards implicitly oblige MFI directors to observe a higher "duty of care" than those in conventional financial institutions (although many now argue that bank directors have a duty of care to depositors, which is established by regulation in some jurisdictions).

Together these factors are spurring recognition that MFI governance needs to catch up. Respondents to the 2011 *Banana Skins* survey, for example, ranked governance as the fourth highest perceived risk; they also ranked three other risks—credit risk, reputation, and competition—as greatest and rising most quickly (Lascelles and Mendelson 2011). Governance plays a central role in managing each of these risks. Investors are uniquely positioned to provide and improve MFI

8 Most mainstream corporate governance reforms are embodied in law and regulation. However, industry initiatives, such as the 2010 UK Stewardship Code, also seek to promote active governance and tackle directors' passivity and overly short-term orientation.

9 A 2327-firm survey found stronger performance in better governed firms (Brown et al. 2010). However, it should be noted that less than 1 percent of governance studies focus on emerging markets or developing countries (Ararat et al. 2011).

10 Responsible microfinance consists of client protection (for all providers) and social performance management (for those with a specific social or development mission). See McKee, Lahaye, and Koning (2011).

11 For more information, see www.smartcampaign.org and www.unpri.org/piif/.

Figure 1. Illustrative: Different investor segments and objectives

	Grant/quasi-equity providers	Social/impact investors	Low-beta, commercial investors	Momentum investors
Focus	• Mission	• Social + financial returns	• Financial returns + Corporate Social Responsibility	• Financial returns
Risk-Return Expectations	• No principal back • No financial return (MFI transformations special case)	• Protection of principal • Range of return expectations (from modest to near-market)	• Risk-adjusted market-rate returns • Patient capital; longer-term orientation (e.g., steady dividend)	• Higher risk/higher return profile • Returns through capital appreciation
Investment Characteristics	• Grant	• Time horizon varies (5–10+ yrs) • Invest in retail MFIs, holding companies or MIVs	• Microfinance small part of overall portfolio • Minimum deal size relatively high • Typical indirect investor	• Shorter time-frame common (e.g., 1–5 years vs. 5–10) • Exit through IPO or sale of shares
Examples	• Foundations, bilateral funders	• DFIs, MIVs, other private investors	• Insurance companies, pension funds	• Late-stage venture capital and private equity (PE) firms, some MIVs

governance, in their roles as directors and sources of new equity.

II. The Microfinance Investment Market is Segmented; Investors Have Ample Opportunities to Govern Actively in MFIs

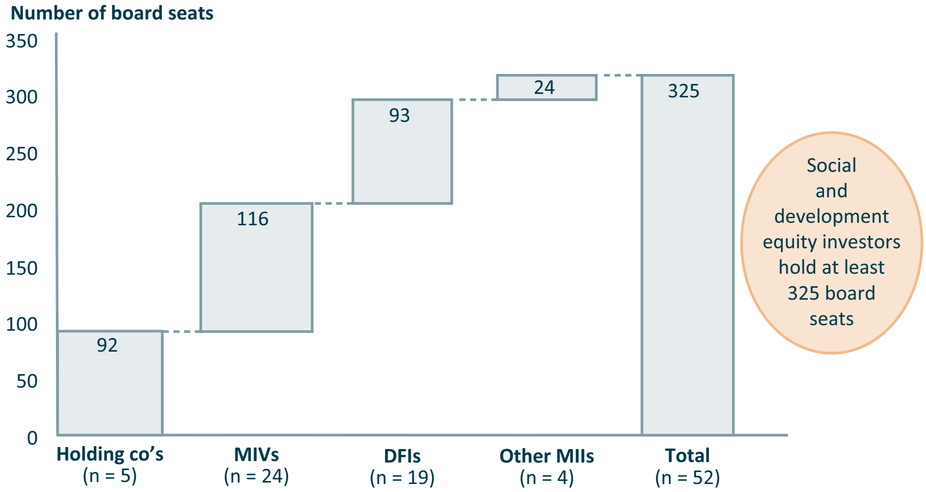
Figure 1 shows a stylized segmentation of an increasingly diverse microfinance equity market. This segmentation affects MFI governance arrangements and governability. Technically, grant funders, such as foundations or bilateral agencies, are not investors, although they have capitalized start-up and growth of many MFIs. Each of the three investor groups has distinct return, risk, and time preferences. Institutional investors in the "low-beta" category might invest if the sector can offer stable dividends and positive social benefits. "Momentum" investors typically have a shorter time horizon and seek to maximize profits; they tolerate higher risk in exchange for higher returns through capital appreciation.

Socially motivated investors are providing increasing amounts of microfinance equity and hold hundreds of board seats on MFIs, funds, and other MIVs. Among public funders, at year-end 2010, the 10 largest DFIs had $1.7 billion in microfinance equity, a gain of 13 percent over 2009. MIV data are less complete; year-end 2010 estimates are in the $500 million to $900 million range. As a result of these ownership stakes, investors have the right to appoint at least 325 board seats—representing a major opportunity for active governance.

Figure 2 shows seats held by holding companies and international networks (such as Advans, FINCA International, and MicroCred), MIVs that are not holding companies (such as Developing World Markets and Oikocredit), DFIs, and other investors. Holding companies and some networks take full ownership or controlling stakes in their MFI affiliates. As a result, typically they fill multiple board seats and appoint the MFI board chair. One international network alone fills 50 board seats. Most other investors take seats on boards when entitled (typically with a 10–20 percent stake), and some aim to invest stakes large enough to secure a seat by the law under which the MFI is organized. Investors may negotiate for a seat even when their stake is below the threshold, generally with support from larger investors.[12] Surprisingly, a handful of investors do not always take the seats to which they are entitled. Others negotiate for a seat but do not fill it or delay nomination of their representative. Either situation

12 For example, the Omidyar-Tufts Microfinance Fund was allocated a seat on one board with an ownership stake of only 6 percent.

Figure 2. Governance opportunity for social and development investors



Sources: 2010 CGAP MIV and funder surveys, Symbiotics

can hinder governance, as in the cases reported where unfilled investor seats made it difficult for boards to achieve a quorum for important decisions. Not filling seats may have to do with the challenge of finding the right candidate, associated costs, director liability worries, or philosophical concerns about "northern" funders dominating "southern" institutions. No matter the reason, the end result is a lost opportunity to provide expertise and guidance.

Investors often provide partner MFIs a combination of debt, equity, and technical assistance (TA). Sometimes they fund the MFI's holding company as well. Networks, funds, and MIVs, such as Incofin, Africap, Equator Capital, and Oikocredit, pursue a "finance-plus" approach with dedicated TA funds. Accion provides management support (including seconded CEOs) as well as equity investment and active governance support. IFC combines substantial MFI capacity-building support with its funding in sub-Saharan Africa. The French DFI PROPARCO receives TA and capacity-building funds from the French development agency AFD. Senior investment officers stressed the value of this model for young companies in fast-changing markets. However, playing multiple roles of lender, shareholder, and TA provider can raise conflicts of interest that need to be managed through governance policies and process.

III. Hot Button Issues in Microfinance Governance

Across the diverse pool of interviewees, the short list of these hot button strategic decisions in the board room was surprisingly consistent. Respondents were asked which were the most difficult or controversial decisions that arise in the governance process. Many of the identified issues involve trade-offs that arise between social and financial performance, at least in the short term.[13] One expert observed: "The double bottom line is a live issue, not just rhetoric." The first half of the list appears to cover relatively more established

Box 2. Which Decisions are Reported to Generate the Most Controversy in the Board Room?

- How fast to grow and where
- Which new products to offer and which client segments to prioritize
- How to price products and ensure long-term client protection
- What profit targets are appropriate and how should profits be allocated
- What level of executive remuneration is appropriate
- How to handle capital increases, entry of new owners, and responsible exit
- How to handle crisis

13 An example of the view that there are no significant trade-offs between social and financial returns is found in J.P. Morgan (2010), whereas other analyses identified both synergies and trade-offs (MIX 2010 and Guarneri et al. 2010). For a useful synthesis, see Di Leo (2011).

debates whereas the second half describes emerging concerns.

Growth

The majority of respondents raised this issue, which comes up as boards approve and oversee the business plan, annual budget, and portfolio performance. Several directors reported cases where the board has reined in management's growth plans year after year. As one pointed out, if managers are not themselves significant shareholders, they tend to focus more on market share than profits. Others described cases where managers proposed moderate growth and boards pushed for more aggressive targets. In several MFIs that failed, insiders reported that although one or more directors voiced concerns about excessive growth, management was bullish, the overall market seemed strong, and it ultimately proved too difficult to "lean against the wind" and chart a more conservative strategy. "Governance needed to come in—otherwise there was no one in the driver's seat who would cool down the growth," explained one fund manager. Investors such as KfW are putting in place internal growth guidelines, tailored to the MFI and market context (for example, acceptable growth rates for start-up and younger firms are higher than for larger and more established providers).

Product diversification and service to new client segments or geographies

These issues raise board concerns about demand, capacity, risk, and competition. Some directors also described divisions between more "finance-first" and "social-first" investors as MFIs considered business lines with high social value but profitability only in the longer term, if at all.[14] Investors committed to serving rural areas or small depositors, for example, described the challenge of building sufficient shareholder support for these activities. Management proposals to serve new market segments, such as small-to-medium enterprises (SMEs), tend to be "heavily debated" as they can raise concerns about mission drift as well as capacity and market potential. Managers may be tempted to reach growth targets by increasing loan size. One fund manager described how an MFI board required specific risk management and social performance measures as a condition for a major proposed increase in average loan size. Support for expansion into consumer lending is also controversial, with different DFIs and MIVs having sharply divergent views on the reputational and mission drift risks involved. Seasoned directors stressed that it is critical for the board to ask tough questions about diversification proposals since young and mature MFIs alike have stumbled due to inadequate planning and overly rapid expansion into new market segments.

Product pricing and client protection measures

Boards set responsible lending policies and monitor MFI business conduct. The recent microcredit crises have raised funder, media, regulator, and politician concerns about nontransparent pricing and how it contributes to borrower debt stress. Pricing debates have sharpened,[15] and respondents report this issue as now more prominent in board rooms and shareholder agreements. Investors reported due diligence analysis of prospects' all-in pricing and peer comparison. More MFI boards now do the same in reviewing pricing policies. Respondents reported several cases where boards have turned down price reductions proposed by directors or management. In contrast, the shareholders of FIE in Bolivia agreed by policy that prices to clients would be reduced when return on equity (ROE) hit 15 percent. One fund manager reported winning over directors who represented more commercial investors to the MFI's policy of periodic rate decreases by citing the sector's reputation risk from its relatively high margins. Many pointed to the need for clearer guidance on responsible pricing.

Boards and investors also are focusing on other dimensions of responsible finance, such as

14 See Monitor Institute (2009) for first use of these terms and Di Leo (2011) for further discussion of microfinance implications.

15 See, for example, Muhammad Yunus' statements on acceptable returns, debates on Compartamos' pre-IPO pricing strategy (including Rosenberg 2007), and documents on the Smart Campaign's "responsible pricing" principle. The Social Performance Task Force (SPTF) is now addressing this issue within its universal standards of social performance (http://sptf.info/sp-standards).

transparency, redress, and collections practices. A few are building these into MFI managers' incentives. One director stressed that the board ". . . must check that each aspect of the strategy—growth, pricing, products—is consistent with responsible finance and make management prove that the targets are sustainable." Another advised boards to "insist on ESG [environment, social, and governance] issues even if management doesn't see it as important at the time—they must come to see it as in their self-interest." Respondents said that endorsing the Smart Campaign was not in itself controversial—and indeed, investors have spearheaded management buy-in to these initiatives. Not surprisingly, however, key players do not always agree on implementation specifics, such as how much to invest in staff training or which upgrades to prioritize. For example, some nominee directors wished their peers would push MFIs harder to report and use credit bureau data. Directors also noted the need to be pragmatic and phase in client protection measures over time.

Profit targets and allocation

Some investors have placed the "balanced returns" issue on MFI board and shareholder agendas. Others are crafting internal guidance on acceptable profit ranges, levels, or allocation (among dividends, retained earnings, and other designated uses, such as MFI "social funds"). For example, a DFI senior manager stated that ROE exceeding 25 percent, or growth projections above 100 percent, would attract close scrutiny, especially for an established MFI. Many urged investors to analyze what is driving some MFIs' relatively high ROE. A fund manager cited this as a factor in turning down three or four deals, including an MFI that "had a moderate interest rate environment, was overcapitalized, and the investors were still making close to 38 percent year in and year out."

One fund manager described a case where the board set specific rural outreach targets and allocated funding for them instead of capping ROE. Some questioned investors' focus on ROE *per se* and advocated analysis of other factors, such as customer benefit from past efficiency gains. Interestingly, some promoters also are limiting MFI profits (Equitas in India reduces prices if ROE hits 20 percent) and screening potential investors to ensure they agree with these limits. In its last capital-raising round, Ujjivan in India limited its entry price to attract the right investors and reduce valuation pressure.

While many respondents were skeptical that boards would or should act to rein in "excessive profits," some voiced frustration that the incentives for many managers and shareholders seem to be such that "the financial bottom line will always win." As an example, one fund manager described how a sustainable rural African MFI was turned down for funding because other social investors found the internal rate of return to be too low. Others shared similar cases of what they considered "misalignment" among owners on the profits–mission balance. Section IV(d) discusses this issue further.

Executive compensation and incentives

The global financial crisis has resulted in many efforts to realign executive pay in mainstream financial institutions to reward safer and more stable performance.[16] One relevant lesson for the MFI sector could be that the composition of compensation (including bonuses and shares as well as base salary) is as important as its overall level. The pay issue for MFI CEOs and fund managers is just surfacing in investor processes and board rooms. Sometimes shareholders agree on this issue upfront in articles of incorporation. For example, Equitas MFI in India caps CEO pay at 40 times that of the lowest paid field staff's pay. Some investors have internal guidance for analyzing total pay; they report using the benchmarks either to screen out investments upfront or to pursue better compensation policies and practices once invested. For example, CEO remuneration at some large Indian MFIs raised eyebrows and deterred some MIVs from investing. Elsewhere an MIV decided to invest in an MFI, despite executive pay it considered excessive, but insisted on creation of a committee of the MFI's board to gather data and gain broad buy-in for changes. New international accounting standards

16 See, for example, Winter (2010), Brown et al. (2010), and Calmeadow (2009) on aligning incentives in MFI transformations.

mandate disclosure of executive compensation, which could also affect views and practice in the sector.

Financing strategy, ownership changes and "responsible exit"

The board shapes an MFI's size and diversification of its assets by overseeing its long-term financing strategy. Respondents reported heated debates around taking on substantial new debt (especially if it comes with forceful covenants) and increasing capitalization to bring in new shareholders. Some criticized MFIs that they perceived had sought out mainstream commercial lenders and equity investors with excessive return expectations. New investors' time horizons were also a common concern. A holding company manager cited cases where PE firms were seeking to exit in two to three years through an IPO or secondary sale, a "time horizon that is in no way consistent with what needs doing."[17] He continued, ". . . some funds say 'We are committed to return 20 percent to our investors,' but how can you do this and be in development?" MIV and fund managers reported turning down big investments when return expectations appeared unrealistic or the time frame too impatient.

Respondents also noted more focus among social investors on how to achieve "responsible exit." While most social investors are likely to sell their shares to a more commercial buyer, many would prefer to find buyers that have a sound understanding of the microfinance business and can at least be counted on to maintain responsible practices. Some investors are seeking to ensure ongoing mission orientation by crafting language in agreements and working with like-minded investors. A DFI manager reported that reputation concerns had led his DFI to block entry of certain new investors. Fund managers also said that they do and will take considerable care at exit, since reputation will play a key role in the success of their future funding rounds. However, to date there have been few MFI exits, and whether socially oriented equity investors are actually willing to compromise on sales price in favor of social goals is not yet clear.

Most of those interviewed believe that the sector will need commercial capital and hope it will be possible to "crowd out the short-term investors with the long term ones" that seek stable companies and steady dividends. Realistically, institutional investors are more likely to come into funds and MIVs than directly into MFIs, but growth financing from more patient institutional investors could replace or complement direct equity from PE firms. Many acknowledged, however, that it will not be easy to tap this source. One fund manager cautioned ". . . we want institutional investors to come in for 20 years and be satisfied with returns of 6–7 percent per annum. This might seem reasonable but our deals are small, it is hard for them to select well, and right now there is a lot of reputation risk."

A special case: MFI crisis and failure

Recent research shows how the MFI crises and the prospect of big financial losses created huge additional strains on governance (Marulanda 2010 and Rozas 2011). Many insiders stated that more effective governance could have mitigated the impact or even averted failure of MFIs, such as BANEX in Nicaragua. The holding companies and networks were reported to respond more quickly in a crisis than others. Few microfinance investors had experienced MFI work-outs, losses, or sector liquidity crises. Directors experienced serious tension between their nominating investor's interests and loyalty to the MFI. Crises also exposed differences in shareholders' and creditors' time horizons and flexibility. Some respondents described the harm to clients and others investors that resulted from rigid covenants and unreasonable work-out expectations.

Lenders close to pay-off were tempted to "cut and run" rather than cooperate on a long-term solution. Respondents reported that financial survival trumped social value for some owners, whose behavior seemed to reflect an attitude that "we paid a lot for our shares and now we need to earn it back." One CEO said, "You see how social your investors are only in the hard times." Many

17 The telescoping of investor time horizons reflects a broader trend worldwide. Bolton (NYSE Index 2010) reports that the average holding period for a stock on the New York Stock Exchange had decreased from around eight years to less than a year within a lifetime.

commented on investors' unrealistic expectations that boards could mediate competing and conflicting interests. One industry insider remarked on "our 'romanticism' around financial institutions created to pursue a double bottom line—since we are all double bottom line it is so hard to imagine power being used in a self-interested way. We demonstrated a real naiveté in our illusion that all the things we see in normal financial institutions could never happen here."

Ongoing debates around responsible finance and commercial investment suggest the need for further clarification and guidance. Investors are developing internal guideposts on issues such as growth, returns, and executive pay. Consultations on the PIIFs and SPTF universal standards are progressing.[18] Yet consensus is elusive for some difficult areas, such as defining returns that balance the interests of clients, providers, and investors. Convergence around a single global standard for acceptable growth or profitability is unlikely. Nor is it advisable. But investors can and should play a key role in the sector's efforts to build consensus on tough issues, where possible and appropriate. Guidance that emerges can inform internal investor processes and external assessments, such as ratings. It can also help shareholders with diverse preferences better align within MFI ownership structures and the boards to which they delegate decision-making to better navigate the hot button issues of the future.

IV. How Effective are Social Investors in Fulfilling Their Governance Role and What Is the State of MFI Governance?

There is a strong consensus that microfinance equity investors can improve the performance of retail MFIs by offering more consistent and proactive governance support. A recent Microfinanza report found that "[d]espite the key role of governance for the sustainable achievement of the social mission and institutional risk management, the current state of the art of microfinance governance is still distant from best practices in many cases" (Guarneri, Moauro, and Spaggiari 2011). This is consistent with our interview findings. Respondents cited frequent examples of investors appearing to underestimate what it takes to be a responsible owner and failing to approach governance roles with adequate strategy and resources, which in turn negatively affected the overall effectiveness of the MFI's governance.

The research suggests five areas for improvement in social investors' governance strategy and behavior; it also revealed promising developments in each of these areas. We address each of these in turn:

1. Governance requires engagement beyond participating in shareholder meetings or filling a board seat. Respondents reported that many equity investors should play a stronger role in governance-related activities throughout the life of their investment.
2. Social investors should carefully consider who they nominate to represent them on the board and monitor how the person performs in this role.
3. Opportunities exist for investors to strengthen MFI governance structures and processes.
4. With the advance in social performance metrics, respondents highlighted the opportunity to improve social governance.
5. There needs to be more attention paid to how the microfinance sector will handle tensions that can arise as investors become more diverse

a. Governance over the life of the investment—entry, legal agreements, monitoring, and exit

Gaps in DFI and MIV due diligence. Funders have considerable leverage at this point, before deciding whether to invest, how much, and on what terms. Improved due diligence will strengthen provider incentives, especially if funders are willing to defer funding until deficiencies are fixed and even say no, as respondents from a diversity of investment

18 http:sptf.info/sp-standards

organizations reported having done. Due diligence also lays the base for active governance once invested. Three areas are reported to need more attention: social goals, responsible finance issues, and expectations of other owners.

Most equity investors have strengthened the process of getting comfortable with the vision and quality of the institution and its leadership, as well as screening ESG factors, including client protection.[19] Examples of progress include the following:

- Tailored due diligence scorecards (e.g., Blue Orchard, Triodos, Oikocredit, Incofin), joint due diligence missions (European Microfinance Platform 2011), and in-depth due diligence analyses that are also available to other investors (BBVA Microfinance Foundation)
- Public reports by third parties on MFIs' compliance with codes of conduct (commissioned by the State Industrial Development Bank of India to support its lending and equity processes)[20]
- A common protocol for assessing client protection (the new Smart Campaign certification tool)
- Increased attention to MFI governance in ratings processes
- Internal benchmarks on acceptable practice (e.g., Dutch and German DFIs, Triple Jump's "red light" tool, Oikocredit's analysis of pricing, executive pay, profits, and dividends)

One due diligence gap cited frequently is the need for investors to better size up the profile and expectations of the other investors and lenders that are in the MFI or fund. Investors are now more aware of reputation risk and scrutinize fellow owners, creditor agreements, and covenants more carefully. For example, a new due diligence questionnaire at KfW assesses funds' governance and responsible finance profile and the fund managers' qualifications and remuneration. Many stressed the need to assess fellow investors' time horizons, as a proxy for their likelihood to help build the company over time, respond to problems, and provide fresh capital if needed. Deciding upfront who will take leadership and how investors will cooperate in the case of a crisis is also emerging as an important focus for due diligence, since timely action is essential.

Legal documents and reporting requirements. Investors can describe goals and preferences in articles of incorporation and shareholder or subscription agreements. Provisions in legal documents offer a basis for addressing trade-offs that arise, including around responsible finance, and anticipating how future problems will be addressed. They also help ensure alignment of the parties around mission, strategy, and targets. While not yet standard practice, diverse investors (e.g., Aavishkaar Goodwell, Agora Microfinance, Equator Capital, and the European Investment Bank) reported including specific provisions on MFIs' mission adherence, client protection, or social performance reporting in shareholder/subscription agreements and some loan covenants. KfW instituted a responsible finance clause and recently added new language in fund manager agreements to ensure MFI adherence to client protection. KfW, FMO, and CDC (the British DFI) built client protection and risk management provisions into a new fund in India. Incofin term sheets have standard language covering social performance and client protection; for example, one partner MFI was required to join the industry association and report to the credit bureau. Several investors urged that indirect investors, such as institutional funders of funds, also step up due diligence around responsible finance. One stated, "They need to build in the right incentives for direct investors, fund managers, and holding companies, through contracts and management compensation formulas." Many look to the PIIF process to help define good practice for institutional investors.

Agreements can strengthen governance, for example, by stating minimum professional qualifications for directors and clarifying which decisions require board or shareholder approval. Specific provisions

19 A recent CGAP Technical Guide advises investors on steps for integrating client protection throughout the investment process and emerging good practices from diverse DFIs and MIVs (CGAP 2011). See also European MF Platform 2011 publication.

20 Small Industries Development Bank of India Web site (http://www.sidbi.in/micro/).

on work-outs and future financing are also appearing in agreements, including the types of new partners that can come in and on what terms. An Agora Microfinance partner asserted that "the shareholder agreement has to be watertight on complete adherence to mission." In response to expectations from retail investors and new standards, MFIs and MIVs also are providing more detailed reporting on social and financial value creation. The European Investment Bank, for example, drew on the KfW clause in designing its social performance reporting requirements for MIVs and will make them more specific over time.

Most of those interviewed believe that specific legal provisions help strengthen governance by setting clear expectations with management and other owners. They acknowledge, however, the difficulty of foreseeing future issues and providing guidance that is actionable but not micromanagement. One director said it will boil down to whether there is "enough trust and common values to deal with what will come up, which is largely unpredictable and cannot be anticipated in agreements." Since agreements are not always legally enforceable, investor incentives also matter. A recent report on responsible governance concluded, for example, that "social principles do not necessarily resolve typical tensions (cost of rural outreach vs. risk, for example) and shareholders' profit expectations. . .. [I]n a very competitive market, investment managers of equity funds may be reluctant to apply strict conditions to shareholder agreements. Some may prefer to help MFIs improve their practices through monitoring" (European Microfinance Platform 2011).

It is important to note that covenants may give lenders considerable direct influence as well, for example, by requiring that they approve key decisions. Many investor staff and directors voiced concern that the number and rigidity of lender covenants sometimes increase MFI risk, rather than reduce it. Lenders may have more forcing power than owners on certain issues, may lobby the board on specific matters, and may also influence MFI governance through TA or informal advice to management.

Exit. While IPOs are possible in a few larger and more developed markets, most equity investors will exit through sales to current shareholders, new buyers, or occasionally management. This is the final point at which a social investor can influence the MFI's governance and direction. One fund manager described it as "always a bit painful" to try to find the right buyer(s) who will balance shareholder financial and social value with helping ensure the company's continued double bottom line success. These issues are getting more attention from both sellers and continuing owners. Exit provisions could help ensure commitment to mission, protect minority shareholders, or maintain a bloc of like-minded owners.

To date microfinance exits have been few and reportedly consensual, so the effect of such provisions is largely untested. The Aavishkaar Goodwell MIV shared a recent case where exit provisions came into play. An MFI that the MIV had helped start increased its capital, diluting the MIV's stake to the point that it lost its board seat. The fund decided to exit, but only after extensive consultations with managers and its own retail investors. The senior staff member who had served on the board described the fund's concern about how to exit responsibly and avoid the perception of being "a vulture investor." To this end, the MIV screened prospective buyers carefully before selling its shares (not to the highest bidder) and recycled the funds into early stage companies in Africa. In this case and others, executing a satisfactory exit required anticipating key issues up front in the legal agreements.

b. Making the most of board representation

Nominating individuals to serve on boards of MFIs or funds is equity investors' most direct opportunity to exercise active governance. Social investors' policies and practices vary widely. While most nominate staff such as investment officers, it is also becoming more common to nominate outside individuals (either local or international). There is also a debate underway about the value and practicality of appointing independent directors—that is, persons who do not represent any single shareholder. Respondents reported that while, in general, directors nominated to fill board seats for social investors bring useful expertise and perspectives, gaps are often evident, including in director skills and qualifications. Another weak spot is directors' time commitment, consistency, and continuity. And a third is nominee directors' duty of loyalty (particularly if they are investor staff) and their willingness and ability to be objective and assertive. This section explores current practices, factors contributing to observed weaknesses, and promising developments.

Deciding whether to take a board seat and how to fill it. An equity investor with a controlling interest may have the right to fill two or three seats and appoint the chair. Most other investors negotiate for a board seat if entitled to one by their stake. Sometimes, however, after insisting on a seat, an investor does not nominate a director or does so only after long delay. Reasons for this may include capacity, cost, concerns about conflict of interest and fiduciary responsibility, or the assumption that others will take on this task. This behavior reflects a serious weakness that some call "the free rider problem."

While many investors devote considerable care to finding strong directors, respondents reported that MFI boards often lack the skills they need, and some nominees lack sufficient seniority or qualifications. One constraint is the limited pool of senior staff to fill multiplying board mandates. Investors typically nominate current or retired senior staff. Sometimes a more junior investment officer serves as alternate. (Younger staff may be cheaper and closer, but they can lack sufficient experience and credibility to serve in the lead role, and senior staff may be better able to raise sensitive issues and make commitments. Weighing the trade-offs, one MIV recently decided to nominate only over-40 staff as directors.) KfW has strict qualifications criteria, and only senior staff can fill its board and committee positions on MFIs, funds, or holding companies, with up to five "mandates" per person. Oikocredit nominates a mix of local and international staff, to optimize time availability, capacity-building, and representation costs. FMO prefers outside experts, but when senior staff serve, they are limited to two mandates. By policy, IFC now nominates outside experts as its directors. An officer at a smaller MIV said: "As early-stage investors, we play a big role in governance, which is embedded in our business model—we bring together a team with local staff and outside experts so that we can be the hands-on investors that we want and need to be." The CHF and Opportunity International networks sometimes appoint MFI CEOs from one country to serve on the board of an affiliate in another country. Several respondents stressed the useful role of strong local directors in managing reputation, regulatory, and political risks.

As MFI business models, product lines, and operating environments become more complex, the skills mix needed by boards evolves. Few board members have direct operational experience. One fund manager echoed a common theme: "MFIs should reach out beyond their silos and recruit directors from the commercial world—business people, accountants, lawyers. . . ." Yet many observed the tendency for managers and boards to "mystify" microfinance as a unique and specialized activity and to be almost suspicious of expertise from other sectors.

Time commitment, consistency, and continuity. Respondents reported that investors' directors often have too little time available for active governance and effective oversight. Director

Box 3. The Special Case of MFI "Owner-Operators"

Typically when investors fund MIVs that take controlling stakes in MFIs (e.g., holding companies and certain international networks), they expect the sponsors to lead on governance. Respondents drew a clear distinction between "operating" owners and other more "passive" shareholders. The sponsor often recruits all initial directors. As new equity is raised, shareholders may even grant the sponsor sufficient voting rights so it stays in the driver's seat. A common example is "greenfields" banks financed by DFIs, MIVs, and sometimes local investors. A fund manager experienced with start-ups sees the sponsor's governance role as "the most powerful tool for value creation." Another advocate for this model explained: "We are more than active investors because we are major shareholders—and someone has to be in the lead because otherwise management can take advantage of a scattered board." However, this model of strong ownership and control could have drawbacks, such as less vigorous oversight by others of the operating owners' proposals. Conflicts of interest can also arise upon exit of shareholders with equity at both the fund and MFI levels.

absence or turnover strains board work, especially that of building effective double-bottom-line accountability or dealing with major problems.[21] Accordingly, investors such as Accion and FMO have strict rules on participation, including in-person board meeting attendance. Africap requires a two-year commitment from directors and three months' notice for resignations. Building capacity and a strong governance culture requires director continuity, leading some to stress the advantages of well-qualified local directors.

Overcoming the fixed-income mindset. Several respondents described a specific gap they see in MFI directors. Many microfinance equity funds have been started up by successful fixed-income fund managers, with investments often growing out of prior debt relationships. Yet the worldview and skills required for success in equity are different than those required for lending with its natural focus on credit risk. Effective equity investing demands a longer term view and willingness to invest in systems, innovation, and strong governance. One fund manager has found the focus of many investment officers with whom he serves on equity fund boards too bank-like and oriented to cash flow stability, and suggested that funds may need to overcome the "fixed-income mindset" by nominating experienced outside directors from other sectors. He continued, ". . . it seems like the [funds] read in a rule book that you should ask for a board seat but don't really have the experience, time, and resources to do it right."

Conflict of interest. When staff serve as directors, most investors go to great lengths to avoid real or perceived conflicts of interest between loyalty to the MFI and to their employer.[22] Indeed, respondents described cases where investor-nominated directors upheld their duty of loyalty to the MFI impeccably as they voted multiple times against their employer's narrow self-interest. However, tensions can arise, and there are gray areas around the director's fiduciary role. One experienced DFI staff director reported awkward cases where "some DFIs appoint themselves, represent themselves, and get their marching orders from the DFI management." As an example of potential conflicts a director cited a case of suspected MFI fraud, where the board chose to conduct a thorough investigation but the investor might have preferred knowing the situation earlier. Conflict of interest can also arise as an investor exits from an MFI, since the ideal timing for the MFI and the investor may differ.

Appointment, orientation, and support of nonstaff directors. Time demands on directors, the limited pool of appropriate staff candidates, and conflict of interest concerns help explain the trend of investors nominating outsiders to represent them. This is not always easy, however. IFC and others reported difficulties in finding MFI and fund nominees with the requisite time, experience, and personal skills. Furthermore, some countries hold corporate directors personally liable. A board member to several younger, smaller MFIs described the governance capacity-building challenge: "The idea is to create the right genetic code that will eventually enable them to attract the right people, but it is quite difficult—why would a really experienced person want to stick her neck out and take on the considerable responsibilities and liabilities of this?"

When relying on nonstaff directors, the investor must also provide an adequate orientation so the nominees grasp the investor's worldview and goals and are able to represent its interests well. Several provide substantial guidance, including appointment letters detailing directors' roles. CHF International has a strategy for recruiting, developing, and compensating local directors (ideally, three per MFI), including orientation for new directors on their board roles and ongoing training on microfinance operations and social and financial performance. Some networks provide specific guidance to directors on how they prefer to achieve the double bottom line, seeing this as an important way to help ensure consistent and effective representation.

21 For the sample of 162 MFIs in the MIX governance dataset, most boards met at least three times per year. In the case of recent MFI crises and failures, many international directors found it hard to step up their time commitments.

22 For example, by IFC policy nominee directors must maximize the MFI's interests over IFC's. IFC does not share all its internal information on the MFI or internal deliberations about IFC's interests. IFC votes directly on shareholder-level issues.

Investors may require outside directors to submit periodic briefings on key board deliberations or annual reporting. Investors including Equator Capital, KfW, IFC, IADB/MIF, Incofin, Oikocredit, Triodos, and SIDI organize director training or convene nominee directors regularly to exchange experience and discuss governance and other challenges.

Covering representation costs. Whether they nominate staff or outside experts, it is expensive for investors to provide high-level expertise in the right amount and at the right times to a portfolio of far-flung investees with diverse and changing needs. Smaller funds may find it particularly challenging to balance budget realities with an optimal level of MFI representation and governance capacity-building. Budget constraints also limit the use of compensated outside directors. Many voiced concerns that the fee expectations of newer, more commercial institutional investors (and even some DFIs) are unrealistic. They argue that it is inappropriate to benchmark microfinance MIV fees against those typical for mainstream private equity funds that have much larger portfolios and developed-country investees.[23] One holding company director asserted, ". . . equity in microfinance should be more expensive than private equity in general because the amounts are small and governance and TA are more needed."

Pros and cons of independent directors. While interest is growing in independent MFI directors (that is, where shareholders agree as a group to appoint individuals without ties to any single investor), the practice is not yet widespread nor without those who question its value and practicality at this time. This practice is now in favor in mainstream corporate governance as a means to achieve more balanced governance by promoting independence, challenging behavior, and a longer term perspective by boards.[24] Sometimes regulation requires it. Certain investors that nominate senior staff to fill their allotted seats also advocate for independent directors. Many argue that independent directors should chair the board and certain key committees, such as Audit, Nominations, and/or Human Resources and Compensation.

Others were skeptical about the value of independent directors for the MFI sector at this time. One concern is the small pool of suitably qualified (and unconflicted) people in many countries to serve in this capacity, even with honoraria (which are uncommon). Another is whether it is realistic to expect an independent director to be more willing than others to stand up to a strong-willed CEO and if these directors would have the necessary focus and diligence without "skin in the game."[25] Respondents described troubled MFIs with apparently "blue-ribbon but in the dark" boards. Another barrier might be shareholder preference: a person who has served on many boards observed, "My experience is that MIVs and DFIs don't want to compensate board members, and they really want to represent their own institutions' interests on the board." A senior DFI manager said, "One of the reasons that I believe some institutions like independent directors is because they cannot be blamed when there is a problem." Section IVc describes policies and governance procedures that might offer additional paths to achieve the benefits ascribed to the use of independent directors.

Board member passivity and "management capture." Governance requires the board to perform a delicate balancing act that avoids both micromanagement and passivity. Many CEOs set the agenda and control information and decisions that come to the board. Respondents focused on the challenge of creating a distribution of power that is balanced rather than concentrated in one or two individuals. Our research suggests that it is much more common for MFI boards to be too

23 A $50 million equity fund with a 2.5 percent fee would generate only $1.25 million in annual revenues, for example. Budgetary provision for representation and travel costs is subject to negotiation and varies widely.

24 While many advocate for independent directors as a best practice, Ararat et al. (2011) found the evidence to be inconclusive.

25 More than one observer has commented on the role played by management capture in the India crisis and observed that having well-known people as independent directors on MFIs was insufficient to ensure independent behavior.

passive rather than too overbearing. Respondents observed that some directors seem to view their appointment as an honor or an opportunity to make a social contribution and lack the necessary toughness and rigor as a result. Many investor nominees were reported to be too consensual and hesitant to scrutinize management submissions carefully. Describing the pressure from peers and managers, one experienced director emphasized "You must be willing to risk the wrath of the CEO." Some speculated that DFI staff might have weaker incentives to be proactive than their MIV peers, due to disbursement pressure and less accountability to shareholders for losses. As one fund manager put it, being held accountable for losses and benefiting from gains "concentrates the mind."

Charismatic founders still lead many MFIs. Some serve as both CEO and board chair. Respondents saw management capture—where management controls many seats or appoints directors with close (and even family) ties—as fairly common. Some investors require the separation of CEO and Chair roles as a condition for investment or set an asset threshold by which it will occur. New directors also reported that longstanding owners may be hesitant to challenge "their" CEO. An MIV director described the challenge of "promoting change when senior management, including often the founder, is resistant." These factors can further limit the board's independence and backbone. When they feel unable to bring about change, some directors resign. As in other sectors, director passivity is exacerbated by fragmented ownership, divergent shareholder goals, and board members with too little time, experience, or incentives to rock the boat. On the other hand, one CEO reported on the benefits of reforms: "I had the board captured but was smart enough to cede control—the new board has held me accountable and instilled a lot of rigor."

Improving governance requires buy-in by management and motivation of many individuals to change. Smaller MFIs tend to see governance reforms as relevant only to their larger peers, the managers of which in turn often see other priorities as more urgent. As one microfinance expert said, "Too many managers and boards think 'we don't have a problem'—we must help CEOs see the 'upside' of good governance, versus seeing dealing with the board as a nuisance." Stronger evidence on the long-term business case will help, as will greater client voice, capability, and insistence on quality. MFI leaders are also concerned about retaining their mission in the face of market pressures. At a recent governance retreat for senior Latin American MFI leaders, one CEO reportedly said, "We need to protect the mission that gave birth to our MFI, to avoid being victims of our own success."[26] Reform processes also are more likely to succeed if they directly address managers' fears of losing control. It is encouraging that more CEOs are adding their voices to the call for reforms and working with shareholders to create balanced leadership. Funders can exercise their leverage in a united front to multiply these examples.

Not surprisingly, respondents report that crisis further tests the management–shareholder power balance. Before one recent MFI failure, some directors questioned the CEO's expansion and diversification plans. When the CEO pushed back, however, others were hesitant to insist on steps such as independent review of management's market assessment and projections. Directors reported that they found it difficult to push for more conservative plans when times seemed good and the MFI was profitable and growing fast. In hindsight, they wished they had asked more questions and built support from other directors to take a firmer stance.

No category of investors or type of nominee is immune from the weaknesses described. Yet all agree that the investor community as a whole could do better in finding well-qualified directors that will serve with the necessary assertiveness and effectiveness. The next section looks beyond the qualities of individual directors to policies, procedures, and structures that can help strengthen MFI governance.

26 As reported by Juan Vega, from workshop organized by Promifin, Calmeadow Foundation and Center for Financial Inclusion.

c. Strengthening board procedures, structures, and accountability

Active governance is aided by workable mechanisms for goal-setting, decision-making, and oversight. There are various MFI governance tools, guidance, and emerging good practices. Yet effective translation into practice is uneven. The research highlighted five key building blocks:

1. Adopting board policies and codes of ethics
2. Improving meeting agendas
3. Ensuring full and timely disclosure to the board
4. Creating an effective committee structure
5. Using external assessments and board evaluations

Many identified social governance as a cross-cutting priority in need of improved procedures and structures.

Establishing policy and procedures. Governance policies formalize expectations about rights and roles of board and officers, individual directors, management, shareholders, and others as relevant. The three priorities cited were clear delineation of management, board and shareholder roles; information disclosure and flows between the parties; and conflict of interest procedures.[27] The research identified several strong practices. For example, Africap Fund's governance charter and the BBVA Microfinance Foundation code and guidelines treat these issues comprehensively. Both funds also expect and support their portfolio MFIs to comply. The MFIs that responded to the MIX governance survey identified recent upgrades in policies on internal controls, client protection, regulatory compliance, and sources of capital. One seasoned director noted that "having formal rules helps a lot in terms of the diversity of individuals and their effectiveness—when you create the culture and norms for the board, newcomers quickly adapt." In contrast, several respondents described boards that operate too informally, with no-objection decision making. In one case, a director said, "All the real decisions were made outside the board meetings, which seemed to be held just to satisfy the regulatory requirements."

Setting the agenda. The agenda itself can strengthen the governance culture by structuring meetings well and allocating significant time for committees, which should lead on performance monitoring, vetting of management proposals, and supervision of the control structure. Some boards create a committee to improve social governance or regularly build in discussion of related topics, such as new product design or findings from client satisfaction surveys. One idea to improve risk governance is for the board to define risk categories and put risk analysis/mitigation as a standing item on the agenda, so management will come to see this as normal rather than intrusive. A standing executive session for board-only discussions also reinforces the division of board–management roles and permits handling of sensitive matters. Some boards create a process for directors to submit concerns to management before the board meeting. Many respondents also pointed out the value of advance consultation among directors: "It's what goes on with like-minded investors before the board meeting that matters—you need to be an organized alliance." This practice is also reported to help counter management capture.

While in many MFIs the same person serves as both CEO and board chair, good practice calls for separation of these roles. The board chair helps ensure effective board meetings by acting as a counter-balance to senior management and an honest broker for diverse stakeholders' interests. One expert characterized the chair role as "giving life to the board" through "the right combination of soft people skills and technical acumen." An effective chair can make sure that long-run strategic issues get on the agenda and guide the membership to consensus. Recruiting new directors and appointing committee chairs are other important tasks. Some described the ideal chair as an independent director who is senior and commands respect. Over time MFIs and owners likely will need to find a way to compensate board chairs to attract the right people and ensure they can devote sufficient time to the job.

Disclosure of information and analysis to the board. Inadequate information flow from management to

27 Earlier referenced guidelines from the BBVA Microfinance Foundation, Cérise, CMEF, and Promifin cover these bases well.

board—described by one director as "the life-blood of good decision-making and supervision"—is a common problem. Board packets often arrive too late for thorough review and do not have adequate breadth and depth of information to paint a total performance picture and inform strategic decisions. A good practice is standing agreement on the "dashboard" of key performance analytics to be generated for the board from the management information system and supplemented by direct reporting from nonmanagement sources, such as internal auditors. Inputs from multiple sources can help create a consistent flow of information from clients to board. Respondents noted that while the quality of social performance reporting tends to lag behind financial analysis, the gap is narrowing in many institutions.

Improving board committees. A half-day board meeting does not allow for diving deeply into specific topics or critically assessing a management proposal. This is a major factor in director passivity. Having committees carry out this work for the board is an important response to the problem. Many noted that while mainstream corporate governance sees committees as the "work horses" of effective boards, they are underdeveloped in MFIs. Among MFIs, the most common committee is Audit/Finance, which specifies what management must report to the board, oversees the external audit, and develops and oversees internal controls. Other committees that are becoming more common include human resources and compensation, risk management, and nominations and board development.[28] Respondents cautioned against overburdening small MFIs with too much structure, however.

Interviewees also stressed the need for more board attention to and clearer, more explicit expectations about social performance. A recent study found that boards tend to devote little focus and few resources to this area. For example, an EDA Rural Systems study (2009) of the Indian MFI Ujjivan found that "the board has hitherto concentrated mostly on the financial performance of the company and although social issues are discussed between the senior management and Board members on a one-to-one basis, no agenda of social significance figures during the formal Board meetings." In response, Ujjivan created a Social Performance Committee with its managing director and two investors (Sequoia Capital and the Michael and Susan Dell Foundation). MFI funds and boards are increasingly putting in place stronger social governance and this area needs continued attention.[29]

Outside information, third-party reviews, and board assessment. Outside information gives boards a more independent view on management analysis and proposals. Sources of outside information include financial audits, which are common, and financial ratings, which are somewhat less common. More MFIs are getting social audits and ratings, which can help the board ensure adherence to client protection and social performance policies. Directors also reported significant benefits from meeting with clients and staff. (One CEO pointed out that this practice also "keep[s] the manager guessing, so he will be more forthcoming.")

Respondents reported that boards are hesitant to commission independent reviews of portfolio quality or key management proposals. Among the reasons cited are cost, the need to get buy-in from all directors, fears of micromanaging, negative reactions from management, and the inherent challenges an outsider will face in coming up with high-quality data and independent analysis. Several interviewees agreed with findings from the studies on MFI failures: if boards had been willing to require independent review of the risks, they would have done better in anticipating and handling the crises. Should the practice of seeking outside reviews become more common, it will be an important marker of the maturity of MFI governance.

Another good practice is periodic assessment of individual directors and the board overall (see, for example, the Incofin board evaluation tool and the Promifin assessment tool).

28 MIX data; forthcoming guidance on risk management from CMEF.
29 Imp-Act/MicroSave (2011). See also Guarneri et al. (2011), Lapenu et al. (2011), and Simanowitz (2011).

Box 4. Some Smaller Shareholders and Individual Directors "Punch Above Their Weight"

In the owner–operator governance model promoted by entities such as ProCredit, Opportunity International, and the BBVA Microfinance Foundation, the locus of responsibility for building governance is clear. But since many MFIs have more fragmented ownership structures, it is less obvious who should take the lead. Some minority shareholders received kudos for prioritizing governance and engaging with a deliberate focus, strategy, and resources. These include Accion, Equator Capital, Grassroots Capital, Incofin, Oikocredit, ProFund, SIDI, and Triodos. Regional MIVs, such as MIV ACP-Peru, Africap Holdings, and India's Lok Capital, also earned praise for their governance work and high-caliber directors. Interviewees cited the personal effectiveness of these investors' directors and their commitment to be present before, after, and between board meetings and to help management translate board guidance into action. Sometimes they lead coalitions of like-minded shareholders. Their capacity-building work includes director training and committee development. They are reported to help shareholders forge consensus around mission, strategy, and performance metrics, and their active engagement benefits other owners and stakeholders as well as giving them out-sized influence.

d. Aligning interests as the microfinance investment market becomes more diverse

What has happened as more mainstream commercial investors have entered the sector? On the one hand, respondents observed that the new investors can enhance MFIs' adherence to mainstream corporate governance standards and help professionalize systems, control structures, committees, and reporting. Several informed observers questioned the dominant narrative that commercial investors in India played a major role in the crisis. One director reported that PE firms seemed to respect others' knowledge of the microfinance business and in fact prioritized consolidation and efficiency as much as growth. While another acknowledged the short-term orientation of PE firms, she continued, "I don't buy the story that they drove irresponsibility—management is always in the driver's seat." Another fund manager pointed out that of more than 300 Indian PE firms, only a few chose to enter the sector while many did not, finding the valuations and growth rates unrealistic and fearing a bubble. Other people interviewed for this research found the quality of momentum investors' representation to be uneven.

While recognizing potential benefits of more commercial investors to MFIs' governance culture, many respondents voiced concerns about their entry into the sector and cited stresses when the new shareholders' performance expectations—in terms of the type, level of, and time horizon for financial returns and the social bottom line (if any)—diverged from those of current owners. This concern underscores the importance of screening prospective equity investors for compatibility and taking steps to socialize them to the MFI's overall goals, strategy, and business practices.

Some respondents found DFI-nominated directors overly "commercial" and asked if DFI staff incentives favor volume over mission or quality. On the other hand, many acknowledged the inherent value of the patient funding model of most DFIs, many of which are able to "stay in the deal" longer than close-ended funds, as long as inflexible targets did not force an early exit. One CEO appreciated how "they [the DFI] stuck around when a hard-core commercial investor might not have." Others described DFIs that provided important capacity and know-how to build MFIs and their governance.

Recent studies confirm the widely held impression that many investors prioritize financial performance over social performance.[30] Goldberg et al. (2011) describe how "some owners are more sensitive to loss of financial or physical assets, and others to loss of reputation, developmental goals, or institutional mission." The 100 plus interviews revealed a striking consensus about where different investors fit along the social–financial spectrum and agreement on which investors, as one fund manager put it, "serve sectors and provide products that aren't the fastest growing and don't earn the highest profits." These preferences do not align neatly by public versus

30 See Lapenu et al. 2011 and Guarneri et al. 2011.

private status. Even those MIVs that are perceived as more socially oriented stressed that they urge partners to adopt an adequately commercial mindset and a disciplined focus on profitability. They also reported framing responsible finance proposals to appeal to the broader risk and financial concerns of more commercial owners of the MFI.

Many stressed how new codes, minimum standards, and performance metrics can "give investors greater confidence that co-investors, directors and managers are fully aligned in the pursuit of the same set of priorities." Improved metrics could better differentiate MFIs by their specific financial–social preferences, enabling investors to select MFIs (and other investors) that best meet their goals.[31] Many MIVs described the pressures of running closed-end funds that typically invest in an MFI for only five to seven years.[32] They reported that the fixed term and investor-return targets can make them push MFIs to achieve higher growth and returns; they can also weaken the incentives to invest in long-term capacity building.

In response, some are proposing innovative financing structures. While most investors prefer the certainty of closed-end funds, for example, they also praised the open-ended funds of Oikocredit, responsAbility, Triodos, Triple Jump, and others that permit a longer term MFI relationship and avoid artificial return targets and premature exits. Other ideas included new legal forms, such as MFI "social businesses," "benefit" or "common good" corporations, or a class of preferred shares where investors could voluntarily accept lower returns, effectively "monetizing the financial–social trade-offs."

V. Industry Initiatives and Next Steps

Section I included a summary of seven key research findings. What is the evidence that MFIs and their investors will take action on this agenda? Across the sector, there are encouraging signs of growing awareness about governance shortcomings—including the implications for responsible finance—and the case for better practices, tools, and metrics. Many now expect more active governance from MFI equity investors in the future.

There is no single approach to filling board seats that is best in all situations. Each investor needs to consider whether it is doing the best it can to nominate people with the right skills, leadership qualities, experience, the time to serve, and the inclination to be informed, objective, and active. Failure to do so burdens the MFI and other shareholders. As MFIs upgrade boards, they will need to balance director skills, independence, and accessibility. Many stressed that boards are more likely to achieve robust and balanced strategies if directors bring diverse but complementary skills and perspectives. Looking forward, the sector may well need and be able to attract paid independent directors, including experienced individuals from other sectors. Measures to promote this (for example, cost–share for governance reforms such as those provided to encourage microfinance ratings) and director training and certification should be explored. Nominee directors have a responsibility to be sure they understand the investor's overall goals before they step into the board room. Well-designed orientation of new directors and annual consultations and training are emerging as good practices.

Good governance requires patience, resources, and a united front. Unless investors leverage their opportunity by insisting on reforms and demanding more over time, good governance will stay on the back burner for many MFIs. Rather than accepting management capture and promoter syndrome (where the founding MFI promoter is the dominant decision maker) as insurmountable, investors need to roll up their sleeves and recognize, as one fund manager put it, that "we are entering imperfect institutions and trying to make them better." Promising practices are emerging to promote effective checks and balances and authoritative, challenging behavior by

31 Di Leo (2011) distinguishes between social first (SF) and financial first (FF) MFIs and their specific impact models. SF MFIs prioritize social outcomes with a floor on financial returns while FF MFIs do the reverse. SF MFIs would have more sophisticated social performance management systems, so boards could decide in advance how to handle future social–financial trade-offs.

32 Investors put capital in a closed-end fund for a fixed time, within which the fund invests in and then exits from MFIs.

Box 5. Governance Initiatives in the Microfinance Sector

- **Indicators and research.** New analysis is underway on current governance practices. MIX, SPTF, Promifin, and others are testing standardized governance structure/process indicators for MIX reporting. Complementary case studies and other qualitative analysis (including action research) are planned to develop and test hypotheses about how governance affects MFI performance. Important insights about the case for active governance (and the consequences of passive governance) come from recent research.[a]
- **MFI tools and capacity.** MFIs and their directors can draw on tools and guidance from the BBVA Microfinance Foundation, CMEF, Cerise, IFC, and others. Peer exchanges and director training (and possibly certification of directors) are also underway or planned by the BBVA foundation, CAF, Center for Financial Inclusion, IADB/MIF, and Calmeadow. The Promifin initiative is a multi-year action research program to conduct detailed third-party assessment of partner MFIs' governance, provide in-depth capacity building, and monitor results on MFI governance and overall performance.
- **Ratings and investor tools.** Specialized raters assess MFI governance (as part of financial ratings), and social governance structures, data, and systems (as part of social audits and ratings). Some advocate for an incentive fund to encourage MFI governance reviews. Investors reported paying more attention to governance in due diligence, agreements and reporting frameworks. Recent studies by the European Microfinance Platform (2010, 2011) describe investor actions, including new tools and investment officer training. Investor associations are updating guidance on key issues such as responsible finance, board compensation, and risk.
- **Policy and regulation.** Many respondents suggested the value of regulation to reinforce good governance. Yet little is known about whether the rules in place for MFIs in some countries are effective. The World Bank is beginning to survey current practice and consider development of MFI governance diagnostic and reform tools for governments.
- **Coordination.** Many players are joining forces to improve industry awareness, practice, and knowledge in this sphere. Work is underway to create a platform to make guidance, tools, and research findings more accessible and useful to MFIs, boards, and funders.

[a]Topics include governance, client protection, and MFI performance linkages (Gonzalez, Guarneri); MFI failures and incentives (Marulanda, Rozas, Lieberman); large bank governance failures (Pugliese); and risk management and value creation (Goldberg).

boards, and many investors now seem committed to improved MFI governance. Additional social investors need to communicate clearly to MFI partners the governance improvements they expect, so reforms have broad ownership, with all shareholders agreeing on what needs doing, crafting a workable plan with managers, supporting the process, and taking action when progress is inadequate.

We need a candid conversation about what stronger MFI governance will cost and whose job it is. As an industry, we have probably underestimated the investment and patience required for effective governance while overestimating the sector's growth and resiliency without it. An experienced director estimated that putting even a basic governance structure in place takes two years. This is particularly challenging for MIVs that must balance investor return expectations, relatively thin margins, and a clock ticking relentlessly toward exit. As the DFIs, funders of funds, and indirect investors finance new equity funds, they must put in place subscription agreements and management compensation formulas that create the right incentives and enable MIVs to govern actively. Over time good governance, particularly high-quality board representation, must become a core cost of doing business for most retail providers. One experienced director made the case for DFIs and MIVs to cover these costs in the meantime: "Spending $10,000 a year to strengthen governance can really increase the value of your investment so much over the longer term—it really pays off."

Governance of social performance and risk needs more attention. Outcome-focused social performance metrics are improving, including in the important area of service quality. Many MFIs could benefit from adopting these metrics and translating them into more rigorous targets, analysis, controls, and decisions about how people and money are to be allocated. Ultimately, the board and the broader governance process must hold management accountable for client outcomes and core business standards. In parallel, more comprehensive risk concepts are emerging that redefine the central role of governance in protecting an MFI's assets and ensuring its long-term survival. Weak governance is cited as a factor in recent crises and MFI failures. Investors can help boards mainstream emerging good risk management practices, drawing upon the new tools and improved ratings methodologies.

The question is not "whether" the sector needs commercial capital to meet unmet demand for quality financial services but what type. While acknowledging that profit-maximizing investors with relatively short time horizons could contribute to responsible market development, many of those interviewed suggested that in light of the sector's business models and clientele, when there is a choice MFI boards should instead try to crowd in more patient investors that see the long-run potential in financial inclusion and seek stable earnings rather than large, fast cash-outs. This can include local individuals and institutional investors; indeed some international social investors prioritize the objective of supporting a more locally-owned ownership base over time. Improved MFI governance can help create a virtuous circle—making the sector more attractive for these investors while creating a stronger framework for mediating diverse (but hopefully not incompatible) shareholder interests within MFIs.

Our research suggests three factors that will shape investors' inclination to govern actively and effectively. First, investors' own incentives need to be well-aligned. Since most investors are fairly liquid now, disbursement and earnings pressures could weaken their incentives to screen potential partners carefully and insist on MFI governance reforms once invested. One MIV manager said, "It is hard to ask the tough questions and push on governance when our competitors are less demanding in requiring difficult structural changes." Governance work by DFI and MIV staff might also need more recognition and support. Second, better social metrics and industry good-practice benchmarks will help investors to better match up money with mission. This in turn should make effective governance easier to achieve. Collective action among investors at the MFI and industry levels is a final success factor. Collaborations around social performance management, joint due diligence processes, standardization of covenants, and over-indebtedness prevention are beginning to yield results.

Value-based investing requires active governance. For those public and private investors with the inclination and resources, this is an area ripe for focused capacity-building, stronger tools and practices, and evidence-based analysis of which improvements result in better financial services for the poor.

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Annex A: List of Interviewees

Interviewees included current and former staff and Directors of the following:

- DFIs
  - European Bank for Reconstruction and Development (EBRD)
  - European Investment Bank (EIB)
  - Inter-American Development Bank/Multilateral Investment Fund (AIDB/MIF)
  - International Finance Corporation (IFC)
  - KfW
  - Netherlands Development Finance Company (FMO)
  - Overseas Private Investment Corporation (OPIC)
  - PROPARCO
- MIVs, including networks and holding companies
  - ABN-AMRO
  - Accion Frontier Fund
  - Advans
  - AfriCap Microfinance Investment Company
  - Agora Microfinance
  - Aavishkar Goodwell
  - BBVA Microfinance Foundation
  - Blue Orchard Finance and Investments/Bamboo Finance
  - CHF International
  - Concern Worldwide
  - Deutsche Bank
  - Developing World Markets
  - European Fund for Southeast Europe (EFSE) and Finance in Motion (FiM)
  - Equator Capital
  - Ethos
  - Grassroots Microfinance Equity Fund
  - IFMR Rural Finance
  - Incofin IM
  - MicroCred
  - MicroVest
  - Oikocredit
  - Omidyar Network
  - Omidyar-Tufts Microfinance Fund
  - Omtrix/ProFund
  - One Planet Investments
  - Opportunity International
  - Participatory Microfinance Group for Africa (PAMIGA)
  - ProCredit Holdings
  - responsAbility/PlaNis
  - International Solidarity for Development and Investment (SIDI)
  - Swiss Microfinance Holding,
  - Triodos Investment Management
- Microfinance Service Providers
  - AMK-Cambodia
  - Arohan Financial Services (India)
  - Banco Solidario (Ecuador)
  - Cashpor (India)
  - Centenary Rural Development Bank (Uganda)
  - Compartamos (Mexico)
  - Equitas (India)
  - MiBanco (Peru)
  - MiBospo (Bosnia-Herzegovina)
  - NRSP Microfinance Bank (Pakistan)
  - Opportunity International Banks of Malawi and of Serbia
  - Pride Tanzania
  - Pudhuaaru KGFS (India)
  - SEWA Bank (India)
  - SogeSol (Haiti)
  - Tameer Microfinance Bank (Pakistan)
  - Uganda Finance Trust
  - Ujjivan (India)
- Other experts including representatives of investor and microfinance associations, development agencies, researchers, and consultants
  - AccessIndia
  - Center for Financial Inclusion
  - Cérise
  - CGAP
  - Council of Microfinance Equity Funds (CMEF)
  - EDA Rural Systems (India)
  - IFMR Trust and IFMR Rural Finance (India)
  - Imp-Act Consortium
  - International Association of Microfinance Investors (IAMFI)
  - Microfinance Institutions Network (MFIN, India)
  - Michael and Susan Dell Foundation
  - MicroRate

- MicroSave
- MIX Marketplace
- SEEP Network
- Symbiotics
- World Bank
- World Microfinance Forum Geneva

• Interviewees (alphabetical listing):
- Matthias Adler
- Motoko Aizawa
- Leticia Alvares Alonso
- Veena Yamini Annadaman
- Rashid Bajwa
- Monika Beck
- Cecelia Beirne
- Alexander Berg
- Els Boerhof
- Pierre-Marie Boisson
- Kea Borann
- Bob Bragar
- Karla Brom
- Edvardas Bumsteinas
- Deborah Burand
- Lauren Burnhill
- Gail Buyske
- Giovanni Calvi
- Fernando Campero
- Anita Campion
- Carlos Danel Cendoya
- V. Chandrachudan
- Renee Chao-Beroff
- Greg Chen
- Anne-Marie Chidzero
- Arjuna Costa
- Lisa Davis
- John Ddumba-Ssentamu
- Jorge De Angulo
- Loic de Canniere
- Dominiek Deconinck
- Jean-Philippe de Schrevel
- David Dewez
- Paul Di Leo
- Pasquale Di Benedetta
- Deborah Drake
- Sebastien Duquet
- Tilman Ehrbeck
- Tryfan Evans
- Claude Falgon
- Todd Farrington
- Mark Flaming
- Aude Flogny-Catrisse
- Stephanie Geake
- Samit Ghosh
- Geeta Dutta Goel
- Emile Groot
- N. Gurunath
- Stefan Harpe
- Darrin Hartzler
- Eric Heinen
- Miguel Herrerra
- Martin Holtmann
- Nadeem Hussain
- Irina Ignatieva
- Kathryn Imboden
- Michael Jainzik
- Tor Jansson
- Davit Karapetyan
- Mathias Katamba
- Frank Kennedy
- Amy Klement
- Jean-Pierre Klumpp
- Cécile Lapenu
- Kate Lauer
- Jean Laville
- Marten Leijon
- Ira Lieberman
- Laura Fernandez Lord
- Tim Lyman
- Asad Mahmood
- Rashid Malima
- Beatriz Marulanda
- Klaus Maurer
- Elissa McCarter
- Rebecca McKenzie
- Ann Miles
- Tomas Miller
- Rochus Mommartz
- Nejira Nalic
- Henk Nijland
- Justin Oliver
- Geert Peetermans
- Pete Powers
- Alok Prasad
- Steve Rasmussen
- Larry Reed
- Xavier Reille
- Elisabeth Rhyne
- Michael Schlein
- Christian Schmitz

- Shubhankar Sengupta
- Moumita Sen Sharma
- Vipin Sharma
- Alex Silva
- Anton Simanowitz
- David Simms
- Frances Sinha
- Pete Sparreboom
- Brad Swanson
- Vidhi Tambiah
- Olga Torres
- Joan Trant
- Bill Tucker
- Marilou van Golstein
- P. N. Vasudevan
- Juan Vega
- Niraj Verma
- Massimo Vita-Damian von Stauffenberg
- Rodger Voorhies
- Jayshree Vyas
- Graham Wright

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